FINANCIAL EXPOSURE OF SECURED CREDITORS AND THE RELEVANCE OF VERTICAL COMPARISON IN RESOLUTION

- ***Richa Saraf***

Editor's Note: *Resolution plans under IBC are designed based on a benchmark value, referred to as 'liquidation value' – this is supposed to be the minimum pay-out below which a resolution plan cannot be said to be feasible. After all, the whole idea of preferring resolution over liquidation is that a stakeholder receives something 'better' in resolution than in liquidation. Here comes in the concept of 'vertical comparison'. The principle has been widely applied by courts in UK to see and identify the irreducible minimum below which the return in a reorganisation plan cannot go.*

This article discusses the concept in the context of resolution plans and exposures of financial creditors (secured and unsecured) under the plans.

Resolution process can be regarded as a mega- restructuring for which an insight into the ranking of claims of various creditors is pertinent. In most of the resolution plans, we can see that the financial creditors are paid a particular value as settlement of claims, and no specific provision exists as to how this amount is to be proportioned amongst various secured and unsecured creditors, or if there will be any priority at all. Most of us are of the understanding that any priority under Section 53 is available only in the case of liquidation, and law does not stipulate for any preferential treatment between the claims of secured and unsecured during resolution process, yet it is a well-established principle that while resolving an entity, the creditors of that entity shall not be put in a situation worse than what would have been in case the entity were to be liquidated (or else, there would be no point in resolving the entity). A comparison between a creditor's entitlement in the resolution plan and in a hypothetical liquidation is referred to as "vertical comparison".

Though there is no explicit provision calling for such vertical comparison, however, inference may be drawn from Section 6 of the UK Insolvency Act, 1986, which provides for challenge of decisions approving a voluntary arrangement on the ground that such voluntary arrangement has the effect of unfairly prejudicing the interests of a creditor, member or contributory of the company under Section 4A. The said rule was emphasised by David Richards J in *Re T & N Ltd. [2004] EWHC 2361 (Ch), [2005] 2 BCLC 488*

> *"While I am wary of laying down in advance of a hearing on the merits of any scheme or CVA any particular rule, there is one element which can be mentioned at this stage. I find it very difficult to envisage a case where the court would sanction a scheme of arrangement, or not interfere with a CVA, which was an alternative to a winding up but which was likely to result in creditors, or some of them, receiving less than they would in a winding up of a the company, assuming that the return in a winding up would in reality be achieved and within an acceptable time-scale: see Re English, Scottish and Australian Chartered Bank [1893] 3 Ch 385."*

In *Prudential Assurance Co Ltd v. PRG Powerhouse Ltd.* *[2007] EWHC 1002 (Ch), [2007] Bus LR 1771*, while deliberating on the fairness of a company voluntary arrangement (CVA), Etherton J. said-

> *"In broad terms, the cases show that unfairness may be assessed by a comparative analysis from a number of different angles. They include what I would describe as vertical and horizontal comparisons. Vertical comparison is with the position on winding up (or, in the case of individuals, bankruptcy). Horizontal comparison is with other creditors or classes of creditors."*

Also, in *Mourant & Co Trustees Ltd v. Sixty UK Ltd* *(In Administration) [2010] EWHC 1890 (Ch)*, while relying upon the views expressed in *Re T & N Ltd (supra) and Powerhouse case (supra)*, the court stated as follows:

> *"(c) In assessing the question of unfairness, a number of techniques may be used, including what may be described as- vertical and horizontal comparisons. A vertical comparison is a comparison between the position that a creditor would occupy and the benefits it would enjoy in a hypothetical liquidation, as compared with its position under the CVA. The importance of this comparison is that it generally identifies the irreducible minimum below which the return in the CVA cannot go."*

Further, in the case of *HMRC v. Portsmouth City Football Club*[37], the court considered the validity of a CVA by examining whether it contravened the general principles of insolvency law by unfairly giving preferential treatment. Several parameters were laid down to regard a CVA as unfairly prejudicial:

1. When considering whether or not any disadvantage resulting from the CVA is unfair, the court will consider both "vertical" and "horizontal" comparisons;

2. When considering the results of a "vertical" comparison, if creditors in general, or a specific class of creditors, stand to receive less in the proposed CVA than they would have in liquidation, the CVA is likely to be regarded as unfair[38];

3. In relation to any "horizontal" comparison, the fact that the creditors were treated differently in something which would call for close scrutiny, but any differential treatment does not automatically make the CVA unfair.[39]

The concepts of unfairness and prejudice are questions of fact. A court is extremely likely to find unfair prejudice and interfere in a CVA if it 'fails' the vertical comparison, i.e. if some creditors are to receive less in a CVA than they would on winding-up. It is, therefore, crucial that the company can demonstrate that the CVA will deliver a better result for creditors than a winding up to ensure the vertical comparison is 'passed'.

[37] [2010] EWHC 2013 (Ch); [2011] BCC 149
[38] Re: T&N Ltd. [2004] EWHC 2361 (Ch)
[39] Practical Company Law and Corporate Transactions by Mark Stamp

Similar provisions also exist in the insolvency laws of US. Section 1129 (a) of Chapter 11 of the US Code lists down the minimum requirements which the reorganisation plan shall meet in order to be confirmed, one such requirement is-

> *"(7)With respect to each impaired class of claims or interests-*
>
> *(A) each holder of a claim or interest of such class-*
>
> *(i) has accepted the plan; or*
>
> *(ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date."*

It is, thus, not possible to use a CVA (or for that matter, Resolution Plan) to modify any rights or to alter the priority of payment of a charge holder, by unilaterally modifying any of the contractual provisions. It is unreasonable and unfair in principle to treat the secured creditors *pari passu* with unsecured creditors. Secured claims rank ahead of unsecured claims and the status should be maintained even in the event of insolvency, as regards the application of the proceeds of realisation of the assets, subject to certain preferred expenses i.e. resolution process costs.

In the matter of ***Binani Industries Limited vs. Bank of Baroda & Anr.,***the Committee of Creditors (CoC) of the Corporate Debtor approved a resolution plan which provided for differential payment to the certain financial creditors to which the corporate debtor had 'indirect exposure' and also, payouts to operational creditors were stipulated in the resolution plan depending on the amount of exposure – higher the claim, lower the payout.. The NCLAT, while laying down the law on this issue, held that the objective of the I&B Code is resolution and its purpose is for the maximisation of thevalue of assets of the corporate debtor and thereby for all the creditors. It is not the maximisation of value for a 'stakeholder' or a 'set of stakeholders' such as creditors and is to promote entrepreneurship. The resolution plan cannot discriminate between creditors who are equally situated.

Therefore, a resolution applicant may propose to resolve the insolvency based on any of the aforesaid actions or measures and this does not necessarily merit equal or similar treatment to the debts of the operational creditor or the financial creditors. In this regard, attention is invited for the long title of the I&B which provides that the insolvency process shall provide for 'balance of interests of all stakeholders'. Therefore, so long as a resolution plan balances the interests of all the stakeholders, which may or may notinclude equal or similar treatment of dues of the financial and operational creditors, the same cannot bad in law.