RELINQUISHMENT OF SECURITY BY SECURED CREDITORS

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Editor's Note: *One of the pillars of'availability of credit' is the rights of secured lenders.The objective of reduction of cost of lending by bringing down the risk premiummay be realised only where the secured creditors may effectively encash their collateral rights. While in resolution, letting secured creditors exercise their rights is not an option; during liquidation, secured creditors do get an option to either enforce their security interests outside liquidatin or relinquish the same and participate in the collective process of liquidation. The law as of this time, however, remains silent on certain aspects, such as, at what point of time should the secured creditor decide to realise/relinquish? Note that a proposed amendment may tackle the issue by amendment of Regulations.*

This note deals with such unanswered issues, in the light to established principles, and judicial precedents.

This Note discusses a significant question in respect of liquidation proceedings under the Code - at what stage does a secured creditor decide whether to relinquish security interest and join the liquidation proceedings, or to enforce security interest outside the liquidation process, and file the claim for the balance amount, if any.

The Note examines the said question, and is, accordingly, structured as follows:

- Background
- Provisions of the IBC
- Provisions of Companies Act, 1956
- Rulings of Courts in India
- Global position

1. Background

Security interest is regarded as "real interest" (right *in rem*) as opposed to "personal interest" (right *in personam*); as such, security interest is the interest in the property itself. Secured lenders may, on default of the personal obligation of the debtor, enforce their rights on the property, and demand the residual debt, if any, from the debtor. This right of the secured debtor is preserved in the situation of winding up/liquidation as well, with the difference there is an appropriation of a *pari-passu* share of workmen's dues.

Thus, IBC, like insolvency laws across jurisdictions, allows the secured creditor the option of either- (a) relinquishing security interest and claiming from the liquidation estate, in which case the ranking of such creditor is the highest among claimants, and *pari passu* with workmen; or (b) enforcing

security interest outside liquidation, in which case, the secured creditor's residual claim, if any, is at 5th level in the waterfall under Section 53, at par with government dues.

The important question is with respect to the stage does a secured creditor is required to exercise the aforesaid options. Below we try to analyse the provisions contained in IBC, with reference to similar provisions in

2 Provisions of IBC

Sub-section (1) of Section 52 provides two alternatives to a secured creditor in liquidation proceedings- (i) relinquish the security interest to the liquidation estate and receive proceeds from the sale of relevant assets by the liquidator in the manner specified in Section 53, or (ii) realise the security interest in the manner specified in Section 52 itself.

The provision, as above, appears to be silent as to the stage one of the two options has to be chosen by the secured creditor. However, if one sees corresponding provisions in the part dealing with individual bankruptcy, the principle becomes clear from Section 172. It states:

"(1) Where a secured creditor realises his security, he may produce *proof of the balance*due to him.

(2) Where a secured creditor surrenders his security to the bankruptcy trustee for the general benefit of the creditors, he may produce *proof of his whole claim*."

The amount of 'proof' submitted to the trustee, as such, becomes a determinant or a reference for the trustee to conclude if the secured creditor has surrendered his security or not.

As might be known, such a provision (Section 172) draws inspiration from age-old insolvency laws – the Presidency Towns Insolvency Act, 1909 (Section 48 read with paras 9 & 10 of the second schedule), and the Provincial Insolvency Act, 1920 (Section 47). Such rules, though particularly applicable to individual bankruptcies, were explicitly applicable in corporate insolvent liquidations (Section 529 of the Companies Act, 1956)-*see* discussion in subsequent paragraphs.

In respect of liquidation of corporate persons, the scheme of the law may be understood from a combined reading of the following:

- The settled scheme of liquidation is that all assets of the Corporate Debtor become part of the liquidation estate, and the claimants make a claim on the liquidation, which, when admitted, will be settled in the priority order mentioned in Section 53.

- In case of assets subject to security interest, only such of the assets become part of the liquidation estate over which the secured creditors have relinquished security interest. This is clear from Section 36(1)(g). That is, if the secured creditor does not relinquish security interest, the asset will not even form part of the liquidation estate.

- Section 52 makes the following clear:
  - Secured creditor(s) have unfettered right to enforce security interest outside liquidation. The liquidation has no role at all in such enforcement, except that he "permits" [Section 52(3)] upon "information" by the secured creditor, and identification of the security interest and evidencing the same [Section 52(2)]. The secured creditor "intimates" liquidation of the

option [Regulation 37] and the liquidator may put up a competing bidder who pays a price than the one obtaining from the private sale by the secured creditor.

- The liquidator has claim on the sale proceeds to the extent of proportionate part of insolvency costs [Section 52(8)]. Vice versa, if there an unrealised amount, the same shall be filed as a claim, and shall rank in terms of Section 53(1)(e).

- It may be argued, based on time-tested principles of Companies Act and reference to provisions of the SARFAESI Act that the *pari passu* share of workmen's dues shall be payable by the secured creditors even when they seek to stay outside liquidation proceedings.

The above discussion makes it clear that the decision by the secured creditors to stay outside liquidation proceedings and enforce security interest by way of a self-help remedy should be exercised early on, and in particular, before filing the claim for which a 30 days' time is given in terms of Section 38. The intuitive basis for this is: the claim of the secured creditor who seeks to enforce security interest is only to the extent of the amount remaining after realisation. Also, since such asset, on which security interest is to be exercised outside liquidation, will not even form part of the liquidation estate, the liquidator must know of such option at sufficiently early stages. Note that during the CIRP stage, enforcement actions are blocked by moratorium. However, once the CIRP proceedings are over, or 180 (or 270) days are over, the secured creditors are free to proceed for enforcement action, should they choose to.

Section 47 of the Provincial Insolvency Act, 1920:

"(1) Where a secured creditor realises his security, he may prove for the balance due to him, after deducting the net amount realised.

(2) Where a secured creditor relinquishes his security for the general benefit of the creditors, he may prove for his whole debt."

Filing (called proving, in insolvency law parlance) of a claim is the process whereby the secured creditor makes a claim to be paid out of the liquidation estate. Section 38 permits the secured creditor to file his claim within 30 days. Regulation 37(1) provides that where the secured creditor prefers to enforce security interest outside liquidation, he would intimate to the liquidator the price at which he intends to sell the asset. It stands to reason to believe that the intimation of the intent to sell, and expected price, should be filed at the very time of filing of claims. It will be counter-intuitive to think of the secured creditor filing claim for the whole of the debt, and still preserving the option to sell outside liquidation, because, in that case, the claim will, in the first place, be only for the residual amount, and also, the secured creditor will have to allow the liquidator to put up a competing buyer.

3. Provisions of Companies Act, 1956

The option to enforce security interest outside winding up is not unique to the Code- the same principle was there under the Companies Act, 1956, and before the Companies Act, 1956, the same principle was extended by way of individual insolvency principles by courts.

Thus, the principle has been recognised in the extant insolvency laws, viz. PTIA, 1909 and PIA, 1920- that a secured creditor has two *alternatives*, viz., to realize the security and to prove for the balance due to him in case on realization of such security he is not able to recover the entire amount due to him. If, however, the secured creditor does not opt to realize his security but relinquishes it for the general benefit of the creditors, then he may prove for his whole debt. The relevant extract of Section 47 of the Provincial Insolvency Act, 1920 is reproduced below:

"(1) Where a secured creditor realises his security, he may prove for the balance due to him, after deducting the net amount realised**.**

(2) Where a secured creditor relinquishes his security for the general benefit of the creditors, he may prove for his whole debt**."**

The principle, as above, prevailed and was observed in winding up of insolvent companies (Section 529 of the Companies Act, 1956). Section 325 of the Companies Act, 2013, which corresponds to Section 529 of the Companies Act, 1956, also contains identical provision as regards applicability of insolvency rules with respect to the estates of persons adjudged insolvent.

4. Rulings of Courts in India

It is relevant to cite the following cases:

a) One of the most commonly cited rulings on the options of the secured creditor, dating prior to the 1956 Act, is the ruling in *M. K. Ranganathan and Another v. Government Of Madras And Others*, 1955 AIR 604, 1955 SCR (2) 374. In this case, the Supreme Court quoted Lord Wrenbury in *Food Controller v. Cork*, 1923 Appeal Cases 647, while describing the position of a secured creditor in winding up –

> "The phrase 'outside the winding up' is an intelligible phrase if used, as it often is, with reference to a secured creditor, say a mortgagee. The mortgagee of a company in liquidation is in a position to say "the mortgaged property is to the extent of the mortgage my property. It is immaterial to me whether my mortgage is in winding up or not. I remain outside the winding up' and shall enforce my rights as mortgagee". *This is to becontrasted with the case in which such a creditor prefers to assert his right, not as amortgagee, but as a creditor. He may say 'I will prove in respect of my debt'. If so, hecomes into the winding up*".

b) In *Allahabad Bank v. Canara Bank & Anr* (2000) 4 SCC 406, the two-Judge Bench of the Supreme Court discussed these rights of the secured creditors in paragraphs 62, 63, 64 and 65 of the judgment as reported in the SCC, which are extracted below:

> "62. Secured creditors fall under two categories. Those who desire to go before the q Company Court and those who like to stand outside the winding- up.
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> 63. The first category of secured creditors mentioned above are those who go before the Company Court for dividend by relinquishing their security in accordance with the insolvency rules mentioned in Section 529. The insolvency rules are those contained in

Sections 45 to 50 of the Provincial Insolvency Act. Section 47(2) of that Act states that a secured creditor who wishes to come before the official liquidator has to prove his debtand he can prove his debt only if he relinquishes his security for the benefit of the generalbody of creditors. In that event, he will rank with the unsecured creditors and has to take his dividend as provided in Section 529(2). Till today, Canara Bank has not made it clear whether it wants to come under this category.

The second class of secured creditors referred to above are those who come under Section 529-A(1)(b) read with proviso (c) to Section 529(1). These are those who opt to stand outside the winding-up to realise their security. Inasmuch as Section 19(19) permits distribution to secured creditors only in accordance with Section 529-A, the said category is the one consisting of creditors who stand outside the winding up. These secured creditors in certain circumstances can come before the Company Court (here, the Tribunal) and claim priority over all other creditors for release of amounts out of the other monies lying in the Company Court (here, the Tribunal). This limited priority is declared in Section 529-A(1) but it is restricted only to the extent specified in clause (b) of Section 529-A(1). The said provision refers to clause (c) of the proviso to Section 529(1) and it is necessary to understand the scope of the said provision."

c) In *Jitendra Nath Singh v. Official Liquidator & Ors*, it was held-

"11. The above provision gives different options that are available and can be exercised by a secured creditor. It, however, has to be kept in mind that in terms of section 529 the rules of insolvency shall prevail and be observed but only with regard to debts provable, the valuation of annuities and future and contingent liabilities and the respective rights of secured and unsecured creditors. Where a secured creditor realizes his security, he mayprove the balance due to him after deducting the net amount realized; or where a securedcreditor relinquishes his security for the general benefit of the creditors, he may prove forwhole of his debt. Still, where a secured creditor does not exercise either of these options, he is entitled to have his debt entered in the schedule and would be entitled to receive the dividend in terms of Section 47(3).

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Lord Wrenbury in Food Controller v. Cork, 1923:

"The phrase 'outside the winding up' is an intelligible phrase if used, as it often is, with reference to a secured creditor, say a mortgagee. The mortgagee of a company in liquidation is in a position to say "the mortgaged property is to the extent of the mortgage my property."

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> *24. The relinquishment of security by a secured creditor certainly requires some conscious act on his part more than the mere filing of a claim in response to a public notice issued by the official liquidator. Once the secured creditor takes such further actions like sale of the secured assets through the liquidator and subject to the control of the Company Court in that event, he would be part of the scheme of payment as rationalized under Section 529 and 529A of the Act.*
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> *****
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> *28. Equally, it can be stated that a secured creditor who, after institution of a claim but without pursuing the remedy outside the provisions of this Act, files claim before the official liquidator, relinquishes his security and agrees to the distribution of the sale proceeds through the official liquidator, subject to jurisdiction of the Company Court,could always be said to be not 'standing outside the winding up' proceedings."*

Very importantly, this ruling is the ruling of a 3 member Bench, where the following observations of the dissenting Judge were not agreeable to the majority:

> "3. Merely submitting of an affidavit or demand by the secured creditor in response to the notice issued by the Official Liquidator inviting claims would not tantamount to effective participation in the winding up proceedings (Ref. ICICI Bank (supra)).
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> 4. Mere institution of a petition by a secured creditor before a court or forum of competent jurisdiction per se will not lead to an inference that the secured creditor has stood outside the winding up proceedings unless it takes some effective steps to pursue those proceedings and realizes its security de hors the specific procedure under the Act.
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> 6. Relinquishment has to be a conscious act on the part of the secured creditor and is incapable of being construed by implication."

d) In the case of *Canfin Homes Ltd. v. Lloyds Steel Industries Ltd.* 2001 (4) BomCR 84, (2001) 106 CompCas 52 Bom**,** the Bombay High Court observed:

> *"15. The secured creditor who seeks to prove the whole of his debt in the course of theproceedings of winding up must before he can prove his debt relinquish his security forthe benefit of the general body of the creditors. If he surrenders his security for the benefitof the general body of creditors, he may prove the whole of his debt. If the secured creditor has realized his security, he may prove for the balance due to him after deducting the net amount that has been realized. The stage for relinquishing security arises when a securedcreditor seeks to prove the whole of his debt in the course of winding up. If, he elects toprove in the course for winding up the whole of the debt due and owing to him, he has tonecessarily surrender his security for the benefit of the general body creditors."*

e) The Gujarat High Court, in *Gujarat Steel Tube Employees v. O.L. Of Gujarat Steel Tubes Ltd.*2006 131 CompCas 410 Guj, (2006) 5 CompLJ 452 Guj, 2006 70 SCL 407 Guj, relied on the decision of the Bombay High Court in the case of *Cafin Homes Ltd. v. Lloyds Steel Industries Ltd.* (supra) and observed as follows:

> *"A secured creditor who seeks to prove the whole of his debt in the course of the winding up proceedings is necessarily required to relinquish the security."*

f) Similar view was taken by the Andhra Pradesh High Court in *Canara Bank v. Mopeds India Ltd.* 2005 124 CompCas 824 AP, 2004 50 SCL 105 AP, wherein it was held-

> *"Insofar as the secured creditors who move the company Court it was held that secured creditor who wishes to come before the OL has to prove his debt and he can prove his debt only if he relinquishes his security for the benefit of the general body of creditors."*

5. UK Insolvency law

Under rule 14.19 of the UK Insolvency Rules, 2016 [corresponding to rule 4.88 of the UK Insolvency Rules, 1986], a secured creditor has the following options:

- Surrender their security and prove for the whole amount of the debt [R. 14.19(2)];
- Place a value on their security and prove for the balance of his/her debt [R. 14.19(1)(b)];
- Rely entirely on their security and not submit a proof of debt;

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- ***Rely entirely on their security and not submit a proof of debt;***

Sir R.M. Goode, in his celebrated work, *Principles of Corporate Insolvency Law*, quoting relevant provisions of the Insolvency Rules, 1986, states as follows:

> "A secured creditor has a number of options. He can surrender his security and prove for the full amount of the debt due to him, a procedure rarely used since it appears to have no possible advantage; he can value his security in his proof and proof for the balance of the debt; he can realise his security and, if the proceeds are insufficient to cover the amount due, can prove for any deficiency; and he can simply rest on his security without lodging a proof at all."

At pg. 168, *ibid*, referring to rule 4.88 of the UK Insolvency Rules, 1986, Goode says, "If he proves for the full debt he is deemed to have surrendered his security".

On perusal of the relevant provisions and the precedents thereto, it is clear that a secured creditor is deemed to have relinquished its security, and participate in winding up proceedings, if the claim is filed for the whole amount before the liquidator.

Lack of clarity in the law and way forward

The Code is new; liquidation proceedings under the Code are even newer. Secured creditors get 30 days' time to file their claim. The filing of the claim by the creditors may be intuitively seen as reconciling their amounts with the books of the company, or otherwise, getting the liquidator's seal

of approval on the total amount claimed. Unfortunately, Section 52 of the Code and Regulation 37(1) do not provide any explicit timelines for the exercise of the option to relinquish. Consequently, several secured creditors may not have been able to connect the filing of the claim with the pre-exercise of the option.

While the need to have clarity in the Regulations is quite obvious, secured creditors need to make their stand on the option under Section 52 clear immediately. Under the scheme of the Code, if the claim for the whole amount would have been admitted, any variation thereof will require the prior approval of the Adjudicating Authority. Therefore, if the claims have been filed and admitted, and the secured creditor still wants to plead lack of clarity of the law and exercise the option to self-enforce the security interest, the secured creditor must obtain approval of the Adjudicating Authority as contemplated in Section 42. Notably, the assets having formed part of the liquidation estate, an option to realise them outside liquidation is not merely an exercise in self-interest of the secured creditor- it impacts all other stakeholder too.
