

# SCALE-BASED LIQUIDATOR'S FEE

## ISSUES AND ANSWERS

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**Editor's Note:** The provisions for determination of fees of the Liquidator have been laid down in the Liquidation Regulations under reg. 4(2) and 4(3). However, there are several points that need deliberation – there can be various factors which can make the computations extremely complicated and the scale difficult to apply. The issue becomes all the more important as the liquidator is paying the fee to itself and thus has to be extremely cautious while determining the same. Several issues have been discussed herein by way of illustrations for better understanding.

Liquidators under the Liquidation Regulations may be paid either based on a fee fixed by the Committee of Creditors [Reg 4 (2)], or where the Committee has not fixed such fees, based on the scale provided in Reg 4 (3) ["scale-based" or "scalar" fees]. There are several points that arise in respect of computation of liquidator's fees under Reg 4 (3). What makes the issue very sensitive is that the liquidator is paying himself out of the liquidation estate, and therefore, he is treading the very delicate issue of conflict where his duties as a fiduciary might be conflicting with his claim to the fees. Like in every case where a person responsible in a fiduciary capacity is paying to himself, the liquidator has to be extremely careful, so as to avoid even the farthest chance of an allegation of self-dealing.

This write-up tries to get into some very tricky questions about computation of liquidator's fees.

### Realisation and distribution – are the two separate?

The foremost question is, are realisation and distribution two separate additives, such that the liquidator is entitled to fees on both realisation and distribution?

*"There may be realisation with no corresponding distribution, and there may be distribution, with no connected realisation."*

It should be easy to get an affirmative answer to this question – looking at the very language of Reg 4(3).

The Regulation reads: *"..the liquidator shall be entitled to a fee as a percentage of the amount realized net of other liquidation costs, **and** of the amount distributed, as under ..(emphasis supplied)."*

The Table thereafter provides separate percentages for fees, based on amounts realised, and amount distributed.

The justification for two separate fee components, one based on realisation and one based on distribution, is understandable: there may be realisation with no corresponding distribution, and

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there may be distribution, with no connected realisation. "Distribution" obviously has to be read in light of section 53, and therefore, it will mean distribution to stakeholders. The possibility of there being a realisation but no equivalent distribution is when there are amounts paid over to third parties not coming under section 53, such as items not forming part of liquidation estate. There may be security deposits or other third party monies which the liquidator may be required to return. There has been a recent view that even shortfall of amounts pending to be contributed to employee benefit funds also does not form part of liquidation estate. There may be tax payments, such as municipal taxes, which take a part of the sale proceeds of property.

On the other hand, there may be distributions, with no corresponding realisation. This may mostly be the case because of cash or cash equivalents available at the start of the liquidation proceedings.

These moneys may be distributed by the liquidator after settling claims; but one cannot claim that there has been a "realisation", as the amounts were already in liquid form.

Hence, there seems little doubt that there are two separate fee components – one based on realisation of assets, and one based on distribution of the proceeds of such realisation.

Realisation is an inflow; distribution is an outflow. The Regulations seem to have considered realisation as involving more time and effort – hence, there is a higher fee attached with realisation, than with distribution.

### **Point of time for accrual of the fee – realisation and distribution**

In fact, the point of time for fee to be accrued comes also clear from Reg 4 (4). If the proceeds of an asset have been realised, but have not been distributed, the liquidator is entitled to only half of the fee related to realisation. However, if the proceeds have also been distributed, the liquidator shall be entitled to the entire fee on realisation, as well as the fee payable on distribution.

Doing a comparison between the realisation stream is not like comparing the like to like – because of costs and third party payments, there may be at least some realisation which has not been distributed at all. However, this is a conclusion one may arrive towards the end of the liquidation process.

In most real life liquidations, realisations and distributions happen in tranches. There is, obviously, no direct nexus between realisations and distributions. Realisations may happen over time; when liquidators have sufficient liquidity, not required for the purpose of liquidation affairs, the liquidator should cause an interim distribution.

In order to know whether what has been realised has been distributed or not, the only possible test to apply will be cumulative realisations and cumulative distributions. A realisation from an asset may be taken as distributed, if the cumulative realisations till the point of time are at least equal to the cumulative distributions till that point. Of course, there is no concept of partial distribution of sale proceeds – hence, if, looking at the cumulative distributions, it is only a part of the realisation that has been distributed, then it should be presumed that the realisation has not been distributed.

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### **“Liquidation costs” and “other liquidation costs”**

In case of the realisation scale, the fee is computed on the amount realised, net of “other liquidation costs”. The expression “other” liquidation cost must be taken to mean liquidation costs, other than the fee payable to the liquidator himself. Note that there is no question of deducting any such costs in case of the distribution scale, which is quite obvious, because distribution happens after all relevant costs and outflows have been accounted for.

The meaning of “liquidation costs” comes from Sec 5 (16) of the Code, read with Reg 2 (1) (ea). Section 5 (16) defines the term to mean “any cost incurred by the liquidator during the period of liquidation subject to such regulations, as may be specified by the Board”. As may be seen, the definition is wide enough to include “any cost”.

However, Reg 2 (1) (ea) seems to be doing some delimitation to such wide meaning. The said Regulation gives a comprehensive definition of the term, however, limiting it to 4 components:

- Liquidator’s own fee
- Remuneration payable to professionals, in terms of Reg 7
- Cost incurred by the liquidator in verification and determination of the claim, in terms of Reg 24
- Interest on interim finance, for a maximum period of 12 months from commencement

The first question that comes is – was Reg 2 (1) (ea) actually meaning to delimit the seemingly unlimited ambit of sec. 5 (16)? Reg 2 (1) (ea) was inserted in the statute to ensure that the priority under section 53 (1) (a) is not applicable to all costs incurred by the liquidator but not paid. Hence, it is notable that the language of Reg 2 (1) (ea) is “payable” or “incurred”, rather than paid. That is to say, if the liquidator has engaged professionals for carrying out liquidation functions, but the said professionals could not be paid, the unpaid fee will have the first claim on the priorities listed in section 53.

But could it the idea of Reg 2 (1) (ea) to say that it is only the 4 items of costs that will be deducted from the sale proceeds of assets?

Depending on the facts of the case, there may be numerous types of costs that may be incurred by the liquidator:

1. Costs and expenses to the extent required to keep the business of the corporate debtor going;
2. Costs and expenses required for beneficial liquidation – for example, if there are half-done jobs, the same may have to be completed to get a right on the
3. Costs of insuring the assets
4. Costs of repairing and maintenance of assets

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5. Security costs
6. Manpower costs – many assets may require regular upkeep; while the employees may have been dismissed on liquidation orders, some staff may have to be retained on retainership contracts.
7. Municipal and other asset-related taxes
8. Professionals fees –including valuations, auditors, auctioneers, consultants or agents to facilitate a sale

Of the 4 elements mentioned in Reg 2 (1) (ea), the liquidator's fee itself is not a deductible in view of the language of Reg 4 (3). The costs incurred for determination of a claim may include those limited cases where a claim was dismissed, and had to be litigated before the claim could be admitted, or costs incurred for verification of the claim from records of information utility, etc. Interim financing may also not be a common occurrence. That leaves only 1 item of deductible in computing the net realisations under Reg 4 (3) – the fees payable to professionals (discussed at length separately).

However, was that the intent of Reg 4 (3) – to confine the deduction from the sale proceeds only to the professionals' fees, and ignore all other costs?

A useful comparison may be Rule 18.22 of the UK Insolvency Rules, 2016. Here, all bankruptcy expenses are to be deducted in applying the realisation scale, excepting the fee of the receiver, and the expenses in carrying on the business of the insolvent, spent out of the money received in carrying on such business. Assuming that the business of the insolvent was not carried on, all the bankruptcy expenses are deducted, except the liquidator's own fees.

Taking any other interpretation will be unrealistic. Following are some examples:

- An asset will sell for Rs 150 if I incur a repairs cost of Rs 20. If I don't incur the expense, it will sell for Rs 100. So, I decide to incur the expense, and sell the asset for Rs 150. Is it justifiable for me to claim a fee on Rs 150, without deducting the cost of Rs 20 which was responsible for the higher realisation.
- The asset in question is a car. The asset will sell for Rs 110 if the asset is insured, with current tax payments. The asset will sell for Rs 100 if the asset does not have an insurance and road tax receipt. So, I spend Rs 10 on the insurance and road tax. Can I claim the realisation scale on Rs 110, without deducting the insurance and road tax?

In essence, if we limit the expenses to be deducted from the sale proceeds, there may be intricacies of having to distinguish between expenses that have contributed to the sale proceeds and those that have not, expenses that have assisted in the sale process and those have not, etc.

Intuitively, if something is a part of bankruptcy expenses, irrespective of whether it is a professionals' fee or not, the same should be deducted from the realisations.

Therefore, the items which are not deductible from the sale proceeds (i.e. realisations) should actually include only such items which are, properly speaking, not costs. These may include:

- Any taxes on sale such as GST (typically, GST should not be treated as a part of realisation as well).
- Any amounts which were not regarded as forming part of liquidation estate, such as moneys held for third parties, or similar

### **Professionals' Fees**

Section 35(1)(i) enables the liquidator to obtain any professional assistance from any person *or* appoint any professional, in discharge of his duties, obligations and responsibilities. Further, Regulation 7 enables the liquidator to appoint “professionals” to “*to assist him in the discharge of his duties, obligations and functions*” for a reasonable remuneration and the remuneration shall form part of liquidation cost.

Notably, reg. 2(1)(ea) refers to reg. 7 and not section 35(1)(i) – therefore, it might be said that “obtaining professional assistance” and “appointing professionals in discharge of duties, obligations and responsibilities” are not one and same. For instance, if the liquidator obtains a legal opinion – the same would qualify as “professional assistance”.

Now, the duties, obligations and functions of a liquidator are multifarious as described in section 35(1) – ranging from verifying claims to distributing the proceeds; taking the assets into custody, preserving those assets and ultimately selling the assets; instituting/defending suits, prosecution or other legal proceedings in the name of on behalf of the company; and even carrying on the business of the corporate debtor for its beneficial liquidation. Besides, the liquidator has been entrusted with various duties/obligations under the Liquidation Regulations – for instance, arranging for valuations, preparation of various reports, receipts and payments account, etc.

Therefore, as it appears, such professionals who “assist” the liquidator in the functions/duties as above are to be included under regulation 7 and consequently the remuneration paid to them shall be a part of “liquidation cost” under reg. 2(1)(ea). Certain instances of such professionals are –

- merchant bankers appointed for facilitating sale of assets;
- valuers appointed for valuation of assets;
- lawyers/counsels, etc. appointed for representing the liquidator/company in legal proceedings

However, there are several such instances where it might not be possible to clearly distinguish whether the professional was appointed “in discharge of duties/obligations” of liquidator – take for example, auditor appointed for receipts and payments, professionals appointed for drafting sale documents, retainers engaged to carry out beneficial liquidation (whether or not they qualify as “professionals”), etc. In view of the above, determination of reg. 7 costs might be an area of conflict and lead to faulty/uneven computation of liquidator’s fee on realisation. Computation of fee on net realisations (that is, excluding all costs, as discussed above) will possibly avoid such conflicting situations.

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### **How to deduct expenses from realisations?**

In case of phased distributions, another issue is – how to deduct expenses from realisations? The expenses are incurred over a period of time. Hence, is it expected that all expenses upto the point of the distribution are deducted from the realisation, or the expenses that pertain to the assets disposed off are to be deducted?

In practice, doing an asset-based allocation of the expenditure will be impractical. Hence, one will to deduct all expenses upto a particular distribution, and then, the expenses from that point onwards may have to be deducted while making the next distribution.

If the view is that expenditure to be deducted from the sale proceeds is all liquidation costs, and that the reference to para 2 (1) (ea) is not relevant to Reg 4 (3), then the easiest way to compute the net realisations will be to start from the distribution, and simply add back the items which are not regarded as “costs” or expenses.

### **Stress on proper format of liquidator's accounts:**

The above discussion also points to the need for standardisation of liquidators' receipts and payments accounts as well. The receipts and payments account not only has to have appropriate groupings of items of inflows and outflows, so as to make intelligible reading, it must also present the sale proceeds, expenses of liquidation, and fees of professionals and the liquidator himself, so as enable the computation of fees.

### **Conclusion**

Seemingly, what is needed is a detailed clarity on regulation 7. Nevertheless, it would be appropriate to consider any cost incurred during liquidation while computing fee on realisation. The same follows a conservative approach, and is recommended because of its reasonability too.

Also, it is suggested that the liquidator's accounts be presented with suitable headings so as to reflect the nature of the expenses paid by the liquidator, alongwith notes, if required.

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