Subordination of Operational Creditors Under IBC: Whether Equitable

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Editor's Notes: *We discussed that IBC has uniquely classified creditors into financial creditors and operational creditors, while maintaining the conventional distinction between secured and unsecured creditors. More often than not, operational creditors would be unsecured – and going by the priorities under section 53 such creditors would fall in the residual entry, thereby lagging behind all and sundry – even unsecured financial creditors. This impacts their returns both in resolution and liquidation.*

Operational creditors are in no manner, a group not necessary for a business to function – in fact, a business would depend on such creditors for its operations and working capital requirements – as also acknowledged by NCLAT in Binani ruling. Priorities under insolvency law are driven by contractual, social, and sovereign considerations – however, subordination of operational debt below unsecured financial debt does not seem to justify any of the above considerations.

This analytical article discusses principles of prioritisation in general and equitability of prioritisation stipulated under section 53 in the light of economic arguments in favour of operational creditors.

1. Why this Article?

Section 53 of the Code puts unsecured financial creditors above the claims of the governments. These unsecured financial creditors may, actually, be even related parties, and therefore, the underlying financial transaction may be in the nature of accommodation provided by promoters or majority shareholders, often at the instance of lending banks. At the same time, there is no specific mention of the priority status of operational creditors, who are, therefore, left in the residual category of "any remaining debts and dues", which is 2 notches below unsecured financial creditors.

Financial creditors in this case are unsecured; so are operational creditors. The law, however, puts one class of unsecured creditors two places ahead of the other, in the priority order of distribution. Is this subordination of unsecured operational creditors justified? Or, is it equitable? Is there an economic argument to contend that the suppliers of goods and services who supplied on credit, and therefore, contributed to working capital, should have lower ranking claim to their money than working capital financiers or other unsecured lenders?

This significant question is discussed in this article in the light of global insolvency laws.

2. The Significance of Insolvency Priorities

Prioritisation of debts in liquidation, technically speaking, is specifying the stacking order in which different creditors of the insolvent debtor would be paid their dues.

Prioritisation of claims, commonly known as liquidation waterfall, is one of the most important aspects of insolvency laws, and has evolved globally over the decades of jurisprudence. Insolvent liquidation is obviously a case of shortfall of assets as against the claims, and therefore, who gets paid first, or does every get to share proportionally, is the key question. If food on the dining table at home is short, we will all share what we have, but we sometimes give priorities to children or the elderly. However, in insolvency waterfall, the concept of prioritisation is that unless the one ahead in the queue has eaten belly-full, the next person in the queue does not get to eat even a morsel. Hence, it is not merely a question of "how much", it is a question of "whether at all". Therefore, priority in distribution in liquidation is not merely a matter of place in the queue – it is whether a stakeholder gets paid at all, or how much it gets paid. Thus, the recovery rate, and therefore, loss given default (LGD –as bankers call it), is directly connected with the prioritisation.

Since the claim that a claimant files in liquidation proceedings is a property right of the claimant, the prioritisation deals with property rights; hence, any casual or unprincipled approach to prioritisation may be fatal to the inherent property rights of the claimants.

3. Principles of Prioritisation

Priorities are specified considering the following fundamental factors –

(i) ***<u>Contractual priorities:</u>*** The priorities specified often recognize and respect different commercial bargains which creditors would have struck with the debtor. As stated in the UNCITRAL Legislative Guide on Law of Insolvency, this is to "*preserve legitimate commercial expectations, foster predictability in commercial relationships and promote equal treatment of similarly situated creditors*". The preservation of contractual priorities in liquidation is based on the principle of certainty, such that creditors are certain of their rights at the time of entering into the contract. For instance, in secured lending, which is in the nature of an inter-creditor and debtor-creditor agreement, the secured lenders are given the first right on the secured assets, and in case the assets are relinquished, then preferential right on the aggregate cashflows of the entity.

(ii) ***<u>Social considerations:</u>*** Prioritisation policies very often reflect legitimate considerations for certain sections of the society or in public interest. For example, the workmen, and the employees. In India, the priority status was given to workmen after elaborate discussion by the Supreme Court in the case of *National Textile Workers v. P.R. Ramkrishnan and Others*, 1983 AIR 75 : 1983 SCR (1) 9, on workmen's rights to be heard in winding up proceedings.

(iii) ***<u>Sovereign considerations:</u>*** Sometimes claims of the State or the Crown are given priority as preferential unsecured claims on the ground of protection of public revenue.

Given the varied nature of claims and obvious conflict arising on the question of their prioritisation, the UNCITRAL Legislative Guide on Law of Insolvency, therefore states –

"While many creditors will be similarly situated with respect to the kinds of claims they hold based on similar legal or contractual rights, others will have superior claims or hold superior rights. For these reasons, insolvency laws generally rank creditors for the purposes of distribution of the proceeds of the estate in liquidation by reference to their claims, *<u>an approach not inconsistent with the objective of equitable treatment.</u>*"

Therefore, equitability is the key underlying principle to fixation of priorities.

4. Prioritisation: Global Perspective

Globally, the principles, as discussed above, are followed in countries like USA, UK, Singapore and even India (under the Companies Act, 2013). For instance, as follows –

– **The Insolvency Act, 1986 of United Kingdom**

Under the Insolvency Act, 1986, read with relevant rules, a secured creditor puts a value on security, and the office-holder can redeem the property at such value. Hence, a secured creditor has a superior right over the secured asset.

Section 175 read with section 386 and schedule VI to the Act and relevant rules, prescribes preferential debts which shall be paid in priority to all other debts. The preferential claims, such as debts due to inland revenue, customs and excise, social security contributions, contribution to occupational pension schemes, etc. rank above the claims of body of unsecured creditors. Such rank equally among themselves after the expenses of the winding up and shall be paid in full, unless the assets are insufficient to meet them, in which case they abate in equal proportions. Also, such preferential debts have priority over the claims of holders of debentures secured by, or holders of, any floating charge created by the company, and shall be paid accordingly out of any property comprised in or subject to that charge.

As is evident, there is no distinction between creditors as financial or operational.

– **Title 11 of the US Code**

Section 706 read with sections 507 and 510 of the dictates the order in which distribution of property of the estate. First, property is distributed among priority claimants, as determined by section 507, and in the order prescribed by section 507. Second, distribution is to general unsecured creditors. Third distribution is to general unsecured creditors who tardily file. Fourth distribution is to holders of fine, penalty, forfeiture, or multiple, punitive, or exemplary damage claims.

Section 507 accords first priority to allowed administrative expenses and to fees and charges assessed against the estate. "Involuntary gap" creditors, are granted second priority, followed by wages, consumer creditors, and taxes (including employment taxes and transfer taxes).

Consumer creditors refer to those who have deposited money in connection with the purchase, lease, or rental of property, or the purchase of services, for their personal, family, or household use, that were not delivered or provided. This can be equated to home-buyers, customers who paid advances for the purchase of goods/services, etc.

Once again, there is no distinction between financial and operational creditors.

– **Singapore Companies Act**

Section 328 of the Singapore Companies Act (as also the Singapore Bankruptcy Act, 1995) gives the order of payment if the winding up order is passed in respect of the company. In all modes of liquidation (voluntary and compulsory), all unsecured creditors share ratably in the assets of the company subject to exceptions for secured and preferential debts. Secured creditors stand outside the liquidation and if the security is inadequate, they may prove as unsecured creditors for the balance. Priority has been given to costs and expenses of winding up, various payments to workers and employees and taxes.

Here too, the law makes no distinction as to financial and operational creditors.

– **The Companies Act, 2013, India**

Section 326 of the Companies Act, 2013 prescribes overriding preferential payments, i.e. workmen's dues and unpaid dues of secured creditor who has realized its security. Subject to the provisions of section 326, section 327 specifies priority for debts like government dues, employee dues, etc. Such debts (as specified in section 327) shall rank equally among themselves and be paid in full, unless the assets are insufficient to meet them, in which case they shall abate in equal proportions, and shall have priority over the claims of holders of debentures under any floating charge created by the company, and be paid accordingly out of any property comprised in or subject to that charge.

5. Creditor classification under the Insolvency and Bankruptcy Code, 2016

IBC makes, for the first time, distinction between financial and operational creditors, while simultaneously retaining the conventional classification of being secured or unsecured. The unique distinction between financial and operational creditors under IBC is based on a recommendation of BLRC which states –

> "The Committee deliberated on who should be on the creditors committee, given the power of the creditors committee to ultimately keep the entity as a going concern or liquidate it. The Committee reasoned that members of the creditors committee have to be creditors both with the *capability to assess viability, as well as to be willing to modify terms of existing liabilities in negotiations*. Typically, operational creditors are *neither able to decide on matters regarding the insolvency of the entity, nor willing to take the risk of postponing payments for better future prospects for the entity.* The Committee concluded that, for the process to be rapid and efficient, the Code will provide that the creditors committee should be restricted to *only* the financial creditors."

The BLRC Committee reasoned that members of the creditors committee have to be creditors both with ***the capability to assess viability, as well as to be willing to modify terms of existing liabilities in negotiations.***

Therefore, it was the "capability to assess viability, and willingness to modify terms of existing liabilities in negotiations", which inspired BLRC to prefer the financial creditors over the operational creditors. The financial creditors were presumed to be *strong creditors* able to decide on matters regarding the insolvency of the debtor and *who are willing to take the risk of postponing payments*. The operational creditors are not expected to bear the burden of postponing payments, let alone foregoing the claims, partly or wholly. This argument may, questionably, be relevant for determining the eligibility to be on the creditors' committee. But should the distinction continue right upto distribution priorities? For example, related parties do not have a place on the committee of creditors, but that does not deny their right in the waterfall, where they are at par with other unrelated parties. This, in turn, paves way for unscrupulous debtors and their related creditors to misuse the machinery for their benefit, at the cost of unsecured operational creditors.

The irony is, the unsecured operational creditors, being placed last, will get a soupçon only after the financial creditors have filled up their bellies, to the extent the plate has to offer. In fact, in many cases, the operational creditors might end up no payment at all, because most insolvencies are deep enough. All because of the prioritisation contemplated under section 53, *as discussed below* – which besides being applicable in liquidation, is also relevant for ascribing liquidation values under resolution plan.

6. Prioritisation of Creditors under Section 53

Section 53 is the relevant section dealing with priorities in liquidation under the Code. The stakeholders have been distinguished and ranked as follows –

1. IRP and liquidation costs;
2. Workmen's dues (for 24 months), *and* secured dues, if the security has been relinquished;
3. Employees' dues (for 12 months);
4. <u>*Unsecured financial creditors;*</u>
5. Government dues, *and* unpaid dues to secured creditor, if the security has been realized;
6. <u>*Remaining debts and dues [which include, unsecured operational debts];*</u>
7. Preference shareholders;
8. Equity shareholders.

Notably, distinction under section 53 is a two-fold distinction – (i) secured/unsecured, and (ii) operational/financial. As regards secured creditors, it does not matter whether the creditor is financial or operational, since section 53(1)(b) uses the expression "secured", and there is no indication as to the nature of debt (financial/operational) owed to such secured creditor. However, when it comes to unsecured creditors, unsecured *financial* creditors appear in the 4th rank; but unsecured operational creditors come in the 6th rank.

7. Equitability of Prioritisation under section 53

As seen above, the unsecured financial creditors have been raised above government dues, while unsecured operational creditors merely become a part of the residual entry. It is important to question as to what could be the basis for this discrimination? Contractually, unsecured financial creditors and unsecured operational creditors stand in the same ranking. Now, if the statute pushes the operational creditors to two notches below the unsecured financial creditors, it is important to question the *vires* of the statute in doing so.

The idea of BLRC to distinguish financial and operational creditors for constitution of committee of creditors is still understandable. The objective might have been based on the consideration that the operational creditors are many, and diversified, and therefore, they may not be in a position to vote on a resolution plan. In any case, many of them may not have the financial acumen required to understand and vote on resolution plans. <u>**But**</u> if the discussion stretches to priority ranking in the waterfall as well, then there are essential questions of principle to be raised.

The BLRC, in its report [page 14], states –

> "The Committee has recommended to keep the right of the Central and State Government in the distribution waterfall in liquidation at a priority below the unsecured financial creditors in addition to all kinds of secured creditors for promoting the availability of credit and developing a market for unsecured financing (including the development of bond markets). In the long run, this would increase the availability of finance, reduce the cost of capital, promote entrepreneurship and lead to faster economic growth."

The BLRC recommendation, as above, justifies the preferential treatment of unsecured financial creditors over government dues but does not provide any reasoning for *not* treating unsecured financial and operational creditors at par.

8. Economic argument of operational creditors

As such, the prioritisation under section 53 fails to consider and appreciate the following –

(i) An economy runs not merely on the financial system, but on the system of supply of goods and services. Goods and services are supplied for credit, which is why operational creditors arise. Supply of goods and services on credit becomes a part of the working capital for the entity, which exactly serves the same purpose as served by financial lenders.

(ii) Supply of goods and services on credit is a crucial part of the economy. The base of the economy of any country is its real sector; financial sector is important, but not at the cost of the real sector. Suppliers of goods and services, including MSMEs, are a part of the real sector.

(iii) How will MSMEs continue to supply goods and services on credit to their customers, if they were to be told that if the customer goes into a default, all the money will go first to bankers, and money will be paid to the suppliers only if there is a surplus left?

9.Concluding Remarks

For the reasons discussed above, the distinction between unsecured creditors, *inter-se*, does not appear to be intelligible; or even if it is intelligible, it lacks economic rationale. The approach for prioritisation under section 53 does not seem to be consistent with the umbrella objective of equitable treatment.

The *vires* of distinction between financial and operational creditors has already been challenged before the courts, with Calcutta High Court upholding such distinction [*refer*, *Akshay Jhunjhunwala & Anr. v. Union of India through the Ministry of Corporate Affairs & Ors.*, W.P. No. 672 of 2017], and the Supreme Court directing the High Courts to refrain from entering the debate [*refer*, *Shivam Water Treaters Private Limited v. Union of India & Ors.*, SLP No.1740/2018]. However, the way the distinction has percolated the priorities under section 53, is yet to be taken up for discussion and debate.

Beyond the Lines . . .

The Hon'ble Supreme Court, in the matter of *Rajputana Properties Pvt. Ltd. v Ultratech Cement Ltd. & Ors*., held that dues of operational creditors must get at least similar treatment as compared to the dues of financial creditors, if not same. *Vide* its order, the Hon'ble Supreme Court, upheld the order of the National Company Law Appellate Tribunal by which the Resolution Plan proposed by Rajputana Properties was identified as discriminatory towards the Operational Creditors and as such was not approved by the Appellate Authority.

The principle that treatment can be differential but not discriminatory was very evidently put forward by the Hon'ble Supreme Court.