TO RELINQUISH OR NOT TO RELINQUISH: A DISCRETION OF SECURED CREDITORS?

- ***Richa Saraf***

Editor's Note: *One of the distinguishing features of lending practices in India is that most loans are secured loans. In global lending practice, granting of security interest on assets in limited to asset-backed lending transactions. Floating charges, a UK practice, has come under several significant judicial pronouncements such as* Brumark, Cosslett*, and* Spectrum

In India, on the other hand, most lending to industrial companies has been secured lending, and more often than not, the security interest is a floating charge. In the past practice of winding up, the practice that gained popularity was thatlenders will not relinquish security interest – they will simply permit the Official Liquidator to sell the asset, thereby converting their charge from charge over the asset to charge over money. There was apparently no strong reason for relinquishment in the past, as the relinquishment of charge will mean the secured creditor will become effectively unsecured.

The Code brings a sea-change in the law: the priority in sec. 53 (1) (b) to be paid from the liquidation estate arises only if the secured creditor has relinquished security interest. This is completely different from how it was under the winding up regime.

Thus, the choices for the secured lender are: sell the asset outside liquidation and claim for the balance money under sec. 53 (1) (e), or relinquish security interest and claim the whole of the money under sec. 53 (1) (b). The secured creditor has to make his choice clearly. He, of course, does not the option of remaining non-committal.

A security interest is a substantive right of a secured creditor, however, once the corporate debtor is in liquidation, a secured creditor has to take the call on whether the secured creditor wants to join the proceedings by relinquishing security interest or wants to enforce its right and file a claim only for the residual amount.

A secured creditor may enforce, realize, settle, compromise, **or** deal with the secured assets in accordance with the applicable provisions of law in relation to enforcement of security and apply the proceeds to recover the debts due to him; however, it is pertinent to note that the option to realize, and option not to realise are *mutually exclusive* options. The secured creditor is under duty to select what option he wants to select, on the creditor's own wisdom, doing such analysis, making such forecasts and doing such assessment, as the secured creditor may want to do.

Provisions of Insolvency and Bankruptcy Code:

Sections 52 and 53(1)(b) of the Code are two alternative routes available to a secured creditor. While Section 52 does not explicitly provide for the stage at which the secured creditors have to exercise one of the two options, the corresponding provisions contained in Section 172 of the Code stipulates:

"(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."

As regards the submission of claim for the full value of the asset, a secured creditor who wishes to come before the liquidator has to prove his debt and he can prove his debt, either for the whole of his claim, or, if he chooses to stay outside liquidation, for the amount of the remainder after realization from the sale of the asset. A secured creditor may file his claim for the full amount only if he relinquishes his security for the benefit of the general body of creditors. The creditor cannot thus, state that while it has filed its claim for the entire amount, the creditor has not relinquished his security and still has the option of realization outside liquidation. Further, on reading of Section 36(1)(g) of the Code, it is amply clear that 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.

If the creditor decides to enforce security interest outside liquidation utilizing the option given in Section 52, it is mandatory under the law for the creditor to notify of such an intent to the liquidator, as required under Regulation 37(1) of the IBBI (Liquidation Process) Regulations, 2016; There is no role that the liquidator has in the secured creditor choosing one of the two rights that the secured creditor has. In fact, the liquidator comes into picture, insofar as the secured asset is concerned, only if and to the extent the security interest has been relinquished, because it is only then that the asset forms part of liquidation estate. However, the creditor cannot wait for months altogether, and contend that it has not relinquished security interest. The creditor does not have any right to stall liquidation proceedings.

Precedents:

The extant Section 52 of the Insolvency and Bankruptcy Code, 2016 and the erstwhile Section 529 of the Companies Act, 1956 has been derived from Section 47 of The Provincial Insolvency Act, 1920, which stipulates-

> *"47. Secured creditors.- (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."*

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On perusal of the aforesaid provision, it is evident that a right was available to the secured creditor, under Section 47 of the Insolvency Act, and has a similar option under the present regime 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. This has been the position in India and elsewhere in the world in case of secured creditors, and remains unchanged under the Code.

The company courts in various rulings have already pointed out the stage at which a secured creditor is required to exercise its options. "*The stage for relinquishing security arises when a*

secured creditor seeks to prove the whole of his debt in the course of winding up. If, he elects to prove in the course for winding up the whole of the debt due and owing to him, he has to necessarily surrender his security for the benefit of the general body creditors." In this regard, it is also 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 Anr. v. Government of Madras and Ors1955 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 be contrasted with the case in which such a creditor prefers to assert his right, not as a mortgagee, but as a creditor. He may say 'I will prove in respect of my debt'. If so, he comes 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 herein below:

> *"62. Secured creditors fall under two categories. Those who desire to go before the Company Court and those who like to stand outside the winding- up.*
>
> *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 debt and he can prove his debt only if he relinquishes his security for the benefit of the general body of creditors. In that event, he will rank with the unsecured creditors and has to take his dividend as provided in Section 529(2)."*

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 may prove the balance due to him after deducting the net amount realized; or where a secured creditor relinquishes his security for the general benefit of the creditors, he may prove for whole 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).****

Cafin Homes Ltd. v. Lloyds Steel Industries Ltd

"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."

Canara Bank v. Mopeds India Ltd:

"Insofar as the secured creditors who move the company Court it was held that secured creditor who

****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. ****

****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."*

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 the proceedings of winding up must before he can prove his debt relinquish his security for the benefit of the general body of the creditors. If he surrenders his security for the benefit of 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 secured creditor seeks to prove the whole of his debt in the course of winding up. If, he elects to prove in the course for winding up the whole of the debt due and owing to him, he has to necessarily 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. 106 Company Cases 52, 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."*

Global position:

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;

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*".

It is a time tested principle of insolvency laws that the secured creditor has the option to either realise his security or relinquish his security. Also, on perusal of the relevant provisions and the precedents thereto, if the secured creditor relinquishes his security, like any other unsecured creditor, he is entitled to prove the debt due to him and receive dividends out of the assets of the company in the winding up proceedings; and if the secured creditor opts to realize his security, he is entitled to realize his security in a proceeding other than the winding up proceeding. Furthermore, 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.

Update

In light of the dilemma w.r.t. such relinquishment, the Draft IBBI (Liquidation Process) (Amendment) Regulations, 2019, provide that if the secured creditor does not provide an explicit relinquishment within 60 days of Liquidation Commencement Date, it shall be a deemed relinquishment.

The Draft Regulation, however, does not provide as to what shall constutite as "proper relinquishment" and has left the same to be decided upon by an Advisory Committee