Secured Creditors under the Insolvency Code
-Vinod Kothari & Sikha Bansal

Vinod Kothari & Company | Resolution Division

Kolkata
1006-1009 Krishna Building
224 AJC Bose Road
Kolkata - 700017
Phone: 033- 2281 7715/ 1276/ 3742
E: resolution@vinodkothari.com

Delhi
A-467, First Floor, Defence Colony,
New Delhi-110024
Phone: 011 6551 5340
E: delhi@vinodkothari.com

Mumbai
403-406, 175, Shreyas Chambers,
D.N. Road, Fort,
Mumbai - 400001
Phone: 022 - 22614021 / 30447498
E: bombay@vinodkothari.com

Secured lending is the very basis of business finance today and is unarguably seen as the device to bring down the cost of credit[1]. A secured transaction is essentially a debtor-creditor contract and becomes an inter-creditor contract when the security interest is perfected by public registration. The essence of insolvency laws is to preserve contractual freedom[2]. However, since insolvency proceedings are collective in nature, the realisation of secured creditors' interest is subject to protection of collective interests. For instance, during reorganisation or resolution process, the law generally imposes a prohibition on creditors' enforcement actions. However, in terminal processes such as liquidation or bankruptcy, a secured creditor is given the liberty to either enforce security interest outside the process, using such law as may be available[3], or relinquish security interest and join the queue in process with other creditors.

This article focuses on the provisions of the Insolvency and Bankruptcy Code, 2016 (Code), which, almost silently ushered in a paradigm shift insofar as the priorities of secured creditors are concerned. It is important to note that the escalation of relinquishing secured creditors'

rights from the equivalent of an unsecured creditor to the senior most position, did not seem to have been discussed at length in either of the two reports of the Bankruptcy Law Review Committee (BLRC)[4]. The objective of the BLRC, *viz*, to encourage secured creditors to relinquish and be a part of the collective process rather than to stay alone[5], may be appreciable, but this is a major shift, both from erstwhile Indian law as also the position in lot of other jurisdictions.

However, realisation *vs.* relinquishment are two alternative modes of realisation of security; the two cannot be so drastically different as to lose their alternative mutuality. The self-help realisation of a secured asset by a secured creditor may be a good guide to understanding the sweep and extent of a relinquishing secured creditors' priority in the common hotchpot, viz., the liquidation estate.

Additionally, the carve-out of the *pari-passu* share of the workmen, and its computation, has intrigued liquidators and winding-up courts over the years. Will this computation be the same under the changed scenario of the law?

There is yet another enigma in the world of secured credit – the floating charge. This interesting device that emanated around 1730s in England has over the years been used by practitioners blurring the distinction from fixed charges. The Code does not have any explicit provision about floating charges, but the moot question remains – whether the mutual subordination of floating charges to fixed charges remains under the Code?

Thus, the article discusses three significant questions– relinquishment *vs.* realisation, workmen's *pari passu* share, and the ranking between fixed and floating charges.

REALISATION VS. RELINQUISHMENT

Conventionally, in terminal processes, the secured creditors have been given the *right to choose* any of the following[6] –

a) ***Realisation***, that is, enforce the security outside winding up. The secured creditor takes away the secured asset from the liquidator and realises the asset independently (though a part of it may be subject to *pari passu* charge in favour of workmen)[7]. In case, there is a surplus, the same is tendered to the liquidator; and in case there is a deficit, the creditor stands in queue with unsecured creditors with respect to the unfulfilled claim.
b) ***Relinquishment***, that is, surrender the security. The secured creditors put the secured asset into the common pool of assets for the general benefit of the creditors and becomes an unsecured creditor for the whole of the debt.
c) ***Substitution,*** that is, converting the right from the secured asset to the value thereof. *In this case*, the secured creditor would consent to the sale of assets in liquidation and transition his security interest on the value of the secured asset, instead of the secured asset itself. This was often a preferred alternative, as it would save the secured asset from being severed from the rest of the asset block, bringing better value realisation, while at the same time protecting the interest of the secured creditor. This option is contained in section 47(3) of the Provincial Insolvency Act, 1920 (PIA) and corresponding provisions of the Presidency Towns Insolvency Act, 1909 (PTIA). The

practice has not been uncommon, as evident from the rulings in State Bank of Mysore v. Official Liquidator & Ors.[8], Gujarat Steel Tube Employees Union & Anr. v. O.L. of Gujarat Steel Tubes Ltd. & Ors.[9], quoted with approval by the Supreme Court in ICICI Bank Limited v. SIDCO Leathers Ltd. & Ors.[10]

Relinquishment of security interest, would therefore, be a disadvantageous proposition as compared to other options, as it would push the secured creditor to the end of the priority ladder. Sir R. M. Goode, in his celebrated work, Principles of Corporate Insolvency Law[11], also observes that surrender of security and proving for the debt is a procedure rarely used since it appears to have no possible advantage.

Under pre-Code insolvency regime, as also under insolvency laws of many jurisdictions, relinquishing secured creditors are treated as unsecured creditors, thereby eliminating any distinction between secured and unsecured creditors. However, the Code shifts from the convention, and accords priority right to relinquishing creditors. On the face of it, it seems self-contradicting, because someone who has relinquished security interest has actually given up the same, and therefore, cannot claim to be a secured creditor even after relinquishment. However, it seems that the BLRC, as it made departure from earlier law and gave a superiority to relinquishing secured creditors was possibly inspired by practice of 'substitution' referred to above, such that even if the secured creditor relinquishes its asset, the creditor will not be treated at par with other unsecured creditors of the debtor, but will be paid in priority to unsecured creditors under section 53(1)(b) of the Code.

On the other hand, the position of secured creditors who choose to realise has not changed much. Such a secured creditor can realise the security interest out of the liquidation proceedings, though, subject to certain conditions as stated under regulation 21A of the Insolvency and Bankruptcy Board of India (Liquidation Process) Regulations, 2016 (Liquidation Regulations), *inter-alia*, tendering proportionate payment towards workmen dues as in case of relinquishment under section 53(1)(b) within 90 days of the liquidation commencement. The secured creditor's decision to stay out of liquidation proceedings is a time-bound option, and if he fails to do so within 30 days, the secured asset is presumed to be a part of the liquidation estate.

Besides, regulation 37 of the Liquidation Regulations, in a way, imitates the provisions of section 47(3) of PIA. The regulation, though, applies only to such a secured creditor who realises security, other than under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act) or the Recovery of Debts and Bankruptcy Act, 1993 (RDBA). In any case, regulation 37 cannot be read *sans* regulation 21A. Irrespective of the law under which the asset is realised, the statutory *pari passu* charge in favour of workmen will subsist.

Now, except in case of peripheral or stand-alone assets which have identifiable value, it is difficult to see much reason for a secured creditor to opt for realisation – thus, the Indian practice may be complete opposite that of UK or other jurisdictions, where relinquishment has been said to be rarity. But then, relinquishment cannot allow the secured creditor to go beyond the value of his own secured asset and give him a disproportionate right in the common hotchpot – the liquidation estate. In essence, we get a strong view that priority under section 53(1)(b) in case of relinquishment is not substantially different from a 'substitution' option – that is, making the asset a part of the common pool and claiming priority over the

value of the asset. But then, the key element in case of relinquishment also is the value of the asset. In essence, the option of realisation under section 52 or relinquishment under section 53(1)(b) will both have to be delimited by the value of the secured asset.

The issue may not be felt if all secured creditors share a *pari passu* charge over the assets of the corporate debtor. But in the complex world of secured credit, there are specific charges on specific assets. There may be multiple silos and verticals where different secured creditors have different security interests – which may be in terms of contractual priority (first vs. second charges) and/or nature of the security interest (fixed vs. floating charges). In such cases, once the assets become part of a common pool, it is not that the underlying collateral values of the secured assets become meaningless. We feel that this issue has not been discussed in its elaborate dimensions[12]. To examine the issue at length, let us first state the problem statement.

PROBLEM STATEMENT

The numbers in the example below are illustrative but will represent most bankrupt liquidations (though, the value of unsecured assets may be way lesser, the same has been included to elaborate the point of view):

Notations and respective (hypothetical) values can be taken as follows –

Particulars	**Notation**	**Amount**
Amount of loan given and outstanding: (for the sake of simplicity, we are assuming the loan originally given and outstanding on the liquidation commencement date (LCD) is the same; we also assume the interest has regularly been serviced. This would represent the secured creditor's **C**laim.	C	100
Value of the collateral at the time of giving the loan: (every lender will expect a certain asset cover ratio – hence, the value of the asset is admittedly higher than the loan amount)	V	125
Value of the collateral on as on commencement of **L**iquidation (on LCD) (based on valuation)	L	80
Actual value **R**ealised on disposal of the collateral (we assume that the realisation on account of the collateral can be segregated and ascertained; in many cases sales happen as a part of a larger block of assets)	R	70
Realisations from **U**nencumbered/**U**nsecured assets	U	100
Total claim of **W**orkmen's dues for past 24 months	W	40
Amount to be ceded by secured creditors from the realisation of the security interest in favour of workmen,	**P**	**?**

and also in relinquishment[13], that is, workmen's **P**ortion		
Amount actually distributable to the **S**ecured creditor in **p**riority u/s 53(1)(b)(ii)	**S_P**	**?**
Distribution to **W**orkmen in **p**riority u/s 53(1)(b)(i)	**W_P**	**?**

As is visible, and may also be experienced in most cases, at the time of lending credit, the loan would be adequately secured with a 'margin'; however, in due course of time, as the liquidation commences and as the asset is eventually realised, the value of security stands depleted. Therefore, commonly,

$$V > C > L > R$$

Now, as L is lower than C as on the liquidation commencement date, our first issue is, when the secured creditor files the claim on the LCD, will he be submitting two parts of his claim? Form D of the Liquidation Process Regulations, though necessitates putting details of 'value of security', however, there is no explicit requirement of segregating the entire claim (that is 'C') into secured and unsecured parts. The question of splitting the debt into two parts arose, because the value of security has fallen short of the claim of the secured creditor, and as we discuss below, the priority entitlement of a secured creditor [u/s 53(1)(b)] is limited to the extent of 'value of security' only.

Next question is, for the purpose of determination of the workmen's share, which is *pari passu* with the secured creditors, is the proportion based on C, or L, or R?

Clearly, the realisation from the asset is R. There might, of course, be several other assets forming part of liquidation estate from which realisation may be done. Hence, we are not saying the total distributable amount in the liquidation estate is R. There can be certain unencumbered assets as well, the realisations from which can form a part of the liquidation estate. Can such realisation be distributed between secured creditors and workmen?

This leads us to the following sequential questions:

(a) First, what is the part of secured creditors' claim, subject to workmen's share that takes priority of section 53(1)(b)? Is it C, or L or R?

(b) Secondly, based on the answer to the above question, what will be the amount to be ceded in favour of workmen (that is, workmen portion) --

- $P = R * W/(C+W)$, or
- $P = R * W /(L + W)$, or
- $P = R* W/ (R+W)$?

(c) Thirdly, based on the answer, the next question is, if the workmen realise P from the collateral. what happens to the rest of their claim, that is, W – P?

(d) Fourthly, the secured creditors realise R - P from the collateral. Now, the total deficit which a secured creditor suffers is a sum of two components, viz., (i) C – R (that is,

deficit in the value of security), and (ii) P (workmen portion). The same can be established with the help of an equation:

$$C = (C - R) + (R - P) + P$$

How are these two parts of the deficit dealt with? Whether (C – R) should go as a part of the unsecured financial debt under section 53(1)(d)? Whether P should be treated as a secured claim, claiming priority under section 53(1)(b) from the total liquidation waterfall?

These intriguing questions arise in every liquidation, and their answers are not straight. The following discussion tries to search for the answers.

VALUE OF SECURITY AND ITS IMPACT ON DISTRIBUTION WATERFALL

To what extent is the secured creditor entitled to priority u/s 53(1)(b)?

The first question relates to that part of the secured creditor's claim which would get priority under section 53(1)(b), *pari passu* with workmen dues. Can a secured creditor claim priority under section 53(1)(b) irrespective of the value of the collateral that he puts into liquidation estate? This would need a little deliberation, though the issue, to some extent, stands clarified in the ILC Report, 2020. The report adequately observes that the priority for recovery to secured creditors under section 53(1)(b)(ii) should be applicable only to the extent of the value of the security interest that is relinquished by the secured creditor.

The observation is in sync with well-established principles of setting boundaries of 'security' of a secured creditor. Years ago, the Supreme Court in Jitendra Nath Singh v. Official Liquidator & Ors.[14], appropriately held that a secured creditor has only a right over the particular property offered to him as security and all the creditors have equal rights over the other properties comprising the estate of the person adjudged insolvent. In this regard, one may also note section 110 and section 123 of the Code, both of which call for segregation of secured and unsecured parts of the debt of a creditor as separate debts. The creditor has to estimate the unsecured part of the part and he can exercise voting rights (in insolvency resolution process) and can file application (for bankruptcy of the debtor) only in respect of such unsecured part of the debt. Such is the case of a so-called, 'undersecured creditor'. The concept has been explicitly dealt with under the US insolvency law[15] - section 506 separates an undersecured creditor's claim into two parts: the creditor has a secured claim to the extent of the value of his collateral; and he has an unsecured claim for the balance of his claim. While the Code envisages an explicit segregation of the secured creditor's claim into a secured part and an unsecured part, it does not contain such explicit provisions for corporate insolvency/liquidation. However, this principle must hold good as a matter of equity, since a secured creditor relinquishing security interest over a specific collateral cannot be demanding more on account of the collateral than the value of the collateral itself.

Therefore, if a secured creditor, or even all secured creditors, relinquish security interest, their collective claim for pay-off under section 53(1)(b) would be limited to the value of the secured asset or secured assets. Any payment to a secured creditor beyond such *'value'* would tantamount to respecting a right which never existed. The principle will apply in both

the cases – the 'priority' entitlement of the secured creditor would be limited to the 'value' of secured asset, and would be subject to ceding a proportion in favour of the workmen. As such, section 53(1)(b) cannot be used so as to have full cake while paying for only a part of it.

So, does that mean, secured creditors have priority under section 53(1)(b) only upto the actual realisation from the secured assets? The answer is yes, but please do connect it with the proportionate share ceded in favour of workmen, as discussed subsequently.

What shall be the relevant time at which 'value' of security is to be fixed?

Once we understand that the priority right of a secured creditor is tied to the value of the asset, it is important to determine such value and the point of time at which such value shall freeze. The value was 'V' at the time of lending credit, became 'L' at LCD, and ultimately became 'R', when the asset is realised.

Therefore, though the claim of a secured creditor is frozen on LCD, the value becomes frozen only when the asset is actually realised[16]. Ultimately, the secured creditor can only have 'R' (that is, the value which is actually realised) as its 'priority' entitlement. Depending upon the realisation from the asset, the claim may be repaid in full or remain insatiate. The insatiate part of the claim becomes an unsecured debt. Therefore, using the notations above, while the total claim is 'C', the priority entitlement of the secured creditor (subject to the ceding a part of it in favour of workmen), would be 'R'. As a result, (C – R) becomes the unsecured part of the claim, for which the secured creditor cannot claim priority under section 53(1)(b). The value of security as on liquidation commencement date, that is 'L', becomes irrelevant for the purpose.

How shall one determine distribution between secured creditors and workmen?

Section 53(1)(b) accords *pari-passu* status to relinquishing secured creditors and workmen (past 24 months' dues). Therefore, after paying off costs under section 53(1)(a), the proceeds of secured assets are to be distributed between relinquishing secured creditors and workmen proportionate to their respective claims. The question can be – how does one determine the proportion? As in, if 'R' is to be distributed between secured creditors and workmen, the ratio would be 'C : W' or 'R : W'?

Since the *pari passu* share for workmen is inherited from the Companies Amendment Act, 1985, one may be guided by the statutory illustration used in section 529 of the Companies Act, 1956 (1956 Act) for computing 'workmen's portion of the security' as follows:

> 'The value of the security of a secured creditor of a company is Rs. 1,00,000. The total amount of the workmen's dues is Rs. 1,00,000. The amount of the debts due from the company to its secured creditors is Rs. 3,00,000. The aggregate of the amount of workmen's dues and of the amounts of debts due to secured creditors is Rs. 4,00,000. The workmen's portion of the security is, therefore, one-fourth of the value of the security, that is, Rs. 25,000.'

In the context of the provisions of section 529 of the 1956 Act, the Bombay High Court, in Maharashtra State Financial Corporation v. Ballarpur Industries Limited[17], , explained the position of workmen *vis-à-vis* secured creditors as co-chargees. The High Court applied the ratio of Privy Council in Sunitibala Devi v. Dhara Sundari Debi[18], , and held that the same would

substantially apply to two charge-holders who have a *pari passu* charge for the recovery of their dues, and that –

> 'The sale proceeds are required to be divided proportionately between them **in the same proportion as their dues**. Hence, when a sale takes place, **it is for the simultaneous recovery of all claims of all pari passu charge-holders**'. [emphasis supplied]

The Supreme Court in International Coach Builders Limited v. Karnataka State Financial Corporation[19], , discussed the observations of the Bombay High Court in Maharashtra State Financial Corporation v. Ballarpur Industries Limited as well as the meaning of the term *pari-passu* and held as follows, besides taking note of section 100 of the Transfer of Property Act, 1882 –

> ''Pari Passu' means "with equal steps, equally, without preference" (Jowitt's Dictionary, Vol. II, 1959 Edition 1294). Black's Law Dictionary, 6th Edition, 115 defines it as 'By an equal progress... used especially of creditors who, in marshalling assets, are entitled to receive out of the same fund without any precedence over each other." It is also defined as "With equal steps, that is to say, proceeding side by side at the same place" (Prem's Judicial Dictionary, Volume III, 1964 Edition, page 1217) **The rights of the pari passu charge holders would run equally, temporally and potently, with the rights of the secured creditors**.' [emphasis supplied]

See also, Bank of Maharashtra v. Pandurang Keshav Gorwardkar & Ors[20]., , wherein the Supreme Court also held,

> 'The relevant date for arriving at the ratio at which the sale proceeds are to be distributed amongst workmen and secured creditors of the debtor company is the date of the winding up order and not the date of sale.'

As such, the ratio in which the proceeds are to be distributed is the ratio of respective claims of the secured creditors and the workmen as on the LCD.

Further, in Allahabad Bank v. Canara Bank & Anr.[1], , the Supreme Court elaborately discussed the illustration under the 1956 Act.

The rulings above make it clear that, once the law creates a charge in favour of workmen on the assets which are already encumbered to secured creditors, the workmen dues would stand at par with the secured creditors' dues. Any realisation from the secured asset, would therefore, be divisible between secured creditor and workmen in the ratio of their actual claims. The illustration under the 1956 Act, adequately captures the principle. Though, in the context of the Code, the formula shall apply in both cases – realisation as well as relinquishment.

Thus, in our case, 'R' will have to be divided in the ratio C : W, and not R : W. Therefore, workmen portion will be calculated as:

$$P = R * W/(C+W)$$

Here, an alternative interpretation is also possible – one may say that the realisation should be distributed in between secured creditors and workmen, not using total claim of the secured creditor in the denominator, but only the *secured part* of the claim of the secured creditor. In

[1] [2004] 4 SCC 406

the author's view, the same would not entail a justifiable treatment towards the secured creditors. The law has chosen to treat secured creditors and workmen as *pari passu* charge-holders (as the rulings also indicate, and the position, effectually, remains the same under the Code). For determination of proportion of share between the *pari passu* charge-holders, if the depletion in the value of security affects one charge-holder (here, secured creditor), but not the other one (here, workmen), then the same would be injustice towards the former. Therefore, both the *pari passu* charge-holder should, in equal proportions, bear the burden of depletion of security – which is only possible if the realisation is apportioned in the ratio of their respective claims.

What happens to the part of claim remaining unpaid to a secured creditor u/s 53(1)(b) or to a secured creditor who opts for realisation?

The amount remaining unpaid to a secured creditor can fall in two categories –

(i) *First,* deficit in the value of security ("*security deficit*"). In our case, it is (C – R).

(ii) *Secondly,* deficit arising because of the value ceded in favour of workmen ("*statutory compromise*") which is the statutory portion ceded in favour of workmen. In our case, P is the workmen portion (as determined above). This P is the amount which the secured creditor has *compromised* on account of *statutory compulsion*.

So, the question is – what happens to these two types of deficit?

As regards 'security deficit', note that if the secured creditor opted to sell the asset outside liquidation, he will still, presumably, realise R. Therefore, the security deficit would still be the same, and the claim for this amount will be filed in terms of s. 53(1)(e) of the Code, as explicitly stated under section 52(9). Note that section 53(1)(e)(ii) refers to 'debts owed to a secured creditor for any amount unpaid following the enforcement of security interest'. However, what happens to the security deficit of a secured creditor who relinquishes security interest? There are two possible answers: first, as financial debts owed to unsecured creditors under section 53(1)(d), and secondly, as any remaining debts and dues under section 53(1)(f). It will be logical to contend that the security deficit portion may be claimed as unsecured financial creditor, assuming that the creditor in question is a financial creditor. In case it was secured operational creditor, the security deficit will come under section 53 (1) (f).

Therefore, if security interest is realised, (C – R) has to be positioned at section 53(1)(e). On the other hand, if security interest is relinquished, (C – R) has to be positioned at section 53(1)(d), or (f), as the case may be.

As regards the 'statutory compromise', that is, deficit arising because of proportionate payment to workmen, note that the same cannot be said to be 'unsecured part', because the deficit is not related to value of the secured asset. Instead, it is actually the statutory apportionment of proceeds of secured asset, which otherwise belonged to secured creditors. Section 529A of the 1956 Act recognised priority rights of secured creditors to the extent of value of security and accorded overriding preferential status to such part of the security which was compromised in favour of the workmen, though the same was applicable to secured creditors realising security interest. This is clear from an array of past rulings.

However, the Code lacks clarity in this regard. But a harmonised and justifiable interpretation is possible if one invokes the principle imbibed in section 529A of the 1956 Act, read in sync with section 53(1)(b). If the liquidation estate has unencumbered assets available for the general pool of creditors, then both the priority claimants under section 53(1)(b), viz., workmen and secured creditors, will have to be paid proportionately from such realisations until their dues are paid in full – (a) secured creditors to the extent of value of security, and (b) workmen dues for 24 months.

Therefore, if P is the statutory compromise made from R in favour of W, then the balance due to secured creditors on this account is P, and that to workmen is (W – P). In case there is any realisation from unsecured asset, the same, to the extent of W, will be distributed to secured creditors and workmen in the ratio P : (W – P). That is, 'U' will first be divided between secured creditors and workmen in that ratio, however, not in excess of W. If anything remains (that is, U-W), the same will be distributed to stakeholders stationed in section 53(1)(c) onwards[21].

Note that the interpretation above is applicable in case of relinquishment. In case of realisation, there seems to be a gap in the law. No category under s. 53, except the residuary clause (f), can seemingly be extended to cover the statutory compromise made by the secured creditor who realises security interest. Section. 53(1)(e) deals only with that part of the debt which could not be realised by enforcement, and not that part of the realisation which has been statutorily compromised.

The propositions above blend into a pictorial representation [Figure 1].

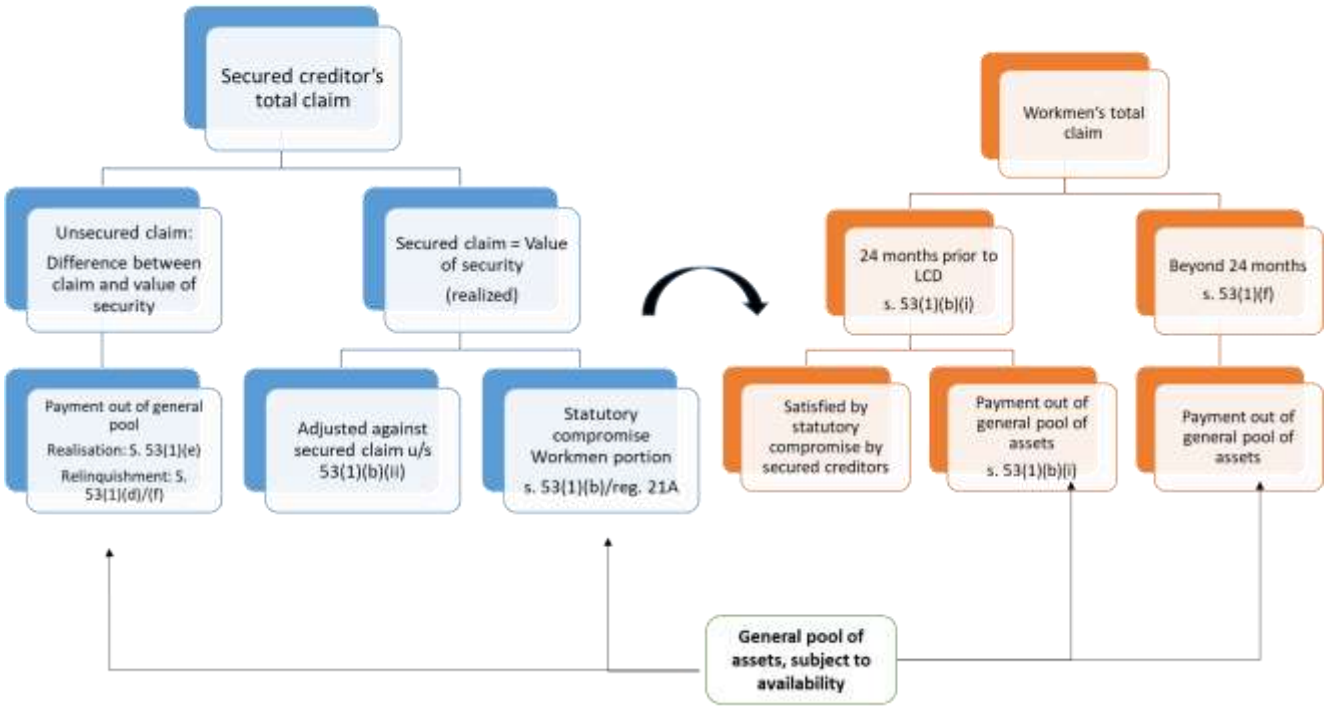

Figure 1: Distribution between secured creditors and workmen

What if there are different categories of secured creditors – say, one having exclusive charge on a particular asset, one having first charge on the second asset, and all creditors having pari-passu charges on all other secured assets?

In such cases, there would be multiple realisation streams, say, R1, R2, and R3 allocable to each type of secured creditor, having claims, say C1 (exclusive charge-holder), C2 (first charge-holder), and C3 (*pari passu* charge-holders) respectively. R1 is to be apportioned between C1 and W in the same manner as explained above. As regards, R2, after the workmen portion is taken out, the remaining part shall go to C2 first. For R3, the same shall be divided between the *pari passu* charge-holders in equal proportions.

In case there are realisations from unsecured assets, payments shall be made to secured creditors as above, in the ratio of value of their respective security to the total value of the secured assets realised, and to the workmen, subject to the limitation of W, in aggregate. However, while making such disbursement too, the *inter-se* priorities shall be respected. Reliance has been placed on ICICI Bank Ltd..

CASE STUDY

Basis the foregoing discussion and the notations/formula coined above, we try to find the value of the unknowns in our example above, that is, P, S_P, and W_P:

a) Maximum priority entitlement of secured creditor under section 53(b)(1)

If R=70, then the balance, that is (C - R) = 30, is an unsecured claim to be covered under s. 53(1)(d)/(f) [for relinquished security interest] or s. 53(1)(e) [for realised security interest].

b) Distribution of R between secured creditors and workmen

R = 70 is to be distributed to workmen and secured creditor in the ratio W : C , that is, 40 : 100

Therefore, P = 20. Payment to secured creditors = R – P = Rs. 50

Balance claim of secured creditors = P = 20
Balance claim of workmen = W – P = (40 – 20) = 20.
Total of these balances is W = 40

[The above is applicable in both realisation as well as relinquishment]

c) Realisation from unsecured assets and distribution

Here, U = Rs. 100

As stated above, U is to be distributed in the ratio P : (W-P), subject to the limitation of W.

Payment to secured creditors, say, U_S= Min (P, U * P/(P+(W-P))) = Rs. 20
Payment to workmen, say, U_W = Min ((W – P), U * (W – P)/ (P+(W-P))) = Rs. 20

Note that the balance of U, that is, Rs. (100-20-20) = Rs. 60 is to be paid off to employees, and not to unsecured claim of the secured creditor.

In case, the realisation from unsecured assets was lower, it could have led to a deficit in the pay-out to secured creditors and workmen too.

d) Distribution to secured creditors and workmen

Based on foregoing workings, total distribution to secured creditors and workmen would be:

$\mathbf{S_P}$ = (R-P) + U_S = (70-20) + 20 = 70. This would be paid under section 53(1)(b)(ii), and the balance amount of 30 remains unpaid.

$\mathbf{W_P}$ = P + U_W = 20+20 = 40. This would be paid under section 53(1)(b)(i).

AN ODE TO FLOATING CHARGES: FINDING A PLACE IN WATERFALL

It is a common knowledge, by now, that floating charges are charges *hovering* over the properties of the debtor – it assumes the form of a shed – any property that comes under the shed becomes subjected to the charge, and any property that leaves the shed becomes free of the charge. Being characterised as such, a floating charge provides liberty to the debtor to deal with the property, generically described to be covered by the charge[22].

Undoubtedly, floating charge is a 'charge' and is a form of 'secured interest'. However, is it the same as a fixed charge? Will it share the same status as that of a fixed charge? Applying all possible parameters of commercial wisdom as well as extant jurisprudence, it is difficult to answer the questions in affirmative. A creditor having fixed charge and a creditor having floating charge are not (and cannot be) equally placed, even after the floating charge crystallises.

The courts have, time and again, acknowledged the prominence of fixed charges over floating charges. Where a specific charge is created on immoveable property, an equitable charge or a floating charge if any, created cannot have priority. State Of Andhra Pradesh v. Rajah Ram Janardhana Krishna[23]. See also, Wheatley v. Silkstone and Haigh Moor Coal Co.[24]. Some rulings do speak about the impact of a floating charge carrying a restrictive clause, that, a registered floating charge carrying a restrictive clause to the effect that the same property shall not be subjected to any charges whether specific or floating will rank before any subsequently created specific charge if the specific chargee had knowledge or notice of the clause. English & Scottish Mercantile Investment Trust.Ltd. v. Brunton[25].

To speak about laws, floating charges have even been subordinated to preferential claims in winding up[26],though the floating charge holders do rank above general unsecured creditors. Under the UK laws, besides being lower in ranking to preferential claims, the floating charge holders even have to cede a prescribed part in favour of unsecured creditors - see section 176A of the UK Insolvency Act.

However, the Code makes absolutely no reference to floating charges, neither the BLRC has discussed about priorities of floating charges. There can be two possibilities – (a) the omission is deliberate so as to incentivise all charge holders to relinquish the secured asset and accord priority to floating charge holders as well, above all, or (b) the omission is inadvertent. In either case, it cannot be said that the inherent demarcation between fixed and floating charges has been blurred. Floating charges merely provide an intermediate way of security to the charge holder. Therefore, if a creditor has floating charge on every description of property of the company (which, generally is the case), it can only be paid subject to the priority rights of fixed charge holders. Irrespective of the fact that the law is not explicitly worded on this, the contractual rights of creditors will be upheld during insolvency – be it the intra-class priority between first and second charge holders, or the priority of fixed charge holders over floating charges.

CONCLUSION

The field of study in security interest and rights of secured creditors is vast and expansive, as well as interesting. With an unconventional treatment given to the secured creditors under the Code, which is different from the conventional Indian laws as well as the laws of other jurisdictions, the intrigue surrounding the interpretation of the provisions and the questions arising from the same cannot be said to be unreasonable. Also, possibilities of alternative interpretations cannot be ruled out. The article tries to touch upon some very basic questions with the help of simplistic examples.

Also, the focus in this article has been to analyse the priority waterfall *vis-à-vis* secured creditors. Nevertheless, including the above, there are still some areas, which can be identified, where the lawmakers can possibly endeavour to provide more clarity on. As discussed above, at present, the priority (position) of the debt of a secured creditor arising out of statutory compromise in favour of workmen is not entirely clear from the provisions, especially in case of creditors realising the security. The same might need some clarification akin to that under the 1956 Act. The law either shall clarify that such deficit too, is covered under section 53(1)(e) of the Code.

With the kind of objective the law seeks to achieve by prioritising relinquishing secured creditor, the law must endeavour to achieve equilibrium between realisation and relinquishment, or say create some advantage in relinquishment over realisation. With certain gaps as above, and some cribbing questions as discussed above, we are yet to attain clarity on the provisions.

Given that the law is still in the process of evolution, one will have to rely on established principles and judicial precedents until the law comes up with explicit clarity.

---

[1] *See*, UNCITRAL Model Law on Secured Transactions: Guide to Enactment. 'To the extent that a secured creditor is entitled to rely on the value of the encumbered asset for the payment of the secured obligation, the risk of non-payment is reduced and this is likely to have a beneficial impact on the availability and the cost of credit' [Para 5].

[2] *Ibid.* It is extremely important that the insolvency law recognizes the effectiveness of a security right, its priority and its enforceability in the case of the grantor's insolvency [Para 9].
See also, UNCITRAL Legislative Guide on Insolvency Law. 'Clear rules for the ranking of priorities of both existing and post-commencement creditor claims are important to provide predictability to lenders, and to ensure consistent application of the rules, confidence in the proceedings and that all participants are able to adopt appropriate measures to manage risk. To the greatest extent possible, those priorities should be based upon commercial bargains and not reflect social and political concerns that have the potential to distort the outcome of insolvency. According priority to claims that are not based on commercial bargains therefore should be minimized'. [Part One, I, B-8].
[3] For instance, section 13 of the SARFAESI Act, or under the Indian Contract Act, 1872 in case of pledges, or common law/agreement.
[4] Interim Report of the Bankruptcy Law Review Committee [Para 5.2, B, A], February, 2015.
The Report of the Bankruptcy Law Review Committee, Volume I: Rationale and Design, November, 2015.
[5] As also expressed in the Report of the Insolvency Law Committee, February, 2020
[6] *See* section. 529 of the 1956 Act read with section 47 of the PIA, or paragraphs 9 to 17 of the Second Schedule to the PTIA,; see section. 326/327 of the Companies Act, 2013 ';Rule 14.19 of the UK Insolvency Rules, 2016]. Such conventional right is protected in section 52 and section 128 of the Code.
See also, Allahabad Bank v. Canara Bank & Anr., [2004] 4 SCC 406.
[7] Proviso to section 529(1) of the 1956 Act; Regulation 21A(2) of the Liquidation Regulations. However, under section 529A of the 1956 Act, so much of the value compromised by the secured creditors in favour of workmen was to be paid as overriding preferential payments. There is no such super-priority under the Code.
[8] 1985 (58) Com Cases 609
[9] 2006 131 Com Cases 410 Guj,; (2006) 5 CompLJ 452 Guj; 2006 70 SCL 407 Guj
[10] 2006(10) SCC 452
[11] Principles of Corporate Insolvency Law, Professor Sir Roy Goode, QC; Dr. Kristin van Zwieten; Sweet and Maxwell, 5th Edition.
[12] The Reports of the Insolvency Law Committee, of 2018 and 2020 have dealt with the issue to a certain extent, and has clarified that *inter-se* priorities of secured creditors would remain intact.
[13] In case of relinquishment, there would be a distribution of realisations from secured assets to secured creditors as well as workmen u/s 53(1)(b).
[14] (2013) 1 SCC 462
[15] Title 11 of US Code: Bankruptcy, Chapter 5: Creditors, The Debtor, and the Estate.
[16] While saying this, we are fully aware that in many cases, an individual asset may be sold as a part of a larger block, or in a slump sale, where the value attributable to a single asset may be difficult to assess. These are nuances of actual liquidation which will have to be resolved based on the framework we discuss here.
[17] AIR (1993) Bombay 392
[18] AIR 1919 PC 24
[19] 2003 AIR SCW 1524
[20] (2013) 7 SCC 754
[21] This actually fits into a larger scheme that the workmen's dues are actually taken as a priority payment from unsecured assets. If the unsecured assets are either not there, or are inadequate, workmen's dues take a proportionate share from the secured creditors' claims.
[22] A plethora of rulings have gone into the discussion of what exactly floating charges are, and how they are distinct from a fixed charge. For instance, *see* In Re Yorkshire Woolcombers Association Limited, [1903] 2 Ch 295, National Westminster Bank and others v. Spectrum Plus, [2005] UKHL 41. See detailed discussion in an Indian ruling H.V. Low And Co., Ltd. v. Pulinbiharilal Singha and Ors., AIR 1933 Cal 154.
See also, an article titled, Floating Charges. The Nature of Security, The Cambridge Law Journal Vol. 47, No 2 (July, 1988), by Eilís Ferran.
[23] AIR 1966 AP 233
[24] (1885) 29 ChD 715
[25] (1892) 2 QB 700. Source: *Ramaiya's Guide to Companies Act*, 18th Edition
[26] *See* section 530(5) of the 1956 Act, and section. 327(3) of the Companies Act, 2013