

Distributive justice between workmen's dues and secured creditors rights, w.r.t sec. 52 and 53 of the Code

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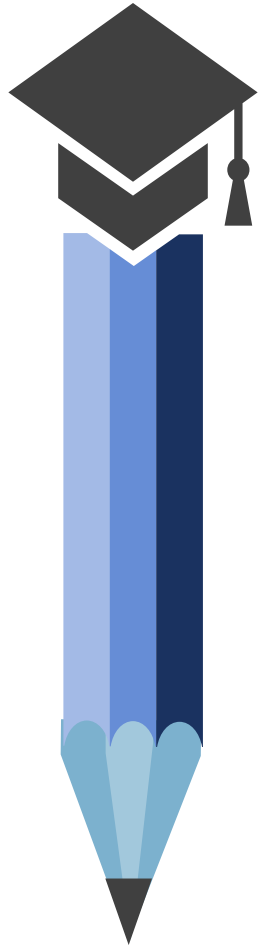


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Agenda



01

The need for prioritization

How priorities encourage equitable treatment

02

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03

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Position w.r.t. workmen dues

Discussion upon various aspects related to workmen dues



The Need for Prioritization

Kinds of Priority & its relevance
Priority ensures “distributive justice”
Global Scenario

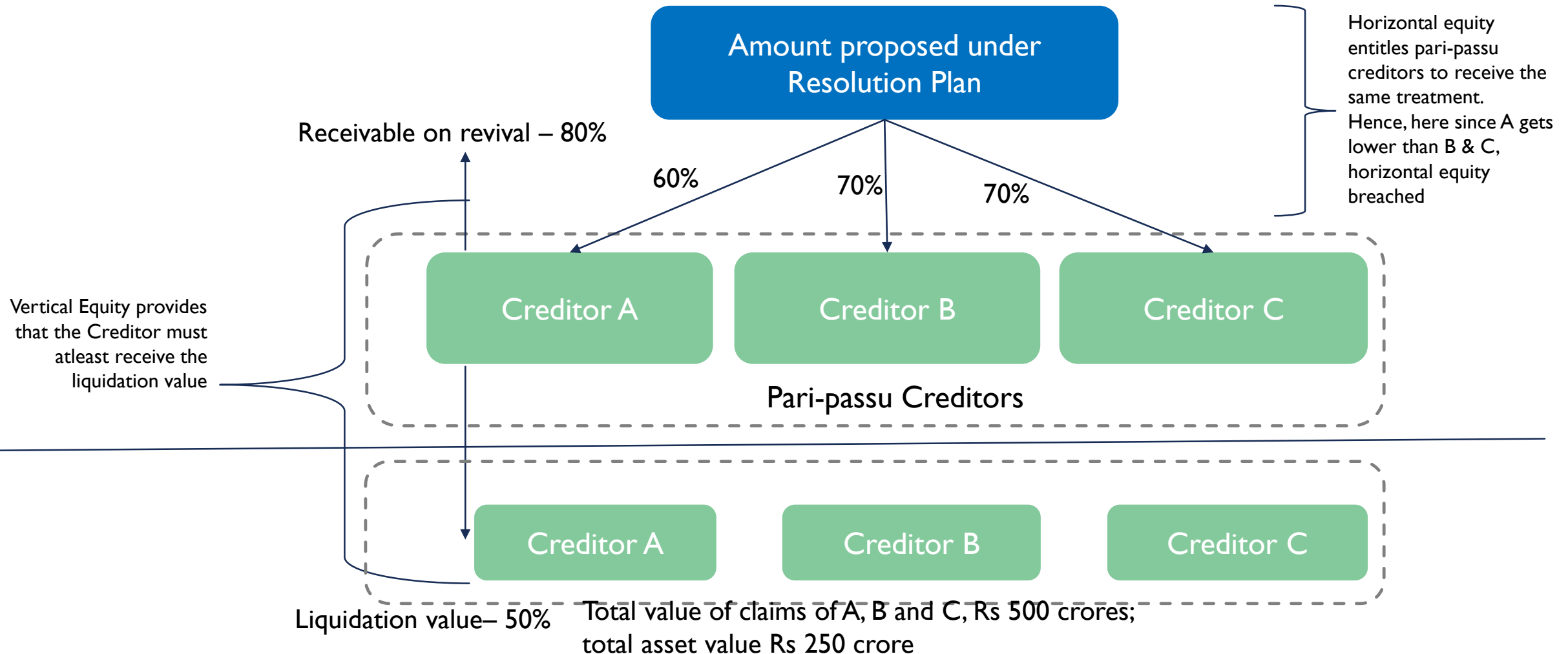
Relevance of Distributive Justice under the Code

Different stages under the Code		
Insolvency Resolution Process	Liquidation Process	Voluntary Liquidation
<ul style="list-style-type: none">Resolution Plan must be take into consideration priority laid down u/s 53-<ul style="list-style-type: none">Ref. sec. 30 (2)(b)(ii) & Sec. 30 (4)Amendment introduced on the basis of order of Hon'ble SC in Essar Steel v. Satish Kumar Gupta & ors.Haircut may be faced by creditors, however, priority must be maintained by resolution plan.	<ul style="list-style-type: none">The crux of the liquidation process is distribution on the basis of priorities.Deficit in realisation makes it necessary to have priorities ascertained with clarity<ul style="list-style-type: none">To ensure distributive justice	<ul style="list-style-type: none">Under voluntary liquidation<ul style="list-style-type: none">Assets > liabilitiesHence, all creditors shall be paid in full.However, by virtue of priority based on sequence, section 53 must be followed<ul style="list-style-type: none">Ref sec. 59 (6)

Relevance of Priority in Resolution Plans

- Enshrined in sec 30 (2) (b)-OCs must receive min.-
 - Liquidation value; or
 - Amount under resolution plan if distributed as per sec. 53, Whichever is higher.
 - Dissenting Financial Creditors u/s 30 (2) must also be paid min. liquidation value
- Section 30 (4) provides that-
 - CoC may approve a resolution plan, after considering feasibility and viability
 - Which may take into account the order of priority amongst creditors u/s 53 (1)
 - Also upheld by Hon'ble SC in **Essar Steel vs. Satish Kumar Gupta & Ors** (Ref. para 40)
 - *Thus, what is left to the majority decision of the Committee of Creditors is the "feasibility and viability" of a resolution plan, which obviously takes into account all aspects of the plan, including the manner of distribution of funds among the various classes of creditors.*
- Proviso to sec. 30 (2)
 - For removal of doubts, it is hereby clarified that a distribution in accordance with the provisions of this clause shall be fair and equitable to such creditors
 - Is this a deeming provision, or overarching requirement?
 - Can a resolution plan have a cramdown unless it is fair and equitable?
 - Sec. 1129 (b) of US Bankruptcy Code
- Regulation 38 (3) (b) requires the resolution plan to be feasible and viable
 - Sec 30 (4) of Code includes taking into account order of distribution while determining priority.

Vertical & Horizontal Equity during Resolution



Horizontal and vertical equity in resolution plans

- Provisions under US Bankruptcy Code – Chapter 11
 - Reorganisation has a “cramdown” provision – 1129 (b)
 - However, sec 1129 (a) (7) provides minimum assurance
- In UK- no explicit provision of vertical equity
 - Courts have applied in several rulings
 - See *Re T & N Ltd* [2004] EWHC 2361 (Ch).
 - *Mourant & Co. Trustee Ltd. v. Sixty UK Limited (In Administration)*, [2010] EWHC 1890 (Ch)
 - *Prudential Assurance Co Ltd v PRG Powerhouse Ltd* [2007] EWHC 10002 (Ch)
- Horizontal equity
 - All creditors of equal ranking must be placed in the same ranking
- Examples of fair and equitable resolution plans:
 - A secured creditor cannot become unsecured creditor or vice versa
 - A senior creditor cannot become junior creditor or vice versa
 - Rights against third parties cannot be obliterated

Treatment of Creditors- Equal vs. Equitable

Q. Whether prioritization disturbs/ distorts equitability?

- Code posits a fair and equitable treatment of creditors- Does not mean that all creditors can be treated equally
 - See *Swiss Ribbons v. Union of India*;
 - *Essar Steel India Limited v. Satish Kumar Gupta & ors.*
- As per Principles for Effective Insolvency and Creditor/Debtor Regimes by World Bank-
 - Insolvency law systems should provide for equitable treatment of similarly situated creditors
- Prioritization encourages equitability-
 - UNCITRAL Legislative Guide states-

“The objective of equitable treatment is based on the notion that, in collective proceedings, creditors with similar legal rights should be treated fairly, receiving a distribution on their claim **in accordance with their relative ranking** and interests.”
 - American Jurisprudence-

The bankruptcy system is designed to distribute an estate as equally as possible **among similarly situated creditors**. Thus, creditors of equal status must be treated equally and equitably.
- Equitable treatment in India

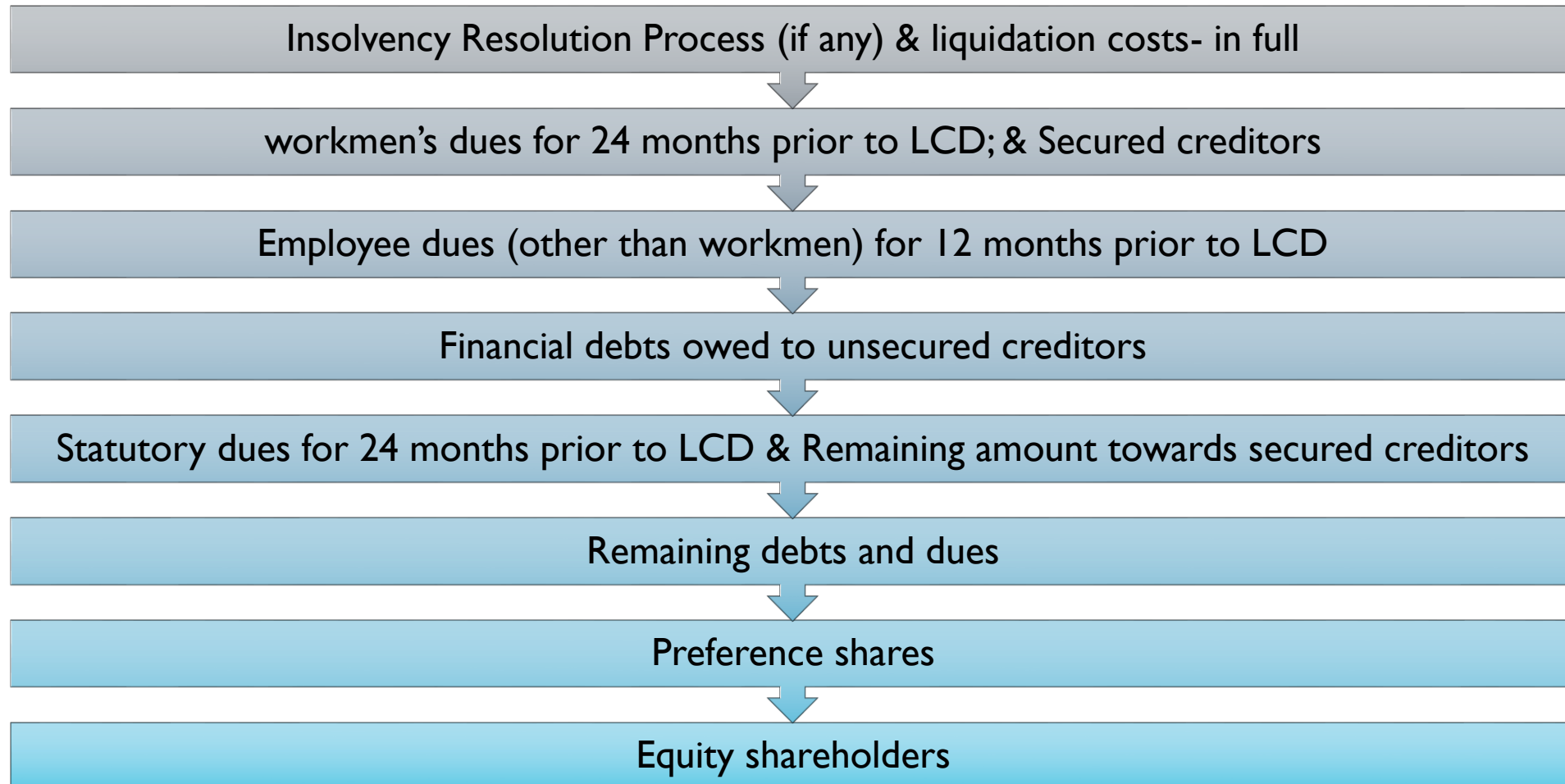
The ruling of SC in Amit Metalics goes to establish equal, rather than equitable treatment



The Waterfall Mechanism



Priorities u/s 53 (I) of IBC



Priorities under Companies Act

Companies Act, 1956

- i. Pari-Passu Payments to –
 - a. workmen' s dues
 - b. debts due to secured creditors
- ii. all revenues, taxes, cesses and rates due from the company to the Central or a State Government or to a local authorities
- iii. all wages or salary in respect of services rendered to the company and due for a period not exceeding four months within the 12 prior to commencement of liquidation
- iv. all accrued holiday remuneration becoming payable to any employee,
- v. all amounts due, in respect of contributions payable during the twelve months next before the relevant date, by the company as the employer of any persons, under the Employees' State Insurance Act, 1948
 - a. Except in case of voluntary liquidation/ arrangement
- vi. all amounts due, in respect of contributions payable, by the company as the employer of any persons, under the Workmen's Compensation Act, 1923,
 - a. Except in case of voluntary liquidation/ arrangement
- vii. all sums due to any employee from a provident fund, a pension fund a gratuity fund- or any other fund for the welfare of the employees
- viii. the expenses of any investigation held in pursuance of section 235 or 237, in so far as they are payable by the company.

Companies Act, 2013

- i. Pari-Passu Payments to –
 - a. workmen' s dues
 - b. debts due to secured creditors, so much of the debts due to such secured creditor as could not be realised by him or the amount of the workmen's portion in his security, whichever is less
- ii. all revenues, taxes, cesses and rates due from the company to the Central Government or a State Government or to a local authority upto 12 months prior to relevant date.
- iii. all wages or salary due for a period not exceeding four months within the twelve months immediately before the relevant date
- iv. all accrued holiday remuneration becoming payable to any employee,
- v. all amounts due, in respect of contributions payable during the twelve months next before the relevant date, by the company as the employer of any persons, under the Employees' State Insurance Act, 1948
 - a. Except in case of voluntary liquidation/ arrangement
- vi. all amounts due, in respect of contributions payable, by the company as the employer of any persons, under the Workmen's Compensation Act, 1923,
 - a. Except in case of voluntary liquidation/ arrangement
- vii. all sums due to any employee from the provident fund, the pension fund, the gratuity fund or any other fund for the welfare of the employees, maintained by the company
- viii. the expenses of any investigation held in pursuance of sections 213 and 216, in so far as they are payable by the company

Priorities under Insolvency laws outside India

US Bankruptcy Code, <u>Chapter 7</u>	UK Insolvency Act	<u>Insolvency, Restructuring And Dissolution Act</u> of Singapore
<ul style="list-style-type: none"> i. Cost of administration (including trustee's fee) ii. certain expenses incurred in an involuntary bankruptcy case before entry of an order of relief or appointment of a trustee iii. Wage, salary or commission claims iv. Claims for contribution to employee benefit plans v. Claims for farmers and fisherman vi. certain claims for alimony, maintenance, or support. vii. certain governmental claims for income, property, employment, and excise taxes, and customs duties. viii. certain claims by a federal depository institution regulatory agency. ix. unsecured claims in which a proof of claim is timely filed by creditor who had no knowledge of the bankruptcy x. unsecured claims in which a proof of claim is tardily who had knowledge of bankruptcy xi. claims for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages xii. interest on the claims paid above from the date of filing the petition at the legal rate. xiii. to the individual debtor or equity holders of the corporate or partnership debtor pursuant to the articles of incorporation or state law. 	<ul style="list-style-type: none"> i. Cost to realising fixed charge assets ii. Fixed charge holders; iii. Obligations under any new contract entered iv. Expenses of insolvency v. Preferential claims vi. Floating charge claims (subject to "prescribed part" provision) vii. Unsecured claims viii. Equity shareholders <p><i>"Prescribed part" refers to a certain percentage of Net Property that must be set aside for payments to be made to the unsecured creditors</i></p> <p><i>Calculation of Prescribed part (sec. 176A)</i> <i>50% of the first £10,000 of assets; and</i> <i>20% of the balance up</i></p>	<ul style="list-style-type: none"> i. the costs and expenses of the winding up incurred by the Official Receiver ii. any other costs and expenses of the winding up, including the remuneration of the liquidator iii. the costs of the applicant for the winding up order iv. all wages or salary including any amount payable by way of allowance or reimbursement under any contract of employment v. the amount due to an employee as a retrenchment benefit or ex gratia payment vi. all amounts due in respect of work injury compensation under the Work Injury Compensation Act vii. all amounts due in respect of contributions payable towards superannuation or provident funds for 12 months prior to commencement viii. all remuneration payable to any employee in respect of vacation leave or, in the case of the employee's death ix. the amount of all tax assessed, and all goods and services tax due, under any written law before the commencement of the winding up

The contours of liquidation estate

- What is to be distributed is the liquidation estate
- Hence, it is important to understand what will not be part of liquidation estate, as these monies are not impressed with the colour of liquidation estate
 - Fall outside the domain of the liquidator
- Sec 36 (4) provides several exclusions
 - Money held in trust
 - For example, security deposit held by the company – if against specific property or obligation, it is typically not a part of the funds of the company
 - Usual rule is – setting aside of a fund for the payment to creditors creates a trust – Baroda Spinning and Weaving Mills, 46 Comp Cas (Guj)
 - Bailment of assets
- Amount in Provident fund, Pension funds and gratuity fund
 - Tall question – what if the company did not have a fund?
 - The liquidator cannot be directed to provide for the same.
 - See SC ruling in Sunil Kumar Jain and ors v. Sundaresh Bhatt and ors
 - See NCLAT ruling in Savan Godiwala v. Apalla Siva Kumar
 - What about the shortfall in contributions – is it a claim against the company or a claim against the fund?
 - It is claim against the fund
 - NCLAT in Somesh Bagchi v. Nicco Corpn. Ltd held that gratuity dues not form a part of the liquidation estate. Similar judgement was passed by NCLAT in SBI v. Moser Baer Karamchari Union*
 - What about other funds – say superannuation fund?
 - Liquidation estate may be enhanced by anti avoidance powers of the liquidator

* Appeal in SBI v. Moser Baer Karamchari Union is pending before SC

Priorities u/s 53 (1) of IBC

Clause (a)- CIRP & Liquidation Costs

What constitutes CIRP Costs- (Sec 5 (13) and Reg 31 of CIRP Regulations)

Amount due to
suppliers of essential
goods and services

Fee payable to AR of
class of creditors

Out-of-pocket
expenses of RP for
discharge of functions

Amounts due to
person whose rights
are prejudicially
affected due to
moratorium

Expenses incurred on
and by the RP

Other costs directly
related to CIRP and
approved by CoC

- Where expenses incurred towards or by IRP are not ratified by CoC- Applicant must bear the expenses
- Only expenses ratified by CoC shall form part of CIRP Cost
- Interim financing and cost thereof – sec 5 (13)
- **Not forming part of CIRP Cost-** (As per IBBI Circular dated 12.06.2018)
 - any fee or other expense beyond the amount approved by CoC,
 - any expense incurred by a creditor, claimant, resolution applicant, promoter or member of the Board of Directors of the CD in relation to the CIRP
 - any fee or other expense incurred before the commencement of CIRP or to be incurred after the completion of the CIRP
 - amount towards any loss, or penalty, if any, incurred on account of non compliance of any provision of law applicable on CD while conducting CIRP/ Liquidation Process (IP Amendment Reg. dated 4th July, 2022)
- Whether the salaries and wages payable to the employees and workers for the CIRP period be included in CIRP costs?
 - SC in Sunil Kumar Jain and ors v. Sundaresh Bhatt and ors held the same shall be included if it is proved that the CD was a going concern during the CIRP period,

Critical Supplies vs. Essential Goods- What Forms Part of CIRP Cost?

Essential Supplies

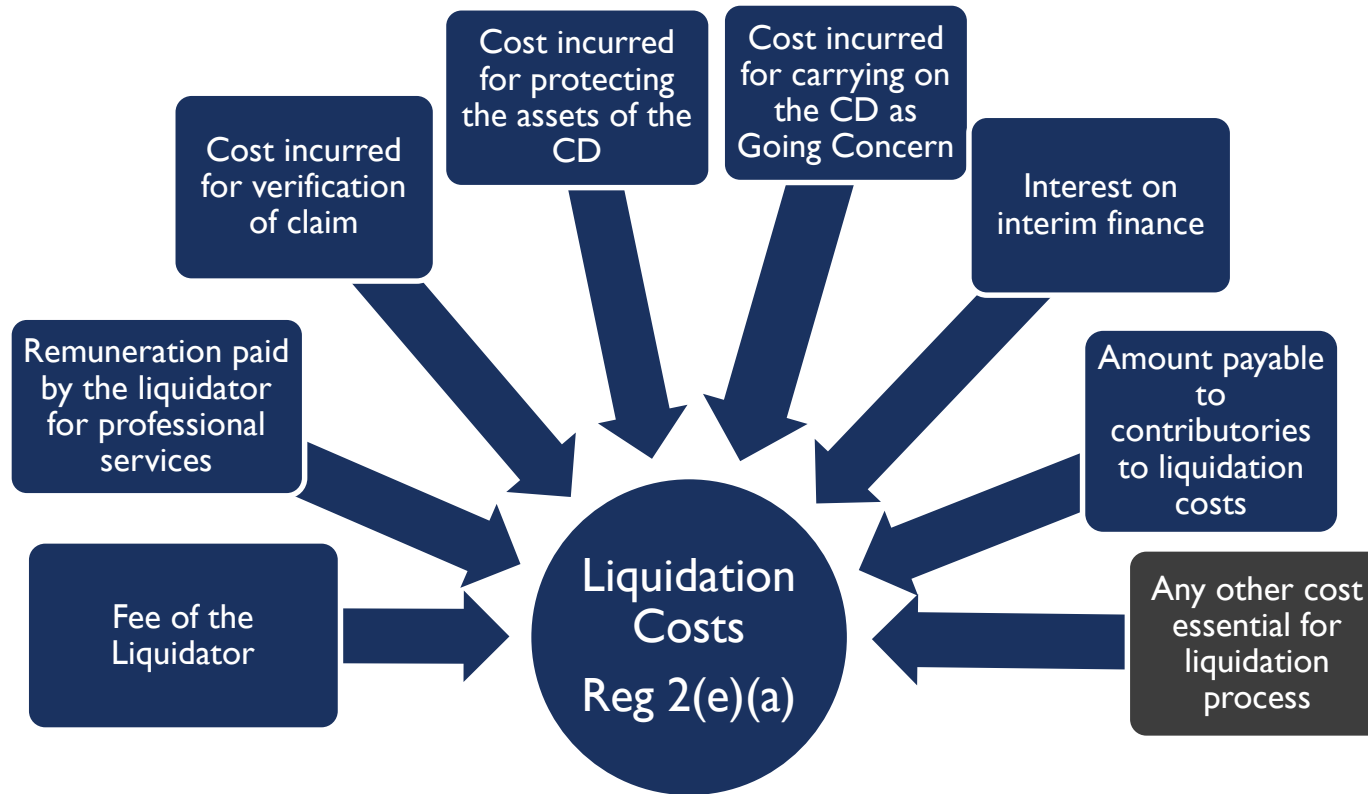
- Forms part of IRP costs under reg. 31(a) of CIRP Regs;
- The essential goods and services shall mean- electricity; water; telecommunication services; and information technology services,
 - to the extent these are not a direct input to the output produced or supplied by the corporate debtor

Critical Supplies

- Not an explicit part of IRP Costs
- Section 14(2A) – inserted by amendment of 2020 (w.e.f. 28.12.2019) on recommendation of ILC report, 2020.
- ‘Critical’ to protect and preserve the value of the corporate debtor and manage the operations of such corporate debtor as a going concern
 - As the IRP/RP considers to be ‘critical’
- the supply of such goods or services shall not be terminated, suspended or interrupted during the period of moratorium
 - except where such corporate debtor has not paid dues *arising from such supply during the moratorium period* or in such circumstances as may be specified
- no specifications as on date
- past dues till insolvency commencement date? – resolution plan

Priorities u/s 53 (I) of IBC

Clause (a)- CIRP & Liquidation Costs

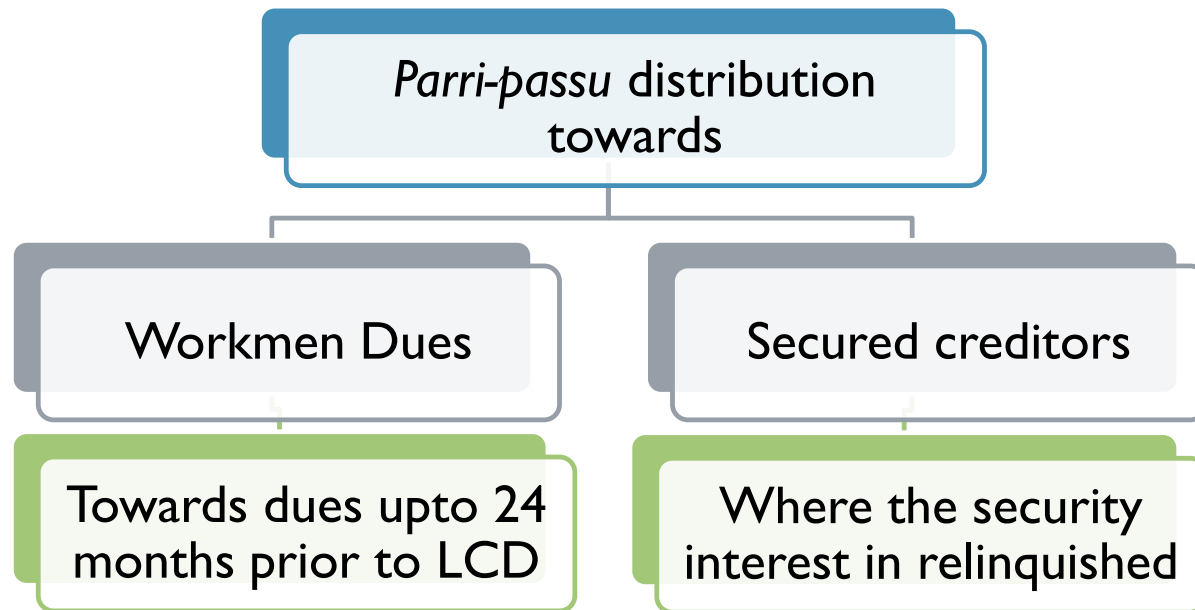


- Fee of the liquidator- in terms of Reg. 4
 - Percentage based; or
 - As decided by the CoC
- **Interest on Interim Finance*** - for the period lower of-
 - 12 months; or
 - LCD till repayment of interim finance
- Contribution under Reg. 2A of Liquidation Regulations - read with Reg. 39B of CIRP Regulations
 - Also entitled to interest @bank rate
- Any cost incurred by the liquidator in relation to a scheme of compromise or arrangement- **does not form part of Liquidation Costs**
 - Shall be paid by the applicant

* IBBI Discussion Paper dated 14th June, 2022 proposes to include the interest on interim finance availed during CIRP till the same is repaid

Priorities u/s 53 (I) of IBC

Clause (b)- Secured creditors & Workmen dues



- Workmen as defined under the Industrial Disputes Act-
 - definition
- Meaning of workmen dues- As per section 326 of the Companies Act, as per which workmen dues mean aggregate of-
 - All salary or wages;
 - Accrued holiday remunerations
 - all amount due in respect of any compensation or liability for compensation in respect of death or disablement of any workman
- Sums due towards PF, Pension & Gratuity outside the scope of Sec 53 read with section 36 (4) (a) (iii)
 - See SBI v. Moser Baer Karamchari Union & Ar
 - See Somesh Bagchi v. Nicco Corpn. Ltd
- Secured creditor's claim is covered to the extent of value of security; and not the total sum due
 - Recommendations of the Second ILC Report

Coverage of the expression “wages” & “workmen dues”

- There have been lots of rulings defining what all is included in “wages”
 - Rulings under the winding up regime of the 1956 Act should all remain relevant
- The following have been included in definition of wages
 - Dearness allowance
 - Bonus
 - Unavailed leave
 - Compensation for Termination is clearly covered by Explanation (b) (i) below sec. 326 (2) of the Companies Act
- The following are not included
 - Ex gratia payments
- Payments against provident fund, pension fund and gratuity
 - Same does not form part of liquidation estate (See NCLAT judgements in Somesh Bagchi v. Nicco Corpn. Ltd and SBI v. Moser Baer Karamchari Union*)

* Appeal in SBI v. Moser Baer Karamchari Union is pending before SC

Secured creditors

- Secured creditors are, evidently, the largest claimants in resolution/liquidation proceedings
- Following points important to understand:
 - Is the person a “creditor”, and a “secured creditor”?
 - Definition in sec. 3 (30) and 3 (31) seem generally broad
 - For example, an owner of an asset taken on financial lease is not a creditor
 - Is the security interest registered?
 - Sec. 77 (3) of the Companies Act. Unregistered charges not to be taken cognizance of
 - Has the creditor relinquished security interest, or are deeming provisions applicable?
- Determining the “security interest”
 - Ascertainable assets or unascertainable assets
- Determining the ranking
- The following are not security interests:
 - A mere obligation to pay, not being an obligation attached to property
 - A negative lien or negative pledge
 - A covenant requiring maintenance of asset cover etc may be a financial covenant but not a security interest
- Also, it is important to note that in sec. 53 (1) (b), it is important to define “secured creditor” and not “financial creditor”
 - There may be secured operational creditor
- Partly secured creditor or fully secured creditor
 - Inter se priorities of secured creditors – ruling of NCLAT in Anil Anchalia, Liquidator of Bala Techno
 - Also NCLAT ruling in Technology Development Board, holding that SC ruling in SIDCO Leathers does not apply u.s 53
- Can security interest realized under SARFAESI be continued if CIRP is initiated before receipt of full payment?
 - See *Indian Overseas Bank v. M/s. RCM Infrastructure Ltd. and Anr.*

Secured creditors and the value of security interest

- Second ILC Report, para 7.1 to 7.4 has an important discussion on this issue
- Repayment to Secured Creditors Covers Value of Security Interest Relinquished
 - this provision intends to replicate the benefits of security even where it has been relinquished
 - However, any they will only have priority for the amount of security interest; not the entire sum due
 - Therefore priority of repayment over their entire debt regardless of the extent of their security interest **is not the intent**.
- 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. *Jitendra Nath Singh v. Official Liquidator & Ors.*
- Similar provisions in sec. 110 (3) (b) and 123 (2)(b)
- What is the relevant point of time at which the value of security should freeze?
 - At the time of lending
 - At the time of liquidation commencement
 - At the time of realisation - logically, this, as only such realised value constitutes priority entitlement
- See detailed article Secured Creditors under the Insolvency Code: Searching for Equilibrium [here](#) –
- Subordination Agreements within the Liquidation Waterfall
 - First ILC Report clarified that valid inter-creditor/subordination agreements would continue to govern their relationship
 - Agreements *inter-se* secured creditors do not disturb the equal ranking sought to be provided by section 53(1)(b) and therefore do not fall within the ambit of section 53(2)

Second ILC Report available at-

<https://www.ibbi.gov.in/uploads/resources/c6cb71c9f69f66858830630da08e45b4.pdf>

Priorities u/s 53 (I) of IBC

Clause (c) and (d)

Clause (c)- Wages and Employee dues

wages and any unpaid dues owed to employees (other than workmen) for the period of 12 months preceding the liquidation commencement date;

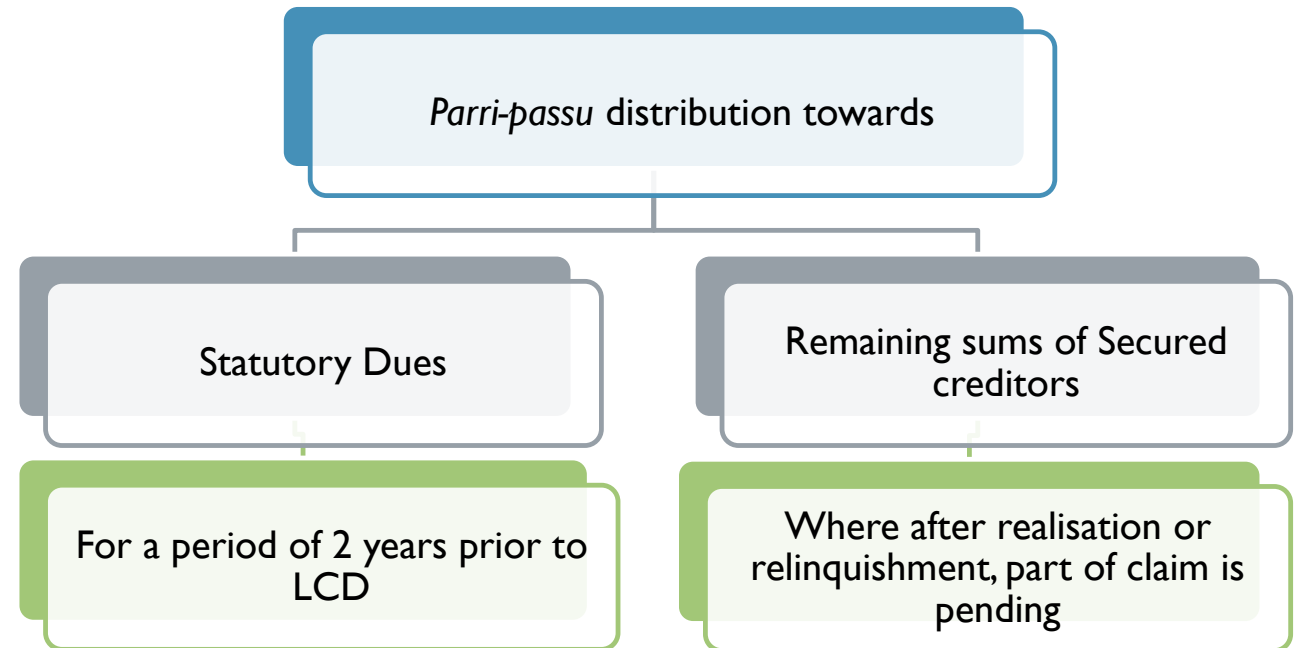
Clause (d) Unsecured Financial Creditors

Unsecured financial debts have been placed prior to Government dues, which have been ranked first in the priority list under the Companies Act, 1956

Priorities u/s 53 (I) of IBC

Clause (e)

- Statutory dues include
 - due to the Central Government;
 - Dues to the State Government;
- includes the amount to be received on account of the Consolidated Fund of India
- Here, Secured creditors mean those who had realised outside of liquidation process.



Priorities u/s 53 (I) of IBC

Clause (f), (g) and (h)

Clause (f)- Residual dues

- These are debts and dues other than those mentioned in the foregoing clauses.
- For example, operational debts owed to unsecured creditors may fall in this category

Clause (g)- Preference shareholders

- Preference shareholders, by nature, receive priority in distribution of dividend and assets in the event of liquidation of companies.

Clause (g)- Equity shareholders

- The residual bite of the assets of the corporate debtor shall go to the equity shareholders (or partners in case of LLPs).

Secured Creditors & Floating Charges under IBC vis-à-vis Companies Act

Point of comparison	Companies Act, 1956	Companies Act, 2013	IBC
Relevant provisions	Sec. 529, 529A, 530	Sec. 326, 327	S. 53, read with s. 52
Applicability of priority rules	Insolvency rules would apply to winding up of insolvent companies	Replaced vide s. 255 of the IBC Priority rules only apply to winding up under the 2013 Act, and not to IBC.	Specific priority rules
Rights of secured creditors realising security interest	<p>In case of realisation, security of secured creditor subject to pari passu charge in favour of workmen – proviso to s. 529.</p> <p>Secured debt which could not be realised as above, payable as overriding preferential payment u/s 529A with workmen dues.</p>	<p>Proviso to s. 326(1) read with s. 326(2) accords priority to workmen dues (for 2 years) for wages, salaries and accrued holiday remuneration.</p> <p>Realising secured creditors at par with workmen dues after the said proviso, at par with workmen dues – sec. 326(1).</p>	<p>S. 52, Reg. 21A, Reg. 37</p> <p>Have to choose within 30 days in the claim Form;</p> <p>Have to cede proportionate share for costs and workmen within 90 days of LCD;</p> <p>Have to tender excess realisation within 180 days of LCD;</p> <p>Failing which, the asset is presumed to be a part of the liquidation estate</p>

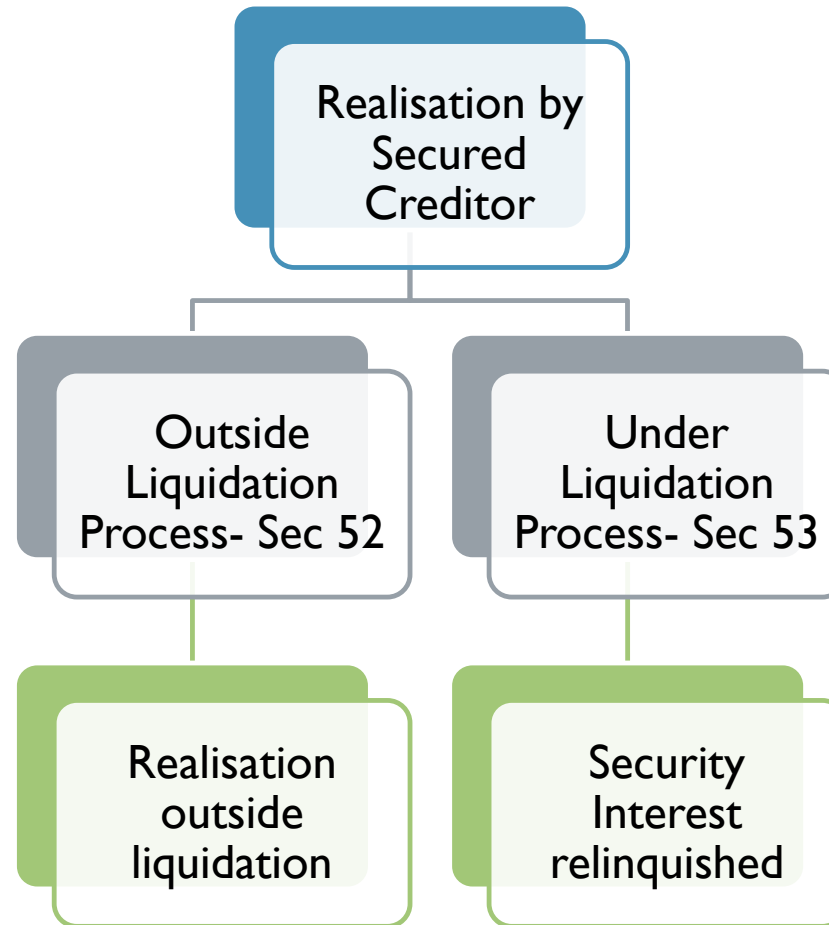
Point of comparison	Companies Act, 1956	Companies Act, 2013	IBC
Rights of secured creditors relinquishing security interest	On relinquishment, would stand at par with unsecured creditor – inferred from a conjunctive reading of s. 529(2), 529A & 530.	Nothing specific. Therefore, treated at par with general creditors.	Pari passu with workmen dues for 24 months – s. 53(1)(b)
Provision relating to floating charge	Sec. 530(5) – Preferential debts, so far as the assets of the company available for payment of general creditors are insufficient to meet them, 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.	Sec. 327(3) – Preferential debts, so far as the assets of the company available for payment of general creditors are insufficient to meet them, 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.	Not specified.



Position w.r.t. Secured Creditors

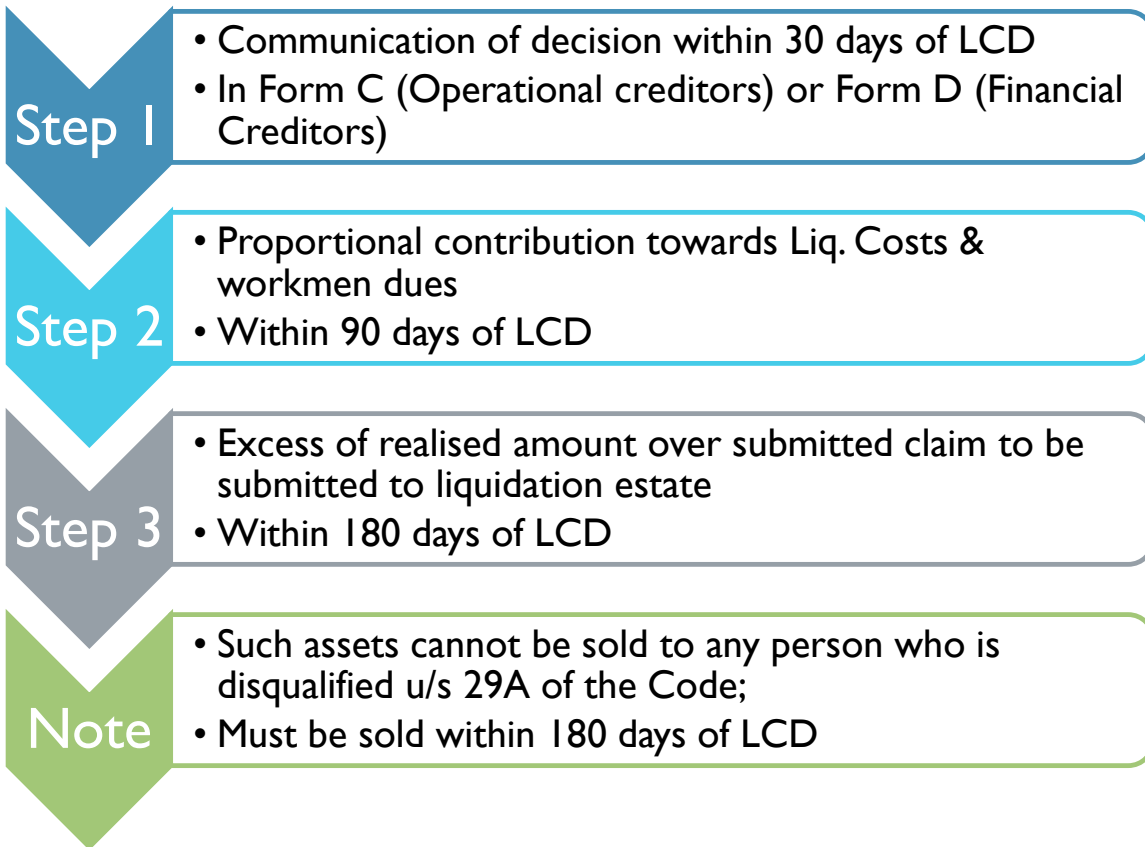


Decision of Secured Creditors- *Realisation vs. Relinquishment*



Realisation outside Liquidation Process

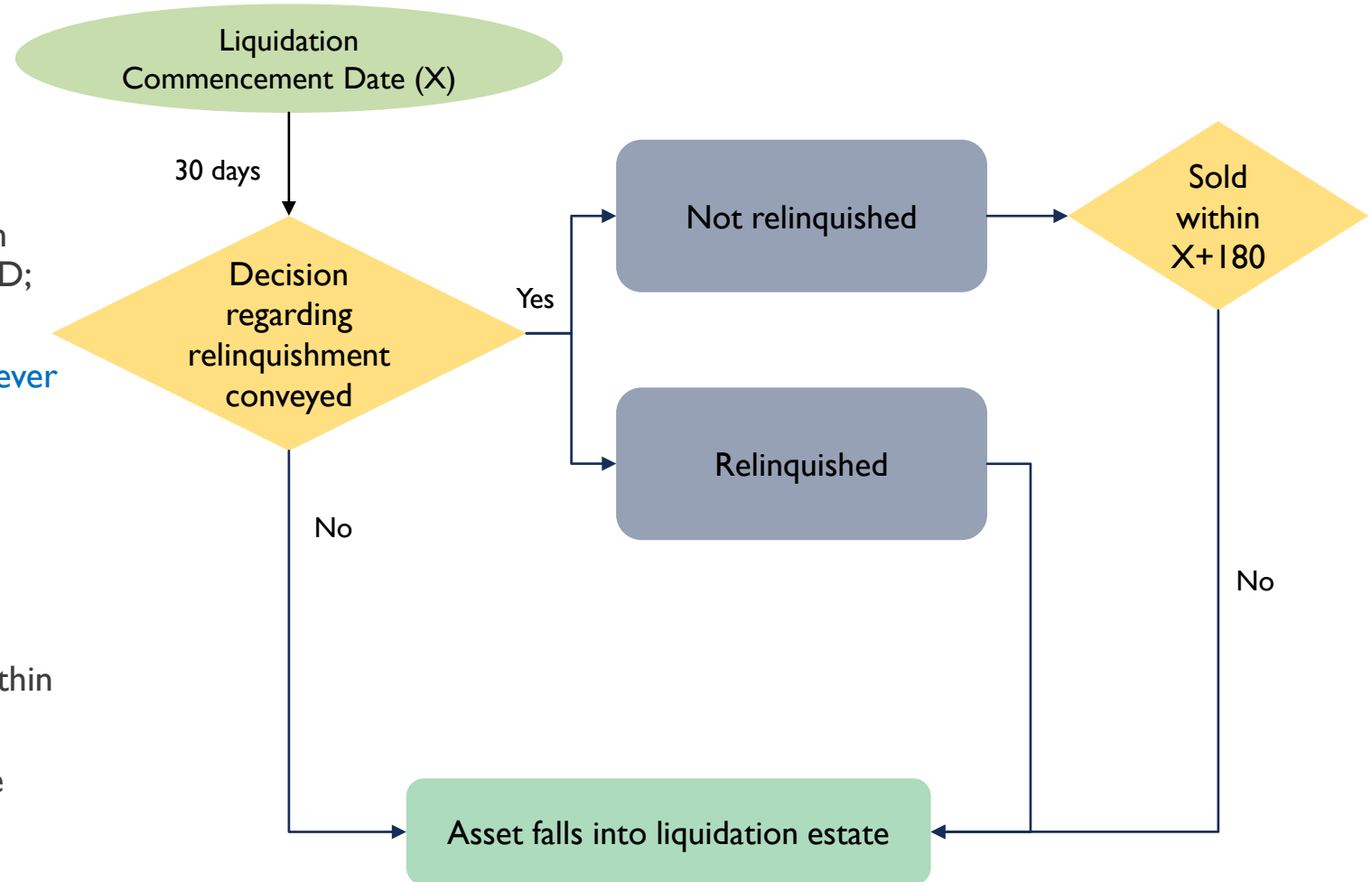
Regulation 21A



- Sec 52: Secured creditor may realize asset outside liquidation estate
 - In case of joint financing: No secured creditor shall be entitled to exercise right unless agreed upon by secured creditors representing at least 66%. (See Srikanth Dwarkanath v. Bharat Heavy Electricals Limited)
- Reg. 37: The secured creditor must intimate the liquidator the realisable price at which he proposes to realise the asset.
- Within 21 days of such intimation, liquidator shall
 - Of a person willing to buy the asset before the expiry of 30 days of intimation; and
 - At a higher price than intimated by the secured creditor
 - Secured creditor shall sell the asset to such person; and bear the cost incurred by the liquidator for identification of such person
- Reg. 37 applies only in cases outside SARFAESI Act

Relinquishment by Secured Creditors

- Encumbered Assets do not form part of Liquidation Estate unless security interest relinquished
- Reg. 21A of Liquidation Regulations requires
 - Secured creditors must inform decision on (non) relinquishment within 30 days of LCD;
 - Proposed to be reduced to 7 days or 1st meeting of consultation committee, whichever is later
 - Failing such communication, it will be a **deemed relinquishment**
 - Asset will form part of the Liquidation Estate
- Where not relinquished, asset must be sold within 180 days of LCD,
 - Else, asset falls back into Liquidation Estate



General Rules of Priority- Fixed v. Floating Charges

- The priority of several specific charges on the same property is determined by the general rules relating to the priority of charges.
 - See *State of Andhra Pradesh v. Rajah Ram Janardhana Krishna*, AIR 1966 AP 233, 1966 36 CompCas 950 AP.
- Section 48 of the TP Act, 1882
 - where a person purports to create by transfer at different times rights in or over the same immoveable property, and such rights cannot all exist or be exercised to their full extent together, each later created right shall, in the absence of a special contract or reservation binding the earlier transferees, be subject to the rights previously created.
- Section 70 of the TP Act, 1882
 - if, after the date of a mortgage, any accession is made to the mortgaged property, the mortgagee, in the absence of a contract to the contrary, shall, for the purposes of the security, be entitled to such accession.
- Fixed charges prevail over Floating Charges
 - Where a specific charge is created on immoveable property, a floating charge cannot have priority. Also, the specific charge which is the first in point of time takes priority over the second.
 - *State Of Andhra Pradesh v. Rajah Ram Janardhana Krishna*, AIR 1966 AP 233, 1966 36 CompCas 950 AP.
 - A registered floating charge *without a restrictive clause* ranks after a prior or subsequent specific charge which is duly registered.
 - *Hamilton's Windsor Iron Works, Re*, (1879) 12 Ch D 707.
 - In the absence of a stipulation to qualify the elasticity of the floating charge, it leaves the company at liberty to create specific mortgages or charges in priority to itself.
 - *Florence Land Co.* (1878) 10 Ch. D. 503, and *Colonial Trust* (1880) 15 Ch. D. 465, as quoted in *Imperial Bank Of India v. Bengal National Bank Ltd.*, AIR 1931 Cal 223

Exceptions to the Rule of Priority- Fixed vs. Floating Charges

- The characteristic of a floating charge the management autonomy to deal with the assets covered by the charge
- If the debtor may deal with the assets in ordinary course of business, the floating chargeholder is bound by a fixed charge or disposal - *Biggerstaff v Rowatt's Wharf Ltd* [1896] 2 Ch 93
- Where a fixed and floating charge was created over land on the same day; and
 - the floating charge prohibiting creation of any subsequent fixed charge,
 - it was held that the fixed charge became effective only after registration with the Registrar of documents which was naturally subsequent to the floating charge, the floating charge had priority over it.
 - See *AIB Finance Ltd. v. Bank of Scotland*, (1995) 1 BCLC 185 (CS).

- 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.

See *English & Scottish Mercantile Investment Trust.Ltd. v. Brunton*, (1892) 2 QB 700.

- Constructive notice of floating charge is not a constructive notice of the restrictive clause *Wilson v. Kelland*, (1910) 2 Ch 306, unless there is proof of wilful blindness to the existence of the earlier charge and its restrictive clauses.

General Rules of Priority- Registration

- Registered charges depend for their validity on registration but they take priority from the date of the creation though constructive notice arises from the date of registration.
 - May be displaced by an estoppel or some equitable consideration or when the latter charge is a legal charge without actual or constructive notice or has a better equity.
- However, the right which the plaintiff has to enforce its mortgage against the property of the company is dependent
 - *not only on upon the registration but also on the terms of the mortgage itself and as per the terms the right which they had, to enforce against the refinery was a second charge only.*
 - As such, a second charge does not become a first charge merely because of prior registration. *Ram Narain & Ors. v. Radha Kishen Motilal Chamaria*, AIR 1930 PC 66.
- Charge created by the company in favour of the second creditor *and registered with the Registrar*, is valid and an exclusive charge in respect of immovable properties of the company and gets priority and prevails over the *unregistered charge* in favour of the first creditor.
 - *Escorts Finance Ltd. v. Fidelity Industries Ltd. and Anr.*, 2003 117 Comp Cas 282 Mad.

First Charge vs. Second Charge- *Treatment of inter-se classifications*

- Meaning
 - First charge holder has the primary security interest over an asset;
 - Second charge holder over the remaining asset (after settling claim of the First charge holder)
- Rights are sequential; not proportional
- Section 53 (2) of the Code states that

*Any contractual arrangements between recipients with equal ranking, if **disrupting the order of priority** shall be disregarded by the liquidator*
- Can first and second charge arrangements, and other inter-se classifications be ignored?
 - liquidation proceedings must ensure parity and proportionality;
 - idea of proportionality is only as far as claims of similar ranking are concerned-
 - First charge holders and second charge holders are **not** similarly ranked
 - Hence, contractual arrangements based on first and second charge interest must remain and distribution be done accordingly

Where, first charge holder does not relinquish interest, will first/ second ranking remain? –

YES. See *ICICI Bank v. Sidco Leathers Ltd.*, (2006) 10 SCC 452

Registered vs. Unregistered Claim

Whether registered with RoC under Companies Act, 2013	Whether registered with CERSAI under the SARFAESI Act, 2002	Whether registered with Information Utility under the Insolvency Code	Outcome
Yes	Yes	Yes	All rights protected under the Companies Act, Insolvency Code, SARFAESI Act
Yes	Yes	No	All rights protected under the Companies Act, Insolvency Code, SARFAESI Act, though mandatory to furnish financial information to IU
Yes	No	No	Rights protected under Companies Act and Insolvency Act, not under SARFAESI.
No	Yes	Yes	Cannot claim secured status under the Companies Act, Insolvency Code. Can enforce security under SARFAESI.
No	No	Yes	Cannot claim secured status. Cannot enforce security.
No	No	No	Same as above. Loses on secured status

Fixed vs. Floating Charges- Illustration

[Assumption: There is no stipulation restricting flexibility of floating charges]

Example 1:

- Creditor A
 - Debt Rs. 300 Crores
 - Fixed charge on assets, which realised Rs. 100 crores
 - Pari passu floating charge on assets, which could realise only Rs. 10 crores
- Creditor B
 - Debt Rs. 20 crore
 - Pari passu floating charge on the same assets as above
 - Second charge on fixed assets as above

Outcome: Creditor A will be repaid Rs. 100 crores from assets subject to fixed charge. Out of realisations of Rs. 10 crores from assets subject to floating charge, Rs. 5 crores each will be paid to A and B.

Example 2:

- Creditor A
 - Debt Rs. 300 Crores
 - Fixed charge on assets, which realised Rs. 200 crores
 - Second charge by way of floating charge on assets, which could realise Rs. 100 crores
- Creditor B
 - Debt Rs. 20 crore
 - First charge by way of floating charge on the same assets as above
 - Second charge on fixed assets as above

Outcome: Creditor B will get Rs. 20 Crores, and Creditor A will get Rs. 200 crores from assets subject to fixed charge, and Rs. 80 crores from assets subject to floating charge.