

Does the IBC recognize inter-se ranking of charges among financial creditors for the distribution of sale proceeds during liquidation?

In a judgement of the Hyderabad bench of the National Company Law Tribunal (“NCLT”) in the cases of *PTC India Financial Services Ltd. v. Vikas Prakash Gupta & Ors.*¹ and *Indo Unique Flame Limited v. Vikas Prakash Gupta & Anr.*² the NCLT held that the waterfall mechanism under Section 53(1) of the Insolvency and Bankruptcy Code, 2016 (“IBC”) does not recognise any inter-se ranking of charges among the financial creditors of a corporate debtor (which has been agreed upon prior to the initiation of its corporate insolvency resolution process (“CIRP”)) for the purpose of distribution of the proceeds during liquidation.

Brief Facts

1. Varam Bioenergy Private Limited (“**Corporate Debtor**”) had availed financial assistance from the State Bank of India and the State Bank of Hyderabad (collectively the “**First Ranking Lenders**”) creating a primary security interest on its assets in favour of the First Ranking Lenders. The Corporate Debtor was obligated to obtain prior written permission of the First Ranking Lenders to avail any other credit facility.
2. PTC India Financial Services Limited (“**PTC**”) and Indo Unique Flame Limited (“**Indo Unique**”) (collectively the “**Applicants**”) also provided facilities to the Corporate Debtor. The Applicants were granted a second charge on the assets of the Corporate Debtor, and the same was created after obtaining a no-objection certificate from the First Ranking Lenders.
3. Upon initiation of the liquidation process of the Corporate Debtor, the First Ranking Lenders filed their claim with the liquidator out of which the claim of INR 62,70,40,457 (Indian Rupees sixty two crore seventy lakh forty thousand four hundred fifty seven only) was admitted. Further, PTC and Indo Unique filed their claims of INR 43,46,78,538 (Indian Rupees forty three crore forty six lakh seventy eight thousand five hundred thirty eight only) and INR 28,22,26,049 (Indian Rupees twenty eight crore twenty two lakh twenty six thousand forty nine only) respectively with the liquidator.
4. During the liquidation process, the liquidator sold the assets of the Corporate Debtor and realized an amount of INR 7,85,00,000 (Indian Rupees seven crore eighty five lakh only) as sale proceeds.
5. The liquidator convened a meeting of the stakeholders consultation committee of the Corporate Debtor and, based on a legal opinion, decided to distribute the sale proceeds as per the inter-se ranking of charges held by the secured financial creditors of the Corporate Debtor. The same was to be done after taking an undertaking from the First

¹ IA No. 1341 of 2022 in CP (IB) No. 377/7/HDB/2018.

² IA No. 254 of 2023 in CP (IB) No. 377/7/HDB/2018

Ranking Lenders that they will refund any excess amount distributed to them by the liquidator as may be determined by any court or authority.

6. Accordingly, the liquidator paid the full amount of the sale proceeds to the First Ranking Lenders and no amount was made available to other secured creditors of the Corporate Debtor including the Applicants.
7. The Applicants were aggrieved by the manner in which the liquidator distributed the sale proceeds. Hence, they filed applications under Section 60(5) of IBC requesting the NCLT to:
 - (a) declare the decision of the liquidator as null and void;
 - (b) direct the First Ranking Lenders to refund the excess amounts distributed to them with interest; and
 - (c) direct the liquidator to re-distribute the sale proceeds equally among all the secured creditors of the Corporate Debtor as per Section 53 of IBC.

Issue

The NCLT was faced with the issue of whether the inter-se ranking of charges among the secured financial creditors of the Corporate Debtor that existed before the initiation of its CIRP must be recognized while distributing the sale proceeds under Section 53(1) of IBC during its liquidation.

Key Arguments by the Parties

Contentions of the Applicants:

1. The Applicants (who were second ranking charge holders) contended that in distributing the sale proceeds only to the First Ranking Lenders on the basis of the legal opinion, the liquidator has acted contrary to Section 53 of IBC as well as the regulations underlying IBC.
2. They pleaded that Section 53(1) of IBC does not stipulate any inter-se ranking amongst the secured financial creditors of a corporate debtor.
3. Further, the Applicants highlighted that in the matter of *Oriental Bank of Commerce v. Anil Anchalia and Anr.*³ (“**Oriental Bank Case**”), the National Company Law Appellate Tribunal (“**NCLAT**”) relied on the judgment of the Supreme Court in *India Resurgence ARC Private Limited v. Amit Metaliks Limited & Anr.*⁴ (“**Amit Metaliks Case**”) and held that upon relinquishment of their security interest, the secured creditors of a corporate debtor cannot exclusively claim any amount realized from the secured assets and will be governed by the waterfall mechanism as provided under Section 53 of IBC.
4. Therefore, the Applicants submitted that the distribution of sale proceeds by the liquidator is liable to be set aside and the excess amount paid to the First Ranking Lenders must be returned by them to the liquidator.

Contentions of the First Ranking Lenders and the Liquidator:

1. The First Ranking Lenders and the liquidator contended that Section 53 of IBC protects the inter-se ranking amongst the secured creditors of a corporate debtor. Hence, the first charge holders of the Corporate Debtor cannot be equated with its second charge holders.
2. They highlighted that the same reasoning has been adopted in the judgment of the Supreme Court in the matter of *ICICI Bank Limited v. SIDCO Leathers Limited*⁵ (“**SIDCO Case**”). In the SIDCO Case, while interpreting Sections 529 and 529(A) of the Companies Act, 1956, it was held that the claims of first charge holders must prevail over the

³ CA (AT) (Ins.) No.547 of 2022.

⁴ 2021 SCC OnLine SC 409

⁵ 2006 SCC OnLine SC 498

claims of second charge holders in a case where the debts due to both the charge holders are to be realized from the assets of the mortgagor.

3. The respondents also contested that their actions are consistent with the findings of the Insolvency Law Committee ('ILC') in its report of 2018.⁶
4. Further, they pleaded that in light of Section 48 of the Transfer of Property Act, 1882 and the maxim "*Qui prior est tempore potior est jure*" which means "who is prior in time is better in law", in case of an inter-se priority of charge on a particular asset of a debtor, the amount so realized from the sale of such asset must first be paid to the first charge holder towards satisfaction of its debt and only the balance amount, if any, must be paid to the second charge holder.
5. They also submitted that the Oriental Bank Case has been challenged before the Supreme Court and is pending for adjudication, and hence, cannot be relied upon.

Analysis and Findings of the NCLT

After considering the submissions of the parties, the NCLT observed as follows:

1. Section 53(1) of IBC does not recognize any inter-se ranking of charges among the financial creditors of a corporate debtor, as existing before the initiation of its CIRP, for the distribution of sale proceeds during liquidation;
2. Section 53(2) of IBC clarifies that the liquidator of a corporate debtor must disregard any contractual arrangement between the recipients of the sale proceeds with equal ranking which disrupts the order of priority provided under 53(1) of IBC; and
3. Section 53(1) of IBC very clearly defines the classes and the order of the waterfall mechanism and does not have scope for adding any other sub-classes under the provision.

Consequently, the NCLT directed the First Ranking Lenders to refund the amount distributed to them and the liquidator to re-calculate and redistribute the sale proceeds to all the secured financial creditors of the Corporate Debtor by putting them on the same pedestal irrespective of the priority of their charge on the assets of the Corporate Debtor.

Conclusion

The rights of secured creditors with different ranking have been a subject matter of debate and deliberation in many judgements. Issues in relation to treatment of secured creditors with different ranking and different value of security interest have been discussed in the ILC Reports of 2018 and 2020. It would be interesting to see how the appellate tribunal will interpret this issue in the appeal filed by the aggrieved parties. The outcome of the appeal will play an important role in how lenders structure their security in a pre-insolvency scenario.

⁶ In the 2018 report, the ILC had observed as follows: "*However, 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). The Committee felt that there was no requirement for an amendment to the Code required since a plain reading of section 53 was sufficient to establish that valid inter-creditor and subordination provisions are required to be respected in the liquidation waterfall under section 53 of the Code.*"

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