Section 53 of IBC, 2016: Camouflage Key Player in the Revival Process

Practical experiences reveal that the Section 30 (2) of the IBC has apparently come in the way of waterfall mechanism provided under Section 53. For instance, if a creditor with minor voting share votes against the Resolution Plan but the Plan is finally accepted by the CoC, the dissenting creditor may get more money than the top creditor. This demoralizes the efforts of the assenting creditors particularly the lead creditor in resolving the Corporate Debtor. In this article, the author through various illustrations has highlighted the tricky nature of the Section 30 (2) of the IBC and has suggested a feasible solution to address the issue through amendment either in Section 30(2)(b) or 53(1)(b)(ii) of the IBC.

Read on to know more…

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1. Introduction

The core theme on which the entire Insolvency and Bankruptcy Code, 2016 (IBC or Code) is built upon is revival of the Corporate Debtor. It has been five years since the Code was implemented and now it has crossed its infancy. Though the Code has been and is being witnessing the fruits of its implementation process, still there are cases where the Corporate Debtor goes into Liquidation in whenever and wherever the resolution fails.

Nevertheless, the Code read with its Regulations has been framed in such an efficient way that even during Liquidation there could be sale of the Corporate Debtor as a Going Concern and hence the chances of revival of the Corporate Debtor during Liquidation cannot be ruled out. If in case the Corporate Debtor fails to taste the fruits of being sold as a Going Concern during liquidation, then steps in the last leg of the Liquidation process being the sale of the assets where a greater emphasis is placed on the realizations and distribution of the proceeds. It is at this juncture comes into role, the key player Section 53 of the IBC.

2. Glimpses of Section 53 of IBC

Section 53 lays down the waterfall mechanism in accordance with which the proceeds from the sale of the Liquidation assets shall be distributed in the order of priority stipulated therein. The provision could be quoted as follows:

".....the proceeds from the sale of the liquidation assets shall be distributed in the following order of priority and within

such period as may be specified, namely: -

(a) the insolvency resolution process costs and the liquidation costs paid in full;

(b) the following debts which shall rank equally between and among the following:

(i) workmen's dues for the period of twenty-four months preceding the liquidation commencement date; and

(ii) debts owed to a secured creditor in the event such secured creditor has relinquished security in the manner set out in section 52;

(h) equity shareholders or partners, as the case may be"

2.1. Interpretation of the Section 53

On a close interpretation of Section 53 on a real time basis in the case of most of the Corporate Debtors under Liquidation, it is predominantly the Secured Financial Creditors who stand to gain something from the realizations while all other creditors following them are left high and dry. Even here it is to be noted that Secured Financial Creditors (SFCs) gain only 'something', which clearly indicates towards the fact that even the SFCs are not able to recover their dues to the full extent, the reason being the asset value of the Corporate Debtor being abysmally low as compared to the dues owed by it, thereby resulting in insufficient realizations.

Thus, in Liquidation, it is Section 53, which plays a pivotal role, since all the stakeholders being Financial Creditors, Operational Creditors, and other stakeholders who are entitled to distribution of proceeds under section 53 in the Company would be interested in knowing how much of their debts are capable of being saved from turning into

bad debts.

3. Role of Section 53 during the Corporate Insolvency Resolution Process

However, it is interesting to note that even in the event of the prime revival process, i.e., Corporate Insolvency Resolution Process (CIRP), Section 53 plays a key role rather implicitly. In fact, it takes an influential role in deciding the fate of the Corporate Debtor.

Through this small illustration, let us probe to understand the Camouflage nature of Section 53:

Facts:

- Company XYZ Limited has been admitted into the CIRP.

Table 1: Liquidation Value of the assets of the Corporate Debtor

S. No.	Asset Description	Liquidation Value (₹ in Crores)
1	Fixed Assets	250
2	Current Assets	50
	Total	**300**

Table 2: Details of the Creditors of the Company along with their claim amounts and security interest:

S. No.	Name of the Creditor*	Claim admitted (₹ in Crores)	Voting share % in CoC	Security Interests
1	A	1000	50%	1st Charge on Fixed Assets. 2nd Charge on Current Assets.
2	B	600	30%	2nd Charge on Fixed Assets. 1st Charge on Current Assets
3	C	400	20%	2nd Charge on Current assets.
	Total	**2000**	**100%**	

***Note:**

(a) All Creditors are Secured Financial Creditors.
(b) It is assumed that there are no other creditors barring the creditors mentioned in Table 2.

3.1. Company PQR Ltd has submitted a Resolution Plan for the Corporate Debtor wherein an amount of ₹ 200 Crores is allocated to the SFCs which shall be divided amongst the SFCs in the ratio of their voting shares in the CoC. The total amount payable to SFCs shall remain constant and shall not be subject to any further increase.

Table 3: Allocation of the Resolution Plan Value to the SFCs as per the terms provided in the Resolution Plan

S. No.	Name of the Creditor	Amount allocated (₹ in Crores)	% of amount allocated.
1	A	100	50%
2	B	60	30%
3	C	40	20%
	Total	**200**	**100%**

4. Distribution to Financial Creditors in the event of assent/dissent by the SFCs.

Scenario 1:

Table 4: Distribution to SFCs in case all the 3 Creditors being A, B and C vote in favour of the Resolution Plan

S. No.	Name of the Creditor	Actual Amount provided in the Resolution Plan (₹ in Crores)	Amount distributed after the approval of the Resolution Plan (₹ in Crores)	Gain (+)/ Loss (-) to Creditors
1	A	100	100	—
2	B	60	60	—
3	C	40	40	—
	Total	**200**	**200**	—

Scenario 2:

Distribution to SFCs in case all the 3 Creditors being A, B and C vote against the Resolution Plan: In that case, since the Resolution Plan failed to secure the 66% votes in favour of it, the Resolution Plan stands rejected and hence there is no question of distribution under the Resolution Plan.

Scenario 3:

Distribution to SFCs in case Creditor A votes in favour of the Resolution Plan and either B or C vote against the Resolution Plan

Table 5A: A and B assent, C dissents

S. No.	Name of the Creditor	Actual Amount provided in the Resolution Plan (₹ in Crores)	Amount distributed after the approval of the Resolution Plan (₹ in Crores)	Gain (+)/ Loss (-) to Creditors
1	A	100	87.5	-12.5
2	B	60	52.5	-7.5
3	C*	40	60.0	+20
	Total	**200**	**200.0**	

Table 5B: A and C assent, B dissents

S. No.	Name of the Creditor	Actual Amount provided in the Resolution Plan (₹ in Crores)	Amount distributed after the approval of the Resolution Plan (₹ in Crores)	Gain (+)/ Loss (-) to Creditors
1	A	100	78.60	-21.40
2	B*	60	90.00	+ 30
3	C	40	31.40	- 8.60
	Total	**200**	200.00	

***Note:**

(a) As per Section 30(2) of the IBC, 2016

"The resolution professional shall examine each resolution plan received by him to confirm that each resolution plan ……provides for the payment of debts of financial creditors, who do not vote in favour of the resolution plan, in such manner as may be specified by the Board, which shall not be less than the amount to be paid to such creditors in accordance with sub-section (1) of section 53 in the event of a liquidation of the corporate debtor".

The phrase "in the event of a liquidation" gains prominence at this juncture.

Thus, in the event of Liquidation B and C will get the following amounts:

B → ₹ 300 Crores (Liquidation Value) * 30% (Voting share) = ₹ 90 Crores.

C → ₹ 300 Crores (Liquidation Value) * 20% (Voting share) = ₹ 60 Crores.

Since the amount payable to the SFCs has already been allocated at ₹ 200 Crores, the excess payments made to dissenting Financial Creditor shall be adjusted against the amounts payable to the assenting creditors proportionately.

(b) The main conundrum arises only in "Scenario 3"

- As per Section 30(4) of IBC, the committee of creditors may approve a resolution plan by a vote of not less than sixty-six percent.
- Since A being a 50% majority shareholding Creditor, the consent of A is indispensable for the approval of the Resolution Plan by the CoC.
- However, either 'B' or 'C' can take a different call rather than approving a Resolution Plan, since the approval of any of them result in voting by requisite majority which would result in successful approval of the Resolution Plan.

4.1. Questions

In the event the Resolution Plan gets approved in accordance with Table 5A or Table 5B, then there arises a need to address the following questions:

(a) **Would it be right for a Creditor to realize more from a Resolution Plan to which it has dissented? While the Creditor with the highest voting share who has voted in favor of the Resolution Plan gets a lower amount?**

Explanation:

Let us take the case of Table 5B:-

Creditor A has a voting share of 50% and receives ₹ 78.60 Crores, whereas Creditor B who has a voting share of 30% receives ₹ 90 Crores.

(b) **If all creditors conceive the same notion that they can realize more by dissenting, then all the votes will be cast against the Resolution Plan, in that case will not the entire revival of Corporate Debtor turn futile?**

Explanation:

If both Creditor B and Creditor C decide to dissent the Resolution Plan since their realization would be more in case of dissenting rather than assent, then the Resolution Plan will lose 50% of the votes which eventually results in rejection of the Resolution Plan by the CoC.

> **"Even here it is to be noted that Secured Financial Creditors (SFCs) gain only 'something', which clearly indicates towards the fact that even the SFCs are not able to recover their dues to the full extent."**

(c) **In order to avoid this conundrum and ensure a fair play amongst the Creditors, should the amounts allocated to the stakeholders under the Resolution Plans have a value higher than the Liquidation Value?**

Explanation:

Most of the companies falling into the hands of CIRP have been subject to lack of proper maintenance and irregular operations by the company management prior to the

commencement of CIRP. In few cases the companies have even been shut down for several years back the line prior to CIRP Commencement. Thus, the Prospective Resolution Applicants willing to acquire the Corporate Debtor will have to incur significant spending on refurbishment and other aspects. Taking these capital costs into consideration, it may not be feasible in all the cases for the Resolution Plan to provide a value to the stakeholders which is higher than the Liquidation Value of the Corporate Debtor. This may serve as an impediment in successful revival of the Corporate Debtor and would defeat the entire purpose of the Code.

"However, the main reason behind this conundrum is that the Section 53 neither establishes any distinction nor provides for further bifurcation amongst the Secured Financial Creditors on the basis of charge holdings extent."

5. Root Cause of the Conundrum and its Impact

(a) With reference to the above illustration, the major cause of concern is that in the CIRP, merely by voting in favour of the Resolution Plan and playing a pivotal role in the Resolution Plan implementation process, Creditor "A" suffers a loss in either case where "B" or "C" dissents the Resolution Plan and despite the same the Resolution Plan gets approved with the requisite majority.

(b) However, in the contrary, in the event of Liquidation, had the First Charge holder of the Fixed Assets being Creditor "A" not relinquished their security interests, then they would have enjoyed the priority in the realization proceeds and would have been on a better footing than in case of approval of the Resolution Plan. If the company gets into Liquidation, then it is also noteworthy that the realization of the Liquidation Value is highly questionable, because once the company gets into the hands of Liquidation then it would become a prey to rock bottom rates and uplifting it to a reasonable price may involve lot of time and efforts. Thus, the irony here is that Creditor A will suffer a loss for being a key factor in the revival of the company – the prima facie intention of the IBC Code, 2016 in case the Resolution Plan gets approved, and he will also suffer a loss in case the Company gets into Liquidation. Thus, Creditor A will suffer a loss either way.

(c) In common practice, the claim of first charge holder shall prevail over the claim of the second charge holder and where debts due to both the first charge holder and the second charge holder are to be realised from the property belonging to the mortgager, the first charge holder will have to be repaid first.

(d) However, the main reason behind this conundrum is that the Section 53 neither establishes any distinction nor provides for further bifurcation amongst the Secured Financial Creditors on the basis of charge holdings. All SFCs who have relinquished their security interests are treated as one class irrespective of the charge holdings and hence no differential treatment is attributed to any individual creditor within the same class.

6. Contextual References: Followings are the recent case laws related to this issue-

(a) In the matter of *Technology Development Board Vs Mr. Anil Goel and 2 others* (Company Appeal (AT) (Insolvency) No.731 of 2020), the issue was raised before NCLAT on whether "whether there can be no sub-classification inter-se the Secured Creditors in the distribution mechanism adopted in a Resolution Plan of the Corporate Debtor as according priority to the first charge holder would leave nothing to satisfy the claim of Appellant who too is a Secured Creditor". The NCLAT in its order[1] on April 05, 2021, held as follows:

"The word "fair" may be interpreted in wide ways by different parties. One treatment which may be considered fair to one creditor may not be so with respect to another creditor."

(i) The impugned order holding that the inter-se priorities amongst the Secured Creditors will remain valid and prevail in distribution of assets in liquidation cannot be sustained.

[1] NCLAT, Technology Development Board Vs Mr. Anil Goel and 2 others, (Company Appeal (AT) (Insolvency) No.731 of 2020), April 05, 2021.

(ii) We allow the same with direction to the Liquidator to treat the Secured Creditors relinquishing the security interest as one class ranking equally for distribution of assets under Section 53(1)(b)(ii) of IBC Code and distribute the proceeds in accordance therewith".

However, the Supreme Court vide an order on June 29, 2021, has imposed a stay on the operation of the above judgement of the NCLAT.

7. Proposed Feasible Solution

Though the explanation 1 to Section 30(2) of the Code, states that the provisions of this clause shall be fair and equitable to such creditors, it still remains a grey area as to what can be construed as "fair and equitable". The word "fair" may be interpreted in wide ways by different parties. One treatment which may be considered fair to one creditor may not be so with respect to another creditor. Subsequently, there may arise disagreements between the Creditors while trying to identify as to what distribution constitutes fairness. Thus, the word "Fair" here will remain subjective unless an explicit meaning is being assigned to it under the Code and thus in order to remove the iota of doubt, the following amendments may be considered in Section 30(2)(b) or Section 53(1)(b)(ii) of the IBC.

7.1. Amendment of Section 30(2)(b): Section 30(2)(b) of the IBC should be amended as follows:

".....provides for the payment of debts of financial creditors, who do not vote in favour of the resolution plan, in such manner as may be specified by the Board, *"which shall be the lower of the amount to be paid to such creditors in accordance with sub-section (1) of section 53 in the event of a liquidation of the corporate debtor or the amount that would have been paid to such creditors, if the amount to be distributed under the resolution plan had been distributed in accordance with the order of priority in sub-section (1) of section 53."*

Or

7.2. Proposed Amendment in Section 53(1)(b)(ii): This subsection should be amended as ... debts owed to a secured creditor in the event such secured creditor has relinquished security in the manner set out in section 52 "provided there shall be an inter se ranking of the Secured Creditors on the basis of the Charge holdings".

8. Conclusion

With the advent of IBC, 2016 numerous companies have been saved from becoming extinct. Since the entire Code being predominantly a creditor driven process where the decision to resolve or liquidate the Corporate Debtor rests on a collective body termed as CoC. It would be in the best interests of all the stakeholders as well as the Corporate Debtor if their interests are balanced in a fair manner without giving rise to any prejudicial benefits to one creditor over the other. In the light of the above, it's high time to amend the sections of the IBC. The suggested amendments will ensure a fair play among the creditors and facilitate faster resolution of the corporate debtor.

[2] Supreme Court, Technology Development Board Vs Mr. Anil Goel and 2 others, Civil Appeal Diary No. 11060/2021, (Company Appeal (AT) (Insolvency) No.731 of 2020), June 20, 2021.