

# Beyond the Waterfall: A Critical Review of Section 53 of the IBC in Global Context



## Biswadev Dash

The author is an Insolvency Professional (IP) member of IIPI.  
He can be reached at  
biswadev.dash@gmail.com

*The Insolvency and Bankruptcy Code (IBC), 2016 marked a major shift in India's insolvency regime, creating a consolidated framework to resolve distressed assets by drawing on existing laws and global best practices. Yet, ambiguities persist, particularly in Section 53, which outlines the distribution priority of liquidation proceeds commonly referred to as 'waterfall mechanism.' This article highlights the absence of clarity on inter se prioritisation among secured creditors with differential charges and the uncertain enforceability of contractual subordination agreements. It also critiques the unequal treatment of financial and operational creditors. Through a comparative study of insolvency regimes in the United States of America (USA), the United Kingdom, and Singapore, the article identifies gaps in the Indian insolvency framework and recommends some crucial reforms. **Read on to know more...***

## 1. Introduction

The Insolvency and Bankruptcy Code, 2016 (IBC/Code) marked a revolutionary step in India's approach to insolvency resolution. Consolidating scattered laws and expediting the resolution process, the Code aimed at improving the ease of doing business and strengthening creditor rights. One of the most critical components of the Code is Section 53, which lays down the waterfall mechanism for the distribution of assets upon liquidation. However, its rigidity, lack of recognition for contractual arrangements such as inter-creditor agreements, and ambiguous treatment of creditor classes raise several concerns. The absence of explicit recognition for inter se prioritization among

secured creditors, especially those with differential charges, is a significant lacuna, particularly given the sophisticated structures prevalent in modern finance. This article examines these issues, compares Section 53 with global insolvency frameworks, and proposes reforms to enhance its efficacy.

## 2. Statement of Problem

Section 53 of the IBC lays down the waterfall mechanism for the distribution of proceeds during liquidation. While it attempts to provide clarity and order to the priority of claims, several key issues have arisen due to ambiguities in inter se prioritization, i.e., the relative positioning of different classes of creditors within the

same tier or across adjacent tiers. The waterfall is structured as follows:

- (a) Insolvency resolution process costs and liquidation costs
- (b) Secured creditors (who relinquish their security) and workmen's dues
- (c) Wages and unpaid dues to employees (other than workmen)
- (d) Financial debts owed to unsecured creditors
- (e) Government dues and remaining secured creditors (who enforced their security outside the liquidation estate)
- (f) Any remaining debts and dues
- (g) Preference shareholders
- (h) Equity shareholders or partners

While the structure appears straightforward, its implementation has triggered legal and practical complexities. The clause failed to accommodate contractual arrangements among creditors and disregards contractual autonomy, a principle well-enshrined in private law. The principal problems stemming from this ambiguity include:

### 2.1. Unclear Ranking within Broad Creditor Categories:

Section 53 groups creditors into broad categories (e.g., secured creditors, workmen's dues, unsecured creditors), but fails to clarify the inter se prioritization within these categories. For instance, secured creditors holding differential charges, such as first and second charge holders, are treated equally under the IBC, disregarding contractual hierarchies established in financing agreements. This equal treatment overlooks the commercial expectations of creditors who negotiated specific charge rankings, leading to perceived inequity and discouraging complex financing structures.

### 2.2. Conflict Between Secured Creditors and Workmen's Dues:

Secured creditors who relinquish their security interest rank *pari passu* with workmen's dues for the preceding 24 months under Section 53(1)(b). In cases of insufficient assets, Regulation 21A of the IBBI Liquidation Process Regulations, 2016, mandates that secured creditors who enforce their security independently must contribute to liquidation costs and workmen's dues as they would have shared had they relinquished their security, within 90 days from the liquidation commencement date. However, the IBC does not provide clear guidance on proportional distribution when assets are inadequate, creating practical challenges and potential disputes between these creditor classes.

### 2.3. Priority of Government Dues vs. Operational Creditors:

Despite the legislative intent to de-prioritize government dues, practical interpretation often blurs their positioning relative to operational creditors. Courts have occasionally adopted inconsistent reasoning, contributing to uncertainty.

### 2.4. Absence of Clarity on Inter-Creditor Agreements:

The Code does not explicitly address the enforceability of contractual arrangements, such as inter-creditor agreements or subordination agreements, which establish relative priorities among creditors (e.g., senior vs. subordinated debt or charge rankings in syndicated loans or bond issuances). This silence leads to confusion when parties seek to enforce such agreements, undermining contractual autonomy and increasing litigation risk.

**The IBC does not provide clear guidance on proportional distribution when assets are inadequate, creating practical challenges and potential disputes.**

### 2.5. Judicial Inconsistency and Delays:

The lack of statutory clarity has led to increased judicial interpretation, resulting in inconsistent rulings by tribunals and courts. This not only causes delays in resolution but also undermines the predictability and efficiency that the IBC aims to promote.

### 2.6. Discouragement of Credit and Investment:

Investors and financial institutions rely on predictability in insolvency outcomes. The uncertainties around inter se prioritization, particularly for secured creditors with differential charges, discourage both domestic and foreign creditors from extending credit, especially unsecured or subordinated debt.

### 2.7. Comparative Deficiency:

In comparison to insolvency regimes in jurisdictions such as the United States (under Chapter 7), the United Kingdom (under the Insolvency Act), and Singapore, the IBC lacks a detailed, nuanced approach to claim prioritization, making it less robust in handling complex creditor hierarchies.

## 3. Literature Review

The Indian Insolvency and Bankruptcy Code (2016) has been extensively discussed in academic and policy-oriented literature since its enactment. Section 53, which prescribes the distribution waterfall during liquidation, has drawn significant scholarly attention for its perceived vagueness and structural rigidity in the prioritization of claims.

1. Shubho Roy et al., *India's Insolvency Code: A Brief Critique*, National Law School Journal, 2018.

2. Ravi Rajan, IBC and the Challenge of Prioritization, *Journal of Corporate Law & Policy*, 2020.

### 3.1. Academic Commentary on the Waterfall Mechanism:

Several scholars have critiqued the lack of specificity in Section 53 regarding inter se prioritization. *Shubho Roy and others<sup>1</sup> (2018)* argue that the Code inadequately distinguishes between sub-classes within broader creditor groups, such as senior versus subordinated debt or differential charges among secured creditors. This leads to disproportionate outcomes and potential disputes during liquidation. *Ravi Rajan<sup>2</sup> (2020)* notes that the binary approach adopted by the IBC—secured vs. unsecured, operational vs. financial—does not reflect the complexity of modern debt instruments and contractual arrangements between parties. The resulting uniformity often fails to achieve equity among creditors of similar standing.

### 3.2. Policy Reports and Institutional Analysis:

Reports by the Insolvency Law Committee (ILC), particularly the 2020 and 2022 iterations, have acknowledged the problem of inadequate clarity in Section 53 but stopped short of recommending specific statutory amendments. The ILC has instead encouraged reliance on judicial precedents and the adjudicatory process, which has led to inconsistency and legal uncertainty. The Vidhi Centre for Legal Policy (2019) has recommended that India incorporate a more layered priority system, akin to the U.S. Bankruptcy Code, which allows for detailed classification and differential treatment within creditor groups. Their research underscores that India's current framework could deter credit flows due to unclear payout expectations.

### 3.3. Judicial Interpretation and Its Limitations:

Case law analysis reveals a lack of uniformity in interpreting the relative rights of claimants. In *SBI v. Anuj Bajpai* (2019) and *Punjab National Bank (PNB) v. Kiran Shah* (2021), the National Company Law Appellate Tribunal (NCLAT) took diverging positions on the enforceability of inter-creditor agreements and the rights of dissenting financial creditors. Legal scholars like **Anirudh Burman<sup>3</sup>** (Brookings India, 2021) argue that the judiciary's role in filling legislative gaps has led to an ad hoc evolution of the law, further complicating the insolvency landscape and undermining predictability in creditor recoveries.

### 3.4. International Comparative Literature:

Comparative legal scholarship frequently highlights that India's approach is far less nuanced than jurisdictions with mature insolvency regimes. For example, in the U.S., Chapter 7 allows detailed claim prioritization and respects contractual subordination, creating a more creditor-sensitive system. Studies by UNCITRAL and the World Bank (2020) also suggest that a good insolvency regime should balance certainty with flexibility—something India's rigid Section 53 fails to achieve.

## 4. Comparative Analysis

A comparative examination of insolvency frameworks across jurisdictions reveals that India's Section 53, while a step forward in codifying creditor priorities, lacks the granularity, adaptability, and contractual respect evident in more developed insolvency regimes. This section assesses key differences with selected jurisdictions—primarily the United States, the United Kingdom, and Singapore—to highlight the structural limitations of India's liquidation waterfall.

### 4.1. United States of America (USA): Chapter 7 of the U.S. Bankruptcy Code

The U.S. system under Chapter 7, which governs liquidation, provides a more sophisticated approach to creditor prioritization compared to India's IBC:

- (a) **Detailed Priority Structure:** Chapter 7 under Section 507 classifies claims into several tiers (e.g., secured creditors, administrative expenses, wage claims, tax claims, unsecured creditors). Secured creditors are paid up to the value of their collateral, with any surplus distributed to priority claimants (e.g., administrative expenses, followed by wage claims). In asset-deficient cases, workmen and employees may receive nothing, unlike India's prioritization of workmen's dues under Section 53(1)(b).
- (b) **Respect for Contractual Subordination:** Under Section 510(a), contractual subordination agreements are enforceable,

**In *SBI v. Anuj Bajpai* (2019) and *PNB v. Kiran Shah* (2021), the NCLAT took diverging positions on the enforceability of inter-creditor agreements and the rights of dissenting financial creditors.**

allowing creditors to negotiate claim rankings, including distinctions between first and second charge holders.

- (c) **Administrative Expenses:** Expenses such as filing fees, court fees, and trustee fees rank below secured creditors, contrasting with India's prioritization of insolvency resolution costs under Section 53(1)(a).
- (d) **Judicial Flexibility:** Courts have discretion to ensure equitable distribution, contrasting with the IBC's rigid waterfall.

**Implication for India:** Section 53 lacks the depth of classification and statutory enforceability of contractual subordination agreements, such as those distinguishing first and second charge holders. The absence of a mechanism akin to debtor-in-possession

3. Anirudh Burman, *Insolvency in India: The Bottlenecks*, Brookings India Working Paper, 2021.



(DIP) financing, available in Chapter 11, further limits incentives for rescue financing.

**4.2. United Kingdom's Insolvency Act, 1986:** The UK system provides a clearer and more established creditor hierarchy:

- (a) **Statutory Waterfall with Sub-Categories:** The Insolvency Act outlines a hierarchical structure similar to India's but includes a "prescribed part" for unsecured creditors, thereby protecting their interests even in asset-light liquidations.
- (b) **Preferential Claims:** Specific categories such as employee wages and certain tax dues are designated as "preferential" and prioritized above floating charge holders.
- (c) **Fixed vs. Floating Charge Distinction:** The UK recognizes and separates fixed and floating charges, with differential treatment, which is not clearly defined in the IBC.
- (d) **Company Voluntary Arrangements (CVAs):** These offer flexible, court-sanctioned compromises with creditors, where priority structures can be temporarily overridden with creditor approval.

**Implication for India:** The IBC does not differentiate between types of security interests with the same precision. Nor does it accommodate mechanisms like CVAs that allow negotiated departures from rigid liquidation rules.

#### 4.3. Singapore's Insolvency, Restructuring and Dissolution

**Act, 2018:** Singapore's modern insolvency regime borrows from both U.S. and UK models but tailors them to ensure creditor confidence and restructuring efficiency.

- (a) **Contractual Flexibility:** The Act explicitly permits subordination and allows class-based treatment of claims during schemes of arrangement.
- (b) **Super-Priority Financing:** Singapore provides statutory support for rescue financing, similar to the U.S. DIP model.
- (c) **Scheme of Arrangement:** Flexible restructuring schemes can override statutory order with majority creditor consent and court approval.
- (d) **Creditor Classes and Voting Rights:** The law mandates separation of creditors into classes for voting purposes, a distinction absent in India's liquidation context.

**Implication for India:** India's IBC provides no express statutory mechanism for prioritizing rescue credit or modifying class treatment during liquidation. Singapore's flexible class-based system contrasts sharply with the rigid uniformity of Section 53.

### 5. What an Existing Statutory Provision Impacts

While Section 53 of the IBC was a landmark development intended to bring predictability and fairness to the liquidation process, a closer analysis reveals several critical shortcomings—

both structural and interpretive—in the way the provision handles the prioritization of claims.

**5.1. Rigid and Oversimplified Waterfall:** Section 53 offers a linear and rigid hierarchy that treats all creditors within a class equally, disregarding the commercial realities of differently structured financial instruments, such as differential charges (e.g., first vs. second charge holders) among secured creditors. In most liquidation cases, assets are insufficient to settle claims beyond secured creditors and workmen's dues under Section 53(1)(b), halting the waterfall and exacerbating the impact of this rigidity on other creditor classes.

**5.2. Absence of Intra-Class Differentiation:** The IBC does not distinguish between:

- (a) Secured creditors with different types or priorities of collateral (e.g., first vs. second charge holders).
- (b) Senior and subordinated unsecured creditors.
- (c) Operational creditors with ongoing supply roles versus one-time service providers.

This absence of intra-class prioritization erodes the fairness and commercial logic of distributions, particularly in asset-scarce liquidations where secured creditors and workmen's dues dominate.

**The UK recognizes and separates fixed and floating charges, with differential treatment, which is not clearly defined in the IBC.**

**5.3. Weak Enforcement of Inter-Creditor Agreements:** Inter-creditor agreements and subordination agreements, which are critical in modern finance for establishing priorities (e.g., senior vs. subordinated debt or charge rankings in syndicated loans or bond issuances), lack consistent enforcement under the IBC. The absence of statutory backing creates legal ambiguity and increases litigation risk, undermining the commercial intent of such agreements.

**5.4. Judicial Activism filling Legislative Gaps:** In the absence of statutory clarity, Indian tribunals and courts have interpreted Section 53 on a case-by-case basis. While this has resolved individual disputes, it has led to legal uncertainty, forum shopping, and inconsistent jurisprudence, defeating the IBC's goal of providing a time-bound and predictable resolution framework.

**5.5. Disincentive to Lending and Rescue Finance:** The lack of clear statutory protection to rescue financiers, such as priority status for post-commencement financing, discourages lenders from supporting distressed entities. Additionally, the equal treatment of secured creditors with differential charges reduces

incentives for senior lending, particularly in complex financing structures, further exacerbating credit constraints in asset-deficient scenarios.

## 6. Recommendations

To make Section 53 more effective and aligned with international standards, a range of legislative, judicial, and policy reforms are recommended:

**6.1. Introduce Statutory Recognition of Contractual Subordination:** Amend Section 53 to recognize and enforce contractual subordination agreements, such as those in inter-creditor agreements or bond issuances, as is done in the U.S. under Section 510(a) of the Bankruptcy Code. This will honour creditors' intent and promote commercial certainty.

**The lack of clear statutory protection to rescue financiers, such as priority status for post-commencement financing, discourages lenders from supporting distressed entities.**

**6.2. Incorporate Intra-Class Prioritization Mechanisms:** Enable further classification within major creditor groups (e.g., first vs. second charge holders, senior vs. subordinated unsecured debt) based on contractual terms and commercial risk. This could be achieved by issuing regulations under Section 240 of the IBC to address the frequent asset insufficiency in liquidations, ensuring fairer distributions for secured creditors.

**6.3. Legislate for Super-Priority Rescue Finance:** Introduce provisions for priority repayment to rescue financiers, akin to DIP financing in the U.S. or rescue finance in Singapore and the UK, to incentivize turnaround capital, especially in asset-scarce scenarios.

**6.4. Clarify the Priority of Government Dues:** Explicitly demarcate the non-preferential nature of statutory dues in Section 53 to avoid litigation and judicial confusion, ensuring consistency with the legislative intent to de-prioritize government dues.

**6.5. Encourage the Use of Inter-Creditor Agreements:** Regulatory bodies such as the RBI and IBBI should promote

**As India aims to be a robust investment destination, reforming Section 53 is not merely desirable—it is imperative.**

standard inter-creditor frameworks that integrate seamlessly into insolvency proceedings, minimizing disputes during distribution and respecting charge priorities among secured creditors.

## 6.6. Adopt a Principles-Based Approach

Adopt a principles-based framework similar to UNCITRAL's Legislative Guide on Insolvency Law, providing guidance on distributions based on fairness, commercial reasonableness, and creditor expectations, particularly for secured creditors in asset-deficient cases.

## 7. Conclusion

Section 53 of the IBC marked an important milestone in streamlining the liquidation process and codifying the order of creditor payments. However, in its current form, the provision suffers from significant conceptual and operational weaknesses. Its rigid categorization, lack of recognition for intra-class distinctions (e.g., differential charges among secured creditors), and failure to enforce inter-creditor and subordination agreements contribute to legal ambiguity and economic inefficiency. In most liquidations, insufficient assets halt the waterfall at secured creditors and workmen's dues, exacerbating these issues.

Through a comparative lens, it is evident that mature insolvency jurisdictions have adopted more nuanced approaches to creditor prioritization, often emphasizing contractual freedom, class-based structuring, and incentives for rescue financing. India's current framework, while evolving, remains overly formalistic and ill-equipped to manage the complexities of modern debt structures. Addressing these deficiencies requires a combination of statutory reform, regulatory clarification, and jurisprudential consistency. Recognizing contractual subordination, introducing intra-class differentiation, and encouraging inter-creditor cooperation are necessary to make the IBC more commercially viable and globally competitive. As India aims to be a robust investment destination, reforming Section 53 is not merely desirable—it is imperative.

