A 'waterfall' for insolvency resolution

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The Insolvency and Bankruptcy Code, 2016, or IBC, has been a work in progress. The Ministry of Corporate Affairs has recently issued a discussion paper inviting comments on the changes it is proposing to further strengthen the IBC. One proposal that has attracted considerable attention is a formula-driven distribution of proceeds of a resolution plan to make it more equitable. It suggests proceeds up to the liquidation value will be distributed in the order of priority provided in the liquidation waterfall to secured and unsecured creditors. Any surplus over the liquidation value will be rateably distributed among creditors in the ratio of their unsatisfied claims.

Creditors strike different commercial bargains with the company. For example, say, three secured financial creditors, A, B, and C, have extended loans to a company. A has lent Rs 100 against security valued at Rs 10; B has lent Rs 100 against security valued at Rs 100; and C has lent Rs 100 against security valued at Rs 200. All three are secured creditors, having different levels of security interest: A is undersecured, B is fully secured and C is oversecured. When they enforce their contract against the company, they would at best get the value of the security.

The insolvency law honours pre-existing contractual relationships between debtors and creditors. Accordingly, secured creditors have priority claims on their respective security. In recognition of the amount of security, an undersecured creditor and a fully secured creditor have different entitlements in an insolvency proceeding. During the rehabilitation stage, the moratorium keeps the security intact, to be available to the secured creditor during liquidation. During the liquidation stage, the secured creditor can either take away the security and sell it on its own, or leave it with the liquidator to sell the security and receive the sale proceeds. That is why insolvency proceedings generally protect the secured claim to the extent of the value of security. Where the secured creditor’s claim exceeds the value of the security, the excess is treated as an unsecured claim.

This principle is firmly ingrained in the liquidation waterfall in the IBC. At the liquidation stage, a secured creditor is entitled to only the value of the security interest, not exceeding the amount of the secured claim. Section 52 of the IBC allows a secured creditor to realise the security interest on its own. If realisation exceeds the debts due to the secured creditor, the excess has to be tendered to the liquidator. Where realisation falls short of the debt owed to the secured creditor, the unpaid debt is to be paid by the liquidator in accordance with the waterfall under section 53. In the waterfall, debts owed to a secured creditor for any amount unpaid following the realisation of security interest ranks lower than the financial debts owed to unsecured creditors.

The rehabilitation process typically realises a part of the going concern’s surplus. Data shows that rehabilitation, on average, realises Rs 177 if the company has assets valued at Rs 100. Assuming that the creditors have a security interest over all the assets, they would get only Rs 100 if the company is liquidated or they enforce their contracts otherwise. The surplus/excess of Rs 77 that the rehabilitation process generates is meant to satisfy the unsecured claims of creditors. How this excess should be distributed has been contentious. In 2019, the legislature and judiciary settled the law that operational creditors and dissenting financial creditors, whether secured or unsecured, should be paid not less than what they would receive in the event of liquidation. In a sense, this replicated the liquidation waterfall in the rehabilitation process, allowing discretion to the Committee

of Creditors to distribute the excess. The Committee has not been generous while exercising discretion. There is a feeling that the excess is being mostly appropriated by members of the Committee. This has been a source of dispute, delaying the conclusion of the rehabilitation process.

The insolvency law generally reflects public interest choices. For instance, it has a bias in favour of rehabilitation. The policy of distribution of excess to satisfy unsecured claims should also reflect public interest choice. Since business needs both financial and operational credit, in the interest of availability of credit, the excess needs to satisfy unsecured claims of financial creditors and operational creditors equitably. There is even a case for prioritising unsecured claims of operational creditors as they do not sit on the decision-making table.

The proposed formula, however, does not appeal to everyone. Some argue that financial debt is essentially public money and, therefore, they should have priority over other debts. This may not be correct, going beyond bank financing. Second, they emphasise the priority of secured creditors — they should be paid fully irrespective of the value of the security —before unsecured claims are considered. This approach would treat unequals (A, B and C in the example above) as equals, obliterating pre-insolvency contractual rights, which is not legally tenable.

We have suggested resolving the dispute *(https://www.business-standard.com/article/opinion/ the-cinderella-of-insolvency. html)* by distributing liquidation value vertically among financial and operational creditors, and sharing any excess resolution proceeds over the liquidation value horizontally among all creditors in proportion to their remaining claims. The National Company Law Appellate Tribunal has, recently in *Excel Engineering*, urged the government and the IBBI, to consider entitlement for operational creditors, based on the amount realised in the resolution plan over and above the liquidation value. The discussion paper has essentially proposed a formula on these lines and equates all unsecured claims at par. In addition to expediting the conclusion of the rehabilitation process, implementing this proposal can keep the insolvency proceedings integrated, rather than making it complex by converting it into two sub-proceedings — the resolution plan and the distribution plan, as proposed.

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