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PRIORITY OF PAYMENTS AND DISTRIBUTION OF PROCEEDS UNDER IBC: A LENDER'S PERSPECTIVE

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Abstract

The Insolvency and Bankruptcy Code, 2016 (IBC), introduced a revolutionary framework for resolving corporate insolvency in India, with Section 53 of the Code serving as a cornerstone for distributing asset sale proceeds during liquidation. This article provides a comprehensive guide to the IBC's priority of payments, elucidating the hierarchy of senior and subordinated debt and the role of intercreditor agreements in aligning creditor rights. Through a step-by-step breakdown of Section 53, illustrative examples, and analysis of landmark judgments like *Essar Steel* (2019), *Rainbow Papers* (2022), and *Swiss Ribbons* (2019), it explores practical challenges for lenders, including secured creditor strategies, government dues, and resolution plan voting. Offering actionable insights for banks, NBFCs, and legal professionals, the article underscores how creditors can navigate the IBC's complexities to optimize recoveries while balancing risks and legal obligations in India's evolving insolvency landscape.

Introduction

The Insolvency and Bankruptcy Code, 2016 (IBC) marked a revolutionary shift in India's corporate and financial landscape by consolidating fragmented insolvency laws into a unified, time-bound framework for resolving or liquidating financially distressed companies. One of the pivotal components of this framework is mentioned in Section 53¹, which says and dictates the order in which the proceeds of the sale of the corporate debtor's assets are distributed among creditors and other stakeholders during liquidation.

¹ Insolvency and Bankruptcy Code, 2016, § 53, India Code (2016), <https://ibclaw.in/section-53-distribution-of-assets/>.

This framework is very crucial for banks, non-banking financial companies (NBFCs), Asset Reconstruction Companies (ARC), and other financial creditors. It directly influences their recovery prospects, risk assessment, and strategic decision-making in insolvency proceedings. This article simplifies the waterfall mechanism, explores its practical implications, and highlights recent judicial judgements, offering insight for lenders to navigate the IBC.²

Understanding Debt Hierarchies and Intercreditor Agreements in the IBC Context

Before starting the specifics of Section 53 (Waterfall Mechanism), let's understand the concept of senior and subordinate debt and intercreditor agreements. These are principles that shape the creditors' priority in insolvency and inform lender strategy under the IBC. The statutory framework is given below.

1. Senior vs. Subordinate Debt: The Repayment Hierarchy³

In corporate finance, debts are structured with a clear repayment order, which becomes critical in insolvency scenarios governed by the IBC.

- **Senior Debt:**
 - **Definition:** Debt with the highest repayment priority, typically secured by collateral (e.g., property, machinery).
 - **IBC Relevance:** Under Section 52, secured creditors (e.g., banks with a mortgage) can enforce their security outside liquidation or relinquish it to join the section 53 waterfall, where they rank high (after insolvency cost and workmen's dues).
 - **Characteristics:** Lower interest rates (e.g., 5-6%) due to reduced risk, backed by the assets.
 - **Example:** A bank lends Rs 50 crore to a company, secured by its factory. In IBC liquidation, if the factory sells for Rs 60 crore, the bank is paid first (if it relinquishes security), ensuring high recovery.

² Harshit Gupta, Waterfall Mechanism: Basic Structure of the Insolvency and Bankruptcy Code, 2016, IBC Laws (2022),

<https://ibclaw.in/waterfall-mechanism-basic-structure-of-the-insolvency-and-bankruptcy-code-2016-by-harshit-gupta/>.

³ Seniority of Debt: Hierarchy of Repayments - How Seniority of Debt Influences LGD, FasterCapital (2023), <https://fastercapital.com/content/Seniority-of-Debt--Hierarchy-of-Repayments--How-Seniority-of-Debt-Influences-LGD.html>.

- **Subordinated Debt:**

- **Definition:** Debt paid after senior debt, often unsecured, carrying higher risk.
- **IBC Relevance:** It is in unsecured financial creditors under section 53(1)(f), paid only after secured creditors, workmen, and employees.
- **Characteristics:** Higher interest rates (e.g., 8-10%) to compensate for risk.
- **Example:** An NBFC lends Rs 20 crore without collateral. In liquidation, it recovers only after senior creditors, risking zero recovery if funds are limited.

Why it Matters: The distinction between senior and subordinated debt influences lender risk assessment and recovery expectations under the IBC's waterfall mechanism, guiding decisions on lending terms and insolvency strategies.

2. Intercreditor Agreements: Governing Creditor Relationships⁴

When a company has multiple lenders, an intercreditor agreement defines their rights and priorities, complementing the IBC's statutory framework.

- **Key Features:**

- **Priority of Payments:** Aligns with the IBC's Section 53 waterfall, ensuring senior creditors (who relinquish security) are paid before unsecured creditors.
 - **Standstill Clauses:** Junior creditors (e.g., unsecured lenders) may be restricted from initiating recovery actions during insolvency, protecting senior creditors' rights.
 - **Subordination:** Reinforces that subordinated debt is paid only after senior debt, mirroring Section 53 hierarchy.
 - **Dispute Resolution:** Provides a mechanism, like arbitration, to resolve conflicts, ensuring smooth insolvency proceedings.
- **IBC Context:** While Section 53 governs liquidation, intercreditor agreements are critical during the Corporate Insolvency Resolution Process (CIRP), where the Committee of Creditors (CoC) negotiates resolution plans. They ensure that dissenting creditors receive at least their liquidation value, as mandated by Section 30(2)(b).
 - **Example:** In a real estate company undergoing IBC resolution, an intercreditor agreement ensures that a bank (senior creditor) is paid from the assets before an NBFC (subordinated creditor), reducing conflicts.

⁴ Seniority of Debt, supra note 3

Why it Matters: Intercreditor agreements provide clarity and enforceability, aligning the creditor's expectations with the IBC's legal framework.

3. Risks and Benefits in the IBC Waterfall

The hierarchy of senior and subordinates' debt is reinforced by intercreditor agreements, which create a balance of risks and rewards for lenders and borrowers under the IBC.

- **For Lenders:**

- **Benefits:**

- **Senior Creditors:** High recovery likelihood due to collateral and priority under Section 53(1)(b). The *Swiss Ribbons Pvt. Ltd. V. UOI* (2019)⁵ Ruling reinforces their superior positions.
- **Subordinated Creditors:** Higher interest rates offer better returns if the company avoids insolvency.
- **Clarity:** The IBC's waterfall and intercreditor agreements provide predictability, as upheld in *Essar Steel India V. Satish Kumar Gupta* (2019)⁶.

- **Risks:**

- **Credit Risk:** Even senior creditors may face losses if asset values are low (e.g., post-liquidation).⁷
- **Statutory Charges:** The *Rainbow Papers Ltd. V. State of Gujarat* (2022)⁸ The ruling elevates government dues with statutory charges, reducing funds for creditors.
- **Delays:** Prolonged liquidation erodes asset values, increasing costs (paid first under section 53)

- **For Borrowers:**

- **Benefits:**

- Access to diverse capital (senior and subordinated debt) supports growth, as seen in real estate projects under IBC.
- Lower-cost senior debt reduces borrowing expenses.

⁵ *Swiss Ribbons Pvt. Ltd. vs Union Of India* on 25 January, 2019 4 SCC 17 (India).

⁶ *Committee Of Creditors Of Essar Steel ... vs Satish Kumar Gupta* on 15 November, 2019 AIRONLINE 2019 SC 1494, (2019) 16 SCALE 319, (2019) 4 CURCC 410, (2019) 8 MAD LJ 524

⁷ S&R Associates, *Renewed Challenges to the IBC Distribution Waterfall*, S&R Insights (2023), <https://www.snrlaw.in/wp-content/uploads/2023/01/SR-Insights-Renewed-Challenges-to-the-IBC-Distribution-Waterfall.pdf>.

⁸ *State Tax Officer (1) vs Rainbow Papers Limited* on 6 September 2022 SCC OnLine SC 1162.

- **Risks:**
 - **Restrictive Covenants:** Senior debt agreements (enforceable under the SARFAESI Act, 2002) may limit operational flexibility.
 - **Default Risk:** Failure to service senior debt can trigger IBC proceedings, risking asset loss.
- **Example:** A manufacturing company under IBC liquidation has Rs100 crore in assets, with Rs60 crore in senior debt (bank loan, secured by machinery) and Rs30 crore in subordinated debt (NBFC loan, unsecured), The bank recovers fully, but the NBFC gets only Rs10 crore after higher priority claims, illustrating the risk-reward trade off.

Key Takeaway

Understanding senior and subordinated debt and intercreditor agreements provides a foundation for navigating through Section 53 of the IBC. These concepts shape lender strategies, from lending decisions to voting on resolution plans, ensuring clarity in the high-stakes insolvency process.

The Waterfall Mechanism: Step-by-Step Breakdown⁹

The IBC's waterfall mechanism under section 53 governs how proceeds from a corporate debtor's asset sales are distributed in liquidation. When a company enters insolvency, its assets are sold either as part of a resolution plan (which is to revive the company) or through liquidation (if revival fails). The proceeds are in order, where each tier represents a category of creditors or stakeholders. Only after a higher amount is paid fully, then only the other get the remaining money. Below is the priority order in simpler language:

1. Insolvency Resolution and Liquidation Costs

- **What's Included?** Fees for the insolvency professional (IP), costs of running the company during the insolvency, legal expenses, and the protection costs of the assets.
- **Why First?** These expenses ensure the insolvency process runs smoothly without any hindrances, so that assets value can be maintained.
- **Impact:** Paid in full without any other claims, reducing the credit that is available for other creditors.

⁹ Section 53 of IBC, 2016, supra note 1.

2. Workman's Dues (Last 24 Months) and Secured Creditors (Who Relinquish Security)

- **Workmen's Dues:** Unpaid salary of the employees (e.g., factory workers) for the past 24 months.
- **Secured Creditors:** Lenders like banks or NBFC with a secured asset (e.g., mortgage or hypothecation) can choose to:
 - **Relinquish:** They can relinquish their security to the liquidation and share this priority tier with workmen, or
 - **Enforce:** They can enforce their security under laws like the SARFAESI Act, 2002¹⁰, bypassing the waterfall (as per Section 52 of IBC)
- **Impact:** Secured creditors who relinquish security get priority over most other claimants but share the credit with workmen.

3. Employees' Salaries (Other than Workmen, Last 12 Months)

- **What's Included?** Unpaid wages for non-workmen employees, such as clerical staff or managers.
- **Impact:** Paid after workmen and relinquish secured creditors, but before unsecured creditors.

4. Unsecured Financial Creditors

- **What's Included?** Loans and debts from financial institutions without any collateral (e.g., unsecured bonds or loans)
- **Impact:** These creditors are paid only after the first three creditors, making recovery risky, aligning with the subordinate debt's position.

5. Government Dues (Last 2 years) and Remaining Secured Creditors

- **Government Dues:** Taxes like income tax, GST, or property tax, etc, owed for the last 2 years.
- **Secured Creditors (Non-Relinquished):** If secured creditors enforce their security independently but recover less than their claim, then address the remaining amount.
- **Impact:** The *Rainbow papers (2022)* ruling elevates certain government dues with statutory charges, impacting creditor recoveries.

6. Other Debts and Dues

- **What's included?** Liabilities like vendor bills or service provider payments.

¹⁰ SARFAESI Act, 2002, Section 13.

- **Impact:** These operational creditors often receive little, as funds are typically exhausted.

7. Preference Shareholders

- **What's Included?** Shareholders with fixed dividend rights, prioritized over equity shareholders.
- **Impact:** Rarely receive payments due to depleted funds.

8. Equity Shareholders

- **What's Included?** Owners or equity shareholders.
- **Impact:** Almost always receive nothing, as nothing is left.

Why it Matters for Lenders

The waterfall mechanism, combined with intercreditor agreements, shapes recovery strategies:

- **Secured vs. Unsecured Status:** Secured creditors' options (enforce or relinquish) impact recovery amounts and timing.
- **Resolution Plan Decisions:** Lenders compare resolution plan payouts with liquidation recoveries to vote in the Committee of Creditors (CoC).
- **Risk Assessment:** The hierarchy informs loan pricing and security structuring.

Illustrative Example: How the Waterfall Works

Consider Company X, which is entering liquidation with Rs 100 crore from asset sales. The claims are:

Category	Amount Claimed (Rs crore)
Insolvency & Liquidation Costs	5
Workmen's Dues (Last 24 Months)	8
Secured Creditors (Relinquished Security)	50
Employees' Salaries (Last 12 Months)	2
Unsecured Financial Creditors	20
Government Dues (Last 2 years)	15
Other Debts (Vendors, etc.)	3
Preference Shareholders	10
Equity Shareholders	5

Distribution Process

- 1. Insolvency Costs (Rs 5 crore):** Paid in full.
Balance: Rs 95 crore.
- 2. Workmen's Dues (Rs 8 crore) + Secured Creditors (Rs 50 crore):** Both paid in full
Balance: Rs 95 – Rs 8 – Rs 50 = Rs 37 crore.
- 3. Employees' Salaries (Rs 2 crore):** Paid in full.
Balance: Rs 35 crore.
- 4. Unsecured Financial Creditors (Rs 20 crore):** Paid in full.
Balance: Rs 15 crore.
- 5. Government Dues (Rs 15 crore):** Paid in full.
Balance: Rs 0 crore.
- 6. Other Debts, Preference & Equity Shareholders:** No funds remain.

Key Takeaways

- Secured creditors who relinquish security recover early, aligning with senior debts.
- Unsecured creditors (subordinate debt) and government dues are paid later.
- Shareholder typically receive nothing, reflecting their lowest rank.

Practical Challenges for Lenders

Lenders face several hurdles when navigating the IBC's waterfall mechanism. These challenges are as follows:

1. Relinquish or Enforce Security?

- **Challenge:** Secured creditors must decide whether to enforce security (e.g., via SARFAESI) or relinquish it for the liquidation. Enforcement may yield higher recoveries if assets are valuable, but legal disputes or market issues can delay payouts.
- **Example:** A bank with a Rs 20 crore charge on a factory may recover Rs 18 crore independently, but only Rs 15 crore under the waterfall mechanism.

2. Estimating Liquidation Value

- **Challenge:** Creditors must estimate the liquidation value to evaluate resolution plans. Misestimations can lead to rejecting viable plans or unnecessary liquidation.
- **Example:** A Rs 50 crore resolution plan may be preferable to a Rs 40 crore

liquidation value if assessed accurately.

3. Government Dues Post Rainbow Papers

- **Challenge:** The *Rainbow Papers (2022)* ruling prioritises government dues with statutory charges reducing funds for creditors.
- **Example:** A Rs 10 crore tax lien competes with secured creditors, lowering recoveries.

4. Delays and Valuation Disputes

- **Challenge:** Liquidation delays and contested valuations erode asset value, increasing the cost paid first.
- **Impact:** Reduces creditor recoveries.

5. Unsecured Creditors' Low Recovery

- **Challenge:** Unsecured creditors (subordinate debt) rank low, often recovering little.
- **Impact:** Requires careful risk management in lending.

Key Judicial Precedents Shaping the Waterfall Mechanism

Landmark rulings clarify the waterfall mechanism and creditor rights:

1. Essar Steel India Ltd. V. Satish Kumar Gupta (2019) [SC]¹¹

- **Ruling:** Upheld CoC's commercial wisdom, allowing flexible resolution plan distributions, provided operational and dissenting creditors receive liquidation value (Section 30(2)(b)).
- It states NCLT doesn't have residual jurisdiction to reject a resolution plan solely based on it being perceived as unfair or unjust to a particular class of creditors as long as the interests of each class are duly considered following Section 53.¹²
- **Impact:** Strengthens lender control, aligning with intercreditor agreement flexibility.

2. Rainbow Papers Ltd. V. State of Gujarat (2022) [SC]¹³

- **Ruling:** Government dues with statutory charges are treated as "secured," competing with creditors.
- In this, it is mentioned that the definition of "secured creditors" is

¹¹ Committee of Creditors of Essar Steel, supra note 6.

¹² Section 53 of IBC, 2016, supra note 1.

¹³ State Tax Officer, supra note 8

comprehensive, in cases it includes even the government, which creates confusion in arriving at correct textual interpretations of the law.

- **Impact:** Requires lenders to scrutinise statutory charges to protect recoveries.

3. **Swiss Ribbons Pvt. Ltd. V. Union of India (2019) [SC]**¹⁴

- **Ruling:** Justified financial creditors' priority over operational creditors due to higher risk.
- Supreme Court held waterfall mechanism doesn't infringe Article 14 as there is a clear and rational basis for the separate classification of creditors
- **Impact:** Reinforces senior creditors' advantage in the waterfall mechanism.

4. **Sundaresh Bhatt V. Central Board of Indirect Taxes and Customs (2022) [SC]**¹⁵ and **PR Commissioner of IT, V. Monnet Ispat and Energy (2018) [SC]**¹⁶

- In this case, the Supreme Court unequivocally said that the IBC framework supersedes Income Tax. Reinforcing the supremacy of IBC.

5. **Paschim Anchal Vidyut Nigam Ltd. V. Raman Ispat Private Ltd. (2023) [SC]**¹⁷

- In this case, three important observations were made by SC:
 - Overlooked waterfall mechanism in Rainbow Paper.
 - Different treatment of government dues.
 - Limited applicability of Rainbow Papers in future cases.

Advisory Approach

Here is some advice that lenders should go through in the IBC's complexities:

1. **Security Due Diligence:** Verify security enforceability and map waterfall position.
2. **Resolution Plan Advisory:** Compare plan payouts with liquidation value to guide CoC voting.
3. **Enforcement v. Relinquishment:** Analyse asset value and risks to recommend strategies.
4. **Government Dues:** Review statutory charges post-*Rainbow Papers*.
5. **Claim Submission:** Draft claims and contest errors to protect priority.
6. **NCLT/NCLAT Representation:** Advocate for lenders in disputes.

¹⁴ Swiss Ribbons, supra note 5.

¹⁵ Sundaresh Bhatt v. Central Board of Indirect Taxes and Customs, 2022 SCC OnLine SC 929.

¹⁶ Pr. Commissioner of Income Tax v. Monnet Ispat and Energy Ltd., 2018 SCC OnLine SC 1434.

¹⁷ Paschimanchal Vidyut Vitran Nigam Ltd. v. Raman Ispat Pvt. Ltd., 2023 SCC OnLine SC 879.

7. Debt Assignment: Structures sales to ARCs for weak recovery prospects.

Practical Tips for Lenders

Conduct security due diligence, use waterfall projections for voting, and monitor judicial updates (e.g., *Rainbow Papers*)

Conclusion

The section 53 waterfall mechanism, rooted in the hierarchy of senior and subordinated debt, reinforced by intercreditor agreements, is central to creditor recoveries under the IBC. Lenders must navigate this framework strategically, balancing enforcement options, the resolution plan voting, and risks like government dues and delays. Judicial precedents like Essar Steel, Rainbow Papers, Swiss Ribbons, etc., provide legal clarity, while law firms offer critical guidance. By aligning commercial strategies with the IBC's safeguards, banks, NBFCs and ARCs can optimise recoveries in India's evolving insolvency landscape.

