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SECTION 327 OF THE COMPANIES ACT, 2013, NOT ARBITRARY OR VIOLATIVE OF ARTICLE 21, SC UPHELDS

AUTHORED BY - ADV. VRINDA GOEL

In the case where the liquidation process is initiated under the Insolvency and Bankruptcy Code, 2016 (hereinafter referred to as “**the Code**”), Section 327(7) of the Companies Act, 2013 (hereinafter referred to as “**the Act**”) provides for the non-applicability of Section 326 and 327 of the Act in that case, as held by the Hon’ble Supreme Court in *Moser Baer Karamchari Union Through President Mahesh Chand Sharma v Union of India and Ors*¹. Further, the Hon’ble Court held that the distribution of assets, in the event of liquidation under IBC, shall be made in accordance with Section 53 of the Code subject to the provisions of Section 36(4) of the Code.

The contention of the Petitioner was that by not defining “Workmen Dues” in the Code itself and also by debarring the application of the Act by the impugned Section, a void has been created, with respect to the definition of workmen dues under the Code. Moreover, by excluding the applicability of the Act, especially Sections 326 and 327, from the proceedings under the Code, it has created an “*unreasonable classification for the distribution of dues of the Workmen*” under the Code, being in stark violation of Article 14 of the Constitution.

Objects and Purposes of Companies (Amendment) Act, 2013

It was necessary to exclude the applicability of Sections 326 and 327 of the Act, 2013, as the two distinct provisions cannot be adopted in case of liquidation of a company, which cannot be deemed to be arbitrary as claimed on behalf of the petitioner in light of the implementation of the IBC.

Whether the Extent of Workmen Dues as provided Under IBC is violative of Article 21 of the Constitution of India?

¹ Writ Petition Civil no. 421 of 2019 and Writ Petition Civil no. 777 and 712 of 2020

The court observed after perusing Section 36(4) of the IBC that it has been a conscious choice made by the Parliament to keep out of the liquidation estate assets any sums owed to any worker/employee from the provident fund, the pension fund, and the gratuity fund, and that the workmen's dues for the twenty-four months prior to the liquidation commencement date shall rank equally between the workmen's dues to the said extent and the dues to the secured creditor. Hence, it cannot be held arbitrary and violative of the Article 21 of the Constitution of India. Further, since the Code is an entirely new insolvency mechanism, its provisions cannot be compared to those of the prior one, namely the Companies Act of 1956/2013.

‘Waterfall Mechanism’

The ‘waterfall mechanism’ is referred to the system of distribution of assets as provided under Section 53 of the Code, providing the hierarchy of the creditors as to who will be given priority during the liquidation process. The Hon’ble Court observed, in the present case, that the Code acknowledges the economic effect on secured creditors or financial institutions that handle public funds because their financial stability is crucial to both the welfare of the general population and the overall health of the national economy. Moreover, the intricate economic issues call for balancing numerous competing interests and a comprehensive rather than partial solution. Each position may be valid, but the court cannot realistically substitute its own wisdom or opinion for that of the legislature, particularly when legislation is the result of a carefully considered and deliberate analysis of the difficult fiscal and commercial issues facing the country. Further, it was stated by the Hon’ble Court that when Section 53 of the Code is in effect, as a result, subsection (1) of the Section 53 will take precedence over all other rights, including those of the secured creditor. Section 53 of the Code is entire and comprehensive in the sense that it ensures asset collection and subsequently specifies how creditors are to be compensated.

Difference Between Winding Up of the Company on Ground Of Insolvency And Inability To Pay Debts And Cases Where Companies are Wound Up Under Section 271 of the Companies Act 2013

The two scenarios, winding up of the company on the ground of insolvency and inability to pay debts and cases where companies are wound up under Section 271 of the Act, are not the same. The Hon’ble Court noted that to determine whether there is discrimination or violation of Article 14 of the Constitution of India, we must consider two laws that deal with two different situations and which, in our opinion, cannot be compared. The Hon’ble Court emphasized that all the parties, including employees, must make some sacrifices in order to revitalize and rebuild

businesses and everyone, even the secured creditors and the Central, and the State Government, must make sacrifices for an insolvent company's survival and rehabilitation and workmen also have an interest in and benefit from the revival of the company, so unless it is determined that the sacrifices envisioned for workmen, who unquestionably constitute a separate class, are onerous and burdensome to the point of being manifestly unjust and arbitrary, we will not disregard the law merely because some or minimal sacrifice is to be made by workers.

The grounds and justifications for winding up under Section 271 of the Act are very different from justifications and arguments for the Code's resurrection and rehabilitation programme. The Hon'ble Court further observed that *"We would also reject the argument that to find out whether there was a violation of Article 14 of the Constitution of India or whether the right to life under Article 21 Constitution of India was infringed, we must word by word examine the waterfall mechanism envisaged under the Act, where the company is wound up in terms of grounds (a) to (e) of Section 271 of the Act; and the rights of the workmen when the insolvent company is sought to be revived, rehabilitated or wound up under the Code. The grounds and situations in the context of the objective and purpose of the two enactments are entirely different."*

In conclusion, the present case clarifies that 'Workmen Dues' as under the Act during the liquidation process cannot be claimed if the liquidation process is initiated under IBC. However, it raises a question on the rights of the other creditors with respect to their claims/dues and whether they can be determined in a similar manner in the event of liquidation process and will be applicable as per the respective legislation that was put in force by the initiation of the liquidation process, given that the grounds for initiating the liquidation process under the Act, and the Code are distinct.