

**IDENTIFYING WEAKNESSES IN THE WATERFALL MECHANISM: AN
EXAMINATION OF SECTION 53 OF THE INSOLVENCY AND BANKRUPTCY
CODE (2016)**

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ABSTRACT

The Insolvency and Bankruptcy Code (IBC) of 2016 transformed India's approach to resolving distressed assets by establishing a formal framework for insolvency procedures. However, the question of inter se precedence among secured creditors remains a concern under the Code, resulting in confusion and inconsistency in its execution. Despite the efforts of the Bankruptcy Law Reforms Committee (BLRC) and the Insolvency Law Committee (ILC) to address the problem, uncertainties remain, confounding court interpretations and practical implementations. This study investigates the challenges and ambiguities of inter se precedence among secured creditors under the IBC. It investigates the legal framework, judicial interpretations, and worldwide best practices to identify the underlying reasons for the problem. Drawing on the UNCITRAL Legislative Guide, the US Bankruptcy Code, and UK insolvency legislation, this study recommends legislative changes and practical measures to improve transparency and predictability. Key proposals include defining the hierarchy of secured creditors in the IBC, modifying Section 53 to reflect a clear priority structure, and encouraging the use of standardized inter-creditor agreements. To avoid disputes and promote openness, a centralized protected transactions registry and enhanced roles for liquidators and resolution experts are recommended. By addressing the inter se priority problem, this study hopes to boost creditor confidence, improve the efficiency of bankruptcy processes, and contribute to a more robust insolvency system in India.

Keywords: Insolvency and Bankruptcy Code, Secured Creditors, Inter Se Priority, Legislative Amendments, Judicial Interpretations.

INTRODUCTION

The Bankruptcy and Bankruptcy Code (IBC), passed in 2016, transformed India's bankruptcy environment by establishing a standardized and time-bound procedure for resolving troubled

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assets. It seeks to increase credit availability, encourage entrepreneurship, and guarantee the effective distribution of resources. The IBC stresses a creditor-driven resolution process by combining numerous bankruptcy laws and creating organizations to monitor proceedings, such as the Bankruptcy and Bankruptcy Board of India (IBBI) and the National Company Law Tribunal (NCLT). Innovative features including the corporate insolvency resolution procedure (CIRP) and the involvement of resolution specialists speed up resolution while protecting stakeholders' interests. Despite its transformational promise, problems remain in operational execution and complicated case management. Nonetheless, the IBC is a crucial reform that promotes efficiency, openness, and accountability in India's bankruptcy ecosystem, hence boosting investor confidence and economic progress.¹

Despite its transformational potential, the Insolvency and Bankruptcy Code (IBC) is complicated and ambiguous. One such problem stems from a lack of clarity on the establishment of inter se precedence among secured creditors. While the IBC gives secured creditors broad precedence in repayment, it does not address prioritization among them, especially when they have various degrees of charges. The Bankruptcy Law Reforms Committee (BLRC) and the Insolvency Law Committee (ILC) have thoroughly explored this subject in their separate findings, yet confusion still exists. Furthermore, inconsistent interpretations by courts and tribunals have contributed to the uncertainty.

This paper looks at the laws regulating secured creditors' standing under the IBC, as well as the issues surrounding their inter se precedence. The BLRC and ILC reports will be examined to determine legislative intent. Furthermore, it investigates international law on the subject and examines how different Supreme Court and tribunal decisions may have misread the IBC, diverging from its aims.

RESEARCH METHODOLOGY

Literature analysis: The researcher undertakes a thorough analysis of the current literature on the Insolvency and Bankruptcy Code (IBC), with a focus on the treatment and priority of secured creditors. This comprises scholarly publications, expert commentary, and pertinent legislation documents. The BLRC and ILC reports are also reviewed since they give

¹ Bankruptcy Law Reforms Committee Report (2015) Insolvency Law Committee Report (2018)

fundamental insights into legislative purpose and the intended framework for secured creditors' goals.

Legal Analysis: The researcher examines specific sections of the IBC, notably Section 53, to better comprehend the statutory priority allocated to secured creditors.

Case Law Examination: The Supreme Court of India and different tribunals' landmark decisions interpreting the IBC laws governing inter se precedence among secured creditors are examined.

Comparative Analysis: International bankruptcy frameworks and jurisprudence in countries such as the United States and the United Kingdom are examined.

LITERATURE REVIEW

Despite its transformational goal, the IBC has encountered several obstacles and uncertainties, most notably the intense precedence among secured creditors.

The BLRC study paved the way for the IBC, stressing a simplified and efficient insolvency resolution procedure. It emphasized the need to prioritize claims in order to optimize asset value recovery. However, although it advocated a general prioritizing of secured creditors above workmen's dues, it did not give specific advice on the inter se precedence of secured creditors with varying amounts of charges.

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On the other hand, the ILC investigated the IBC's ambiguities and operational issues. It noted a lack of clarity on inter se precedence among secured creditors and proposed clear remedies to address these issues. The ILC advised legislative modifications to address this problem but did not give specific answers, allowing space for varying judicial interpretations.

Scholars and legal professionals have extensively argued how secured creditors are treated under the IBC. Saxena and Agarwal claimed that the IBC's silence on inter se priority has resulted in contradictory court judgments, causing confusion in the bankruptcy resolution process. They suggested that this uncertainty lowers secured creditors' trust and reduces the overall efficiency of the insolvency regime. Gupta's study emphasizes the need for a more thorough regulatory framework to govern the handling of secured creditors with varying amounts of charges. He advises using worldwide best practices to develop a more predictable and transparent priority structure.

Cases involving *Essar Steel India Ltd. v. Satish Kumar Gupta and Swiss Ribbons Pvt. Ltd. v. Union of India* supported the IBC's validity while recognizing the necessity for continual development in its interpretation and implementation to handle growing difficulties, such as claim prioritizing.

The US framework provides a thorough and hierarchical structure for creditor claims, as well as explicit criteria for secured creditors facing varied degrees of penalties. This predictability serves to reduce litigation and improve settlement results. Furthermore, the UK's bankruptcy framework has detailed procedures for prioritizing claims, ensuring that secured creditors' rights are clearly stated and honored, thus improving the efficiency and fairness of the insolvency process.

METHOD

The key question driving this study is: "What are the implications of the lack of clear inter se priority among secured creditors under the Insolvency and Bankruptcy Code (IBC) of 2016, and how can this issue be resolved to improve the efficiency of the insolvency resolution process in India?"²

The debt recovery procedure has never been simple for secured creditors, since it has always been guided by market traditions and inter-creditor business practices. Interestingly, Section 2(16) of the Companies Act of 2013 and Section 3(4) of the IBC describe "charge" as an interest or lien on a company's property or assets used as security. Charges may be exclusive, *pari passu*, or subordinate/priority. Prior to the IBC, the principle of secured creditors' priority was recognized in previous laws. For example, Section 48 of the Transfer of Property Act of 1882 specifies that earlier rights take priority over subsequent ones unless expressly stated differently in a contract. This approach was incorporated into business legislation, notably the Companies Act of 2013 and the SARFAESI Act, which recognizes secured creditors' priority rights.

During the IBC's formulation, the Bankruptcy Law Reforms Committee (BLRC) recognized secured creditors' priority rights and proposed a separate clause to create them. This was

² Committee of Creditors of Essar Steel India Limited (through authorized signatory) v. Satish Kumar Gupta and Others, (2020) 8 SCC 531
Swiss Ribbons Pvt. Ltd. v. Union of India, AIR 2019 SC 739
United States Bankruptcy Code, Chapter 11
United Kingdom Insolvency Act 1986

integrated into Section 53 of the IBC, which establishes a liquidation waterfall that prioritizes secured creditors alongside workmen's dues. However, the Code makes no mention of inter se precedence among secured creditors, leaving uncertainty between first and priority charge-holders. Section 53(2) complicates things further by permitting liquidators to ignore contractual arrangements between creditors, putting inter-creditor agreements at risk.

Secured creditors have the option of exercising their security under Section 52 to settle their obligation. Section 53 encourages high charge-holders to repay their debts by enforcing their security outside the liquidation estate. This may be accomplished by either yielding their security interest to the estate and obtaining the sale profits as a priority or by realizing their security interest under Section 52 and claiming outstanding obligations under Section 53(1)(e), which has a lesser priority.

The 2019 Amendment intended to safeguard secured creditors by requiring payments to dissident financial creditors to be at least the amount payable in a notional liquidation. However, the lack of clarity on the priority of charges and security interests makes it difficult for financial creditors to agree or disagree with resolution plans. The vagueness of the Code leads to varying interpretations by courts and tribunals, undermining the Code's goal of maximizing asset value.

THEORETICAL CONUNDRUM IN THE PRIORITY OF SECURED CREDITORS

The question of inter se precedence among secured creditors in liquidation proceedings under the Insolvency and Bankruptcy Code (IBC) of 2016 poses a fundamental theoretical puzzle. While Section 53 of the IBC offers a basic framework for prioritizing secured creditors alongside workmen's dues, it does not address the inter se precedence of secured creditors with varying amounts of charges. This absence has resulted in two competing schools of thought, each with its own reasoning and repercussions.

THERE ARE TWO SCHOOLS OF THOUGHT

The Theory Of Priority And Equitable Ownership

The first school of thought is founded on the notion of priority, which is a key tenet in both common law and Indian jurisprudence. This philosophy holds that earlier rights, such as those of the original charge bearer, should take priority over subsequent rights. This approach is

backed by Section 48 of the Transfer of Property Act of 1882, which provides that if numerous rights are formed over the same immovable property, the first right takes precedence unless a particular agreement specifies otherwise. Other legislation, such as the Companies Act of 2013 and the SARFAESI Act, recognize and protect the priority rights of secured creditors. Proponents of this viewpoint say that prioritizing exclusive or first charge holders improves certainty and fairness in the credit market. It is consistent with pre-insolvency contractual rights and the expectations of secured creditors who lend credit based on the security interest.

The Philosophy Of Equitable Treatment And Group Solutions

The second school of thought stresses the notion of equitable treatment, which seeks to guarantee that all creditors, especially those with shared collateral, are treated equally throughout bankruptcy proceedings. This viewpoint is founded on Equitable Treatment, which holds that creditors with identical legal status or interests should get proportional treatment in order to prevent excessive losses or advantages. It also focuses on the Group Solution, which advocates for more collaborative handling of creditors, with the goal of maximizing total recovery for all stakeholders rather than rigidly sticking to pre-insolvency priority rights. Advocates of this viewpoint say that treating all secured creditors equally contributes to the IBC's overall aims, such as the revival and value-maximizing of the distressed organization. It aims to prevent any one creditor from excessively profiting at the cost of others, which might jeopardize the collaborative settlement process³.

JUDICIAL INTERPRETATIONS OF INTER SE PRIORITY BETWEEN SECURED CREDITORS

The Insolvency and Bankruptcy Code (IBC), 2016, has uncertainty about inter se precedence among secured creditors, which has led to a variety of court interpretations. The developing jurisprudence reflects the endeavor to strike a balance between the principles of priority and equitable treatment, with courts and tribunals providing differing viewpoints on how secured creditors' claims should be treated. Here are some important instances that demonstrate this changing landscape:

³ *Supra* note 3

India Resurgence Arc Pvt. v. M/S. Amit Metaliks Limited & Anr. 2021 SC OnLine SC 409
Technology Development Board v. Anil Goel 2021 SCC OnLine NCLAT 349

Essar Steel India Ltd. vs Satish Kumar Gupta

In this historic case before the Supreme Court of India in 2019, Essar Steel's bankruptcy resolution highlighted concerns about the treatment of secured creditors. The court's judgment affirmed secured creditors' precedence in asset distribution, highlighting their entitlement to bigger compensation than unsecured creditors. This ruling first seemed to support the conventional position that secured creditors should be prioritized based on their security interests, which is consistent with the first school of thinking. It emphasized that secured creditors should obtain at least the liquidation value of their claims, so supporting the idea of fair treatment within the larger framework of the IBC.

India Resurgence Arc Pvt Ltd vs. M/S. Amit Metaliks Ltd.

This case, considered by the Supreme Court in 2021, concerned a company's resolution procedure, in which dissident financial creditors disputed the resolution plan agreed by the Committee of Creditors. The court determined that the legislative aim underlying the IBC modifications was to guarantee fair treatment of creditors. It underlined that dissident financial creditors should get a fair portion, but not necessarily preferential treatment over other secured creditors. This ruling represented a change toward the second school of thinking, which emphasized equal treatment above strict adherence to pre-insolvency priority rights.

Technology Development Board vs. Anil Goel

In this case, before the NCLT Ahmedabad in 2021, the priority of secured creditors during Gujarat Oleo Chem Ltd.'s liquidation procedure was addressed. The tribunal ruled that the charges should be sequential rather than proportionate, thereby prioritizing the initial charge holders over succeeding charge holders. Although this ruling supported the first school of thinking, it was eventually reversed by the appeal panel, illustrating the continuous judicial disagreement.

Technology Development Board vs. SASF

The continuing issue before the Supreme Court includes a disagreement between secured creditors over the priority of claims under the IBC. The outcome of this case is likely to give more clarification on the question of inter se precedence among secured creditors. The

judgment might either reinforce the trend of equal treatment or support secured creditors' conventional priority privileges.

Binani Industries Ltd vs. Bank of Baroda

In this case, before the NCLAT in 2018, Binani Industries' settlement procedure generated concerns regarding the treatment of dissident secured creditors. The tribunal held that all creditors, including dissident secured creditors, should be treated fairly and given an equal portion of the resolution profits. This ruling upheld the notion of equal treatment, emphasizing the value of fairness in the settlement process.

State Tax Officers vs. Rainbow Papers Ltd.

In 2022, the Supreme Court addressed crucial concerns concerning secured creditors' priority in Rainbow Papers Ltd's bankruptcy proceedings. The court presented a nuanced reading of the IBC, stressing the need to balance fair treatment requirements with the conventional priority concept. This case emphasized the Supreme Court's efforts to strike a balance between competing principles and gave much-needed clarification on how inter se priority should be addressed.

INTERNATIONAL PERSPECTIVE ON THE PRIORITY RIGHTS OF SECURED CREDITORS

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UNCITRAL Model Laws

The UNCITRAL Model Law on Cross-Border Insolvency establishes a framework for insolvency procedures, with an emphasis on fair and efficient administration. It stresses the notion of fair treatment of similarly situated creditors, especially secured creditors. The Model Law proposes three techniques to handle secured creditors:

Libertarian technique: This technique permits secured creditors to assert their security outside of bankruptcy procedures, so avoiding voting on the resolution plan. This respects secured creditors' contractual rights prior to bankruptcy.⁴

⁴ Stressed Asset Stabilisation Fund v. Technology Development Board [2021], CA No. 2206/2021 (XVII) (SC) or Civil Appeal Diary No. 11060 of 2021

Binani Industries Ltd. v. Bank of Baroda & Anr. Civil Appeal No. 9402-9405 of 2018

State Tax Officers v. Rainbow Papers Ltd. 2022 SCC. OnLine SC 1162

UNCITRAL, Legislative Guide on Insolvency Law 220-221

Group Solution strategy: This strategy establishes a distinct class for secured creditors, acknowledging their priority rights while including them in the resolution process to guarantee a coordinated approach to asset distribution.

The Hybrid Approach incorporates parts of the previous two systems, enabling secured creditors to exercise their security interests while also giving them a role in the bankruptcy procedures if their claims are not fulfilled.

US Bankruptcy Code (Chapter 11)

The United States Bankruptcy Code, especially Chapter 11, provides strong protection for secured creditors. Creditors are divided into secured and unsecured groups. Secured creditors have the right to keep their lien and receive delayed payments equivalent to the collateral's current value. If a plan is not approved by all classes, the court may nonetheless confirm it (cramdown) if it fulfills scientific requirements, such as guaranteeing that secured creditors get at least the value of their collateral. This clause suspends any collection activities against the debtor's assets, safeguarding the secured creditors' interests by preserving the collateral's value during the proceedings.

United Kingdom's Insolvency Act

The UK Insolvency Act 1986, combined with the Enterprise Act 2002, provides a defined framework for the precedence of secured creditors. During administration, an administrator cannot interfere with secured creditors' rights unless they agree or the court approves. This guarantees that secured creditors' rights are protected. Secured creditors are given priority in asset distribution during liquidation, so strengthening their position over unsecured creditors. The Act differentiates between floating and fixed charges, with fixed charge holders receiving preference over floating charge holders in asset distribution.

SUGGESTIONS

Given the complications and ambiguities concerning inter se priority among secured creditors under the 2016 Insolvency and Bankruptcy Code (IBC), a number of approaches might be recommended to effectively resolve these concerns. These ideas seek to align the principles of fair treatment with the conventional notion of priority, resulting in increased clarity and predictability in insolvency procedures.

Legislative amendments

Clear Definition of Priority: Amending the IBC to properly establish the inter se priority of secured creditors. This should contain rules that distinguish between various levels of charges (first charge, second charge, etc.) and explicitly express their order of precedence throughout both the liquidation and settlement procedures.

Revisiting Section 53: Modifying Section 53 to provide a thorough hierarchy of secured creditors, guaranteeing that high charge-holders have precedence over later charge-holders would bring the IBC in line with the principles established by the Transfer of Property Act of 1882 and other business laws.

Implementing International Best Practices

Adopt UNCITRAL Legislative Guide techniques: Including the techniques specified in the UNCITRAL Legislative Guide, notably the group solution strategy, which establishes a distinct class of exclusive creditors. This ensures that secured creditors with main charges are clearly identified and prioritized.

Learn from US and UK Models: The US Bankruptcy Code (Chapter 11) and UK insolvency rules provide a clear division of creditors based on their claims and guarantee that secured creditors keep their liens or get equal payments. Similar regulations might improve predictability and justice in the Indian setting.

Judicial Clarity and Consistency

Precedent Harmonization: The Supreme Court and appellate tribunals should have uniformity in their rulings on secured creditors' priorities. Creating a dedicated bench or specialized committee to deal with insolvency matters might aid in the development of unified jurisprudence.

Clarifying Judicial Interpretations: Issuing practice directions or guidelines based on landmark decisions (such as Essar Steel and Rainbow Papers) might assist lesser courts and tribunals in consistently applying the IBC.

By applying these proposals, the IBC may be improved to better handle the problem of secured creditors' inter se priority, resulting in a more predictable, fair, and efficient bankruptcy resolution system.

CONCLUSION

The Bankruptcy and Bankruptcy Code (IBC) of 2016 revolutionized India's bankruptcy environment by introducing an organized and efficient mechanism for resolving troubled assets. However, the subject of inter se precedence among secured creditors is still unclear, creating enormous ambiguity. Despite efforts by the Bankruptcy Law Reforms Committee (BLRC) and the Insolvency Law Committee (ILC) to resolve this problem, misunderstandings remain, resulting in divergent court interpretations and complicating the resolution process.

The absence of precise rules in Section 53 of the IBC governing the hierarchy of secured creditors, particularly those with varying amounts of charges, has caused uncertainty. This has resulted in conflicting court opinions, undermining the Code's goals of value maximization and quick recovery.

International practices, such as those outlined in the UNCITRAL Legislative Guide, the US Bankruptcy Code, and the UK bankruptcy legislation, provide useful insights. These methods clearly identify and safeguard secured creditors' priority rights, resulting in predictable results. Incorporating comparable concepts into the IBC may increase its efficacy.

To solve these challenges, legislative changes are required. Clarifying the inter se precedence of secured creditors under the IBC and modifying Section 53 to reflect a clear hierarchy would give the required clarity. Promoting standardized inter-creditor agreements and creating a centralized secured transactions registry may help to reduce disputes and increase transparency.