Pre-CIRP Payment of dues by Resolution Professionals

With the introduction of an entirely new insolvency procedure, there exist certain unsettled areas which make the application of the Insolvency and Bankruptcy Code, 2016 (Hereinafter 'the Code') uncertain. One of the unresolved issues, on which the courts have yet to give their views and settle the position of law, is on the power of Resolution Professionals to make pre-CIRP (Corporate Insolvency Resolution Process) payment to some or all of the Operational Creditors providing essential goods and services to the Corporate Debtor.

Under the new regime of the insolvency law, the Resolution Professional has been given certain powers and has been put under certain obligations to ensure that the entire insolvency process ends smoothly. The Code provides that on the commencement of the insolvency process the Resolution professional has to manage the operation and business of the Corporate Debtor. [1] Therefore, it is the duty of the Resolution Professional to ensure that the Corporate Debtor continues to be a going concern without losing its industrial character. In addition to this, the Resolution Professional is also tasked with preserving the value of the assets of the Corporate Debtor to the extent that any insolvency resolution brought about by approval and implementation of a resolution plan is sustainable so that the feasibility and viability of the said resolution is not compromised.[2]

It is in context of such duty, the issue raised in this article is to determine if the Resolution Professional can make payment of the dues to some or all of the operational creditors whose services are necessary to keep the Corporate Debtor as a going concern. There can be circumstances wherein an operational creditor refuses to provide its services during the CIRP unless the previous dues are cleared. Such action of the Operational Creditors is generally based on their internal business policies which do not allow them to do business with the company undergoing liquidation or insolvency process. The issue raised above will also help to determine the extent of the powers of the Resolution professional towards their duty to keep the Corporate Debtor as a going concern.

The above mentioned issue finds its origin in the American jurisprudence wherein the payment can be made to the *critical vendors* before the beginning of the insolvency process

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[1] Insolvency and Bankruptcy Code, 2016. s 17 [Hereinafter "the code"]

[2] The Code, s 20 & 25.

under the 'Necessity of Payment Rule'.[3] It is a judge made rule which enables a debtor, while filing the petition for initiation of bankruptcy proceedings, to file a motion for payment of pre-petition debts to certain trade creditors after identifying them on the basis of their criticality and indispensability to the conduct of the business during the bankruptcy process and to ensure survival of the business of the company as a going concern.[4]

Therefore, the primary objective of this article is to determine as to what extent the India jurisprudence will support the Necessity of Payment Rule if any claim is filed based on it before any Indian tribunal. To answer the aforementioned issue, this article has been divided into three parts. The part I will discuss the Necessity of Payment Rule as this article aims to analyse the application of the doctrine in the Indian context. In part II, the existing laws of our country will be analysed to argue that the Resolution Professional does not have the power to make pre-CIRP payment of the due to the Operational Creditors. Further, in part III, the UK jurisprudence will be seen to substantiate the position that making payment of the pre-CIRP dues of the Operational Creditors is beyond the power of the Resolution Professionals.

Part I- Necessity of Payment Rule

The necessity of payment rule has emerged in the case concerning the bankruptcy process of a railroad company where the question was whether pre-petition debts of certain creditors could be paid in order to ensure that the business of the railroad corporation is continued during the bankruptcy process. In the background of the fact that the business of the railroad corporation concerned the general public at large, the Supreme Court of Appeal in ***Miltenberger and Others vs. Logansport, C & S. W. R. Co. and Others***[5]evolved the necessity of payment rule doctrine.

The doctrine applies in the cases wherein the creditors threaten to impose economic sanction on the debtor if the payment is not made. To prevent creditors from resorting to such action which may lead to the termination of oppression with disastrous effect[6], the courts were allowing such prepetition payment by using equitable power under section 105(a) of the

[3] *B&W Enter. Inc. v. Goodman Oil Co.* 713 F.2d 534, 536 (9th Cir. 1983).

[4] *Miltenberger and Others vs. Logansport, C & S. W. R. Co. and Others,* 106 US 286.

[5] 106 US 286

[6] Russell A Eisenberg & Frances F. Gecker, 'The Doctrine of Necessity and Its Parameters', 73 Marq. L. Rev. 1 (1989).

Bankruptcy Code which states that *[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code].*[7]However, the appellant courts were always hesitant of the use of section 105(a) to apply the doctrine and noted- *"whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code."*[8]

The major criticisms for the application of this doctrine were that it violates the automatic stay provided under 362(a) and priority scheme set by the law.[9] To limit the application of the doctrine, the court adopted a three parts test in the case of ***In re CoServ***[10] to determine the situations where the prepetition claims could be allowed. The three parts test is as follows:

"The debtor must show three elements are present. First, it must be critical that the debtor deal with the claimant. Second, unless it deals with the claimant, the debtor risks the probability of harm, or, alternatively, loss of economic advantage to the estate or the debtor's going concern value, which is disproportionate to the amount of the claimant's prepetition claim. Third, there is no practical or legal alternative by which the debtor can deal with the claimant other than by payment of the claim."

There was a shift in the position of law in 2002 while adjudicating the case of ***In re Kmart Corp. and Capital Factors, Inc. v. Kmart Corp.***[11] The objections were raised by the 'non-critical' service providing creditors as the payment was made to several creditors based on their prepetition claims, prejudicing their interests. It was observed by the district court that the bankruptcy courts do not have the power to exercise their discretion to redistribute the rights because such prepetition payment will put critical creditors above the non-critical creditors which are contrary to the priority scheme of law.[12]

Further, the Court of Appeal in 2004 reaffirmed the district court's decision and held the priority rule of the bankruptcy is sacrosanct and the equitable principle under section 105(a) cannot be used by the bankruptcy courts to make payment of dues before the completion of

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[7] 11 U.S.C. § 105(a)

[8] *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988).

[9] *Chiasson v. J. Louis Matherne C. Associates* 4 F.3d at 1334.

[10] 273 B.R. at 498.

[11] 359 F.3d at 874.

[12] *In re Krnart*, 291 B.R. at 82.

bankruptcy proceedings. In the opinion of Judge Easterbrook *"doctrine of necessity is just a fancy name for a power to depart from the Code."*[13]

Part II – Indian Scheme of Law

As seen from the US jurisprudence, which introduced the concept of making payment of dues before the bankruptcy proceedings, the courts were cautious of making such payment to protect the interests of the other creditors and the scheme of law. Therefore, the necessity of payment doctrine shall also stand the scheme of law and the public policy to have its application in India.

A Corporate Debtor in most of the circumstances has availed the services of several Operational Creditors. Therefore, if some of those Operational Creditors are paid their dues in full, it would create two categories of the Operational Creditors. Such categorisation of the Operational Creditors has not been envisaged by the Code. Besides this, the payment to some of the Operational Creditors is discriminatory in nature having a negative impact on their monetary interests. It is because the Operational Creditors who will receive their claims post the completion of the CIRP will get proportional payment of their claim as decided in the resolution plan, unlike other Operational Creditors who would have received full payment of their admitted claims as a pre-CIRP payment. Such differential treatment is also contrary to Article 14 of the Indian Constitution and the settled law which prescribes for non-differential treatment of similarly situated Operational Creditors or the Financial Creditors.[14]

The decision of the Resolution Professional to make a payment towards the claims of certain Operational Creditors stems from section 20 of the Code. The section requires that the Resolution Professional has to make every endeavor to protect and preserve the value of the property of the Corporate Debtor. The cost incurred by the Resolution Professional towards such endeavor or in running the business of the corporate debtor as a going concern is termed as *Insolvency Resolution Process Cost* (Hereinafter "IRPC")[15].

It is important to note that IRPC does not include any fee or other expense incurred before the commencement of CIRP or to be incurred after the completion of the CIRP as clarified by

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[13] *In re Kmart*, 359 F.3d at 874.

[14] *Binami Industries Limited v Bank of Baroda*, Company Appeal(AT) (Insolvency) No. 82 of 2018

[15] The Code, s 5(13)(c)

IBBI vide its circular.[16] Therefore, it is clear that payment of pre-CIRP dues cannot be made by the Resolution Professional.

Furthermore, the Code provides for a moratorium on all the past dues of the Corporate Debtor, therefore, the payment of pre-CIRP claims is also contrary to Section 14 of the code. The intention of the legislature behind providing the moratorium is "*to provide the debtors a breathing spell in which he is to seek to reorganize his business"*[17].

To further maintain the smooth completion of the insolvency process and ensure a continuance of Corporate Debtor as a going concern, the Code provides for non-disruption of the essential goods and services during moratorium under Section 14(2) of the Code. However, it cannot be alleged that in lieu of such essential services being provided by the Operational Creditors, the services providers of these essential goods and services need to be paid for their past dues.[18]

The argument for the payment of pre-CIRP dues to ensure continuous supply of essential goods during moratorium is not sustainable for two reasons – *firstly*, such arrangement has not been envisaged anywhere in the Code rather it categorizes the operational creditors in two different categories which are discriminatory in nature as mentioned above; *Secondly*, the Code itself provides for the sufficient consideration for providing such services and payment of pre-CIRP dues is not necessary. The second reason mentioned finds its justification from the reading of section 14(2) along with Regulation 31 and 32 of Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 (Hereinafter "Regulations"). These provisions make it clear that the costs incurred in procuring essential goods and services to keep the Corporate Debtor as a going concern will come under IRPC. By putting these costs under IRPC, the suppliers of these services are put at the higher pedestal than all other Creditors.[19] Moreover, the acceptance of a resolution plan is preconditioned upon making a separate provision for IRPC in the resolution plan. Therefore, the priority is given to the operational creditors providing essential services to ensure that such operation creditors are paid for providing essential goods and services before anyone else.

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[16]IBBI, Circular No. IBBI/IP/013/2018, (12 June 2018), clause 8(c).

[17]*Innovative Industries Limited v ICICI Bank Limited*, 2018 (1) SCC 407.

[18]*Uttarakhand Power Corporation Limited v ANG Industries Limited,* Company Appeal (AT) (Insolvency) No. 298 of 2017

[19] The Code, s 30(2)(a)

In addition to the priority given to such operational creditors, it is crucial to note that the essential goods and services in section 14(2) are very narrow in scope. The essential goods and services have been defined in Regulation 32 which states that *the essential goods and services referred to in section 14(2) shall "means"*, which implies that the definition is exhaustive in nature. As per the law laid down by the Hon'ble Supreme Court, the term 'means' in a definition indicates that the "*definition is a hard- and-fast definition and no other meaning can be assigned to the expression that is put down in definition".*[20]Therefore, the tribunal is bound by the definition as provided in Regulation 32.

So, the essential goods and services only means electricity, water, telecommunication services and information technology services that also to the extent these are not a direct input to the output produced or supplied by the corporate debtor.[21]There were certain deviations from such an interpretation of the regulation.[22]However, the Appellate Tribunal has approved the exhaustive nature of the definition of 'essential goods and services' in Regulation 32 in the case of ***Sony Pictures Networks India Limited v Ortel Communication Ltd.***[23] In this case, the Appellate Tribunal dealt with the issue of essential goods and services for a digital cable television service provider and held that broadcasting services, conditional access system and video links are not essential goods and services under section 14(2) of the Code as they are direct input to the Corporate Debtor.

The requirement of making payment for outstanding dues for the period prior to the CIRP has been considered in the case of ***Uttarakhand Power Corporation Limited (UPCL) v ANG Industries Limited.***[24] The Appellate Tribunal in this case while allowing the application under Section 14(2) of the Code seeking for restoration of electricity supply to ensure that the Corporate Debtor remains a going concern, held that the UPCL (Appellant) cannot recover the dues which are unpaid for the period prior to the insolvency.[25]For the pre-CIRP claims, the Appellant Tribunal made the findings that the appellant has the right to submit claim before RP.

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[20]*P. Kasilingam & Ors v P.S.G. College Of Technology*, 1995 AIR 1395. p 19

[21] Insolvency and Bankruptcy Board of India (Insolvency Resolution process for corporate persons) regulations, 2016, Regulation 32

[22]*Canara Bank v Deccan Chronicle Holding Limited*, Company Appeal (AT) (Insolvency) No. 147 of 2017

[23] Company Law Tribunal, CP No. IB-761(ND)2018, dated 27-11-2018

[24]Company Appeal (AT) (Insolvency) No.298 of 2017, dated 24-01-2018

[25] Id. p 3

Therefore, pre-CIRP payment to certain Operational Creditors cannot be made by RP. Such payment to the operational Creditors is not only discriminatory to the other similarly situation Creditors, but also dilutes the scheme of the Code.

Part III-UK jurisprudence

The abovementioned analysis regarding payment of pre-CIRP payment to Operational Creditors is also supported by jurisprudence laid down with respect to pre-administration payment in UK. The UK laws do not allow the differential treatment of creditors by pre-administration payment which is prejudicial to the interests of the other creditors. Earlier, there also existed a dilemma regarding ability of administrators to make payments to creditors otherwise than through the vehicle of a voluntary arrangement or a scheme of arrangement. It was a settled law that the power to pay off classes of creditors lies only with the liquidators and not the administrator in administering an insolvent estate.[26]

Subsequently, the power of the administrator was broadened to allow him to make pre-administration payment for the more advantageous realization of the company's assets than would be effected on a winding up and to keep company as a going concern. In this regard the decision of Chancery Division in ***John Slack Ltd, Re*** is considered as the prevailing law. In this case, the Court decided that the administrator has the power to make payment towards the pre-administration order creditors in full to ensure the survival of the company as a going concern.[27]

However, it is crucial to note that such decision was taken under peculiar circumstances wherein the assets of the Company undergoing liquidation were more than the liabilities. The company therefore was not insolvent and had sufficient surplus to make payment towards the claims of *all* pre-administration creditors in full. The power of an administrator to make pre-administration payment only in certain special circumstance has also been reiterated in ***Re WBSL Realisations 1992 Ltd*** by Chancery Division Court while permitting the full payment of the claims to all creditors as there was sufficient fund to do so.[28]

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[26] *Re St. lves Winding Ltd* (1987) 3 B.C.C. 634 (Chancery Division)

[27] [1995] B.C.C. 1116

[28] [1995] B.C.C. 1118

Therefore, even though an administrator has wide power to make pre-administrator payment, such power can only be exercised under certain peculiar circumstances.[29]Moreover, regardless of the reason for which pre-administration payment is made, under no conditions the payment which is prejudicial to the other creditors would be allowed. Even in the earlier cases, the full payment of all creditors was allowed because there were no dissentients.[30] To ensure that the pre-administration payment is not prejudicial to the other creditor, the administrator also makes the order of such payment by putting certain conditions to safeguard the interests of other creditors as done in the decision of ***Re Mount Banking plc,*** which held as follows**:**

"There were precautions taken in that the amount was calculated so as not to exceed the amount that they would have received in the event of a liquidation, and the payment was to be made on terms that the depositors undertook to bring into account on a subsequent liquidation the payments they received from the administrators and hold any dividends received by them in any such liquidation on trust for other creditors so far as necessary to ensure that other creditors were not prejudiced by the payment on account."

Therefore, even in the UK jurisprudence, full payment of pre-administration claims only to certain Creditors has not been recognized. Pre-administration payment has only been allowed only if there are sufficient funds to make such payment to *all* creditors and when such payment order of the administrator is not prejudicial to other creditors who are placed at the same position.

Conclusion

In India, the Insolvency and Bankruptcy is an evolving regime witnessing a lot of amendment and the judicial pronouncements shaping it form and giving certainty regularly. Till Today, there is no judicial decision given by the courts on the issue of payment to critical operation creditors. However, on the basis of the above discussion and analysis, it is clear that the Indian scheme of the legislation did not intend to have the situation wherein the dues are paid to some or all the Operational Creditor. Though, there are can be such circumstance where some of the creditors can be required to be paid, however, such category is narrow in scope.

[29]Id.

[30] Supra (n 11)