

**The stacking order of priorities in secured lending:
An analysis of Supreme Court ruling in
*Central Bank of India vs. State of Kerala***

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The Supreme Court's latest ruling *Central Bank of India vs. State of Kerala & othrs* dated February 27, 2009, in the matter of priorities between statutory first charges and secured lenders makes the landscape of conflicting priorities of charges over assets even more complex. Regrettably, the courts are having to do what the lawmakers must have done – write a clear law on priorities. There has not been any concerted, cohesive effort either to think or to codify the law of priorities over last several decades. Therefore, there are fragments of laws scattered over different enactments, each of which seems to assert its own preponderance disregarding other claims or interests. It is rather unfortunate that such a significant area on secured lending is left to be settled by case law rather than by well-knit policy of the government. Law-making in this very serious area has been sporadic and ad-hoc – just limited to achieving a limited result, rather than comprehensive review of the matter.

There are several enactments currently competing for super-priority – sec. 529A of the Companies Act creates a *pari passu* interest between secured lenders and workmen. Sec 11 of Employees' Provident Funds and Miscellaneous Provisions Act, 1952, provides that in case of insolvency of the employer or winding up of the company, the amount so due from the employer shall be deemed to be the first charge on the assets and shall be paid in priority to other debts. Sales tax laws of most states, for instance, sec 38C of Bombay Sales Tax Act, 1959, provides that subject to the provisions regarding first charge in any Central Act, any sum of money due under this Act shall be the first charge on the property. Likewise sec 14A of Workmen's Compensation Act, 1923 provides that any liability accrued with respect of any compensation to be paid by the employer shall have first charge on the assets, on the other hand, sec 11 of the Central Excise Act, 1944 read with sec142 of the Customs Act 1962 says that the amount of duty may be recovered by attachment and sale of excisable goods.

While these are the different laws that provide for stacking order of priorities, there are several “special recovery” laws enacted from time to time, such as Recovery of Debt due to Banks and Financial Institutions Act,1993, SARFAESI Act, SFC Acts, IDBI Act, IFCI Act, etc. These special recovery laws either provide the secured lender direct right to sell (for instance, SARFAESI Act, SFC Acts, IDBI Act, IFCI Act, SIDBI Act), or empower a DRT to order the sale of assets to meet the claims of the secured lender.

The question of priority order of different claims will arise (a) in the event of distribution of liquidation proceeds in liquidation proceedings; (b) on recovery orders of a body like

DRT; (c) self-help repossession and sale of assets by secured lenders under SARFAESI Act, IFCI Act, SFC Act etc.

Rules of priorities:

In *Central Bank of India vs. State of Kerala*, the Supreme Court was concerned with the significant question whether the statutory first charges created by various central and state laws will prevail over the claims of the secured lender even while disposing of assets under the DRT law or the SARFAESI Act. After considering a series of rulings given in the past, such as *Bank of Bihar vs. State of Bihar* [(1972) 3 SCC 196], *Dena Bank vs. Bhikhabhai Prabhudas Parekh & Co. and others* [(2000) 5 SCC 694], *Central Bank of India vs. Siriguppa Sugars & Chemicals Ltd.* [(2007) 8 SCC 353], *State Bank of Bikaner & Jaipur vs. National Iron & Steel Rolling Corporation and others* [(1995) 2 SCC 19], the SC came to the conclusion that the primacy of statutory first charges prevails even in case of recovery under the DRT law and the SARFAESI Act.

Some quick principles to decide the stacking order of priorities that emerge out of the SC ruling are as follows:

- Central law prevails over a state law – hence, if a Central law provides for a statutory first charge, it has to gain primacy over a conflicting state law. Sec 38C of the Bombay Sales Tax Act, clearly states that;
“.... if any Central Act provides for first charge, the charge created under Section 38C of Bombay Sales Tax Act is overridden”
- As usual, the doctrine that a later law prevails over an earlier law applies here too. So, if there are several central laws providing for priority, the later law will prevail over the earlier one.
- Unless the law clearly provides for a “first charge”, a mere provision for attachment or recovery as land revenue does not by itself create a first charge. Based on analysis of the provisions of the Central Excise Act, in the case of *SICOM vs Union of India*, I (2007) BC 82 the Supreme Court came to a conclusion that the Excise dues rank only above the claims of ordinary creditors, and not secured creditors.
- If the law creates a first charge, the date of creation of the charge is irrelevant - that is, the normal rule of priorities based on the date of creation of the charge is not relevant in case of statutory first charges.

Do unpaid government dues become “secured lender” under SARFAESI Act?

An important provision of the SARFAESI Act (sec 13 (9)) is that in case there are multiple security interests on an asset, no secured lender may take an action against such asset without the consent, in writing, of at least 75% of the secured lenders. As per the principles of statutory first charges, obviously, the government becomes a security interest holder over an asset to the extent of unpaid taxes. This is automatic, and without any need for registration of charges or any similar act of creation or perfection of security

interests. The question is, if such a security interest exists, is a bank or financial institution, as secured lender, entitled to take action against an asset without consulting the government as a security interest holder?

The word “secured creditor” is defined in sec 2 (zd) of the Act to mean only such persons who have extended financial facility against an asset. An unpaid government is certainly a security interest holder, but not a secured lender. Hence, sec. 13 (9) does not seem applicable to need the consent of the government before taking of any action under sec 13 (4).

However, surely enough, in light of the statutory first charge, the distribution of assets upon sale by the secured lender will have to be first towards the statutory first charge holders, and thereafter, to other secured lenders.

Illustrations

Assuming the value of assets of an entity is Rs 10 crores, and the entity has the following outstandings:

- Dues to banks, holding charges over the assets: Rs 15 crores
- Excise dues: Rs.1 crore
- Sales-tax dues Rs.1 crore
- EPF dues Rs.1 crore
- Workmen’s Compensation dues Rs.1 crore
- Workmen’s dues Rs.3 crore

Assuming the company is not under liquidation, the order of priorities will run as follows:

1. Workmen’s Compensation Dues – Rs.1 crores
2. Sales Tax Dues – Rs.1 crores
3. Dues to Banks – Rs. 8 crores

Assuming the company is under liquidation, the order of priorities will run as follows:

1. EPF dues – Rs.1 crores
2. Workmen’s Compensation Dues – Rs.1 crores
3. Sales Tax Dues – Rs.1 crores
4. Dues to Banks (*pari passu with Workmen’s Dues*) – Rs.5.83 crores
5. Workmen’s Dues (*pari passu with Bank Dues*) – Rs.1.17 crores