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An Analysis of the Need for Creditor's Protection

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Abstract

Creditors are individuals or entities other than company members who are owed money by a company. They can include those who have lent money, sold goods, or provided services to the company. Creditors are typically external to the company, but a member can also become a creditor if they have lent money to the company that is still outstanding. There are four types of creditors, viz., Secured creditors, Unsecured creditors, Financial Creditors, and Operational creditors. They have enjoyed several rights under the Companies Act of 2013, the Insolvency and Bankruptcy Code of 2016, the SARFAESI Act of 2002, etc. Creditor's rights not only protect their interests against debtors but also within themselves. Some of the rights available under the Indian Companies Act, 2013 are Creditor's meeting, preference in payment, the appointment of a liquidator, the right to make decisions affecting creditor's interest, and the right to nominate directors, and control over corporate spending This article will discuss the definition of creditors, the different types of creditors, the need for creditor protection, and the rights available to the creditors in the Companies Act of 2013.

Keywords: *Creditors, Protection, Rights, Need for Protection.*

I. Introduction

Creditors are individuals or entities other than company members who are owed money by a company. They can include those who have lent money, sold goods, or provided services to the company. The creditor-debtor relationship gives creditors the ability to have some control over a borrower's business affairs. Creditors are typically external to the company, but a member can also become a creditor if they have lent money to the company that is still outstanding. Creditor's rights not only protect their interests against debtors but also within themselves. This article will cover the definition of creditors, the different types of creditors, the need for creditor protection, and the rights available to the creditors.

(A) Meaning of creditor

A creditor is one to whom an amount of money is due. Firm creditors are other firms,

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individuals, and perhaps the government to which it owes money in return for goods supplied, services rendered, and taxes for which it is liable. It is an antonym of debtor.[2] The expression of Section 392 of the Companies Act, 1956 regarding creditor is that, on the application of any person interested in the affairs of the company should be treated as a creditor.[3]

A person, company, etc. to whom money is owed. A creditor is one who trusts or gives credit, correlative to the debtor. A creditor is entitled to take our letter of administration if there is no next of kin or the next of kin does not. Creditor means any person who at the date of payment to him, would have had to come in and prove and rank with other creditors in the bankruptcy. A surety would be such a person.[4]

(B) Definition of creditors

The term Creditor has been defined under **Section 2(10) of the Insolvency and Bankruptcy Code, 2016** to mean any person to whom a debt is owed. A debt refers to a liability or obligation regarding a claim due from any person. An essential part of the term claim is that there arises a right to payment, or a right to remedy for breach of contract, which gives rise to a right to payment. Therefore, to be considered as a creditor of the corporate debtor, it is essential that a right to payment arises. Likewise, persons or entities seeking a remedy of specific performance, injunction, or other remedy, which do not give rise to a repayment, would not be a creditor.

Section 126 of the Indian Contract Act, 1872 defines that a person to whom the guarantee is given is called the creditor.[5] Andhra Pradesh High Court held that [6] to become a creditor there should be a debt legal or equitable owing or accruing. It must be an actual debt which means a definite ascertained sum of money, that is now payable or will become payable in the future by reason of the present obligation. It should be a conditional or contingent one.

(C) Types of creditors

The term "creditor" may have different definitions depending on the context, but it usually refers to an individual or financial institution that is owed money. Generally, creditors can be classified as either personal or real creditors. Personal creditors are those who are friends or family members to whom you owe money. Real creditors are financial institutions, such as banks or credit card issuers, that have the legal right to be repaid.

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[2] Penguin Commercial Dictionary 2nd Ed.
[3] 'Nitin Khanna', *Company Law Lexicon*, New Edition 2000, page No. 74
[4] Re Blackpool Vs Blackpool (1901) 1 Ch. 77
[5] Syndicate Bank Vs Vijay Kumar, AIR 1992 SC 1066
[6] C. Krishnaiah v. MW Muthiah, AIR 1958 A.P. (342)

- **Secured Creditors**

In the context of a company's winding-up, a secured creditor refers to a person who holds a mortgage, charge, or lien on any of the company's property or any part of it. This security is held as collateral for any debt owed to them by the company. It is not required for a secured creditor to prove their debt during the winding-up process. They can rely on their security and proceed to collect their debts independently, without being involved in winding-up proceedings.

Loans secured in this way are referred to as secured debts. Some examples of secured creditors include the financial institution holding your mortgage (if you fail to make payments, they may take possession of and sell your house), the financial institution holding your car loan, a leasing company, a rent-to-own company, a finance company, and any other creditor to whom you pledge your possessions to receive credit.

In the case of the **Board of Industrial and Financial Reconstruction Vs Swadeshi Mills Ltd.,**[7] the secured creditors holding the first charge on the property were responsible for paying the guards and for protecting the property. I was further directed to the official liquidator not to appoint security guards from private agencies but to send his requisition to the Security Guards Board constituted under the Act.

- **Unsecured Creditors**

In the event of a company going bankrupt, there are two types of creditors - secured and unsecured. Unsecured creditors do not have any security interests in the company's assets and are not preferential creditors. In such cases, all unsecured creditors must provide evidence of their debts, and the liquidator will decide the amount owed to them. However, unlike secured creditors, unsecured creditors do not have any collateral to claim, and they must go through the liquidator to prove their debts. When the company's assets are distributed among the creditors, the Pari passu rule states that unsecured creditors will receive an equal share. This rule applies to both court-ordered and voluntary winding up of the company.[8]

It is important to know that there are three types of unsecured creditors which are described by the Bankruptcy & Insolvency Act. These are preferred, deferred, and ordinary creditors.

A preferred creditor is someone who has a claim or a partial claim that is entitled to receive a dividend before any of the other unsecured creditors in a personal bankruptcy or a consumer proposal. Examples of preferred claims include employee wages, traveling salespersons'

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[7] (2002) 112 Com Cases 698 (Bom)

[8] Daizi Hazarika, *Protection of Creditors,* available at https://papers.ssrn.in

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expense accounts, and court-ordered support agreements.

On the other hand, deferred creditors are persons or companies that will not receive any money from a trustee administering a personal bankruptcy or consumer proposal until all the other creditors have been paid in full. Often, family members and other related parties are classified as deferred creditors.

Lastly, if a debt doesn't fall into the deferred or preferred subclasses, then it is an ordinary unsecured creditor. These debts include things like credit cards, bank loans, and income taxes. Most unsecured creditors fall into the ordinary subgroup.[9]

- **Financial Creditors**

The Insolvency and Bankruptcy Code of 2016 distinguishes between two types of creditors - financial creditors and operational creditors. According to Section 5(7) of the Code, a financial creditor is someone who has provided financial debt, which is defined under Section 5(8) of the IBC. Financial debt is a debt disbursed as a consideration for the time value of money. To qualify as a financial creditor, the debt must meet the definition of financial debt.

- **Operational Creditors**

The second category of creditor under IBC is that of the operational creditor. An operational creditor is defined under **Section 5(20)** of IBC. To determine if an individual would fall within the definition of an operational creditor, it must be determined by the background whether the debt owed to such a person must fall within the definition of an operational debt as defined under **Section 5(21)** of the Code.

According to Section 5(21), an operational creditor is defined as a person who has a claim related to the provision of goods or services, including employment, or a debt that requires repayment under any currently applicable law. This debt can be owed to either the Central Government, any State Government, or any local authority."

II. Need for creditor protection

The need for creditor security occurs when a corporation is being wound up. This idea is given a lot of weight during the winding-up process to protect the creditors who lend money to the company. The debtor-creditor relationship is born out of the development of credit, which is what makes insolvency possible in the first place.

Insolvency refers to a company's inability to pay its debts. It is a justification for the court to

[9] Scott Schaefer, CA, LIT, "Types of Creditors in Bankruptcy –Secured, Unsecured & Preferred," available at https://www.hoyes.com

wind up a company, but it is not the only reason. Liquidation is the process of a business that has become insolvent. This condition of insolvency occurs when a corporation is unable to pay the due sum that it has borrowed from creditors to collect the required funds. The creditor-debtor relationship is thus formed. When winding up the business, creditors' interests are considered so that they can receive a portion of their due sum from the assets realized during the process.[10]

Credit can be obtained from several sources, including individuals and organizations. A creditor may be someone who isn't a business member. He may be an individual, a financial institution, or someone else willing to lend the company money. They may be institutional lenders such as banks who play an important role in providing loans to businesses; trade creditors who provide products or services to businesses; affluent individuals; government agencies; workers, and so on.

In **Boolani Engineering Corporation Vs Asup Synthetics and Chemicals Ltd.,**[11] the Rajasthan High Court held that special provision for recovery of the scope of winding up. There is no effect of the Companies Act provision. Here, no need to leave of Court, and the creditor sale the property without the intervention of the court.

In **Central Bank of India Vs Fimot Engineering Co., Pvt. Ltd. (in liquidation),**[12] it has been held that secured creditors have no need of any permission of the court or liquidator, to defend creditor suit with court leave it is necessary that the suit should be transferred to winding up court for trial.

In **Maharashtra State Financial Corporation Vs Official Liquidator High Court Bombay,**[13] it has been held that sanction of the court is not required to realize debt by sale of mortgaged property without any intervention of the court in case of the secured creditor.

Credit can be received in a variety of ways by a company. They may be as follows:

(A) By offering security

Borrowing companies provide security to lenders, which might appeal to them because it lowers their loan risks by granting them priority claims to repayment in the event of the company's insolvency. Such assets could include the company's premises, equipment, and plants, among others.

[10] Daizi Hazarika, "*Protection of Creditors*", available at https://papers.ssrn.in
[11] (1994) Com. Cas. Vol. 1. Raj. 72
[12] (1994) Co. Cases Vol.2. Bom.10
[13] (1995) Co. Cases Vol.2. Bom. 243

(B) By seeking an unsecured loan

A business can get a loan without putting up any collateral, but the lender takes the risk that if the company goes bankrupt, their loans will be paid after the secured creditors are paid.

(C) By resorting to a third-party guarantee

A third party, such as an actual director of the debtor company, can guarantee a loan from a borrower such as a bank. The guarantor agrees to assume responsibility for the principal debtor's default.

Section 391 of the Companies Act, 1956 defines "creditor" in a comprehensive manner, to which even the Sales Tax Department can be considered as a creditor, even if its claims against the company are future or contingent. However, the Income Tax Department cannot be considered as a creditor until an assessment is made. Similarly, workers who claim payment under an agreement under the Industrial Disputes Act cannot be regarded as creditors of the company.

If a party wishes to make any submission, even at the stage of ex-parte hearing, the court must hear them in the interest of justice. Additionally, both the Central Government and the shareholders of the company, who are distinct legal entities apart from the company, are entitled to be heard before a decision is taken under section 391(1) of the Companies Act, 1956.[14]

The disappearance of the substratum of a company, unless it imperils the recovery of his dues, is not a ground on which a creditor could be permitted to bring and succeed on a petition for the winding up of the company. The right of a creditor to a winding-up order is not his individual right but a representative right.

The courts will not uphold a plea of absence of locus standi in the person petitioning as a creditor when the company puts forward only a vague plea. unsupported by details, that the debt claimed by the petitioner, is not presently due to him. Winding up an application by a creditor whose debt was time-barred passed on the notice of demand for payment and failure to comply with it is not maintainable. A transferee and not the transferor is a creditor of the company. Where a part of the debt owing to a secured creditor was satisfied out of the sale proceeds of the property pledged, it was held that he was entitled to present a petition for winding up being still a creditor for the balance amount.[15]

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[14] J Saini, "*Protection of investors and creditors under the company law A critical analysis*", available at https://shodhganga.inflibnet.ac.in

[15] Nitin Khanna "*Company Law Lexicon*", New Edition 2000

III. RIGHTS OF CREDITORS IN COMPANIES ACT, 2013

(A) Meeting of Creditors

When a company aims to arrange with its creditors, it calls for a meeting of creditors. The Companies Act, in sections 391 to 393, not only empowers the company to compromise with its creditors but also outlines the procedure for doing so. If the liquidator believes that the company will not be able to pay its debts in full, it will be considered a creditors' voluntary winding up. In this case, the liquidator will summon a meeting of the creditors according to section 495 of the Companies Act. Sections 499 to 509 provide for the meeting of creditors during voluntary winding up. In general, any person who has a monetary claim against the company that can be estimated is considered a creditor.[16]

In **Power Builders (Surrey) Ltd., Power Vs Petrus Estates Ltd,** the creditors resolved at their meeting for voluntary winding-up. The chairman objected to a creditor's vote. The question in this case was as to what the effect of the chairman's decisions would be rejecting the creditor's vote. The court found no prospect of calling a new meeting. The court dismissed the appeal.

There are legal provisions for the meeting of the creditors on winding up (voluntary). When the meeting of creditors is not called on such voluntary winding up, they can approach the court or CLB for the same reason. As the creditors are the main investors in the company with the shareholders. They have given a large amount to the company and if the company is winding up then there will be loss to the creditor at large.

(B) Appointment of liquidator

During the meetings mentioned in section 500, the creditors and the company have the right to nominate a person who will act as a liquidator. The role of the liquidator is to wind up the company's affairs and distribute its assets. If the creditors and the company choose different people for the role, then the person nominated by the creditors will be selected. However, if any member, director, or creditor of the company disagrees with this selection, they can apply to the court within seven days. They can either request that the person nominated by the company be made the liquidator instead or they can appoint another person, such as the Official Liquidator, to act as the liquidator instead of the person appointed by the creditors.

In case no person is nominated by the creditors, the liquidator will be the person nominated by the company. Similarly, if no person is nominated by the company, the liquidator will be the

[16]Akash Shah, *"Meeting of creditors"*, available at http://www.legalservicesindia.com

person nominated by the creditors. It is important to note that during a creditors' voluntary winding up, the creditors have a preferential right and can nominate a liquidator. The court has the power to vary the appointment if a director, member, or creditor applies within seven days. A liquidator is appointed by a resolution of the members and cannot be replaced by one appointed by many creditors in value but not in number.[17]

(C) Preference in payment

1 In the winding up of a company, debts owed to workmen and secured creditors must be given priority over all other debts. If the assets of the company are insufficient to fulfill the payments, the debts payable will be paid in full. This provision was included specifically to ensure that the workmen are not left in the lurch in the event of the company's liquidation. Workmen of the company are treated as secured creditors in relation to their claims, and the company's assets will remain charged for the payment of their dues. This charge will be on an equal footing with the charge of the secured creditors. Under section 529A, the dues to the secured creditors will be treated equally and must be given precedence over all other dues.

2 The Madras High Court examined the effect on the position of a secured creditor in Indian Bank vs Perumal Raja. In this case, the applicant sought leave from the court to continue the suit against the respondent company, which had been ordered for winding up by the court for a substantial amount of money. The court granted leave subject to the condition that, since the applicant had chosen to ignore the liquidation and was relying on the security, if there was a deficiency by the sale of the securities, the applicant would be excluded from all shares in any dividend that may be declared by the official liquidator in the liquidation, except and to the extent provided under Section 529A of the Companies Act, 1956. The applicant appealed before the court.

3 The court held that Section 529A of the Act enables the secured creditor, who has suffered in paying the workmen's dues from the realization of his security, to recover what he has suffered from other assets in the hands of the official liquidator, preferentially. That is, the amount suffered by him shall be paid in priority to all other debts. However, this does not mean that he cannot recover any other unrealized portion of the debt due to him. Thus, Section 529A enables the secured creditor, who has suffered in paying the workmen’s dues out of the realization of his security, to recover

[17] http://www.legalservicesindia.com

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what he has suffered from the other assets in the hands of the liquidator, and that amount shall be paid in priority to all other debts.

IV. Rights in making company decisions affecting creditors interests

The company is required by law to arrange a meeting with its creditors immediately or on the day following the general meeting in which the resolution to wind up voluntarily is proposed. The company must send notices of the meeting to its creditors.[18]

The directors may be fined for not complying with section provisions, but it does not render the meeting invalid. In the case of E. V. Saxton and Sons Ltd. v. R. Miles (Confectionaries) Ltd., a creditors' voluntary winding-up meeting was held without prior notice. However, the resolution for winding up was still considered valid.

In case of liquidation of a company, the creditors have a preferred right to appoint a liquidator who will have the power to wind up the company's affairs and distribute its assets. In case of any disagreement between the company and the creditor regarding the nomination of the liquidator, the creditor's nomination shall be considered final. Additionally, an application can be made within seven days by a director, member, or creditor to vary the appointment of the liquidator. When a company is unable to pay its debts in full, the liquidator is responsible for calling a meeting of the creditors. At this meeting, the liquidator must present a statement of the company's assets and liabilities. It is also the liquidator's duty to hold a meeting with both the company and the creditors one year after the winding-up process begins, as well as at the end of the winding-up process. During these meetings, the liquidator must present his accounts of the company's activity. It is the liquidator's obligation to show the company's accounts and other affairs during the winding-up process to both the members and creditors of the company.

These responsibilities apply to both winding up by the court and voluntary winding up. The main reason for these provisions is to make the creditors of the company aware of the company's affairs and to allow them to make any decisions regarding the company's affairs that may directly affect them. The Company's Act has made provisions to ensure that the creditors are informed of the company's affairs during winding up, making the entire process transparent to them.

V. Conclusion

Creditors do not have the same status as members of a company, but they play a key role in keeping the company running. In fact, they are the backbone of the company. There are four

[18] section 500 of the Companies Act, 1956.

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types of creditors: secured, unsecured, operational, and financial. Secured creditors have a more protected position compared to other creditors. In the event of a winding-up, they don't need to prove their debt and can rely on their security to recover their debt outside of the winding-up proceedings.

The protection of creditors arises during the winding up of the company and during the company becomes insolvent. This article has discussed the need for creditor protection in this paper. It can be concluded that the rights of the creditors are given much importance as they are the people in a company that provides finance to help the company in the smooth running of their business. Because of the role played by the creditor, the rights of the same were considered, and hence effective legislation has been enacted to investigate their rights.

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