



GRAVITAS LEGAL

## A different prism for trust and retention account agreements to be looked through?

### Part 1 of 3

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#### **Introduction**

Trust and Retention Account (**TRA**) mechanism<sup>1</sup>, a common feature across infrastructure projects, finds its genesis in one of the first few guidelines issued by Reserve Bank of India (**RBI**) on infrastructure financing, namely, Circular on Financing of Infrastructure Projects dated April 23, 1999 bearing reference number IECD. No. 26/08.12.01/98-99 issued by RBI. Under the TRA mechanism, control over future cash flows is removed from the hands of the borrower and placed with an independent agent called TRA Agent/Trustee (appointed and acting for the benefit of lenders). With such earmarking of cash flows, allocation in a pre-determined manner for various purposes including debt servicing, towards Government and Statutory Dues, operation and maintenance expenses (amongst others) can be made and transparently monitored. Upon meeting of pre-defined line items of expenses (usually in consonance with pre-approved budgets), residual cash flow is made available to the borrower subject to satisfaction of certain conditions (known, typically, as Restricted Payments Conditions or Distribution Conditions). While TRA Agreements may vary across the board in terms of specific line items and the overall look and feel, principally, a large part of the pith and substance will be based on the above.

In this part of (the intended) **three-part series** of articles on this subject, we limit our analysis to treatment/priority accorded to Government and Statutory Dues vis-à-vis the rights of creditors.

#### **Treatment of Government and Statutory Dues in Trust and Retention Account in light of Insolvency and Bankruptcy Code, 2016 (IBC)**

<sup>1</sup> Sometimes nomenclated differently – illustratively, as Escrow Account. However, for distinction between TRA mechanism and Escrow mechanism, reference may be made to Circular on Financing of Infrastructure Projects dated April 23, 1999 bearing reference number IECD No. 26/08.12.01/98-99 issued by Reserve Bank of India.

### **Position (as it presently stands?) pre IBC**

Under TRA Agreements, the Government and Statutory Dues (for payout of which a separate sub-account is created usually) are given first priority in terms of utilization/end-use of revenue receipts or other collections. Sometimes, one may also find stipulations according overriding priority to Government and Statutory Dues in the event of competing payments/shortfall in cash flow (on a particular date/in a particular period) to meet all liabilities as have devolved. One of the main reasons (historically) for this priority is that Government and Statutory Dues bear the flavour of ‘crown debt’, with the principle of priority of crown debt founded on the rule of necessity and of public policy – the State is entitled to raise money by taxation because, unless revenue is received by the State and it is in possession of necessary funds, it would not be able to discharge its functions at all. The Hon’ble Supreme Court of India also held that the arrears of tax due to the State can claim priority over private debts in view of the common law doctrine relating to priority of crown debts (common law doctrines would carry the force of law within the meaning of Article 372 (1) of the Constitution of India)<sup>2</sup>. Viewed from another angle, if tax dues remain unpaid, Government and Statutory Authorities would have the right to attach the assets and realize tax dues from the disposal of such assets, thereby prejudicing the functioning of the project altogether and justifying according top priority to Government and Statutory Dues within the TRA waterfall.

### **IBC – Rights of Lenders in Liquidation**

While the Companies Act (2013 or for that matter 1956) set out a particular distribution priority in the event of winding up of a company, IBC marks a departure in terms of Section 53 thereof. In a liquidation scenario, crown debt (Government and Statutory Dues) ranks below insolvency resolution process/liquidation process costs, workmen’s dues/dues of the secured creditors, dues of the employees (other than workmen) and financial debts owed to unsecured creditors. There are, by now, several judicial decisions that have recognized the rights of Government Authorities in relation to such dues as those belonging to unsecured operational creditors.

### **This Begs the Question**

Because this relates specifically to a liquidation scenario, the natural question is why should TRA Agreements not accord priority to Government and Statutory Dues since that may be relevant in the ordinary course of business as well as during the corporate insolvency resolution process (CIRP) and also because any TRA Agreement which has a waterfall/distribution mechanism contrary to Section 53 of the Code will in any case be overridden.

### **Treatment of Government and Statutory Dues in CIRP /Liquidation**

It is true that as far as the banks/financial institutions are concerned under the scheme of the IBC, in case of both CIRP and liquidation, their rights are protected as they are the financial creditors with the Government and Statutory dues being recognized as operational debt and the Apex Court having affirmed on more than one occasion that equality is among equals and financial and operational creditors are at a different footing<sup>3</sup>.

### **Overall Position**

The overall scheme on this subject has evolved by virtue of the enactment/enforcement of the Code leading to amendments to the Companies Act, 2013<sup>4</sup> and now, in case of winding up process of a company under the aegis of the courts, Government and Statutory Dues no longer

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<sup>2</sup> *Dena Bank vs. Bhikhabhai Prabhudas Parekh & Co.*, [2000 (5) SCC 694].

<sup>3</sup> *Committee of Creditors of Essar Steel India Limited vs. Satish Kumar Gupta and Others*, [2019 SCC Online 1478].

<sup>4</sup> Section 326 of the Companies Act, 2013.

receive the same priority. There are amendments to certain other statutes<sup>5</sup> relating to debt recovery which can be said to trace their origin to the enactment of the Code, but these are not of immediate concern for the purposes hereof.

### **Then Why Relook?**

It should be noted that the Hon'ble Supreme Court of India in one of its recent decisions on this subject held that, unless preference is given to the crown debt by a statute, the dues of a secured creditor have preference over crown debts<sup>6</sup>. *For the purposes hereof, we will call the key judicial finding in this decision as the Connectwell Principle.*

Even outside the scope and ambit of the Code, as far as income tax dues or dues under the Central Goods and Services Tax Act, 2017 are concerned, as a matter of practice, linked to security creation (or otherwise), permission (for creation of security on assets) under relevant statutory provisions<sup>7</sup> would have been obtained or independent confirmation (often taken on periodic basis) regarding there being no tax dues outstanding would have been obtained.

Further, the Hon'ble Supreme Court of India<sup>8</sup>, has also recognized that Section 31B of the Recovery of Debts and Bankruptcy Act, 1993 and Section 26E of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 respectively have purported to create priority of recovery of secured creditors over Government and Statutory Dues. Even if the state tax law provides for priority of Government and Statutory Dues, in view of Article 246 of the Constitution of India, central Acts will prevail. Consequently, it is held by several High Courts that the secured creditor can recover the sale proceeds out of sale of secured assets in priority over Government and Statutory Dues even if Government and Statutory Dues are outstanding and have been claimed<sup>9</sup>. Based on the above and the Connectwell Principle, even though Government Authorities may exercise their rights to have their debt adjudicated and thereby proceed for attachment of assets, dues owed to secured creditors would always have priority and supercede<sup>10</sup> such Government and Statutory Dues.

Even if one were to consider the larger basket of the Government and Statutory Dues (as the definition of 'Statutory Dues' or 'Taxes' contained in TRA Agreements or Loan Agreements are typically wider) covering provident fund or employee state insurance or other similar

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<sup>5</sup> Section 31B of the Recovery of Debts and Bankruptcy Act, 1993 and Section 26E of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 – Also discussed further in the article.

<sup>6</sup> *Connectwell Industries Pvt. Ltd. vs. Union of India*, (2020) 5 SCC 373].

<sup>7</sup> For example, under Section 281(1) of the Income Tax Act, 1961.

<sup>8</sup> *UCO Bank & Another vs. Dipak Debbarma & Others*, [2017 (2) SCC 585] – while interpreting Article 246 held that regard must be had to the constitutional scheme which visualises a federal structure giving full autonomy to the Union Parliament as well as to the State legislatures in their respective/demarcated fields of legislation. In case of conflict, it will be plain duty of the Constitutional Court to see if the conflict can be resolved by acknowledging the mutual existence of the two legislations. If that is not possible, then by virtue of the provisions of Article 246(1), the Parliamentary legislation would prevail and the State legislation will have to give way notwithstanding the fact that the State legislation is within the demarcated field (List II). This is the principle of federal supremacy which Article 246 of the Constitution embodies.

<sup>9</sup> *Axis Bank Limited vs State Of Maharashtra And Anr.*, 2017 (3) AIR (Bom) R 305.

<sup>10</sup> For the purposes hereof, we have not considered a situation where a Government Authority proceeds under the Insolvency and Bankruptcy Code, 2016 for dues owed to it because in such a scenario, even if Government Authority initiates CIRP it will be considered a proceedings *in rem* by virtue of *Swiss Ribbons Pvt. Lmt. vs. Union of India* (2019 SCC OnLine SC 73), and a secured creditor will always get priority over Government under the Code.

statutorily mandated payments/provisioning, the special purpose vehicles housing the project usually never have workmen on their rolls as EPC contracts and O&M contracts are seldom executed in-house. Resultantly, the compliance thresholds under various labour laws in India do not usually get triggered.

### **Conclusion**

Although the risks relating to attachments and garnishee type orders cannot be ruled out, and such proceedings remain real possibilities in situations of tax default or delinquency, from the perspective of lenders, the time is right for evaluating whether or not Government Dues or other Statutory Dues need to be accorded top priority contractually. In terms of TRA Agreements and drafting thereof, there is no better time than this to assess whether separate sub accounts are required for Government and Statutory Dues or whether it is more appropriate for them to be treated as part of the larger outflow from an Operating Expenses/O&M Account or Debt Service Payment Account. Since conflict between contractual stipulations and what may be provided in, or emanate from, law/judicial decisions should always be avoided, is this one of the aspects in TRA Agreements that one should revisit with a view to conform TRA Agreements to the current legal position/judicial disposition?

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