

Government Dues under IBC: Rainbow Papers Explained

Rainbow Papers: The Judgment

In *State Tax Officer (1) v. Rainbow Papers Ltd.*, 2022 SCC OnLine SC 1162 (“**Rainbow Papers**”), the Supreme Court dealt with the question as to whether the provisions of the Insolvency and Bankruptcy Code, 2016, (“**IBC**”) (specifically Section 53) overrides Section 48 of the Gujarat Value Added Tax Act, 2003 (“**GVAT Act**”).

Section 48 of the GVAT Act provides as follows.

Section 48. Tax to be first charge on property:

“Notwithstanding anything to the contrary contained in any law for the time being in force, any amount payable by a dealer or any other person on account of tax, interest or penalty for which he is liable to pay to the Government shall be a first charge on the property of such dealer, or as the case may be, such person.”

It was held as follows:

- i. Section 48 of the GVAT Act is not contrary to or inconsistent with Section 53 or any other provisions of the IBC. Under Section 53(1)(b)(ii), the debts owed to a secured creditor, which would include the State government under the GVAT Act, are to rank equally with other specified debts including debts on account of workman’s dues for a period of 24 months preceding the liquidation commencement date;
- ii. The State is a secured creditor under the GVAT Act. Section 3(30) of the IBC defines secured creditor to mean a creditor in favour of whom security interest is created. Such security interest could be created by operation of law. The definition of secured creditor in the IBC does not exclude any Government or Governmental Authority;
- iii. if the resolution plan excludes statutory dues payable to government or a government authority or legal authority, altogether, the NCLT is bound to reject such resolution plan;
- iv. if a company is unable to pay its debts, which should include statutory dues to the Government and / or other authorities and there is no plan which contemplates dissipation of those debts in a phased manner, uniform proportional reduction, the company would necessarily have to be liquidated and its assets sold and distributed in the manner stipulated in Section 53 of the IBC; and
- v. the committee of creditors (“**CoC**”), which might include financial institutions and other financial creditors, cannot secure their own dues at the cost of statutory dues owed to any Government or Governmental Authority or for that matter, any other dues.



Departure from Objectives of IBC on treatment of Government Dues

The treatment of dues owed to government or statutory authorities as secured creditors was seen as a departure from the objectives of IBC.

The Report of the Bankruptcy Law Reforms Committee of November 2015 provides as follows:

“The Committee has recommended to keep the right of the Central and State Government in the distribution waterfall in liquidation at a priority below the unsecured financial creditors in addition to all kinds of secured creditors for promoting the availability of credit and developing a market for unsecured financing (including the development of bond markets). In the long run, this would increase the availability of finance, reduce the cost of capital, promote entrepreneurship and lead to faster economic growth. The government also will be the beneficiary of this process as economic growth will increase revenues. Further, efficiency enhancement and consequent greater value capture through the proposed insolvency regime will bring in additional gains to both the economy and the exchequer.”

Further, the Preamble to the IBC provides as follows:

*“An Act to consolidate and amend the laws relating to reorganisation and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner for maximisation of value of assets of such persons, to promote entrepreneurship, **availability of credit and balance the interests of all the stakeholders including alteration in the order of priority of payment of Government dues** and to establish an Insolvency and Bankruptcy Board of India, and for matters connected therewith or incidental thereto.”*

In January 2023, the Ministry of Corporate Affairs had put up certain proposed changes to IBC for public comments. One of the proposals was to neutralize the disruptive effect of *Rainbow Papers* by introducing an amendment to provide that all debts owed to government or statutory authorities will be treated at par with other unsecured creditors, irrespective of any statutory provisions creating a first charge, except in cases where a security interest

has been created in favour of the government pursuant to a “transaction” between it and the borrower.

Certain judgments dealing with applicability of Rainbow Papers to Government Dues arising under other statutes

Rainbow Papers saw an increase in demands from various statutory authorities to be given the same treatment as “secured creditors” resulting in delays in approval / implementation of resolution plans. Further, the Adjudicating Authorities were also examining whether the resolution plans pending for approval before them were in compliance with *Rainbow Papers*.

The National Company Law Appellate Tribunal in *Department of State Tax v. Ashish Chhawchharia Resolution Professional For Jet Airways (India) Ltd. & Anr.*, (Judgment dated October 21, 2022) (“**Jet Airways**”) was dealing with the issue whether the Department of State Tax can be treated as a ‘secured creditor’ for the purposes of IBC pursuant to provisions of Section 82 of Maharashtra GST Act, 2017 which provides as follows:

“Tax to be first charge on property. –

Notwithstanding anything to the contrary contained in any law for the time being in force, save as otherwise provided in the Insolvency and Bankruptcy Code, 2016 (31 of 2016), any amount payable by a taxable person or any other person on account of tax, interest or penalty which he is liable to pay to the Government shall be a first charge on the property of such taxable person or such person.”

Placing reliance on *Sundaresh Bhatt, Liquidator of ABG Shipyard vs. Central Board of Indirect Taxes and Customs*, 2022 SCC Online SC 1101, the NCLAT held that provisions of Section 82 of the Maharashtra GST Act, 2017, contains an exception with regard to IBC and therefore, on the strength of dues under Maharashtra GST Act, 2017, no charge can be claimed on the assets of the corporate debtor. In our view, the NCLAT correctly held that *Rainbow Papers* will not be applicable to dues under the Maharashtra GST Act, 2017 in view of the specific exclusion of IBC under Section 82. Going by the same analogy, the reasoning of *Rainbow Papers* will not be applicable to other statutes

which contain a specific exclusion of IBC in their charging provision such as the Customs Act.

On July 17, 2023, the Supreme Court in *Paschim Anchal Vidyut Vitran Nigam Limited vs. Raman Ispat Private Limited and Others 2023 SCC OnLine SC 842* (“**Raman Ispat**”), while dealing with the interplay between the Electricity Act, 2003 and the IBC, held that Section 238 of the IBC overrides the provisions of the Electricity Act, 2003 despite the latter containing two specific provisions which open with non-obstante clauses (i.e., Section 173 and 174). While dealing with the issue at hand, the Supreme Court held that:

- i. *Rainbow Papers* did not notice the ‘waterfall mechanism’ under Section 53 – the provision had not been adverted to or extracted in the judgment;
- ii. Whilst the GVAT Act creates first charge in favour of the State, the separate and distinct treatment of amounts payable to secured creditor on the one hand, and dues payable to the government on the other under the waterfall mechanism in Section 53 clearly signifies Parliament’s intention to treat the latter differently - and in the present case, having lower priority. This is also evident from the Preamble to the IBC; and
- iii. *Rainbow Papers* has to be confined to the facts of that case alone.

It was felt that Raman Ispat will provide the necessary course correction and ensure that the object of IBC to accord lower priority to government and statutory dues

(as brought out from the preamble to IBC) will be upheld going forward.

Review of Rainbow Papers

Five review applications were filed against *Rainbow Papers* which were allowed by the Supreme Court for hearing on November 13, 2022. On October 31, 2023, the Supreme Court in *Sanjay Kumar Agarwal v. State Tax Officer (1) & Anr.*, [Review Petition (Civil) No. 1620 of 2023 in Civil Appeal No. 1661 of 2020] (“**Rainbow Papers Review judgment**”) dismissed the various review petitions (and connected intervention / impleadment applications).

Impact of the Dismissal of the Review Petitions

The dismissal of the review petitions in relation to the *Rainbow Papers* will mean that the decision of the *Rainbow Papers* will continue to be applicable in CIRP cases. However, in our view, the analysis of *Rainbow Papers* will be applicable only in such cases where the statutory provision creating first charge in favour of the relevant government or statutory authority is *pari materia* with the provision of Section 48 of the GVAT Act.

Rainbow Papers does not support the argument that all government dues will be secured dues under all circumstances. Basis the Supreme Court’s view in *Rainbow Papers*, the classification of government dues will have to be undertaken in a two-pronged manner as follows:

Step 1	examination of the provisions of the governing legislations (both Central and State) to ascertain whether or not a charge is created in favour of the relevant government and statutory authority in respect of their claim
Step 2	whether or not the provisions of such governing legislation are expressly made subject to IBC or have a provision pursuant to which IBC is given primacy

If the concerned governing legislation creates a charge and is not subject to IBC (as was the case in the relevant statute which was subject matter in *Jet Airways*), then such statutory authority will have to be classified as a “secured creditor” for the purposes of Section 53 and accordingly, will be eligible for distribution in terms of Section 53(1)(b) (ii) of the IBC.

Going by the aforesaid, it may be noted that the dues owed to Customs authorities (by virtue of Section 142A¹ of The Customs Act, 1962, as amended) as well as to the GST authorities (by virtue of Section 82² of Central Goods and Services Act, 2017, as amended) will not have first charge as the respective provisions have been specifically made subject to IBC. It may also be noted that the Income Tax Act, 1961, as amended, does not have a provision for creation of first charge. This has been upheld by the NCLAT in the *Jet Airways* case. Further, this also finds support from the decision of a 3-Judge Bench of the Supreme Court in *Lalu Prasad Yadav & Others v. State of Bihar & Others* (2010) 5 SCC 1.³

Section 30(2)(b) provides that one of the mandatory contents of a resolution plan is that it must provide for the payments of debts of operational creditors which shall not be less than: (i) the amount to be paid to such operational creditors in the event of a liquidation of the corporate debtor under Section 53; or (ii) the amount that would have been paid to such operational creditors, if the amount to be distributed under the resolution plan had been distributed in accordance with the order of priority in sub-section (1) of Section 53, whichever is higher. Accordingly, the assessment whether a government or statutory authority is a ‘secured creditor’ within the meaning of IBC will have

to be made while deciding on matters of distribution of proceeds to operational creditors.

Rainbow Papers itself provides that a resolution plan must provide for uniform proportionate reduction of claims of all secured creditors. Therefore, the secured operational creditors will not have any priority over such secured financial creditors who have a first charge on the relevant assets or vice versa. All secured creditors (both financial and operational) will have to be paid as per the provisions of Section 53(1)(b) of IBC. Accordingly, in case of resolution plans, the secured operational creditors must have at least the same percentage recovery as the similarly placed financial creditors having first ranking *pari passu* charge over the assets of a corporate debtor.

Concluding Remarks

On a plain reading, it appears that *Rainbow Papers* is at odds with one of the stated legislative intents behind IBC *viz.* to accord a lower priority to Government dues as against dues owed to secured lenders/banks/financial institutions. The said intent is manifest not only in the *Preamble* to the IBC but also from other provisions of the IBC and the regulations framed thereunder. The various reports of expert committees including the Bankruptcy Law Reforms Committee and the Insolvency Law Committee also bear out the same. It is appropriate that the law laid down in *Rainbow Papers* is re-considered by a larger bench of the Supreme Court, if a suitable corrective amendment does not come through swiftly.

¹ Section 142A provides as follows:

Section 142 A. Liability under Act to be first charge:

Notwithstanding anything to the contrary contained in any Central Act or State Act, any amount of duty, penalty, interest or any other sum payable by an assessee or any other person under this Act, shall, save as otherwise provided in section 529A of the Companies Act, 1956 (1 of 1956), the Recovery of Debts Due to Banks and the Financial Institutions Act, 1993 (51 of 1993) and the Securitisation and Reconstruction of Financial Assets and the Enforcement of Security Interest Act, 2002 (54 of 2002) and the Insolvency and Bankruptcy Code, 2016 (31 of 2016) be the first charge on the property of the assessee or the person, as the case may be.

² Section 82. Tax to be first charge on property:

Notwithstanding anything to the contrary contained in any law for the time being in force, save as otherwise provided in the Insolvency and Bankruptcy Code, 2016, any amount payable by a taxable person or any other person on account of tax, interest or penalty which he is liable to pay to the Government shall be a first charge on the property of such taxable person or such person

³ The question before the Supreme Court was whether in view of the provisions of Section 378 of the Code of Criminal Procedure, 1973, as amended, (“CrPC”) whether the State Government (of Bihar) has competence to file an appeal from the judgment dated 18th December, 2006 passed by Special Judge, CBI (AHD), Patna, acquitting the accused persons when the case has been investigated by the Delhi Special Police Establishment (CBI). It was held that in view of the opening words “Save as otherwise provided in sub-section (2)” in Section 378(1) of CrPC, the State Government has no power to file appeals in cases under sub-section (2) of Section 378 of CrPC.

In any event, as discussed above, the decision in *Rainbow Papers* has limited application and it is incorrect to rely upon *Rainbow Papers* to contend that all government dues are secured dues. *Rainbow Papers* does not lay down that all government departments/authorities will automatically

have status of 'secured creditor' for the purpose of IBC. The said position depends on the language and intent of the underlying legislation which regulates the relevant government dues.

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