ANALYZING THE IMPLICATIONS OF THE STATE TAX OFFICER V. RAINBOW PAPERS CASE AND CHARTING A PATH FORWARD

Venu Madhav, Damodaram Sanjivayya National Law University

ABSTRACT

The recent judgment in the case of State Tax Officer v. Rainbow Papers by the Supreme Court of India has far-reaching implications for the Insolvency & Bankruptcy Code (IBC). The case underscores the importance of addressing statutory and government dues in resolution plans for financially troubled companies facing insolvency, with a failure to do so potentially leading to mandatory liquidation under Section 53 of the IBC. This judgment has sparked significant debate and critique on several fronts by treating government dues under IBC over and above other Operational Creditors. The preference given to government dues in comparison to other operational creditors is seen as inequitable and not in line with the IBC's objectives. Moreover, the Court's decision to grant government dues the same status as secured creditors within the IBC's defined waterfall mechanism is criticized. This has the potential to alter the priority structure and undermine the legislative intent behind the IBC. Lastly, the judgment's interpretation of Section 48 of the Gujarat Value Added Tax Act, in favour of government dues, is seen as inconsistent with Section 53 of IBC and its "business-first" principle. It's argued that the IBC should take precedence over the state act as mandated by Section 238. In light of these concerns, it's recommended that the Supreme Court reexamines the judgment to provide further clarity. If the existing legal position remains unaltered, it could deter potential resolution applicants, reduce asset values, and lead to higher losses for creditors. The Ministry of Corporate Affairs has also sought public input on potential amendments to the IBC, addressing issues such as the nature of "security interest" and the treatment of government dues. It remains to be seen how these proposed changes will be reconciled with the recent judgments while preserving the balance between the interests of the government and private creditors under the IBC.

Introduction

In a recent ruling in the case of State Tax Officer v. Rainbow Papers,[1] the Supreme Court of India has emphasized that a resolution plan designed to revive a financially troubled company facing insolvency must adhere to the legal requirement of addressing statutory and government dues. Failing to account for these obligations in the plan could lead to the mandatory liquidation of the corporate debtor under Section 53 of the Insolvency & Bankruptcy Code (IBC). This case specifically revolved around unpaid taxes owed under the Gujarat Value Added Tax Act of 2003 (GVAT) and how this conflicted with the priority of debt repayment outlined in Section 53 of the IBC , often referred to as the "waterfall mechanism." The waterfall mechanism established under Section 53 of the IBC serves as a legal framework that dictates the order of debt repayment when a corporate debtor undergoes liquidation. The core issue addressed in this judgment concerns the clash between private secured debts and the outstanding claims of government entities. Therefore, it is crucial to revisit this ruling and examine its implications on the fundamental purpose of the IBC.

Background of Statutory Dues Vis-à-vis Private Secured Debt

Before delving into the intricacies of the Insolvency and Bankruptcy Code (IBC), it is essential to grasp the historical significance and judicial attitudes towards statutory dues. The pivotal judicial decision on this matter was delivered by the Supreme Court in the case of Dena Bank vs. Bhikhabahai Prabhudas Parekh,[2] In this landmark case, the Supreme Court clarified that when it comes to income-tax dues, which are essentially considered as government debts or Crown debts, they do not hold priority over secured creditors, who are private individuals or entities. This principle was reaffirmed and elaborated upon in a subsequent case, Stock Exchange Bombay v V. S Kandalgaonkar[3], wherein the court expounded on the rationale behind this decision. The court emphasized that secured creditors, who have a legal interest in the debtor's assets as collateral, must be given precedence in the event of insolvency proceedings. This preference is grounded in the principle that private creditors, who have extended loans or credit based on collateral, should have their claims satisfied before government dues, such as income tax, are addressed. This approach aims to ensure the protection of the rights and interests of private creditors and to encourage lending and

[1] State Tax Officer v. Rainbow Papers, MANU/SC/1109/2022

[2] Dena Bank vs. Bhikhabhai Prabhudas Parekh and Co, MANU/SC/0317/2000.

[3] Stock Exchange Bombay v V. S Kandalgaonkar, MANU/SC/0876/2014.

investment by providing a secure legal framework for secured transactions. In essence, the judiciary's stance underscores the importance of maintaining a balance between the interests of the government in collecting its dues and the interests of private creditors in safeguarding their financial investments, contributing to a more predictable and equitable insolvency regime. The Gujarat High Court, in the case of Bank Of India vs State of Gujarat,[4] resolved a legal conflict between Section 31B of the Recovery Of Debts And Bankruptcy Act, 1993, and Section 48 of the GVAT Act. It established that the rights of secured creditors to recover their debts through the sale of assets associated with their security interest take precedence over all government debts and obligations, including taxes owed to the State Government. This indicates a consistent pattern of giving preference to secured private debts over various types of government dues. With this fundamental point understood, let's now explore the grounds on which the recent judgment is being challenged.

A Government Entity is Not a Secured Creditor

In reaching the aforementioned conclusion, the Court emphasized a crucial point, stating that since the State Government holds the primary claim or "first charge" on the property, it is legally considered a "secured creditor" under the Gujarat Value Added Tax, 1974. For liquidation purposes, it should therefore also be classified as a "secured creditor" under Section 53 (1) (b) (ii) of the IBC. It is argued that this interpretation is inconsistent with the IBC's goals and that the meaning prescribed by one act cannot be transferred to another. The term "secured creditor" as used in the IBC aims to safeguard and encompass organizations that assumed the risk of repaying the corporate debtor's debts in case of default. It was not intended to allow government agencies to use it as a means of recoupment. The main objective of giving "secured creditors" such a high priority under Section 53 was to protect creditors exclusively in the event of the corporate debtor's insolvency and to give them a buffer against any cascade or domino insolvencies. Strictly speaking, security lowers the cost of credit and draws in capital. The GVAT Act does not include any of these elements, and the way that the word "secured" is used therein is completely different from how it is used under the IBC scheme. Therefore, tax obligations may be collected in accordance with a revenue statute, but this cannot be construed to circumvent the IBC's waterfall mechanism. Furthermore, the ruling states that a "security interest" may also be created by operation of law, and that laws such as the GVAT Act grant the government authorities the status of "secured creditor." One could argue that this

[4] Bank Of India vs State of Gujarat, MANU/GJ/0130/2020

interpretation is incorrect because the Court disregarded the definitions of "security interest" and "transaction" found in Sections 3(31) and 3(33) of the IBC, presumably as a result of an oversight. When both of these definitions are considered together, it becomes evident that a security interest can only arise through a transaction that is mutually agreed upon by two or more parties, driven by their commercial motivations. These definitions should be interpreted in a strict and literal sense, excluding any instances that are initiated and enforced solely by legal mandates. The compulsory and non-consensual imposition of a statutory charge on property by tax authorities cannot reasonably be categorized as a 'transaction' under the Insolvency and Bankruptcy Code (IBC).

Discrimination Meted Out to Other Operational Creditors

Based on Section 30(2) of the IBC, the SC determined that the Adjudicating Authority under Section 31 must only approve a resolution plan if it is objectively satisfied that the statutory debts, which are operational debts in nature, are paid up in full. Although Section 30(2) of the IBC is an enabling provision for the operational debtors' protection and benefit, it does not imply that these debts will be paid in addition to any outstanding secured and financial obligations. It is now standard procedure that a resolution plan is legitimate and effective even if no information is given to the operational creditors, so long as the Committee of Creditors made the decision to do so in order to maximize the value of the Corporate Debtor's assets. Note that the Court has only made this particular observation with regard to the debts held The Supreme Court held that the Adjudicating Authority, under Section 31, could only approve a resolution plan if it guaranteed the obligatory payment of statutory operating debts. The Supreme Court based this decision on Section 30(2) of the Insolvency and Bankruptcy Code (IBC). Although Section 30(2) of the IBC protects the rights of operational debtors, it does not mean that payment of these debts will come at the expense of other outstanding debts, secured or otherwise. A resolution plan can be deemed legitimate and legally sound even if it does not provide for operational creditors, as long as the Committee of Creditors has decided to do so in order to maximize the value of the Corporate Debtor's assets. This is now a well-established legal principle. It is important to remember that the Court's special observation in this respect only applies to debts owed to the government, not to other creditors involved in operations.

There isn't a plausible rationale for giving government obligations a special status under the more general heading of "Operational Creditors." A related argument, which is covered below,

can also be used to explain this apparent favoritism toward government agencies. Financial creditors are typically included in the category of secured creditors. Still, there may be circumstances in which a debtor that is operating could be considered a "secured creditor." For example, in the case of Concast Steel & Power Ltd. v MSTC Limited,[5] Because of a pledge agreement that was signed with the corporate debtor, the National Company Law Appellate Tribunal categorized an operational creditor as a secured creditor. There are fundamental problems with this interpretation even if it is assumed without being acknowledged that the State tax obligations are secured debt under the IBC. A close examination reveals that, although ignorance of statutory debts will make a resolution plan null and void, ignorance of claims from parties such as secured operational creditors won't stand in the way of the plan's effective execution. Thus, there is a tacit discrimination which is being meted out to the class of secured operational creditors. Consequently, the class of secured operational creditors is the victim of tacit discrimination. Due to the creation of a subcategory within the larger group of operational creditors, which is against the mandate of Section 30(2)(b) of the IBC, this discrimination is fundamentally unfair and unequal to the operational creditors as a class. To put it succinctly, this kind of differentiation is wrong on two counts: firstly, it is unfair to other secured operational creditors; and secondly, the IBC scheme does not allow for this kind of preference for government entities.

Altered the Waterfall Mechanism for Liquidation

The Court additionally emphasized that these statutory dues should also be granted precedence during the liquidation process. As discussed earlier, the waterfall mechanism outlines the order that must be followed when distributing the proceeds obtained from liquidating the assets of the Corporate Debtor. On initial consideration, it may appear that the Court has not disrupted the existing priority structure established in Section 53 of the IBC and has avoided a clash between the two Acts. However, it is contended that by designating government dues as 'Secured Creditors,' it has effectively elevated the priority originally granted to government authorities. It is a well-established principle that what cannot be accomplished directly cannot be achieved indirectly. Therefore, any implied modification or alteration of the defined waterfall mechanism would amount to rewriting the legislature's intentions and ultimately undermine the very purpose of the IBC. It is apposite at this stage to revisit these lines from

[5] Concast Steel & Power Ltd. v MSTC Limited, MANU/NL/0627/2021.

the Andhra Court in the case of Leo Edibles & Fats Limited v. Tax Recovery Officer,[6] "t is evident that tax dues, as they contribute to the Consolidated Fund of India and the states, unquestionably fall under the purview of Section 53(1)(e) of the Code. If the Legislature, in its wisdom, has designated these dues to hold the fifth position in the order of priority, it is not within the jurisdiction of this Court to scrutinize or undermine the reasoning behind this decision."

Overlooks Section. 238 and goes against IBC's intent

Section 238 of the Insolvency and Bankruptcy Code (IBC) establishes its supremacy over other laws in cases of conflict, a principle that is well-established and confirmed. The Supreme Court has also reaffirmed this in various rulings. However, in the present case, the Supreme Court observed that Section 48 of the Gujarat Value Added Tax (GVAT) Act is not contradictory to the provisions of the IBC. Nevertheless, a plain reading of these provisions reveals a clear inconsistency. Section 48 of the GVAT Act empowers the government to hold a primary claim over a dealer's property for any amounts owed to the government. This is in direct contrast to the framework outlined in Section 53 of the IBC, which establishes the order of priority for paying dues in the event of a company undergoing liquidation. Under Section 53, statutory dues do not occupy the top position in the hierarchy of payment; they are only addressed once outstanding obligations to various other stakeholders, including secured creditors and workers, are satisfied. As a result, the provisions of these two laws are indeed conflicting and inconsistent, and the IBC should take precedence over the GVAT Act as mandated by Section 238. The primary legislative intent in giving lower importance to government dues and placing them after secured creditors, workers, and other parties is an extension of the 'business-first' principle upon which the IBC is founded. In this framework, the government is perceived as a mere facilitator and not an active participant in the commercial affairs of an entity. By granting tax authorities the same status as secured creditors, the Supreme Court undermines this intent and enhances the power of government authorities to recover outstanding dues, thereby burdening the insolvency process.

Implications for Insolvency and Government Dues Prioritization

In the case of Paschimanchal Vidyut Vitran Nigam Ltd. v Raman Ispat Pvt. Ltd[7] the Supreme

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[6] Leo Edibles & Fats Limited v. Tax Recovery Officer, MANU/AP/0426/2018

[7] Paschimanchal Vidyut Vitran Nigam Ltd. v Raman Ispat Pvt. Ltd, MANU/SC/0771/2023.

Court was addressing the issue of prioritizing the dues of an operational creditor who had a first charge, established by a statute, on the assets of the corporate debtor. Specifically, Clause 4.3(f)(iv) of the Uttar Pradesh Electricity Supply Code, 2005, states that any unpaid dues will have the status of a first charge on the company's assets. In light of the rulings in Duncans Industries Ltd. v. AJ Agrochem[8] and Sundaresh Bhatt, Liquidator of ABG Shipyard v. Central Board of Indirect Taxes and Customs,[9] The Apex Court reiterated that the Electricity Act of 2003's provisions are superseded by Section 238 of the IBC. The Supreme Court noted that regulations or statutory provisions could both result in a "charge." As a result, the Apex Court determined that PVVNL met the criteria for being a "secured creditor" in this case since a charge was established on the corporate debtor's assets in accordance with Clause 4.3(f)(iv) and the parties' agreement. The Supreme Court, taking into account the nature of functions and private involvement in PVVNL (Paschimanchal Vidyut Vitran Nigam Limited), determined that the dues or amounts owed to PVVNL do not fall within the category of 'government dues' as defined in Section 53(1)(e) of the Insolvency and Bankruptcy Code (IBC). The Court further clarified that dues that are required to be deposited in the Treasury, such as taxes and tariffs, which broadly align with the scope of Article 265 of the Constitution, qualify as 'government dues.' Moreover, the Supreme Court delved into the question of the order of priority of secured 'government dues' in comparison to the order of priority under Section 53 of the IBC. While analyzing the judgment passed in the case of Rainbow Papers (supra), the Court noted that the Gujarat Value Added Tax (GVAT) Act, although it does create a charge for the amount due and payable, Section 53 of the IBC establishes a distinct and separate treatment for amounts owed to secured creditors on one hand and dues owed to the government on the other. This indicates the clear intention of the Parliament to differentiate government dues from those of secured creditors. As a result, 'government dues,' whether secured or unsecured, are categorized under Section 53(1)(e) of the IBC as a unique and separate class.

Future Outlook

The Ministry of Corporate Affairs, in a notice dated January 18, 2023, has requested public input regarding potential amendments to the Insolvency and Bankruptcy Code (IBC). The notice aims to clarify that the concept of "security interest" was originally intended to cover

[8] Duncans Industries v. AJ Agrochem, MANU/SC/1385/2019

[9] Sundaresh Bhatt, Liquidator of ABG Shipyard v. Central Board of Indirect Taxes and Customs, MANU/SC/1060/2022.

consensual transactions between parties and not interests established solely through statutory operation. The notice also suggests that the Ministry is considering the equal treatment of all unsecured creditors, which includes financial creditors (FCs), operational creditors (OCs), and any government or authority, except for workmen and employees, in the distribution process under Section 53 of the IBC. Furthermore, it is being contemplated that all debts owed to both the Central and State Governments, irrespective of whether they are secured creditors due to statutory operations, will be treated on par with other unsecured creditors. The notice introduces the idea of a separate category of government dues where security interest is established through a transaction between the government and the corporate debtor, granting the government secured creditor status in the order of priority. It's worth noting that this notice may not have been brought to the attention of the Supreme Court in the PVVNL case. It will be interesting to see how the Legislature seeks to reconcile these proposed changes with the rulings in the PVVNL and Rainbow Papers cases while attempting to strike a balance between the two.

Conclusion

In view of this situation, it is recommended that the Supreme Court reexamines the recent judgment and provides further clarity on this matter. It is quite clear that if the existing legal position remains unaltered, it could undermine the objectives that the Insolvency and Bankruptcy Code (IBC) is meant to achieve. As a consequence, the current legal stance could deter potential resolution applicants who may be discouraged by the added responsibility of addressing existing or potential government and statutory dues. This could ultimately lead to a decrease in the number of resolution applications, reduced asset values, and higher losses for creditors.