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The Status of Government as a Creditor in Insolvency Proceedings in India

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ABSTRACT

The government's position as a creditor in Indian bankruptcy proceedings has undergone substantial changes under the bankruptcy and Bankruptcy Code, 2016. The State Tax Officer v. Rainbow Papers Ltd., 2022 case established a significant legal precedent by granting the government the same level of priority as secured creditors, therefore treating its statutory dues as equivalent to other secured obligations. Nevertheless, this position encountered obstacles because of its potential influence on investment and legal disputes with the IBC's waterfall structure. The Paschimanchal Vidyut Vitran Nigam Ltd. judgement in 2023 provided more clarification on the government's position in insolvency proceedings. It established that the government should be treated equally to operational creditors, establishing a fair and balanced approach.

Keywords: *Insolvency, creditor, government, waterfall mechanism.*

I. INTRODUCTION

The Insolvency and Bankruptcy Code, 2016 (IBC) was introduced as a comprehensive legislation to address the insolvency and bankruptcy issues in India. One of the significant areas of discussion in this realm of IBC is the treatment of various creditors, including that of the government. This blog critically examines the status of the government as a creditor in insolvency proceedings in India, with a focus on two landmark judgments: *State Tax Officer v. Rainbow Papers Ltd., 2022*³ and *Paschimanchal Vidyut Vitran Nigam Ltd. Vs. Raman Ispat Private Limited & Ors., 2023*.⁴ Before dwelling into the two aforementioned judgements, it is pertinent to note that under the IBC, creditors are classified into financial creditors, operational creditors, and other creditors. The government, when owed statutory dues, falls under the category of operational creditors. However, the question then arises: Should the government be given a preferential status over other creditors, given its role in public welfare and governance? The question was categorically dealt with in the case of *State Tax Officer v. Rainbow Papers*

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³ *State Tax Officer v. Rainbow Papers Ltd.* 2022 (13) SCR 808.

⁴ *Paschimanchal Vidyut Vitran Nigam Ltd. Vs. Raman Ispat Private Limited & Ors.*, 2023 SCC OnLine SC 842.

Ltd. The Apex court emphasized that the definition of "Secured Creditor" under the IBC is comprehensive and includes all types of security interests, whether created by contractual agreements or by operation of law. This definition does not exclude any Government or Governmental Authority. The court highlighted that such security interest could be created by operation of law, reinforcing the government's position as a secured creditor. Specifically, the court observed that the debts owed to a secured creditor, which would encompass the State under the Gujarat Value Added Tax Act, are to rank equally with other specified debts. This essentially means that the State, under the GVAT Act or similar statutes, holds a position equivalent to other secured creditors. The Supreme Court's ruling underscored that the government's statutory demands cannot be ignored or side lined in any resolution plan. If a resolution plan fails to account for the statutory dues owed to the government or any legal authority, it stands liable for rejection. The judgment firmly establishes the government's position as a secured creditor, ensuring that its statutory dues are given due importance in insolvency proceedings.

II. POSITION IN LIGHT OF RAINBOW PAPERS

The Supreme Court's decision in *State Tax Officer Vs. Rainbow Papers Limited* that equated the government's position with other secured creditors under the IBC raised several concerns. Firstly, government dues, such as taxes and penalties, were fundamentally different from contractual debts owed to financial institutions. While the latter emerged from mutual agreements with clear terms, government dues were often unilateral and imposed without the debtor's explicit consent. This distinction became crucial when considering the attractiveness of insolvency proceedings. Potential investors might have been deterred if unpredictable government dues, accruing with penalties, overshadowed other debts. Moreover, the government's dual role as both a regulator imposing penalties and a beneficiary creditor created an inherent conflict of interest. This parity with secured creditors could also have side lined genuine lenders who took calculated risks, leading to minimal recoveries in insolvency resolutions. Furthermore, businesses might have become risk-averse, fearing that government dues would always supersede their credit, potentially stifling economic growth.

III. LEGAL BREAKDOWN

Severe legal challenges on the ground of a disregard of the waterfall mechanism as envisaged in Section 53 of IBC can also be raised against this treatment of the government's debt equal to other debts. The previous legal position was quite apart from this verdict, as the apex court had already stated in its verdict in *PR Commissioner of Income Tax v. Monnet Ispat and Energy*

*Limited*⁵, where it categorically held that “IBC has overriding effect on the every existing law inconsistent to it including the Income tax law.”⁶, thus the treatment of government as on par with other creditors with a blatant ignorance of Section 53⁷ of the IBC in lieu of the GVAT Act, seems not in line with the previous ratio of the Apex Court. Also, prior to the Rainbow Papers judgment, the Bombay High Court in the case of *M/s Edelweiss Asset Reconstruction v. M/s Tax Recovery Officer, 2021*⁸ had held that secured debt shall take priority over “Government” dues/tax dues. The court based this decision on the fact that the Income Tax Act makes no reference to the obligations of the Income Tax Department taking precedence over secured debt. The Revenue was not permitted to impede the petitioner’s rights as a secured creditor. The order for attachment was invalid.

IV. POSITION IN LIGHT OF PASCHIMANCHAL VIDYUT VITRAN NIGAM LTD.

The incongruent ratio of Rainbow Papers was recently curtailed via the recent judgment of *Paschimanchal Vidyut Vitran Nigam Ltd. Vs. Raman Ispat Private Limited & Ors., 2023*. In the aforementioned case, the Apex Court delved into the classification of dues payable to statutory corporations like the Appellant, Paschimanchal Vidyut Vitran Nigam Ltd. The Court clarified that such dues, which are not owed directly to the Central or State Government but to statutory corporations, should be classified either as financial debt or operational debt based on the nature of the transaction with the Corporate Debtor. These dues do not come under the purview of the dues owed to the Central or State Government as outlined in Section 53(1) (e)(i)⁹ of the Insolvency and Bankruptcy Code (IBC). The judgment also importantly distinguished the "State Tax Officer v. Rainbow Papers Ltd." case on its facts, emphasizing that the corporate debtor in the "Rainbow Papers" case was undergoing insolvency resolution proceedings, whereas in the present case, the corporate debtor was undergoing liquidation. The Court highlighted that the "Rainbow Papers" judgment did not consider the waterfall mechanism under Section 53 of the IBC, which led to the state government being treated as a "secured creditor." In contrast, the present judgment underscored the intention of the Parliament to treat dues owed to the government distinctly from those owed to a secured creditor. The Court's decision reiterated the distinction between government dues and dues to statutory corporations, emphasizing the unique position of the government as a creditor in insolvency proceedings. Lastly, the court expressed severe apprehensions on the veracity of the ratio of Rainbow Papers and restricted

⁵ PR Commissioner of Income Tax v. Monnet Ispat and Energy Limited (2018) 18 SCC 786.

⁶ Ibid.

⁷ Insolvency and Bankruptcy Code, 2016, §53.

⁸ *M/s Edelweiss Asset Reconstruction v. M/s Tax Recovery Officer*, (2021) 438 ITR 568.

⁹ Insolvency and Bankruptcy Code, 2016, §53(1)(e)(i).

the ratio of the same only to the facts of that case.

V. CRITICAL ANALYSIS

Historically, the 'waterfall mechanism' of the IBC prioritized secured creditors over government dues. However, the earlier "Rainbow Papers" case disrupted this hierarchy by equating the State's position to that of a 'secured creditor.' This deviation posed significant challenges for insolvency professionals and could have diluted the claims of secured creditors, potentially deterring future lending and investments. The recent judgment sought to restore the traditional understanding, emphasizing the IBC's supremacy over other laws and its primary objective of efficient insolvency resolution. By distinguishing between government dues and those of secured creditors, the court struck a balance, ensuring that while government dues are essential, they shouldn't override the rights of secured creditors. This decision not only upholds the IBC's intent but also sets a clear precedent for future insolvency proceedings, offering clarity and predictability to all stakeholders.

VI. CONCLUSION

The status of the government as a creditor in insolvency proceedings under the IBC has been a contentious issue. Whilst the initial landmark judgment of Rainbow Papers might have muddied the water, the novel two-judge bench judgment in Paschimanchal Vidyut Vitran Nigam Ltd. has indeed cleared some lacunas on this aspect. While the government's role in governance and public welfare is undisputed, in the realm of insolvency proceedings, it is treated on par with other operational creditors. This approach ensures that the objectives of the IBC are met while balancing the interests of all stakeholders.
