

## Analysing Impact of Rainbow Judgment: One Step Forward, Two Steps Backward?



*The recent judgment of Supreme Court, namely, Sales Tax Officer Vs. Rainbow Papers Limited (Rainbow) has been termed as a disruptive judgment, upsetting the settled legal understanding. In the present article the author analysis the impact of this judgement on various process under the Insolvency and Bankruptcy Code, 2016 (Code) from commencement of the CIRP to approval of the Resolution Plan. He also recommends the necessity to amend Section 53 of the Code to clarify the position that secured financial creditors have priority over government dues, whether secured or unsecured. Till such time the amendments are brought in, Insolvency Professionals and their legal teams would do good to distinguish Rainbow judgment on the lines suggested in this Article.*

**Read on to know more...**

### A New Normal called IBC

Evolution of law is a welcome sign but what about disruptions on constant basis? Starting from zero base, any new law develops through jurisprudence guiding the law users in its application and interpretation. Judgments of highest courts, attaining the status of law of the land, are expected to provide clarity and remove any confusion rather than confounding it. Insolvency and Bankruptcy Code, 2016 (Code), hailed as landmark legislation in recent times, disrupted unscrupulous promoters taking advantage of laws protecting them for an extended period mostly at the cost of creditors. A new normal was underway.

### Interpretational Judgments of Apex Courts under IBC

The true sources of interpreting Code are Bankruptcy Law Reforms Committee Report (BLRC Report) Vol I, Parliamentary Committee reports and discussion leading to passing of Insolvency Bill into law, preamble of the Code and Supreme Court judgments. The Code has evolved over its journey of almost 6 years with amendments every year since 2016. The role of Apex Court has been extremely significant in clearing the air guiding the Adjudicating and Appellate Authorities, Regulators and service providers primary being the



### Ashish Makhija

The author is an Insolvency Professional (IP) Member of IIPPI. He can be reached at [iiipi.journal@icai.in](mailto:iiipi.journal@icai.in)

Insolvency Professionals. Through interpretational judgments, the role of Committee of Creditors (CoC) was also explained, defined, and circumscribed. The judgments dealt with principles of natural justice to be followed by Adjudicating Authorities (AA) while admitting applications initiating corporate insolvency resolution process (CIRP), the relevant factors to be considered in such applications, expounding eligibility criteria of Resolution Applicants, authoritatively cautioning the Authorities below about the judicial interference in the matters of approval of Resolution Plans limiting their role by giving prominence to commercial wisdom of the CoC on money matters, establishing grounds and circumstances of withdrawal of admitted cases, clearing the air on applicability of limitation laws to the Code, defining roles of financial and operational creditors, edifying the status of home buyers under the Code and upholding the constitutional validity of the Code in the face of strong opposition on several occasions. The list is long. The journey has been eventful, and the judgments of Apex Courts were in the nature of confirming the legislative intent and upholding the concepts driving the Code.

### Rainbow Judgment – Beginning or end of a disruptive trend?

Of late, few judgments of the Supreme Court have brought in a new twist in the tale. With no change in law, the established jurisprudence is seeing rainbow shades. In law schools, it is taught that law is not black and white but has many shades of grey. The untold truth, however, remains is that the interpretational judgments can have colorful shades of rainbow. The recent judgment of Supreme Court, namely, *Sales Tax Officer Vs. Rainbow Papers Limited (Rainbow)*<sup>1</sup> has been termed as a disruptive judgment, upsetting the settled legal understanding. Here is the analysis of Rainbow with possible impact on the pending resolution plans vis-à-vis the statutory dues.

### What Rainbow is All About?

The ratio of *Rainbow* does not only question the supremacy of the commercial wisdom of the CoC in a CIRP but also shatters it to pieces. It has disturbed the established norm of finality of resolution plans and its element of binding nature on all the stakeholders including government authorities. The *Rainbow* lays down the following broad legal propositions:

- a. Timelines in IBC are directory;
- b. Sales tax department wasn't required to file any claim before the Interim Resolution Professional or the Resolution Professional (IRP/RP);
- c. Resolution Professional failed to include the claim of sales tax department in the Information Memorandum as per books of account;
- d. Sales tax department is a secured creditor;
- e. Section 53 of the Code does not override Section 48 of the Gujarat Value Added Tax Act, 2003 (GVAT Act);
- f. Security Interest could be created by operation of law;
- g. Plan not meeting the requirements of S. 30(2) is invalid and cannot be binding on the Central Government (CG), State Government (SG), any statutory or other authority, any financial creditor or other creditor to whom the debt is owed under any law;
- h. If the Resolution Plan ignores the statutory demands payable to any State Government or a legal authority, altogether, the AA is bound to reject the Plan;
- i. Resolution Plan must contemplate dissipation of those debts in a phased manner, uniform proportional reduction or else the company would necessarily have to be liquidated and its assets sold and distributed; and
- j. The CoC, which consists of financial creditors cannot secure their own dues at the cost of statutory dues owed to any Government or Govt Authority or for that matter, any other dues.

### Understanding Facts of Rainbow

In *Rainbow* case, the Supreme Court was considering the appeal against the judgment of National Company Law Appellate Tribunal (NCLAT) holding that the government cannot claim first charge over the property of the corporate debtor as Section 48 of GVAT Act cannot prevail over Section 53 of the Code. The case has its unique facts whereby sales tax department had initiated recovery proceedings against the corporate debtor for its outstanding dues by attaching properties prior to commencement of CIRP. The sales tax department filed its claim for outstanding dues belatedly before the Resolution Professional. It wasn't considered and perhaps no amount was proposed as payable to sales tax department under the Resolution Plan approved by CoC and later by the NCLT.

<sup>1</sup> Civil Appeal No. 1661 of 2020 decided on 6th September, 2022

## Questions Before the Supreme Court and its Impact

The Apex Court had to primarily answer a short question as to whether the provisions of the Code and, in particular, Section 53 thereof, overrides Section 48 of the GVAT Act, 2003? While answering that question, the Apex Court went adrift and made sweeping observations as mentioned above. Was it required? There is no easy answer, but Rainbow case is to be seen in the context of given facts. It is a well settled proposition that judgments and observations in judgments are not to be read as provisions of statute. Judicial utterances and/or pronouncements are in the setting of the facts of a particular case. Typically, text must match the context. But the far reaching, all-encompassing and across the board observations made by the Supreme Court in Rainbow have all the ingredients to cause misperception about the status of statutory dues and whether Resolution Plans, failing to adhere to proposition laid down in Rainbow, would face the same fate as it met in Rainbow.

**Infact, the process of quoting Rainbow has started, and the Authorities have now been asking the RPs to file an affidavit explaining how Rainbow does not apply to their case where the Resolution Plans are pending for their approval.**

Infact, the process of quoting Rainbow has started, and the Authorities below have now been asking the Resolution Professionals to file an affidavit explaining how Rainbow does not apply to their case where the Resolution Plans are pending for their approval. This has serious repercussions on the success, fate, and future of the Code. The existence

of the Code itself has come in question. If CoC decision does not bind the government authorities, and statutory dues have to be paid at par with secured financial creditors in the Resolution Plans, then why would the secured financial creditors be interested in initiating the CIRP of a corporate debtor or in its resolution. The secured financial creditors would be better off if they recover their dues through alternative remedies such as using the provisions of Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 (SARFAESI Act, 2002) where their rights have been held to be superior to the dues of the relevant department of the State Government provided such securitization, reconstruction and creation of security interest is registered with the Central registry (CERSAI)<sup>2</sup>.

The threat of using the observations in Rainbow by statutory authorities is real and days to follow will see more litigation at several levels at the behest of statutory authorities.

## Distinguishing Rainbow

The task of the Resolution Professionals, successful Resolution Applicants and CoC members is to defend their actions and plans as against the onslaught by the statutory authorities on the basis of Rainbow. They must successfully demonstrate that the facts in their case differ from Rainbow. The sweeping statements made in Rainbow have the capacity to cause some damage with some intensity, but a tabular presentation of distinguishing features would make the task of convincing Adjudicating and Appellate Authorities much easier. Here is the guidance to do so:

Serial Number	Ratio/Observation in <i>Rainbow</i>	Basis of Ratio/Observation	Possible Distinguishing Factors
1.	Timelines in IBC are directory.	The <i>Rainbow</i> judgment turns on its facts. The issue before Apex Court was whether the timelines specified in the CIRP Regulations in respect of filing of claims are mandatory or directory.	The Apex Court, while dealing with specific facts of the case, made the observation that timelines in IBC are directory. Looking at the issue at hand in <i>Rainbow</i> and in view of the settled legal proposition that <i>text</i> and <i>context</i> must match, it can be concluded that the Apex Court made this observation in the context of Regulations prescribing timelines for filing of claims in CIRP. All timelines in the Code were not held as directory by the Supreme Court as this issue was never before it.

<sup>2</sup> Jalgaon Janta Sahakari Bank Ltd. & Anr. Vs. Joint Commissioner of Sales, Tax Nodal 9, Mumbai, & Anr., Writ Petition No. 2935 of 2018, Bombay High Court dated 30th August, 2022

Serial Number	Ratio/Observation in <i>Rainbow</i>	Basis of Ratio/Observation	Possible Distinguishing Factors
2.	Sales tax department was not required to file any claim before the Interim Resolution Professional or the Resolution Professional.	The Supreme Court made this observation in the light of unamended provisions of Regulations 12 of CIRP Regulations. Prior to amendment effective from 4 <sup>th</sup> July 2018, the Regulations used the phrase “Proof of Claim” amendment, no claims were supposed to be filed by tax authorities and the IRP/RP should have considered the claims on the basis of books of account or statutory notices/demand or pending litigation. After having examined the claims, it was incumbent upon him to ask for submission of 'proof of claim' from the tax authorities.	<p>The ratio can be distinguished on following grounds: -</p> <ol style="list-style-type: none"> <li>a. <i>Rainbow</i> judgment deals with claims filed prior to 4<sup>th</sup> July 2018. After the amendment, the position has changed, and it cannot now be argued by statutory authorities that they were not required to file any claim and it was obligatory on the part of IRP/RP to ask for 'proof of claim' in case of doubt.</li> <li>b. Mere disclosure by Resolution Applicant in Information Memorandum is not equivalent to a lodging of proof of claims by the creditor. The submission seems to imply that if a Resolution Professional can be shown to have been aware of a claim by creditor, then the creditor has no obligation to file its proof of claims with the IRP or RP. Such a submission is not correct as it would play havoc with the entire structure of the CIRP process.</li> <li>c. Mere knowledge of existence of claim in books of account does not mean that the claims stand verified and proved on their own by the mere filing. The IRP/ RP is no mere post-office to merely take a claim and send it forward. The IRP is required to verify the claim. There may be questions of limitation. Some claims may require adjudication. There may be several other reasons why such claims may not be accepted at all or in the full form in which they are submitted to the IRP.</li> <li>d. The provisions of Section 13 and 15 of the Code and Regulations 7, 8, 8A, 9, 9A, 10, 12A and 13 were probably not brought to the attention of Apex Court. Conjoint reading of these provisions makes it amply clear that filing of claim was mandatory regardless of the amendments carried out on 4<sup>th</sup> July 2018 in the Regulations.</li> </ol>

3.	Resolution Professional failed to include the claim of sales tax department in the Information Memorandum as per books of account.	It was incumbent upon the Resolution Professional to include the dues of sales tax department as per books of account in the Information Memorandum.	Typically, Information Memorandum is a base document which helps the prospective resolution applicants to make up their mind and finalize the Resolution Plans. It helps them in conducting due diligence. The Resolution Professionals should make every endeavor to disclose whatever information is available with them, including the details of claims not filed with him. The observation of Supreme Court is correct in this regard.
4.	Sales tax department is a secured creditor and Security Interest could be created by operation of law.	Supreme Court considered the specific provisions as contained in Section 48 of GVAT Act which provides that <i>“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 maybe, such person.”</i> . The Supreme Court read this provision in conjunction with Section 3(30) and 3(31) of the IBC to arrive at this conclusion.	The observation of the Supreme Court cannot be faulted with. The specific provisions contained in GVAT Act 2003 provide for statutory first charge. The RP's would be advised to check specific provisions in respective laws in case statutory authorities file their claim to ascertain their status as secured creditor or not.
5.	Section 53 of the Code does not override Section 48 of the Gujarat Value Added Tax Act, 2003 (GVAT Act)	Section 48 provides that dues payable to sales tax authorities are considered as first charge. Section 53 deals with priority of payment of dues. Both the provisions operate in different sphere and there being no clash between the two, the question of Section 53 overriding in the context of 'secured creditor' status of the sales tax department does not arise.	To this extent, the Supreme Court has rightly held that Section 53 of the Code and Section 48 of GVAT Act operate in different spheres. The question of superseding comes when there is inconsistency between the two provisions dealing with same subject. This position may be used to lay emphasis on the point that Section 48 of GVAT does not deal with priority in payment, which is specifically dealt by Section 53 of the Code. Hence Section 48 cannot be construed as giving priority in payment to the dues of sales tax.
6.	Plan not meeting the requirements of S. 30(2) is invalid and cannot be binding on the CG, SG, any statutory or other authority, any financial creditor or other creditor to whom the debt is owed under any law	The Supreme Court held this due to provisions that exist in Section 30(2)(b) that ensures minimum payment to operational creditors under the Resolution Plan. One of the minimum payment criteria is the payment of liquidation value to the operational creditor if distributed in accordance with Section 53. After holding that sales tax authorities are secured creditors, the Supreme Court	Entitlement of operational creditors to a minimum amount as per the limits laid down in Section 30(2)(b) is not in dispute. However, the conclusion drawn by Supreme Court can be distinguished on following grounds: - a. The preamble of IBC states that one of the purpose of enactment of IBC is the alteration in order of payment of government dues leading to balancing the interest of stakeholders.

		held that if Liquidation value is distributed in accordance with priority laid down in Section 53, the sales tax authorities are entitled to pro-rata payment equivalent to other secured creditors. Since the Resolution Plans fails to do that, hence the plan was held to be invalid.	<p>b. As per S. 53, the payment of government dues are to be aid at fifth level and not at par with other secured creditors. The word 'government dues' is sufficient to cover secured or unsecured dues.</p> <p>c. The intention of legislature in lowering the priority of government dues cannot be ignored.</p> <p>d. State law cannot override a Central law.</p> <p>e. The judgment ignores the established proposition laid down in <i>Ghanashyam Mishra &amp; Sons Pvt Ltd v Edelweiss Assets Reconstruction Company</i> that once the Resolution Plan is approved by the Adjudicating Authority, the legislative intent is to freeze all claims “so that the Resolution Applicants starts on the clean slate and is not flung with any surprise claims”.</p>
7.	If the Resolution Plan ignores the statutory demands payable to any State Government or a legal authority, altogether, the AA is bound to reject the Plan.	The basis of this proposition has not been explained in the judgment. However, it seems the Court was swayed by the reasoning that Resolution Plan is not in accordance with provisions of Section 30(2)	The grounds of distinction as stated in Point 6 apply here also.
8.	Resolution Plan must contemplate dissipation of those debts in a phased manner, uniform proportional reduction or else the company would necessarily have to be liquidated and its assets sold and distributed.	The basis of this observation is unexplained in the judgment. Probably the status of sales tax authorities as Secured Creditor weighed on their mind.	This proposition runs contrary to the scheme of IBC. Government dues have lower priority as per section 53 and hence dissipation of their dues in uniform proportional reduction is not called for.
9.	The CoC, which consists of financial creditors cannot secure their own dues at the cost of statutory dues owed to any Government or Govt Authority or for that matter, any other dues.	The basis of this proposition is also not explained in the judgment. It seems that secured creditors status was at forefront of this conclusion.	This seems to be a sweeping statement, which may be used by statutory authorities to claim rejection of Resolution Plan.

## Conclusion

The *Rainbow* judgment brings forth the significance of drafting of any statute. The Review Petition in *Rainbow* matter seems to have been filed. Regardless of the fate of such a Review Petition, it would be necessary to amend Section 53 of the Code to clarify the position that secured financial creditors have priority over government dues, whether secured or unsecured. The following amendments are suggested.

- a. In section 53(1)(b)(ii), replace the words “secured creditor” with “secured financial creditor”;
- b. In section 53(1)(e)(i), add the words “whether secured or unsecured” at the end.

It must be borne in mind that operational creditors, other than government dues, can also be secured creditors. Rationally, they must be entitlement for payment in priority to unsecured financial creditors and other operational creditors including government dues. Their priority may also be clarified by way of suitable amendment in Section 53.

Till such time the amendments are brought in, Insolvency Professionals and their legal teams would do good to distinguish *Rainbow* judgment on the lines suggested in this Article.

