ARTICLE

Sales Tax Now a Priority 'Secured' Creditor: Reversing Waterfall!

Section 53 of the IBC, 2016 provides a preferential order for distribution of the proceeds obtained from the sale of Corporate Debtor (CD) through a resolution plan or liquidation of its assets. This provision, commonly referred to as the waterfall mechanism, gives high priority to the dues of secured creditors. Since operationalization of the IBC, there have been several attempts, directly and indirectly, by various unsecured and operational creditors etc. to enter in the space of secured creditors, which were timely detected and refuted. However, while approving the tax dues of Gujarat GST Department, the Supreme Court in the matter of State Tax Officer Vs. Rainbow Papers Ltd. has granted operational creditors the status of a secured creditor. Besides the waterfall mechanism, this judgement has adversely affected the applicability of several provisions of the IBC.

Read on to know more…

Nipun Singhvi and Mayur Jugtawat

The author is an Insolvency Professional (IP) member of IIIPI, and Co-author is a practicing lawyer. He can be reached at canipunsinghvi@gmail.com.

Introduction

The Supreme Court of India in a recent verdict in the matter of *State Tax Officer (1) Vs. Rainbow Papers Limited*[1] has declared State Sales Tax (Gujarat VAT department) as secured creditor within the ambit of IBC recognising under Section 3(30) of the Insolvency and Bankruptcy Code, 2016 (IBC or Code). While discussing the various provisions Hon'ble Court has categorically held that definition of secured creditor in the IBC does not exclude any Government or Governmental Authority.

Another important issue discussed by apex court is with respect to claims filed by the Statutory authorities. It is stated that such claims should be considered in plan as per books of account of Corporate Debtor irrespective of the fact that claim form is filed by such authority or not. This article attempts to analyse the judgment keeping in mind objectives of the Code.

No timeline for claim

While discussing the claims to be filed by sales tax department, Court held that the timelines in the Code are directory and not mandatory. This is in contradiction to what has been held till now by the Courts. Till date the

[1] Civil Appeal No. 1661 of 2020 with Civil Appeal No. 2568 of 2020

legislature as well as Courts have taken the view that the Corporate Insolvency Resolution Process (CIRP) is time bound process and in specified case the timeline may be increased from 180 to outer limit of 330 days. However, the judgement held that the timelines are directory and not mandatory for the process under Code.

It is important to mention that the insolvency process which is a court monitored process lays much emphasis on time is essence of the process. Further, the claims filed are to be done in 90 days from the date of insolvency commencement, however court have been liberal to allow even till approval of resolution plan by Committee of Creditors (COC). However, declaring complete timelines shall lead to delays which needs to be reconsidered.

No charge registration!

Bankers lend to the companies based on the documents and data available in public domain. Therefore, the registration of charge has been made mandatory in Companies Act, 2013 and also was required in earlier company laws. There is always a charge registered by the bankers on the company whether it is mortgage, pledge, hypothecation, or any other form. This leads to a caution and the insolvency professionals are also guided by the charge registration and register so that the rights can be crystalised and proper distribution of recovery can take place.

This judgement holds that the charge in case of Sales Tax is created by operational law and grants supremacy to the fictional charge created as per respective law (Gujarat VAT law in this case). The view is contradictory to larger bench judgement of Apex Court in the matter of *Ghanshyam Mishra Vs. Edelweiss ARC* wherein the Court held that the purchaser (resolution applicant) cannot be allowed to be burdened with surprise claims. The concept of Clean Slate Theory was accepted right from Essar Steel case till date. Hon'ble Supreme Court has clarified the position by stating that the mischief which was noticed prior to amendment of Section 31 of the I&B Code was that though the legislative intent was to extinguish all such debts owed to the Central Government, any State Government or any local authority, including the tax authorities once an approval was granted to the resolution plan by NCLT; on account of there being some ambiguity, the State/Central Government authorities continued with the proceedings in respect of the debts owed to them. In order to remedy the said mischief, the legislature thought it appropriate to clarify the position that once such a resolution plan was approved by the adjudicating authority, all such claims/dues owed to the State/Central Government or any local authority including tax authorities, which were not part of the resolution plan shall stand extinguished

Relinquishment of Rights

Another analysis to this judgment is implications on rights of secured creditors under Section 52 of the IBC, 2016. A mortgaged security created in favour of financial institutions and security created by charge by the state tax department will create collusion while determining relinquishment rights. Though through catena of apex court judgments, the law is well settled that enactment which has come in later point in time shall have overriding effect over the earlier law, the effect of this judgment shall have a bearing effect on ascertaining true nature of security under Section 52 of the Code. The impact of judgment will reduce the approval of plans by CoC due to involvement of state tax department which will claim parity in distribution mechanism leading Corporate Debtor to go under Liquidation which is the last resort under IBC.

"The impact of judgment will reduce the approval of plans by CoC due to involvement of state tax department which will claim parity in distribution mechanism leading CD to liquidation."

A *pari passu* charge over any property for the assets having formed part of the liquidation estate, an option to realise them outside liquidation is not merely an exercise in self-interest of the secured creditor, it impacts all other stakeholders as well. Hon'ble Supreme Court has further observed that CoC which might consist of 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 dues. If the judgement stands as it is every statutory authority like Income tax, State tax (VAT/GST), ESI, PF, etc will come to ask for their pie in the distressed asset wherein the financial creditor is otherwise the sole stakeholder.

The Apex court held that any plan which ignores the statutory dues i.e government dues or governmental authority dues shall not be binding on the State. Further, it held that no plan can be passed at the cost of statutory dues. This is absolutely against the spirit of the Code wherein the preamble itself states that the alteration in priority of the

government dues shall happen. Further, the big plans approved till date shall be never approved if the bankers are to sacrifice to statutory authority. It is for this reason that even Securitization law was amended in 2016 to clarify that the bank dues shall be in priority to government dues.

Popping of Hydra

The precedent laid down by Apex court will now create difficulties for RP, COC and other stakeholders whose resolution plan is either approved or pending before Hon'ble Adjudicating Authorities because the requirement of this judgment will now become compliance for any resolution plan. The precedent is set to invite huge amounts of tax dues against a debt laden company which will defeat the objectives of the Code and Section 238 (non obstante clause), which in true sense intentionally keeps government dues at third layer in waterfall mechanism as per Section 53 of the Code.

> **Earlier, the Supreme Court has held that a successful resolution applicant cannot suddenly be faced with "undecided" claims after the resolution plan submitted by him has been accepted.**

Hon'ble Supreme Court in *Committee of Creditors of Essar Steel India Limited Through Authorised Signatory Vs. Satish Kumar Gupta & Ors*[2]. and *Ghanshyam Mishra and Sons Private Limited Vs. Edelweiss Asset Reconstruction Company Limited*[3] has already observed that a successful resolution applicant cannot suddenly be faced with "undecided" claims after the resolution plan submitted by him has been accepted as this would amount to a hydra head popping up which would throw into uncertainty amounts payable by a prospective resolution applicant who successfully take over the business of the corporate debtor. As settled in the case of Ghanshyam Mishra, the past claims/debts in respect of the payments of dues arising under any law for the time being in force including the ones owed to the central government, any state government or any local authority shall stand extinguished. Therefore, such interpretation of law which is per incuriam will create an extra compliance/scrutiny for RP, COC and RA while reviving the Corporate Debtor.

If the dues of tax authorities are termed as a secured creditor, the same will render Section 53(1)(e) redundant because Government Authorities would come up in the ladder with the other secured creditors. If a secured creditor enforces his security interest in accordance with Section 52 of the Code, such secured creditor ranks lower in priority to a secured creditor and pari passu with government dues rather than a secured creditor who relinquishes his security interest. The Preamble to the Code lays down the objects of the Code to include "the insolvency resolution" in a time bound manner for maximisation of value of assets in order to balance the interests of all the stakeholders. Concerns have been raised that in some cases extensive litigation is causing undue delays, which may hamper the value maximisation. There is a need to ensure that all creditors are treated fairly, without unduly burdening the Adjudicating Authority whose role is to ensure that the resolution plan complies with the provisions of the Code. Various stakeholders have suggested that if the creditors were treated on an equal footing, when they have different pre insolvency entitlements, it would adversely impact the cost and availability of credit. Further, views have also been obtained so as to bring clarity on the voting pattern of financial creditors represented by the authorised representative.

Overriding Effect

As such provisdions of the Code shall prevail over provisions of other legislations being special law. the overriding effect of IBC over the Income Tax Act has been examined by the Hon'ble Supreme Court in the case of *Pr. Commissioner of Income Tax Vs. Monnet Ispat and Energy Ltd*[4]., wherein the court has ruled that Sec. 238 of IBC will override anything inconsistent contained in any other enactment, including the Income Tax Act. This has significant impact on regular tax matters as can be inferred from judicial development over the period. Section 238 of the Code provides for an overriding effect and Section 53 of the Code will prevail, wherein debt owed to secured creditors is given priority over government dues as reflected in Section 53(1) of the Code.

The overriding effect are always enacted to protect and achieve objectives of any legislations. However, in the present case, the impact of Section 238 has been made limited wherein government dues are given liberty to encroach the jurisdiction of IBC as secured creditor which is against the objectives of the Code.

---

2. Civil Appeal No. 8766-67 of 2019
3. Civil Appeal No.8129 of 2019
4. Special Leave to Appeal (C) No(s). 6483/2018

Conclusion

It is urged that the Government takes stake of the matter immediately and a review be filed in Hon'ble Supreme Court as once the judgement makes observation it becomes law of the land.

In authors' view the presumption if interpreted in light of the object of the Code shall mean that the charges created by law shall be subservient to the charge of the financial creditors. The lending by the bankers happens due to security interest they create, and tax department earns tax on the sales/income they effect. If the presumption of law is taken to be overriding the charge of banks or even pari passu to them the banking industry shall stop lending immediately. It is seen from the past that a financially distressed company shall always have huge tax liability since if the debt is not getting served, it is logical that the taxes which are normally paid on periodically basis would have been defaulted.

There is an urgent need of an ordinance to realign the intention of the legislature else majority of the pending matters will either be liquidated or withdrawn. Similar ordinance had been brought from time to time like blocking defaulting promoters from buying the company, inclusion of homebuyers as financial creditors, removal of attachment by enforcement agencies etc.

There is an urgent need of an ordinance to realign the intention of the legislature else majority of the pending matters will either be liquidated or withdrawn.

As an interim measure, a stay be brought against the operation of said order and same may be declared *per incuriam* in the interest of banking industry. Even Apex court has time and again upheld the scheme of the code and held that Code is an improvement for benefits of financial creditors especially bankers. Such commercial economic laws should not be left in lurch and immediately process to reconsider the matter be done.