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### GOVERNMENT'S SECURED CLAIM CANNOT BE EXCLUDED FROM A RESOLUTION PLAN: RAINBOW PAPERS VIEW UNADDRESSED IN REVIEW

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On 31 October, 2023, in *Sanjay Kumar Agarwal v State Tax Officer 1*, 2023 SCC OnLine SC 1406, the Supreme Court of India (SC) in the exercise of its powers of review under Article 137 of the Constitution of India, (Rainbow Review) affirmed the view expressed by another bench of the SC in *State Tax Officer (I) v. Rainbow Papers Limited* 2022 SCC OnLine SC 1162 (Rainbow Judgment) that may have far reaching effects on the treatment of dues to the Government or governmental authorities in insolvency resolution proceedings under the Insolvency and Bankruptcy Code, 2016 (IBC).

#### ***Background to the Rainbow Judgment***

The State of Gujarat through the State Tax Officer (I) (Department) was assessing Rainbow Papers Limited (CD) under the Gujarat Value Added Tax Act, 2003 (GVAT). Pursuant to one such assessment, the CD was found to be in arrears to the tune of Rs. 53,71,65,489/- for the assessment year 2011 - 2012. For this shortfall, in October 2018, the Department proceeded to attach certain properties belonging to the CD. Prior to such an attachment, the CD was put into corporate insolvency resolution process (CIRP) by the National Company Law Tribunal, Ahmedabad (NCLT) in September 2017, which appointed a resolution professional (RP). A resolution applicant proposed a resolution plan (Plan) for the CD. The Plan was approved of by the committee of creditors of the CD in June 2018 with an approval percentage of 79.79%. After the approval of the Plan, in October 2018, the Department made a claim before the RP for the sum of Rs. 53,71,65,489/-. The RP informed the Department that its claim of Rs. 53,71,65,489/- had been waived under the Plan.

The Department challenged the Plan which waived its claim citing that government dues could not be waived. The NCLT rejected the application of the Department stating that government dues could be waived and that the Plan had also been approved. The Department filed an appeal before the National Company Law Appellate Tribunal (NCLAT), which upheld the findings of the NCLT. The Department therefore approached the SC.

#### ***Issue in the Rainbow Judgment***

The main issue before the SC in the Rainbow Judgment was the interplay between the provisions of the IBC and the GVAT, in particular, Section 48 of the GVAT which made a tax liability a first charge on the property of an assessee, and section 53 of IBC which provides for the priority of distribution of sale proceeds from the sale of assets in liquidation proceedings.

### *Findings of the court in the Rainbow Judgment*

The SC held that in light of the fact that the Department's claim was secured and statutory, and on a co-joined reading of the IBC and the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 (Regulations) its claim ought to be recognised. The SC justified this position drawing from Section 53 of the IBC wherein secured creditors were recognised as part of the waterfall mechanism.

The SC went thereafter to hold that a resolution plan that falls foul of the provisions of the IBC cannot and ought not to be sanctioned by the NCLT and/ or the NCLAT. The fact that the Department had a first charge in respect of its demand and had also attached the property of the CD, did not permit the NCLT and NCLAT to approve the Plan without addressing the Department's claim. The SC held that a condition precedent for the approval of the Plan was its compliance with Section 30(2) of the IBC and that a plan that did not meet the requirements of Section 30(2) would be invalid. The SC further observed that if a resolution plan ignores the statutory demands payable to any State Government or a legal authority altogether, the NCLT and/ or NCLAT is bound to reject such a resolution plan. The SC observed that the Committee of Creditors could not secure their own dues at the cost of dues that were liable to be paid to the government or governmental authorities and set aside the Plan.

### *Rainbow Review background*

Being unsatisfied with the findings in the Rainbow Judgment, the RP of the CD and the lead bank of the committee of creditors of the CD, amongst others, filed the Rainbow Review before the SC, requiring the SC to review the Rainbow Judgement. The Rainbow Review was strongly premised on the SC's observations in relation to the Rainbow Judgment made in Paschim Anchal Vidyut Vitran Nigam Limited v. Raman Ispat Private Limited, 2023 SCC OnLine SC 842 (Paschim judgment). In the Paschim judgment the SC observed that the waterfall mechanism contemplated under Section 53 of the IBC had not been adverted to in the Rainbow Judgment. Our Ergo update on the Paschim judgment can be viewed here - <https://www.khaitanco.com/thought-leaderships/Raman-Ispat-Supreme-Court-confines-applicability-of-Rainbow-Papers>

### *Rainbow Review findings*

The SC held that the Rainbow Judgment was not affected by any of the circumstances that would warrant its review and consequently, the merits of the Rainbow Judgment remained unaffected. The SC was of the view that the observations of another bench of the SC cannot form the basis for the review of a judgment, since one bench of the SC cannot question the correctness of a judgment of another bench. The SC observed that should there be doubts over the correctness of a judgment passed by a bench, the proper recourse would be to refer the judgment to a larger bench for laying down the law. The SC also held that the Paschim judgment spoke of Section 53 of the IBC in the context of liquidation, but the Rainbow Judgment was not dealing with liquidation proceedings, but only approval of the Plan as part of CIRP. In saying so, the SC dismissed the Review Petitions and consequently affirmed the Rainbow Judgment.

### *Comment*

The Rainbow Judgment for the first time gave the concept of "crown debts" a weighted position in the process of insolvency resolution. This position has hitherto been unrecognised and also does not flow directly from the statute. The Rainbow Review has affirmed this view and today creates a classification amongst debts, being secured debts owed to the government, unsecured debts owed to the government and other non - governmental debts. The Rainbow Judgment and Rainbow Review leaves open the question as to what would be the treatment that would be given to unsecured governmental debts and dues. This view appears to be in conflict with the view expressed by a three-judge bench of the SC in

Ghanashyam Mishra, (2021) 9 SCC 657, where the three-judge bench categorised dues to the Government as being "operational debt" under IBC.

With the dismissal of the Rainbow Review, Central and State Governments have an upper hand when it comes to dues payable to them over other creditors, which casts a burden on the RP to undertake exacting due diligence to ensure the quantum of any governmental debts and dues payable by a corporate debtor at the time of issuance of an expression of interest. The Rainbow Review also imposes an additional obligation on the committee of creditors, NCLT and NCLAT insofar as governmental dues and the approval of resolution plans are concerned. Further, the finding that dues to the Government and other statutory authorities that flow from law cannot be waived in a resolution plan does not appear to be backed by law and does not appear to be the avowed intention of the Code.

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