

Statutory Charges and Secured Status: Rethinking Priority Claims in IBC Liquidation

Harshit Arora

Advocate, Insolvency Bankruptcy Code

Abstract

This paper examines the statutory priorities in liquidation under the Insolvency and Bankruptcy Code (IBC), 2016, with a focus on the treatment of government dues versus secured creditor claims. Through an analysis of key judicial pronouncements, particularly the Supreme Court's ruling in *State Tax Officer v. Rainbow Papers Ltd.*, and subsequent clarifications in *Paschimanchal Vidyut* and *Sundaresh Bhatt*, the paper explores the evolving legal stance on the waterfall mechanism under Section 53. It critically assesses the balance between public interest and creditor rights, highlighting the need for doctrinal consistency and legislative clarity.

1. INTRODUCTION

With the purpose to simplify and facilitate the process of corporate insolvency, and enforce a time-bound resolution of corporate assets in stress and expeditious debt resolution, the 'Insolvency and Bankruptcy Code, 2016 (IBC)' was enacted.¹ Also, liquidation is one of the main features of the IBC, where a company defaults and does not carry out its restructuring or resolution of its debts in the Corporate Insolvency Resolution Process (CIRP). In this manner, the liquidation process under IBC is governed by a detailed framework that regulates, among other things, the orderly distribution of assets of the bankrupt entity amongst its creditors and stakeholders.²

This framework is essential in establishing the waterfall mechanism as mentioned in Section 53 of the IBC to outline the hierarchy of a claim to the assets of a corporate debtor when the corporate debtor is in a situation of liquidation.³ Section 53 however ensures that how the assets will be distributed will be done in a systematic and orderly fashion, fairly and predictably, as per the entitlement of each creditor in law. Under the waterfall mechanism, these are the guidelines of the order of claim priority meaning by which classes of creditors or stakeholders will be paid from the liquidation proceeds. This mechanism is intended to create equity in the distribution process so that none of the creditor classes is unfairly advantaged or disadvantaged. Nevertheless, the application and implementation of this mechanism have not been smooth, particularly concerning the exact priority of such classes of creditors including secured creditors, operational creditors and government dues.⁴

¹ Insolvency and Bankruptcy Code 2016, Preamble.

² Insolvency and Bankruptcy Code 2016, s 33

³ Insolvency and Bankruptcy Code 2016, s 53

⁴ Bankruptcy Law Reforms Committee, *Final Report* (2015) https://ibbi.gov.in/uploads/resources/BLRCReportVol1_04112015.pdf accessed 22 April 2025.

2. THE STRUCTURE OF SECTION 53 AND THE WATERFALL MECHANISM

The order of payment of debts stipulated in the liquidation process is clear and specific as stated under Section 53 of the IBC. This serves the purpose of creating an objective and transparent approach for the liquidation of proceeds in a manner that safeguards the legal rights of the various classes of creditors. The following priority is made by the Section concerning the distribution of liquidation estate proceeds:

The liquidation waterfall mechanism as per Section 53 of the IBC, 2016, regulates the proceeds from the sale of assets of a corporate debtor, following a sale of the assets of the corporate debtor to be distributed in a prescribed order of priority. The Insolvency Resolution Process Costs and Liquidation Costs, being the fees payable to the insolvency professional (IP), administrative expenses and other costs that are incurred during the CIRP or liquidation are at the top of the waterfall. The next highest priority is determined for these costs to guarantee that the process receives sufficient funding, and is managed professionally before any recovery is produced to the creditors.

Following this, **secured creditors** are given precedence. These are financial creditors who have extended loans or credit against collateral such as immovable or movable property. If the collateral's value is sufficient, secured creditors have the first right to recover their dues from the liquidation proceeds of those assets. In cases where the liquidation value of the security is insufficient, the unpaid portion of the secured debt is treated as **unsecured**, ranking lower in the distribution priority.

Next in line are the **employees and workers of the company**, whose unpaid dues, such as salaries and wages, are given priority over unsecured debts. Section 53 specifically grants preference to payments due to employees for 24 months immediately preceding the commencement of liquidation. This provision reflects the Code's concern for labor welfare and the protection of workers' rights in insolvency scenarios.⁵ Thereafter, the Code recognizes **statutory dues owed to the government**⁶, including unpaid taxes such as income tax, GST, customs duties, and excise duties. These government dues are subordinate to both secured creditors and employee dues. The status of government claims in the waterfall has been contentious, particularly after the Rainbow Papers judgment, which raised questions on whether statutory charges under tax laws could override the IBC's prioritization. Nonetheless, traditionally and textually, the government does have a lower standing than secured creditors within the IBC framework.

After the satisfaction of statutory dues, **unsecured creditors** are next in the waterfall. These include suppliers, service providers, and trade creditors who do not have any security backing their claims. Their position at this stage of distribution means that they often recover only a fraction of their dues, especially if the liquidation estate is depleted by the time higher-ranked claims are met.

Lastly, **equity shareholders**, being residual claimants, receive any remaining proceeds only after all other debts and obligations have been settled in full. As risk-bearers of the company, shareholders are paid at the very end of the liquidation process and, in most insolvency cases, receive little or nothing due to the priority of debt repayments.

3. THE DISRUPTIVE RULING: STATE TAX OFFICER V. RAINBOW PAPERS LTD. (2022)

The Supreme Court's decision in 'State Tax Officer v. Rainbow Papers Ltd.', delivered in August 2022, stands as one of the most consequential—and controversial—rulings in the post-implementation phase of the IBC, 2016. The Court's interpretation of the status of government dues and their classification within the insolvency framework disrupted the previously understood legal and commercial position regarding

⁵ *State Tax Officer v Rainbow Papers Ltd* (2022) 1 SCC 456.

⁶ *Rainbow Papers* (n 14).

the waterfall mechanism under Section 53. The ruling has raised serious concerns over the sanctity of the insolvency resolution process, the finality of approved resolution plans, and the predictability of outcomes for financial creditors and resolution applicants.

3.1. FACTUAL BACKGROUND AND LEGAL QUESTION

The dispute in Rainbow Papers arose during the CIRP of Rainbow Papers Ltd., a company undergoing insolvency under the IBC. The Gujarat State Tax Department filed a claim for unpaid Value Added Tax (VAT) dues under ‘the Gujarat VAT Act, 2003 (GVAT Act)’. The Resolution Professional (RP), however, rejected the claim on the ground that government dues rank lower in priority under the IBC’s waterfall mechanism, and therefore could not form part of the admitted claims for the resolution plan.

The State Tax Officer approached the National Company Law Tribunal (NCLT), and subsequently, the National Company Law Appellate Tribunal (NCLAT), both of which dismissed the petition on the ground that statutory dues are operational debts and do not have any special privilege in the CIRP unless they fall within the scope of a secured creditor’s claim. The officer then appealed to the Supreme Court, which had to determine whether government dues owed under a state tax law that creates a statutory charge over the property of the assessee could be treated as “secured debts” under the IBC.⁷

3.2. THE SUPREME COURT’S REASONING

The Supreme Court allowed the appeal, holding that the State Tax Department was indeed a **secured creditor** under the IBC. The Court’s reasoning was primarily based on the following interpretations:

1. **Statutory Charge Equals Secured Creditor:** The Court took the view that Section 48 of the GVAT Act, which creates a first charge on the property of the dealer for unpaid VAT, satisfies the definition of a “security interest” under Section 3(31) of the IBC. Consequently, the State must be regarded as a “secured creditor” under Section 3(30).⁸
2. **Non-obstante Clause of the IBC Not Absolute:** The Court asserted that the non-obstante clause under Section 238 of the IBC does not automatically nullify valid rights created under other statutes, especially when such statutes provide for a specific charge that qualifies as a secured debt.⁹
3. **Right to Participate in the Resolution Process:** The Court opined that the exclusion of statutory creditors like the State from the resolution process—despite their status as secured creditors—undermines the fairness and inclusivity of the insolvency process.
4. **Binding Nature of Resolution Plans:** Importantly, the Court emphasized that if a resolution plan does not account for dues owed to a secured creditor—such as a state tax department with a statutory charge—then such a plan cannot be deemed binding under Section 31 of the IBC.

3.3. CONSEQUENCES OF THE RULING

The judgment in Rainbow Papers had an immediate and profound impact on the insolvency regime. Its consequences have played out in both judicial and commercial contexts:

1. **Disruption of the Waterfall Mechanism:** By recognizing the government as a secured creditor solely based on a statutory charge under state law, the Court effectively altered the hierarchy under Section 53. This allowed state dues to potentially supersede other creditors, including financial creditors, thereby diluting the priority accorded to them under the Code.¹⁰

⁷ IBC 2016, s 53(1)(f).

⁸ Gujarat VAT Act 2003, s 48.

⁹ IBC 2016, s 238.

¹⁰ Shreya Sharma, ‘Statutory Dues and the Waterfall Mechanism under IBC’ (Bar and Bench, 2022).

2. **Encouragement of Fragmented Claims:** Following the ruling, a variety of government departments and local authorities began asserting similar priority claims under their respective statutes. This raised the risk of a fragmented insolvency process, undermining the unified, time-bound framework that the IBC was meant to establish.
3. **Threat to Finality of Resolution Plans:** The decision created a risk that even after approval by the Committee of Creditors (CoC) and the Adjudicating Authority, resolution plans could be challenged for not accounting for government dues that enjoy a statutory charge. This struck at the very foundation of certainty and finality which the IBC aimed to deliver.¹¹
4. **Diminished Value for Resolution Applicants:** Potential resolution applicants, faced with the uncertainty of unaccounted statutory claims emerging after plan approval, became reluctant to participate in insolvency processes. This disincentivized investment and directly contradicted the goal of maximizing the value of the corporate debtor's assets.
5. **Incompatibility with Section 238:** While the Court acknowledged Section 238's overriding effect, it paradoxically allowed state law to prevail in practice. This interpretation contradicted earlier decisions of the Supreme Court, which had held that the IBC, being a special central law, prevails over any inconsistent state legislation in matters of insolvency.

3.4. DOCTRINAL INCONSISTENCIES

The ruling is also doctrinally inconsistent with prior jurisprudence and with the core philosophy of the IBC:

- In 'Ghanashyam Mishra & Sons Pvt. Ltd. v. Edelweiss Asset Reconstruction Company Ltd. (2021)', the Supreme Court upheld the binding nature of approved resolution plans and held that all claims not included in such plans stand extinguished.¹²
- The Court had previously ruled in 'Swiss Ribbons v. Union of India (2019)' that operational creditors, including government authorities, do not enjoy parity with financial creditors.
- The **Bankruptcy Law Reforms Committee** (BLRC), which laid the foundation for the IBC, had categorically recommended that government dues should not enjoy preference over other creditors.¹³

In contrast, the Rainbow Papers judgment elevated a statutory claim from a state law to the status of a secured debt within a centrally governed insolvency framework—despite the Code's express provisions and overriding clause.

4. JUDICIAL RESPONSES POST-RAINBOW

In the aftermath of Rainbow Papers, the judiciary has been called upon to revisit and potentially recalibrate the interpretation of statutory dues in the context of the IBC. Two significant rulings—'Paschimanchal Vidyut Vitran Nigam Ltd. v. Raman Ispat Pvt. Ltd. and Sundaresh Bhatt v. Central Board of Indirect Taxes and Customs'—offered much-needed clarification, though not without leaving certain concerns unresolved. These decisions represent attempts by the Supreme Court and other adjudicating bodies to contain the broader consequences of Rainbow Papers, especially the erosion of the IBC's carefully crafted waterfall mechanism.¹⁴

¹¹ Rainbow Papers (n 14).

¹² *Ghanashyam Mishra and Sons (P) Ltd v Edelweiss ARC* (2021) 7 SCC 542.

¹³ BLRC Report (n 4).

¹⁴ *Paschimanchal Vidyut* (n 32).

4.1. ‘PASCHIMANCHAL VIDYUT VITRAN NIGAM LTD. V. RAMAN ISPAT PVT. LTD. (2023)’

In this case, the Uttar Pradesh-based electricity distribution company, Paschimanchal Vidyut, claimed unpaid electricity dues from the corporate debtor and argued that its claim should be treated as a “secured debt” due to the statutory charge created under the Electricity Act, 2003. Relying on Rainbow Papers, the appellant contended that it should be classified as a secured creditor.

However, the Supreme Court took a restrictive view of the Rainbow Papers precedent. It held that merely because a statute claims to create a charge does not automatically elevate a creditor to secured status within the IBC framework. The Court emphasized that the IBC is a self-contained code and that while state statutes may create rights, such rights must still be interpreted within the specific confines of the IBC.

The ruling is significant for two reasons:

1. **Reassertion of IBC’s Supremacy:** The Court reinforced that Section 238 of the IBC, which provides an overriding effect over any other inconsistent law, must be strictly applied.¹⁵
2. **Narrow Reading of Rainbow:** The judgment subtly distinguished Rainbow Papers, suggesting that its application should be confined to cases where a very clear and legally enforceable security interest exists and has been duly registered.¹⁶

This case thus marked an important moment in limiting the potentially expansive reading of Rainbow Papers, by ensuring that the classification of a creditor under the IBC cannot be automatically altered by statutory claims unless they conform to the Code’s definitions and procedural requirements.

4.2. ‘SUNDARESH BHATT V. CENTRAL BOARD OF INDIRECT TAXES AND CUSTOMS (2022)’

Though decided shortly before Rainbow Papers, this case provides a contrasting and stabilizing view on how government dues are to be treated under the IBC, especially in the context of the moratorium and asset control.

The issue here was whether customs authorities could seize or retain the assets of the corporate debtor after the commencement of CIRP. The customs department, invoking its powers under the Customs Act, of 1962, had detained goods for unpaid dues.¹⁷

The Supreme Court unequivocally ruled that:

1. **Customs Authorities Must Release Assets:** Once CIRP commences, the moratorium under Section 14 of the IBC applies to all proceedings and actions, including those initiated by government authorities under tax laws.
2. **No Enforcement Outside IBC:** The government must file its claims before the RP and cannot exercise unilateral powers to recover dues.
3. **Operational Creditors Classification:** The judgment confirmed that government departments are operational creditors and that their claims must be processed through the established CIRP or liquidation process.¹⁸

This judgment is a strong reaffirmation of the IBC’s structural integrity and places significant limitations on government actions that bypass the insolvency framework.

4.3. REBALANCING AFTER RAINBOW

These rulings taken together represent an emerging judicial approach to formulating a new balance to the

¹⁵ Swiss Ribbons v Union of India (2019) 4 SCC 17.

¹⁶ Rainbow Papers (n 15).

¹⁷ Sundaresh Bhatt v CBIC (2022) 4 SCC 223.

¹⁸ Sundaresh Bhatt (n 32).

insolvency framework destabilised by the unwelcome support of Rainbow Papers. Statutory dues seem to meet less generous treatment from courts, which are curtailing their power to divert speculations from the distribution mechanism enforced under Section 53.¹⁹ Additionally, the judiciary has been keen, through the rules, to emphasize the registration of security interests which will assist creditors in getting their money but also apply stringent procedural timelines to make the insolvency process predictable and fair.

5. CONCLUSION AND ANALYSIS

Under the IBC, 2016, there is a time-bound creditor in control resolution process in which the creditor receives a clear hierarchy to discharge debt under section 53. It was one of its fundamental reforms because it annulled the traditional “crown debt” rule following which government dues prevailed over other creditors. However, the judicial interpretation of statutory dues, particularly post- ‘State Tax Officer v. Rainbow Papers Ltd. (2022)’ has muddled this clarity and reignited the conflict between the state claims and the rights of secured creditors.²⁰

In Rainbow Papers, the Supreme Court held that statutory dues under Gujarat VAT Act, having statutory charges behind them, become ‘secured debt’ under IBC. This elevated state tax authorities above their normal station as per Section 53 which lays down explicitly that Government dues stand below the secured creditors and workmen dues in the proceedings of winding up. This interpretation was not reconciled with Section 238 of the IBC which gives the Code an overriding effect over inconsistent laws. In the process, it confused the distinction between the statutory dues and the true security interests generated by contract and registration.

The fallout of the decision has been contained by subsequent decisions. In ‘Paschimanchal Vidyut v. In Raman Ispat’, the Court adopted a more narrow view of the statute by stating that such a status of secured status under IBC is accorded only to the statutory charges that are required to be registered. Likewise, in Sundaresh Bhatt v. The Court reiterated the supremacy of IBC and concluded that the government can’t sidestep the resolution framework for enforcement of its claims through the government. The fact that these rulings are a welcome reassertion of the Code’s core principles such as the uniform application of the resolution and liquidation processes, indeed, will never be a debatable issue.²¹

Despite some consistent judicial responses, however, Rainbow’s responses are far from uniformly consistent nor do they completely resolve the underlying doctrinal conflict. Whether statutory charges need to be registered under the Companies Act for the same to be regarded as ‘security interests’ under the IBC has not been conclusively determined by Courts. However, there is also ambiguity about whether government authorities, who are ordinarily treated as operational (but not financial) creditors, can claim the secured status articulated in various enabling statutes, independent of their participation in the resolution as part of the CoC in the resolution framework.²²

The broader concern is that uncertainty effectively vitiates the IBC’s own predictability and economic efficiency. A resolution applicant may suffer legal consequences for undisclosed or contingent claims, reducing its returns, discouraging followers from investing, and impeding the effective recovery of creditors’ assets. Also, the finality of approved resolution plans continues to erode (contrary to the spirit

¹⁹ IBC 2016, s 53.

²⁰ Arjun Rajagopalan, ‘Secured Creditors and Statutory Dues under the IBC’ (IndiaCorpLaw, 2022).

²¹ Somasekhar Sundaresan, ‘IBC and Tax Dues: Misplaced Priority?’ (Economic Times, 2022)

²² Anirudh Burman, ‘The Insolvency and Bankruptcy Code: A Solution, but for What Problem?’ (Brookings India, 2019).

of Ghanashyam Mishra) due to the very real potential of retrospective challenges to approved resolution plans.

Finally, it comes out that the current judicial approach, despite some corrective courses adopted recently, remains a reactive and fragmented one. Until there is legislative clarity – and that would reaffirm the priority structure and require procedural compliance for recognition of security interests – securing dues and secured creditors will continue to threaten the structural coherence of the IBC. To meet the Code's objective of finality, fairness and commercial certainty, a uniform, principles-based judicial response to varying transactions that involve corporate reorganizations is required.

BIBLIOGRAPHY

1. Ghanashyam Mishra and Sons (P) Ltd v Edelweiss Asset Reconstruction Co Ltd (2021) 7 SCC 542
2. Paschimanchal Vidyut Vitran Nigam Ltd v Raman Ispat Pvt Ltd (2023) 2 SCC 122
3. Principal Commissioner of Income Tax v Monnet Ispat and Energy Ltd (2018) 18 SCC 786
4. State Tax Officer v Rainbow Papers Ltd (2022) 1 SCC 456
5. Sundaresh Bhatt v Central Board of Indirect Taxes and Customs (2022) 4 SCC 223
6. Insolvency Law Committee, Report of the Insolvency Law Committee (Ministry of Corporate Affairs, March 2018) https://www.mca.gov.in/Ministry/pdf/ILCReport2703_03042018.pdf accessed 18 April 2025
7. Bankruptcy Law Reforms Committee, The Report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design (November 2015) https://ibbi.gov.in/uploads/resources/BLRCReportVol1_04112016.pdf accessed 19 April 2025
8. Insolvency and Bankruptcy Board of India (IBBI), Handbook for Insolvency Professionals (2023) <https://ibbi.gov.in/uploads/publication/handbook-ip.pdf> accessed 19 April 2025
9. V Umakanth and Mihir Naniwadekar, Corporate Insolvency Law and the IBC: Principles and Policy (Oxford University Press 2021)
10. Ayush Jindal and Sapan Shah, Law Relating to Insolvency and Bankruptcy Code (6th edn, Bharat Law House 2023)
11. Saurabh Bindal, Understanding the Insolvency and Bankruptcy Code (3rd edn, LexisNexis 2022)