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Questioning priority: Govt dues in IBC

Courts must safeguard the basic structure of the Insolvency and Bankruptcy Code

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The Insolvency and Bankruptcy Code (IBC) has a noble objective — resolving the stress of companies. When this is done in the manner the IBC provides — in a time-bound process, calm environment, priority rule for claims, and a clean slate takeover — it yields several benefits. These include maximising the asset value of the stressed person, promoting entrepreneurship, and improving credit availability within the economy. Any deviation from this course frustrates the objectives and denies the intended benefits. Such deviations have originated from various quarters. In most instances, the Supreme Court has rectified them. However, of late, a few deviations have emanated from the Supreme Court itself. When a company is stressed, it can honour the claims of a few creditors fully, but not all. In such situations, creditors may rush to recover their claims before others do, triggering a run on the company's assets. They recover on a "first come first serve" basis until the assets of the company are exhausted. The insolvency framework endeavours to resolve the stress while discharging the claims of creditors to the extent realistically possible. For this purpose, it overwrites the pre-

insolvency rights and entitlements of parties and prioritises their claims in a hierarchical order (priority rule). This priority rule overrides every other law. Overwriting and overriding are essential features of insolvency frameworks worldwide.

The IBC, in its long title, provides for “alteration in the order of priority of payment of Government dues” to achieve its objective. This gets reflected in section 53, which prescribes the priority rule for various claims. A claimant listed higher in the priority is paid first and fully, and if there is any surplus, the next claimant listed in the priority is paid, and this process is repeated until the entire proceeds are exhausted. The priority of claims is as follows: Resolution costs, workmen’s dues and secured debts, employees’ dues, unsecured financial debt, “any amount due to the Central Government and the State Government including the amount to be received on account of the Consolidated Fund of India and the Consolidated Fund of a State, if any”, and any remaining debt and dues.

Accordingly, all central revenue legislations provide for first charge of govt dues, subject to the IBC.

The priority rule, which includes the prioritisation of government dues, reflects the policy of the government. Notes on clauses to the Bill explain why unsecured financial debts have a priority above government dues. The Parliamentary Standing Committee, which endorsed the IBC Bill, noted that safeguarding the dues of unsecured creditors aims to encourage the market for corporate bonds and other unsecured debt. The Bankruptcy Law Reforms Committee, which conceptualised the IBC, has explained at great length the rationale behind assigning lower priority to government dues. In Moser Baer Karmachari Union Vs Union of India & Ors, the Supreme Court recently held that any change in the priority rule will have a cascading effect on the balance of rights. Thus, the priority rule is a basic structure of the Code.

The apex court recently deviated from the basic structure of the Code and the stated policy objective. In State Tax Officer vs Rainbow Papers Ltd, it held that the Gujarat State Tax Office is a secured creditor, considering the provision in the Gujarat Value Added Tax Act, 2003, that any amount payable by a dealer to the government under the Act is a first charge on its property. It overlooked the explicit provision that government dues remain government dues, even if these are secured by a statutory fiction, and rank below unsecured financial debts under the IBC.

Against a company, the government may have two types of claims, namely, claims arising from providing a service, and claims arising from tax dues. The company

may have taken the same service from both government as well as non-government suppliers. Claims for these services is an operational debt, whether secured or unsecured, based on service terms and security interest. In respect of the latter, however, a claim can be made only by the government. Even if the tax laws make tax dues secured, its ranking does not change in the priority rule. This question was not new before the Supreme Court in the Rainbow case. A significant set of laws prescribe that the government authority would have first charge on its claims, and the apex court had already dealt with this question in the context of IBC. In Sundaresh Bhatt vs CBDT, which was decided months before the Rainbow case, a similar provision of the Customs Act provided for a first charge for dues under it, subject to the Code. Therefore, the Court ruled that the governmental dues would be discharged in accordance with the priority rule. The legal community and academia heavily criticised the Rainbow judgment. A review has been admitted and is awaiting adjudication. Meanwhile, on July 17, the Supreme Court pronounced its judgment in Paschimanchal Vidyut Vitran Nigam Ltd vs Raman Ispat Private Limited & Ors, which has practically overwritten the Rainbow judgment.

Paschimanchal has made two vital findings. First, the priority rule “was either not brought to the notice of the court in the Rainbow case or was missed altogether”. This amounts to saying that the Rainbow judgment does not reflect the correct position of the law as it overlooked the relevant provision in the IBC. Second, and more important, government dues remain government dues when the IBC refers to them as such. They cannot have the priority of a secured creditor by a fiction of law provided in another Act.

Deviations, as in the Rainbow case, from explicit provisions of statute frustrate parliamentary vision and mandate, with huge costs to business and the economy. Given the consequences of their rulings, the courts must apply the rules in the IBC in the spirit they have been enacted and correct their mistakes, as seen in the case of Paschimanchal.

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