
GOVERNMENT DUES IN CORPORATE INSOLVENCY: RE-EXAMINING CREDITOR HIERARCHY AFTER RAINBOW PAPERS AND THE 2025 IBC AMENDMENT

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ABSTRACT

The prioritisation of government dues in corporate insolvency proceedings has remained a significant issue within India's insolvency framework under the Insolvency and Bankruptcy Code, 2016. While the Code introduced a structured creditor hierarchy through the waterfall mechanism under Section 53, placing government dues below secured and unsecured financial creditors, judicial developments have created uncertainty regarding the status of statutory tax claims. The controversy gained prominence after the decision of the Supreme Court of India in *State Tax Officer v. Rainbow Papers Ltd.*, where the Court held that a statutory charge created under a tax statute could confer secured creditor status upon government authorities.

This article analyses the evolving legal position concerning the treatment of government dues under the IBC. It first traces the historical development of the Crown debt doctrine in India and the priority traditionally accorded to government claims in insolvency proceedings. The article then examines the creditor hierarchy established under the IBC, particularly the waterfall mechanism governing the distribution of liquidation proceeds. It further evaluates the implications of the *Rainbow Papers* judgment and the concerns raised by financial institutions and insolvency professionals regarding the potential disruption of the creditor priority framework. The study also considers subsequent judicial clarification in *Paschimanchal Vidyut Vitran Nigam Ltd. v. Raman Ispat Pvt. Ltd.*, which sought to restrict the broader interpretation of statutory dues as secured claims. In addition, it analyses the proposed Insolvency and Bankruptcy Code (Amendment) Bill, 2025, which aims to clarify that statutory charges arising solely by operation of law do not constitute security interests under the Code.

The article argues that maintaining a predictable creditor hierarchy is essential for ensuring credit market stability, facilitating efficient insolvency resolution, and reinforcing the fundamental objectives of the IBC. Overall, recent judicial developments and proposed legislative reforms reaffirm the structured treatment of government dues within India's insolvency regime while preserving the primacy of secured creditors.

I. Introduction

The determination of priority among competing creditors has long been one of the most complex issues in insolvency jurisprudence. The question of whether government dues should be given preferential treatment over private creditors has generated significant debate across various jurisdictions. In India, this debate acquired renewed importance with the enactment of the Insolvency and Bankruptcy Code, 2016 (IBC), which introduced a comprehensive framework governing insolvency resolution and liquidation.

Prior to the IBC, government dues such as taxes, duties, and statutory levies frequently enjoyed a preferential position under various statutes and through judicial doctrines like “Crown debts.” However, the IBC fundamentally altered this position by introducing a structured “waterfall mechanism” under Section 53, which placed government dues lower in the priority hierarchy.

Despite the Code’s attempt to establish a clear order of priority, the Supreme Court’s judgment in **State Tax Officer v. Rainbow Papers Ltd. (2022)**¹ triggered considerable controversy by holding that statutory dues secured by a statutory charge could elevate the status of the State to a secured creditor under the Code. This interpretation appeared to disrupt the diligently designed creditor hierarchy and created uncertainty among financial institutions, insolvency professionals, and policymakers.

Subsequent judicial decisions attempted to confine or clarify the implications of the Rainbow Papers ruling. Eventually, the legislature intervened through the proposed **Insolvency and Bankruptcy Code (Amendment) Bill, 2025**², which sought to explicitly clarify that government dues would not obtain priority merely by virtue of statutory charges.

This article examines the evolution of the law relating to the priority of government dues under the IBC. It traces the historical treatment of crown debts in India, analyses the framework established by the IBC, evaluates the jurisprudential shift introduced by Rainbow Papers judgment, and studies the corrective developments through subsequent rulings and legislative amendments.

II. Historical Background: The Crown Debt Doctrine in India

Before the enactment of the IBC, Indian insolvency law was influenced by the common law doctrine of **Crown debts**, under which debts owed to the sovereign enjoyed priority over other

¹ State Tax Officer v. Rainbow Papers Ltd., (2022) 13 SCR 808 (India).

² Insolvency and Bankruptcy Code (Amendment) Bill, 2025, Bill No. 107 of 2025 (India).

debts. The rationale behind this doctrine lay in the principle that public revenue was essential for governance and therefore deserved preferential recovery.

The Supreme Court recognised the doctrine in several decisions. In *Builders Supply Corporation v. Union of India (1965)*³, the Court acknowledged that government debts may have priority in certain circumstances, though it clarified that such priority would generally apply only against unsecured creditors and not against secured creditors with existing charges over property.

Similarly, in *Dena Bank v. Bhikhabhai Prabhudas Parekh & Co. (2000)*, the Supreme Court reaffirmed that crown debts do not automatically override secured debts unless the statute explicitly creates a first charge in favour of the State.⁴ The Court observed that secured creditors retain priority over government claims unless a statutory provision clearly provides otherwise.

Furthermore, several statutes in India incorporated provisions creating statutory first charges in favour of the State for recovery of taxes. For instance, Section 48 of the Gujarat Value Added Tax Act, 2003, Section 37 of the Maharashtra Value Added Tax Act, 2002 and similar provisions under land revenue and municipal laws

These statutory charges often led to conflicts between government authorities and financial institutions when the debtor enters insolvency or liquidation.

Before the IBC, insolvency proceedings were governed by a fragmented framework consisting of:

- the Companies Act, 1956
- the Sick Industrial Companies (Special Provisions) Act, 1985
- the Recovery of Debts Due to Banks and Financial Institutions Act, 1993

This fragmented regime created uncertainty regarding creditor priority and recovery processes.

The need for a consolidated insolvency framework eventually led to the enactment of the IBC.

III. Reordering Creditor Priorities under the IBC

The Insolvency and Bankruptcy Code, 2016 represented a paradigm shift in Indian insolvency law. One of its central objectives was to maximise asset value and promote credit availability by ensuring predictable creditor rights. The Bankruptcy Law Reforms Committee (BLRC),

³ Builders Supply Corporation v. Union of India, AIR 1965 SC 1061 (India).

⁴ Dena Bank v. Bhikhabhai Prabhudas Parekh & Co., (2000) 5 SCC 694 (India).

whose recommendations formed the basis of the IBC, emphasised the need for a clear and predictable priority structure to enhance credit markets. According to the BLRC Report, uncertainty in creditor priority discourages lending and reduces the efficiency of insolvency resolution.

1. Waterfall Mechanism under Section 53

The IBC introduced a structured priority system for the distribution of liquidation proceeds under Section 53⁵, often referred to as the “waterfall mechanism.” The order of priority is broadly as follows:

1. Insolvency resolution process costs and liquidation costs
2. Secured creditors and workmen’s dues (for the preceding 24 months)
3. Wages and unpaid dues owed to employees
4. Unsecured financial creditors
5. Government dues and remaining secured debts
6. Other debts and dues
7. Preference shareholders
8. Equity shareholders

Notably, government dues appear only at the fifth level, i.e. Section 53(1)(e)(i) significantly below secured and unsecured creditors. This legislative structure clearly indicates Parliament’s intention to subordinate government claims to financial creditors, thereby strengthening the credit ecosystem.

2. Overriding Effect of IBC

Section 238 of the IBC contains a non-obstante clause, providing that the provisions of the Code shall prevail over any inconsistent laws. This provision was intended to ensure that conflicting statutory claims, such as tax authorities asserting priority would not undermine the insolvency framework. The Apex Court reinforced this principle in *Principal Commissioner of Income Tax v. Monnet Ispat and Energy Ltd. (2018)*,⁶ holding that the IBC overrides inconsistent provisions in other statutes. Similarly, in *Ghanashyam Mishra and Sons Pvt. Ltd.*

⁵ § 53, Insolvency and Bankruptcy Code, 2016 (India).

⁶ *Principal Commissioner of Income Tax v. Monnet Ispat and Energy Ltd.*, (2018) 18 SCC 786 (India).

*v. Edelweiss Asset Reconstruction Co. Ltd. (2021)*⁷, the Court ruled that once a resolution plan is approved, all claims not included in the plan stand extinguished, including statutory dues owed to government authorities. These decisions strengthened the view that government dues under the IBC do not enjoy special priority.

IV. The Rainbow Papers Judgment (2022): A Significant Departure

The legal clarity established under the IBC framework was disrupted by the Supreme Court's decision in *State Tax Officer v. Rainbow Papers Ltd. (2022)*.⁸

The Facts of the case are as follows. The case involved tax dues owed by Rainbow Papers Ltd. to the State of Gujarat under the Gujarat Value Added Tax Act, 2003.⁹ Section 48 of the Act¹⁰ provided that unpaid tax dues constituted a first charge on the property of the dealer. During the insolvency resolution process, the resolution plan did not account for the State's tax dues. The State Tax Officer challenged the plan, arguing that the statutory charge under the GVAT Act made the State a secured creditor.

The Supreme Court held that:

1. A security interest may arise not only through contractual arrangements but also by operation of law.
2. The definition of "secured creditor" under Section 3(30) of the IBC¹¹ is broad enough to include government authorities.
3. Therefore, the statutory charge created under the GVAT Act gave the State the status of a secured creditor.¹²

As a result, the Court concluded that government dues secured by statutory charges could rank alongside secured creditors under the waterfall mechanism.

The Judgment significantly altered the interpretation of the IBC framework. Firstly, it suggested that statutory charges created under tax laws could elevate government authorities to the status of secured creditors. Secondly, it introduced uncertainty in insolvency proceedings. Financial institutions feared that statutory dues might consume a substantial

⁷ Ghanashyam Mishra and Sons Pvt. Ltd. v. Edelweiss Asset Reconstruction Co. Ltd., (2021) 9 SCC 657 (India).

⁸ State Tax Officer, (2022) 13 SCR 808 at 1 (India).

⁹ GVAT Act, 2003. (India).

¹⁰ § 48, Gujarat Value Added Tax Act, 2003 (India).

¹¹ § 30(3), Insolvency and Bankruptcy Code, 2016 (India).

¹² IBC § 53 (India).

portion of liquidation proceeds, thereby reducing recoveries for lenders.¹³ Thirdly, the decision appeared inconsistent with the objective of the IBC to prioritise financial creditors and facilitate credit availability. Scholars and practitioners criticised the judgment for undermining the certainty of the insolvency framework and potentially discouraging lending.

V. Judicial Reconsideration and limiting the scope of Rainbow Papers judgment

Following widespread criticism, subsequent Supreme Court decisions attempted to clarify and limit the implications of the Rainbow Papers ruling.

1. Paschimanchal Vidyut Vitran Nigam Ltd. v. Raman Ispat Pvt. Ltd. (2023)¹⁴

In the above case, the Supreme Court revisited the issue of creditor priority in the context of electricity dues. The Court observed that the Rainbow Papers decision had not adequately considered the waterfall mechanism under Section 53 of the Act.¹⁵ It emphasised that the legislative design of the Code clearly places government dues at a lower priority compared to secured creditors. The Court held that Rainbow Papers should be confined to its specific factual context and cannot be interpreted as granting general priority to statutory dues. This judgment reaffirmed that the IBC's priority framework must be respected and that government dues ordinarily rank below secured and unsecured creditors.¹⁶

2. Review Proceedings in Sanjay Kumar Agarwal v. State Tax Officer (2023)¹⁷

Review petitions were filed challenging the Rainbow Papers decision. In *Sanjay Kumar Agarwal v. State Tax Officer (2023)*, the Supreme Court dismissed the review petitions but clarified that differences between coordinate benches do not automatically justify review. Although the Court did not overturn Rainbow Papers, the subsequent jurisprudence effectively limited its practical application.

VI. Legislative Response to the Insolvency and Bankruptcy Code (Amendment) Bill, 2025

The controversy created by the Supreme Court's decision in *State Tax Officer v. Rainbow Papers Ltd.* generated considerable uncertainty in the insolvency ecosystem. Financial creditors, insolvency professionals, and policymakers expressed concerns that the judgment

¹³ J. Vikas, *Resolution of Debts and Insolvency and Bankruptcy Code, 2016: The Status of Government Dues and Taxes*, J. Nat'l L. Univ. Delhi (2021).

¹⁴ *Paschimanchal Vidyut Vitran Nigam Ltd. v. Raman Ispat Pvt. Ltd.*, Civil Appeal No. 7976 of 2019 (SC) (India).

¹⁵ IBC § 53.

¹⁶ D. Parbhakar, *Corporate Insolvency and Bankruptcy Code, 2016: Success, Challenges, and the Road Ahead*, *J. Advance & Future Rsch.* 15 (2025).

¹⁷ *Sanjay Kumar Agarwal v. State Tax Officer*, Review Petition (Civil) 2023.

had the potential to significantly alter the creditor hierarchy under the Insolvency and Bankruptcy Code, 2016 (IBC). In particular, the interpretation that statutory dues secured by operation of law could elevate government authorities to the status of secured creditors raised serious concerns about the stability of the insolvency framework.

In response to these concerns, the Government proposed legislative clarification through the **Insolvency and Bankruptcy Code (Amendment) Bill, 2025**. The objective of the amendment is to reaffirm the original legislative intent of the IBC and eliminate ambiguities regarding the treatment of government dues during insolvency proceedings. Legislative intervention in this context reflects a broader policy commitment to maintaining the integrity of the creditor priority structure established under the Code. Scholarly commentary has consistently emphasised that uncertainty regarding creditor hierarchy can undermine the effectiveness of insolvency regimes by discouraging credit flows and complicating resolution processes.¹⁸ The proposed amendment therefore represents an attempt to restore predictability and reinforce the fundamental objectives of the IBC.

1. Clarification Regarding Security Interests

One of the central aspects of the proposed amendment concerns the clarification of the concept of **security interest** under the IBC. The Rainbow Papers decision interpreted the definition of “secured creditor” broadly by recognising that a statutory charge created under a tax statute could constitute a security interest under the Code. This interpretation led to the possibility that government authorities could claim priority alongside secured financial creditors. The proposed amendment seeks to clarify that statutory charges arising solely by operation of law shall not be treated as security interests for the purposes of the IBC. Instead, the amendment emphasises that only consensual security interests created through contractual arrangements, such as mortgages, pledges, or hypothecation agreements, would qualify for secured creditor status.

This clarification is consistent with the broader structure of the IBC, which primarily recognises commercial lending relationships as the basis for secured claims in insolvency proceedings. Financial institutions typically extend credit against specific collateral arrangements, and their priority in liquidation is intended to reflect the risks undertaken in providing such credit.¹⁹ Recognising statutory tax claims as secured debts could undermine this structure by allowing

¹⁸ Vikas, *Resolution of Debts and Insolvency*, supra note 13, at 5.

¹⁹ P. Datta & R. Vyas, *Prioritising Tax Claims in Corporate Insolvency: Boon or Bane?*, 9 *NLS Bus. L. Rev.* 1, 15 (2023).

government authorities to assert priority over financial creditors without having extended credit or assumed comparable commercial risks. The amendment therefore seeks to restore the distinction between statutory claims and consensual security interests.

2. Position of Government Dues in the Waterfall

The proposed amendment also clarifies the position of government dues within the **waterfall mechanism under Section 53 of the IBC**, which governs the distribution of liquidation proceeds. Under the existing framework, government dues fall within **Section 53(1)(e)(i)**, which provides that dues owed to the Central Government or State Government for the period of two years preceding the liquidation commencement date are to be paid after unsecured financial creditors.²⁰ The amendment reiterates that such dues shall continue to be treated as operational liabilities rather than secured claims.

Furthermore, the amendment clarifies that government dues that arise beyond the two-year period preceding liquidation would fall under Section 53(1)(f), which places them even lower in the priority hierarchy. This structure reflects a deliberate legislative choice to subordinate government claims in order to promote credit availability and enhance recovery prospects for financial creditors.

Importantly, the amendment explicitly states that government dues shall not be treated as secured debts even if a statute creates a charge in their favour. This provision effectively resolves the ambiguity created by the Rainbow Papers ruling and ensures that statutory tax provisions cannot override the insolvency priority framework established under the IBC. Legal scholars have argued that such clarification is necessary to maintain the integrity of the insolvency process and to prevent conflicting statutory regimes from undermining the Code's objectives.²¹

3. Legislative Intent

The legislative intent behind the proposed amendment is to restore the original design and policy rationale of the IBC. The Code was enacted with the aim of creating a predictable and efficient insolvency regime that would promote economic growth and facilitate credit availability. Allowing statutory claims to disrupt the creditor hierarchy would weaken these objectives. The amendment therefore seeks to ensure that government authorities do not obtain priority merely through statutory provisions. Instead, the insolvency framework prioritises

²⁰ Insolvency and Bankruptcy Code, 2016, § 53 (India).

²¹ Bankr. L. Reforms Comm., *Report of the Bankruptcy Law Reforms Committee 73* (2015).

creditors who have extended financial resources to the debtor and whose recoveries are essential to maintaining confidence in the credit system. This legislative clarification effectively neutralises the broader implications of the Rainbow Papers judgment by reaffirming the supremacy of the IBC's priority structure. In doing so, the amendment reinforces the principle that the IBC constitutes a comprehensive and overriding insolvency framework, capable of resolving conflicts with other statutory regimes.

VII. Significance and Contemporary Relevance of the Issue

The priority of government dues remains a critical issue in the contemporary insolvency landscape. The resolution of this question has far-reaching implications not only for insolvency proceedings but also for broader economic and constitutional considerations.

1. Impact on Credit Markets

Predictability in creditor priority is essential for the efficient functioning of credit markets. Financial institutions extend credit based on an assessment of risk, which includes evaluating the potential recovery of debts in the event of insolvency. If statutory authorities are able to assert priority over secured creditors, lenders may perceive greater uncertainty regarding recovery prospects. This uncertainty can lead to higher borrowing costs and reduced availability of credit, particularly for businesses operating in sectors where statutory liabilities are significant. As noted by the Bankruptcy Law Reforms Committee, a clear and predictable priority structure is crucial for encouraging lending and fostering economic growth.²²

The controversy surrounding the Rainbow Papers decision highlighted the potential consequences of disrupting this structure. The proposed legislative clarification therefore plays an important role in restoring confidence among lenders and investors.

2. Federalism Concerns

The issue also raises significant questions regarding the relationship between central insolvency law and state taxation statutes. Many state laws, such as value added tax and land revenue statutes, contain provisions creating first charges in favour of the State for the recovery of tax dues. If such provisions were recognised in insolvency proceedings, they could undermine the uniform framework established by the IBC. The Constitution of India permits Parliament to enact laws relating to insolvency and bankruptcy under Entry 9 of the Concurrent List, thereby enabling the creation of a national insolvency regime. The clarification provided

²² *Monnet Ispat & Energy Ltd.*, supra note 6, at 4.

through judicial interpretation and legislative amendment ensures that central insolvency law prevails over conflicting state statutes. This approach is consistent with the Supreme Court's earlier decision in *Principal Commissioner of Income Tax v. Monnet Ispat and Energy Ltd.*, where the Court held that the IBC overrides inconsistent provisions of other laws by virtue of its non-obstante clause.

3. Efficiency of Insolvency Resolution

Another important dimension of the issue relates to the efficiency of insolvency resolution processes. The IBC was designed to promote the time-bound resolution of distressed assets and to maximise the value of the debtor's estate. Uncertainty regarding creditor priority can create delays in the approval of resolution plans and complicate negotiations between stakeholders. Potential resolution applicants may be reluctant to invest in distressed companies if they face uncertainty regarding the distribution of proceeds among creditors. By clarifying the position of government dues, the proposed amendment strengthens the predictability of insolvency proceedings and supports the broader objective of ensuring efficient and effective resolution mechanisms.

VIII. The Settled Position of Law

In light of the judicial developments and the proposed legislative clarification, the legal position regarding the priority of government dues under the IBC has become considerably clearer.

First, the IBC establishes a **structured priority framework under Section 53**, which governs the distribution of liquidation proceeds. This framework reflects a deliberate legislative choice to prioritise insolvency costs and secured creditors in order to maximise recoveries and maintain confidence in the credit system.

Second, government dues ordinarily rank **below secured and unsecured financial creditors**. This position reflects the policy objective of ensuring that creditors who have extended financial resources to the debtor are able to recover their claims to the greatest possible extent.

Third, statutory charges created under tax laws do not automatically grant secured creditor status under the IBC. The proposed amendment clarifies that such charges cannot override the priority structure established by the Code.

Fourth, the Rainbow Papers judgment represented a limited departure from the prevailing interpretation of the IBC. Subsequent judicial decisions and legislative proposals have sought to confine its implications and restore the original policy framework.

Lastly, the **IBC (Amendment) Bill, 2025** aims to conclusively clarify that government dues cannot claim priority merely by virtue of statutory charges. This legislative clarification ensures that the creditor hierarchy under the IBC remains stable and predictable.

Thus, the present legal framework reaffirms the primacy of secured creditors in insolvency proceedings, while still recognising the importance of government claims within the structured waterfall mechanism.

IX. Conclusion

The evolution of the law relating to the priority of government dues under the Insolvency and Bankruptcy Code demonstrates the dynamic interplay between judicial interpretation and legislative policy. The historical doctrine of crown debts granted governments preferential recovery rights in recognition of the importance of public revenue. However, the enactment of the IBC marked a deliberate shift away from this tradition by introducing a structured and predictable creditor hierarchy. The Supreme Court's decision in *State Tax Officer v. Rainbow Papers Ltd.* temporarily disrupted this framework by recognising statutory tax dues as secured debts. The judgment raised concerns regarding the stability of the insolvency regime and the potential impact on credit markets. In response, subsequent judicial decisions sought to limit the scope of the ruling, while the Government proposed legislative amendments to clarify the position of government dues.

Through these developments, the legal framework has largely returned to the original design of the IBC. Government dues, although important for public revenue, do not enjoy priority over secured creditors in insolvency proceedings. Instead, they are treated as operational liabilities within the structured waterfall mechanism established under Section 53.

This approach reflects a broader policy objective of promoting economic growth, ensuring efficient insolvency resolution, and maintaining confidence in India's credit markets. By reaffirming the primacy of secured creditors and clarifying the treatment of statutory claims, the evolving jurisprudence and legislative response strengthen the overall effectiveness of the IBC as a modern insolvency regime.