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Secured Under Tax Law, Unsecured Under IBC: Redefining "Secured Interest" and the Consequences for Statutory Creditors

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1. Introduction

Few questions in insolvency law have proved as consequential or as contested as this: when a company collapses into liquidation and its assets are auctioned off, can a statutory authority that missed the claims window simply point to an attachment order from years past and demand that the auction purchaser bear the burden? The answer, as the Division Bench of the Madras High Court has now made clear, is an unequivocal no.

The judgment under discussion arose from an appeal against a Single Judge order that had upheld an attachment order issued by the Tamil Nadu VAT authorities over properties that had been subsequently sold in a public auction conducted under the Insolvency and Bankruptcy Code, 2016 (IBC). The purchaser at that auction having paid good money at a court-sanctioned sale sought to have the attachment lifted. The Single Judge refused, leaning heavily on the Supreme Court's decision in *State Tax Officer v. Rainbow Papers Ltd.* [2022] 142 taxmann.com 157/174 SCL 250 (SC). The Division Bench, on appeal, disagreed and reversed that conclusion.

What makes this case particularly significant is its timing. The Division Bench's ('DB') reasoning is powerfully reinforced by the Insolvency and Bankruptcy Code (Amendment) Act, 2026 ('**Amendment Act**') which amends Section 3(31) of the IBC to explicitly exclude statutory charges created by operation of law from the definition of 'security interest'. The amendment is declaratory in nature and, therefore, retrospective in effect. Together, the DB ruling and the Amendment Act deliver a decisive and long-overdue answer to the rainbow of confusion that *Rainbow Papers* had inadvertently cast over insolvency proceedings.

2. Factual Background

The subject property was purchased by the writ petitioner in a public auction from the liquidator. Crucially, the first respondent i.e., the State Tax Officer under the Tamil Nadu Value Added Tax Act, 2006 ('**TNVAT Act**') had passed an order of attachment over the very same property as early as in 2016, that is, nearly three and a half years before the liquidation order. The Writ Petitioner, seeking the benefit of a clean title following the IBC auction, approached the High Court seeking to have this attachment order quashed.

The learned Single Judge, while dismissing the Writ Petition, held that tax dues under a statutory first charge operate as a 'secured interest' and that the first respondent, being a secured creditor within the meaning of Section 3(30) of the IBC, retained rights over the property that the liquidator could not disregard. It was this finding that the DB was called upon to examine.

3. Submissions on Behalf of the Petitioner

Before the DB, counsel for the auction purchaser raised a three-pronged challenge to the Single Judge's order.

First, it was submitted that the learned Single Judge had mechanically applied *Rainbow Papers* without appreciating that subsequent Supreme Court decisions had significantly qualified its reach, and that *Rainbow Papers* itself is a fact-specific pronouncement that cannot be applied universally across all insolvency scenarios.

Second, and most critically, reliance was placed on the Amendment Act. Section 2 of the Amendment Act amends Section 3(31) of the IBC to clarify the nature of 'security interest', inserting an "explanation" that expressly provides that a security interest created by operation of law shall not qualify as a 'security interest' under the Code. Since this is a clarificatory amendment enacted for the removal of doubts, it was submitted that it applies retrospectively and therefore undermines the foundation of the Single Judge's reasoning.

Third, it was pointed out that once the claim of the first respondent had not been filed in time and the liquidation sale had been completed, the assets of the corporate debtor could only be dealt with under Section 53 of the IBC i.e., the waterfall mechanism and that the overriding effect of Section 238 of the IBC left no room for a collateral recovery by statutory authorities outside that framework.

4. Submissions on Behalf of the Respondent (TN VAT Department)

The TNVAT authorities rested their defence squarely on two pillars. **First**, they relied upon Section 42 of the TNVAT Act, 2006, which provides that arrears of tax operate as a charge on the properties of the person liable to pay tax, a right, they contended, that crystallised as early as in 2016 with the attachment order. **Second**, they submitted that this position had been authoritatively settled by the Supreme Court in *Rainbow Papers*, and that so long as a statutory right exists, no auction purchaser can seek its removal.

5. Findings of the High Court

5.1 The Threshold Fact: Claims Filed Belatedly and Rejected

At the outset, the DB noted the admitted position: the first respondent's claim had not been filed within the stipulated time before the Liquidator. It was rejected as belated and the subsequent application before the NCLT was dismissed for non-prosecution. This procedural failure proved fatal to the respondent's case in more ways than one.

The Supreme Court, in *RPS Infrastructure Ltd. v. Mukul Kumar*, [2023] 154 taxmann.com 243/180 SCL 501 (SC), had already settled that belated claims cannot be entertained under the scheme of the IBC. The respondent's failure to participate in the claims process, therefore, closed the door on any recovery within the IBC framework.

5.2 Extinguishment of Statutory Dues Upon IBC Proceedings

The Court referred to the settled position established in the landmark judgement in *Ghanashyam Mishra & Sons (P) Ltd. v. Edelweiss Asset Reconstruction Co. Ltd.*, [2021] 126 taxmann.com 132/166 SCL 237 (SC), wherein the Supreme Court had unequivocally held:

"All the dues including the statutory dues owed to the Central Government, any State Government or any local authority, if not part of the resolution plan, shall stand extinguished and no proceedings in respect of such dues for the period prior to the date on which the adjudicating authority grants its approval under Section 31 could be continued."

The DB applied this principle originally stated in the context of resolution to the liquidation stage, reinforced by the primacy of the Section 53 waterfall mechanism, and noted that Section 238 of the IBC contains a non-obstante clause giving the Code precedence over all other laws in matters relating to distribution of the corporate debtor's assets.

5.3 Why Rainbow Papers Does Not Govern the Present Case

The Court's analysis of *Rainbow Papers* is perhaps the most instructive part of the judgment. Rather than overruling or ignoring it, the DB undertook a careful dissection to establish that the case has been consistently misunderstood

and misapplied.

The first point of distinction lies in the regulatory regime. *Rainbow Papers* arose under the **unamended Regulation 12** of the IBBI (CIRP) Regulations, 2016. Prior to the 2018 amendment, Regulation 12 required a creditor to submit only a '**proof of claim**', whereas, after the amendment, the requirement was elevated to 'a **claim with proof**'. The Supreme Court in *Rainbow Papers* found fault with the rejection of the STO's claim because, under the unamended Regulation, there was no mandate to file a formal claim. In the present case, however, the proceedings arose after the amendment, making the obligation to file a 'claim with proof' unambiguous. The first respondent's failure to do so was its own default.

The second point of distinction was that *Rainbow Papers* arose at the stage of the **CIRP**, not at the stage of liquidation as in the present case. The rights and priorities applicable during CIRP are materially different from those that govern distribution during liquidation under Section 53.

The third and most significant point is that *Rainbow Papers* simply did not engage with the waterfall mechanism. The Supreme Court, in *Paschimanchal Vidyut Vitran Nigam Ltd. v. Raman Ispat (P) Ltd.*, [2023] 152 taxmann.com 421/180 SCL 30 (SC), had already observed that *Rainbow Papers* did not notice Section 53 and the provision was neither adverted to nor extracted in the judgment and that the decision must, accordingly, be confined to its own facts.

5.4 Whether the VAT Authorities Qualify as Secured Creditors Under the IBC

The DB then addressed the foundational question: does a statutory first charge under Section 42 of the TNVAT Act elevate the VAT authority to the status of a '**secured creditor**' within the meaning of **Section 3(30) of the IBC**?

The Court observed that a secured creditor under Section 3(30) is one in whose favour a '**security interest**' as defined in Section 3(31) has been created. Reading Section 3(31) on its plain terms, the Court held that the definition is confined to cases where a security interest is created **by act of parties** through contract or agreement and **does not** extend to a charge created by **operation of law**. The VAT authorities' claim to the status of a secured creditor, therefore, failed at this definitional threshold.

5.5 The IBC (Amendment) Act, 2026: A Declaratory Clarification With Retrospective Effect

The DB's reasoning on the definition of security interest finds powerful statutory endorsement in the IBC (Amendment) Act, 2026. Section 2 of the Amendment Act amends **Section 3(31) of the IBC** by inserting an Explanation, which reads as follows:

*"**Explanation.** For the removal of doubts, it is hereby clarified that the security interest shall exist only if it creates a right, title or interest or a claim to a property pursuant to an agreement or arrangement, by the act of two or more parties, and shall not include a security interest created merely by operation of any law for the time being in force."*

The legislative intent behind this amendment is unambiguous and it seeks to explicitly undo the consequence of the Supreme Court's decision in *Rainbow Papers*, wherein statutory dues were treated as deserving the status of secured debts.

The Court also observed that the amendment is **declaratory in nature**. It does not create a new right but merely clarifies what the law always meant. The consequence being that the amendment operates **retrospectively**. Accordingly, even if there were any doubt about the correctness of the Single Judge's approach at the time of the impugned judgment, the Amendment Act resolves that doubt definitively and retrospectively in favour of the auction purchaser.

6. Conclusion

The DB's decision represents a jurisprudential course-correction long and can be understood at below three levels:

At the **factual level**, a statutory authority that allows its claim to lapse through delayed filing and non-prosecution cannot revive it collaterally by pointing to a pre-insolvency attachment. The Section 53 waterfall, read with the non-obstante clause in Section 238, forecloses that escape.

At the **doctrinal level**, the Court carefully confines *Rainbow Papers* to its own facts under the unamended Regulation 12, with no engagement with the liquidation waterfall. It declines to read *Rainbow Papers* as a universal charter for statutory authorities across all insolvency proceedings and rightly so.

At the **legislative level**, the Amendment Act provides much-needed clarity. By declaring that a security interest must be created by act of parties and cannot arise by mere operation of law, Parliament has consciously adopted a narrower definition of "charge" and "security interest" than what is generally understood under the Transfer of Property Act or other statutes from which the concept might otherwise be borrowed.

For **law students** (including me), this is a vivid reminder of an age-old constitutional truth: the legislature is competent to define the same term differently across different enactments. It may, if it chooses, define the sun as the moon and the moon as the sun and both definitions are valid within their respective legislative domains.

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