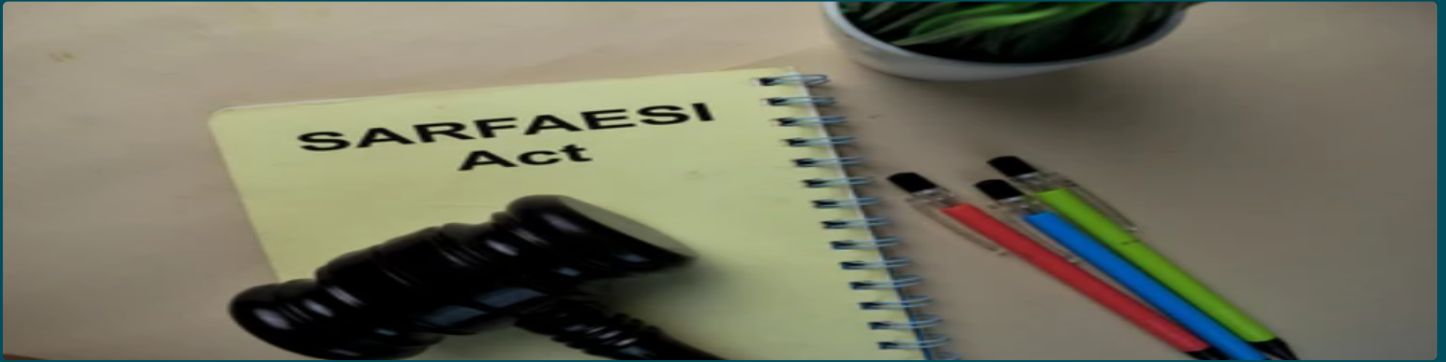




CIVIL

Statutory Charges and Secured Creditors: Analyzing Priority Post-Section 26E SARFAESI

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Introduction

In a significant ruling, the Madras High Court, comprising of the Hon'ble Dr. Justice Anita Sumanth and the Hon'ble Mr. Justice G. Arul Murugan, held that the provisions of Section 26E of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act) and Section 34 of the Recovery of Debts and Bankruptcy Act, 1993 (RDB Act) prevail over charge created under Section 24 of the Tamil Nadu General Sales Tax Act, 1959 (TNGST Act). The court in the case of Indian Bank, Kilpauk Branch vs. Commercial Tax Officer, Ambattur Assessment Circle & Ors., brought clarity vis-à-vis the priority of claims between secured creditors and taxation authorities over subsequent tax demands.

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Background of the case

The case pertains to a dispute over the priority of claims between the Indian Bank and the Commercial Taxes Department of Tamil Nadu. In 1990, the Indian bank had sanctioned secured overdraft facilities and loans to Shree Ragavendra Engineering Industries and Shree Balajee Industries (assessee), who had created an equitable mortgage over their property located at Kilpauk, Chennai in favor of the bank as collateral (security). The bank had also been a tenant, occupying a portion of the property, and the lease rent was adjusted towards the outstanding dues of the assessee to the bank.

However, in December 2001, the Commercial Taxes Department issued notices under Section 26 of the TNGST Act, demanding that the bank pay the lease rentals to the Sub Treasury Officer in favor of the Commercial Tax Officer, as the assessee was in arrears of sales tax. Despite the bank's explanation regarding its prior secured claim, the tax department persisted with its demands, leading to the litigation.

Key Issues

- **Priority of Charge:** Whether the Commercial Tax Department's claim for sales tax dues had precedence over the bank's prior mortgage.
- **Impact of Section 26E of SARFAESI Act:** Whether Section 26E, granting priority to secured creditors, overrides the claims of the Commercial Tax Department.

Statutory Provisions

The court examined several key provisions:

1. **Section 26E of the SARFAESI Act**– the provision explicitly provides that “notwithstanding anything contained in any other law for the time being in force, after the registration of security interest, the debts due to any secured creditor shall be paid in priority over all other debts and all revenues, taxes, cases and other rates payable to the Central Government or State Government or local authority.”
2. **Section 34 of RDB Act and Section 37 of SARFAESI Act**- Section 34 of RDB Act contains a general non-obstante clause giving it overriding effect. Section 37 of SARFAESI Act states that its provisions “shall be in addition to, and not in derogation of” other laws. The court found that the specific provision (Section 26E) would prevail over the general provisions.

3. **Section 24 of the TNGST Act**– the provision creates a charge on the properties of tax defaulters but notably does not establish a “first charge.” The absence of “first charge” language was deemed significant when compared to statutes like the Gujarat Value Added Tax Act and Rajasthan Sales Tax Act

Court’s Findings

- **Genuineness of Transactions:** The Court held that the mortgage and lease arrangements were genuine. The bank had entered into the mortgage and tenancy agreements long before the Commercial Tax Department issued its recovery notices.
- **Priority of Charge:** The Court emphasized that Section 26E of the SARFAESI Act, which provides secured creditors priority over all other debts, including government dues, must prevail. Since the mortgage was created in 1991, much earlier than the tax arrears notices issued in 2001, the bank’s claim had precedence.
- **Interpretation of Statutory Provisions:** The Court compared Section 24 of the Tamil Nadu General Sales Tax Act (TNGST Act) and Section 26E of the SARFAESI Act. It observed that Section 24 of the TNGST Act creates a statutory charge but does not confer a “first charge” overriding prior encumbrances like mortgages.

Judicial Precedents

The court relied on landmark judgments, particularly:

- Punjab National Bank v. Union of India (2022), which established that without a specific “first charge” provision in a statute, crown debts cannot have priority over secured creditors.
- SICOM Limited v. Union of India (2009), which held that a debt secured by statutory provisions creating a first charge would prevail over unsecured crown debts.
- State Tax Officer v. Rainbow Papers Limited, wherein the tax authorities prevailed. The court distinguished this case as term “first charge” was present in the Gujarat Value Added Tax Act. The TNGST Act in the present case created only a “charge” without specifying priority

Implications for Banking and Financial Institutions

The judgment ushers in a new era of certainty for banks and financial institutions across India. The judgment brings greater certainty for banks, ensuring that properly registered security interests will take priority over later government claims. This reduces lending risks, promotes better credit terms, and strengthens the secured lending framework. By affirming the supremacy of Section 26E of the SARFAESI Act, the Court has reinforced banks’ rights, enabling faster and more confident recovery of stressed assets.

Implications for Tax Authorities

The judgment limits tax departments’ recovery powers, emphasizing the need for timely action to avoid being subordinated to prior secured claims. It highlights that unless a statute explicitly grants a “first charge,” tax claims may lose priority. Authorities operating under laws like the TNGST Act may need legislative reform to strengthen their position. The traditional doctrine of crown prerogative, which historically gave government claims priority, has been shown to have clear limitations in India’s modern statutory framework. Tax authorities must now navigate a more complex legal landscape where their recovery rights are bounded by the specific language of applicable statutes and the chronology of competing claims. This necessitates more sophisticated approaches to tax recovery, perhaps including greater coordination with financial institutions earlier in the default cycle.

Conclusion

The Madras High Court’s decision reinforces the protection afforded to secured creditors under the SARFAESI Act and RDB Act, particularly when their interests predate tax claims. This judgment provides welcome clarity to financial institutions regarding the security of their loans and will likely influence similar disputes across the country. This decision thus strikes a careful balance between the interests of financial institutions and the state’s revenue collection mechanisms.

Beyond the immediate parties, this judgment carries significant implications for legislative policy and judicial approach to competing statutory schemes. The court’s meticulous attention to statutory language sends a clear message to legislative drafters about the importance of clarity and specificity when creating priority rights. Future legislation intended to confer priority to government claims must explicitly create a “first charge” and address its relationship with other priority provisions like Section

26E of SARFAESI Act.

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