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Tracing the Liability of Personal Guarantors under IBC

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ABSTRACT

Section 128 of the Indian Contract Act, 1872 deals with the contract of guarantee. As per Section 128 of the ICA, "The liability of the surety is coextensive with that of the principal debtor unless the contract otherwise provides it." Part III of the Insolvency and Bankruptcy Code, 2016 ("IBC") encompasses the provision related to the personal guarantor. However, there have been various ambiguities with regard to the liability of personal guarantors under the IBC, which arose in the landmark cases like State of Bank v. V. Ramakrishnan and Another and Piramal judgement.

Recently, the Ministry of Corporate Affairs, vide its amendment dated 15.11.2019, made Part III of the Code the personal guarantor of the corporate debtor. Through this Amendment, sub-sections (e), (f) and (g) were inserted in Section 2 of the Code. Section 2 provides the categorisation of entities on whom the Code will be applicable. Section 2(e) of the Code provides that the code shall apply to personal guarantors to corporate debtors, thereby excluding such personal guarantors from the ambit of individuals provided under Section 2(g).

Many petitions were filed before the High court challenging the validity of the said amendment under Article 32 of the constitution on the grounds that it was violative of Section 1(3) of the Code as it restricted the applicability of the provisions of the Code to the specific category of persons, which is a personal guarantor to the corporate debtor. A similar question arose recently in the case of Lalit Kumar v. Union of India, in which the Supreme Court had finally adjudicated all the objections regarding the liability and initiation of CIRP against the personal guarantors.

The researcher in this paper will try to analyse all the possible issues that arose after the amendment was passed and the decision of the Supreme Court on those issues in the case of Lalit Kumar.

I. INTRODUCTION

A personal guarantor, according to Section 5(22) of the Code², is an individual who acts as the surety in a contract of guarantee to a corporate debtor.

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² Insolvency and Bankruptcy Code, 2016, S.5 (22).

The contract of guarantee is covered by Section 128 of the ICA, 1872³. "Unless the contract otherwise specifies," says Section 128 of the ICA, "the surety's responsibility is coextensive with that of the principal debtor." The personal guarantor provision is included in Part III of the Insolvency and Bankruptcy Code, 2016 ("IBC"). However, there have been a number of ambiguities about personal guarantors' liabilities under the IBC, as evidenced by historic judgments such as Ramakrishnan⁴ and the Piramal⁵ judgment.

Part III of the Code was recently extended to the personal guarantor of the corporate debtor by the Ministry of Corporate Affairs in an amendment dated 15.11.2019.

Petitions were filed in the High Court challenging the legality of the said notification under Article 32 of the constitution, claiming that it violated Section 1(3) of the Code by selectively enforcing provisions of the Code to only a certain class of persons. A similar issue emerged recently in the case of "Lalit Kumar v. Union of India",⁶ in which the Supreme Court eventually resolved all objections to the liability of personal guarantors and the commencement of CIRP against them.

The researcher in this paper will try to analyse all the possible issues that arose after the amendment was passed and the decision of the Supreme Court on those issues in the case of Lalit Kumar.

II. LIABILITY OF PERSONAL GUARANTORS IN LIGHT OF LALIT KUMAR JAIN'S DECISION

The ambiguous relationship between guarantors and corporate debtors has been tested multiple times before various courts under the auspices of the IBC, 2016. The issue of initiating a CIRP against two debtors or guarantors for the same set of debt under the Code first arose in the case of "Dr. Vishnu Kumar Agarwal vs M/s Piramal Enterprises Limited"⁷ before the NCLAT, it was held that a financial creditor could not file two separate CIRPs against the corporate debtors or their guarantors for the same set of default. If an application for insolvency is admitted against either the debtor or guarantor, the application for CIRP against the other debtors or guarantors cannot be filed on the same default settings.

The Tribunal's decision caused a full uproar in the market because, while the Tribunal agreed on the "concept of co-extensive liability of the principal debtor and surety", it ignored the said

³ Indian Contract Act, 1872, S. 128.

⁴ V Ramakrishnan v. State Bank of India, (2018) 17 SCC 394.

⁵ Vishnu Kumar Agrawal v., Piramal Enterprises, Company Appeals (AT) 343/2018.

⁶ Lalit Kumar v. Union of India, (2021).

⁷ Vishnu Kumar Agrawal v., Piramal Enterprises, Company Appeals (AT) 343/2018.

principle within the scope of the Code. This is why various appeals against the Piramal judgement are pending before the SC, which has directed the status quo to be maintained in the Piramal case.

While the Piramal Judgment is being challenged in the SC, a new spin has emerged in the matter of “Athena Energy Ventures Private Limited”⁸, in which the appellate tribunal held that the financial creditor could initiate a simultaneous CIRP against the corporate debtor and his guarantor for the same set of default.

In this regard, a considerable part of the insolvency jurisprudence has evolved with the decision of the SC in “*Lalit Kumar Jain v Union of India and ORs*”.⁹

The petitioners, in this case, were into providing the guarantees to the banks and financial institutions in their position as directors, chairman and promoters of the firm. The stakes, in this case, were invoked, and the proceedings against the company were initiated and were pending.

They filed a petition in the SC contesting the validity of the impugned notification and were of the stringent belief that the said notification would increase the risk and liability they may face as a personal guarantor.

The main issues dealt with in the case were:

1. “Whether the selective enforcing of some of the provisions in the Code by the government through a notification in relation to a specific category of individuals are in violation of the authority provided to it?”
2. “Whether the approval of the resolution plan in case of the corporate debtor would also discharge the personal guarantor from its liability?”

The impugned notification was held to be valid by the SC. The court observed that the notification did not amount to excessive delegation on the part of the government on the ground that there was no compulsion in the IBC for it to be applicable in its totality to all classes of individuals at the same time and also, there has always been an intrinsic connection between the corporate debtors and their personal guarantors. The court determined that the challenged notification was issued with the purpose of furthering the implementation of the IBC provisions. Until now, these persons were exempt from the CIRP's purview and remained untouched. According to the court, the NCLT would be the adjudicating body in such matters,

⁸ (2020) SCC online, NCLAT 774.

⁹ *Lalit Kumar Jain v Union of India and Ors.* (2021).

which would benefit creditors in the long run.

When considering the first issue, the court determined that the parliament intended for the IBC to treat personal guarantors differently than other individuals. Because of the intrinsic relationship between a corporate debtor and its personal guarantor, as well as the possibility of two separate processes taking place before different adjudicating authorities, each with its own set of outcomes, personal guarantors have been classified as a separate category of people.

Thus, the courts found that the contested notification did not result in the selective implementation of the Code's provisions.

On the issue of discharge of personal guarantor, the court ruled out the provision given under Section 133 of the Indian Contract Act. The SC held that the approval of a resolution plan and the finality conferred on it by Section 31 do not act as a discharge of the personal guarantor's liability. Because the liability of the personal guarantor arises from a separate contract, the scope of liability would largely depend on the conditions of the guarantee.

And so, it was held that the approval of the resolution plan does not ipso facto discharge the personal guarantor from his liability set out under the contract of guarantee. The corporate debtor is released from liability by operation of law, i.e., by involuntary process, and it does not mean that there is a discharge of liability of the surety or personal guarantor arising out of a separate contract. Consequently, an involuntary process such as by operation of law or due to insolvency or liquidation process will not discharge the guarantor from their liability in case of discharge of the corporate debtor.

The SC highlighted many reasons why the NCLT should be a common forum for adjudicating insolvency proceedings involving corporate debtors and personal guarantors when examining the NCLT as an adjudicating authority for both corporate debtors and personal guarantors. As a single adjudicating authority, it will be able to deal with the entire issue.

III. QUESTIONS THAT AROSE AFTERMATH OF THE JUDGMENT

The apex court recognised the lacunae concerning the Notification, yet it failed to consider its implications, which may lead to practical inconsistencies. The possible contingencies are present in three-fold arguments below: –

(A) Right Of Subrogation

The question that arose as a result of it was whether the challenged notification was in violation

of Section 140¹⁰ of the Indian Contract Act, 1872. Under Section 140 of the ICA, the guarantor is placed in the position of a creditor, with identical rights to recover the debt from the principal debtor following payment of any debts covered by the guarantee. The application of this provision has been a matter of contention since the notice. If the personal guarantor is liable for paying the CD's debts to its creditors, the latter must have the right of subrogation to pursue the same debt against the former. As a result, it's unclear what will happen to the personal guarantor's liability. Additionally, the I&B Code's goals include balancing the interests of all stakeholders, which the judgement appears to vitiate when it comes to the protection of Personal Guarantors.

The SC found that when the resolution plan is approved, PGs are not absolved from their liabilities under the guarantee contract. They affirmed the Supreme Court's judgement in "*Maharashtra State Electricity Board Bombay v. Official Liquidator*"¹¹, in which creditors were permitted to seek full payment from the personal guarantor. The CD's debt to the personal guarantor, on the contrary, does not simply disappear into thin air.

In the case of "*Essar Steel Ltd*",¹² the SC held that "the object of the resolution process is to provide the corporate debtor a fresh start, a concept known as the "clean slate" theory". Giving the personal guarantee the power of subrogation would go against the spirit of a fresh start, because after the approval of the resolution plan, subrogation allows the guarantor to act in the place of the creditor and file claims against the debtor as if he were a creditor himself. Because creditors are prevented from pursuing future claims against the debtor once the debts have been discharged, the clean slate principle prohibits this.

Unlike Indian law, "Sections 506 to 509 of the US bankruptcy code"¹³ expressly recognise the subrogation right. In the case of "*in re Sensor Systems*"¹⁴, *Inc.*, the US Bankruptcy Court dismissed the reasoning for such a distinction, indicating that "the only significant difference arising from a full prepetition payment is that the original secured creditor would no longer be a creditor of the debtor at the time of filing," the court noted. "Why this fact would or should be important in assessing subrogation rights of the co-obligor who makes the payment is utterly apparent to us," the Court stated.

Furthermore, 'Section 509 of the United States Bankruptcy Code is quite procedural. The guarantor must establish that it is liable to the debtor for a creditor's claim against the debtor

¹⁰ Indian Contract Act, 1872, S.140.

¹¹ [2017] ibclaw.in 19 SC.

¹² Committee of Creditors of Essar Steel Ltd. vs Satish Kumar Gupta, (2019).

¹³ U.S. Bankruptcy Code, S. 506 & 509.

¹⁴ *In re Sensor Systems, Inc.*, 79 B.R. 623 (Bankr.E.D.Pa. 1987).

and that it has paid that claim. Unlike the United States, India's Law does not include a specific provision dedicated to the concept of subrogation. Instead, Indian Contract Law governs it. In the case of a conflict between two laws in force, Section 238¹⁵ of the IBC expressly says that the IBC's provisions take precedence. However, this presents several issues that the court has yet to consider.

When deciding on the issue of the approval of a resolution plan and settlement of the debts between the corporate debtor permits them to extinguish the rights of the personal guarantor, the court must keep in view the decision in the case of “*Krishna Pillai Rajasekhar Nair v. Padmanabhan Pillai and OR's*”¹⁶, wherein the SC has held that:

“A subrogation rests upon the doctrine of equity and the principles of natural justice and not on the privity of contract. One of these principles is that a person paying money which another is bound by law to pay is entitled to be reimbursed by the other. This principle is enacted in Section 69 of the Contract Act, 1872. Another principle is found in equity: ‘he who seeks equity must do equity.’”¹⁷

(B) Double Dipping

After the ruling, the second issue is whether, once a creditor has filed a CIRP application against either the corporate debtor or the personal guarantor/corporate guarantor and the application has been admitted, can the creditor file an application against the other entity for the same debt and default (also referred to as “double-dipping”).

“Double Proof v. Double Dip”

The double-dip rule is founded on the notion of equity, which has stood the test of time. In the case of “*Kaupthing Singer Friedlander Limited*”¹⁸, the SC of the United Kingdom held that collecting a double dividend on the same debt was prohibited ('rule against double proof') but that the same might be acquired against two distinct estates (double-dipping).

In the case of “*Ivanhoe Building Loan Association of Network*”¹⁹, the United States Courts applied a principle of double-dipping, allowing a creditor to realise the whole claim against the debtor even after foreclosing on the third-party collateral securing the loan. The court stated that a creditor could collect on all of his claims against the debtor as long as he does not seek

¹⁵ Insolvency and Bankruptcy Code, S.238.

¹⁶ (2004) 12 SCC 754.

¹⁷ Sampriti & Sugi Malati Murmu, ‘Subrogation Rights of Personal Guarantor: A Comparative Analysis’ (2021). Accessed at <https://nualslawjournal.com/2021/06/29/subrogation-rights-of-personal-guarantor-a-comparative-analysis/>.

¹⁸ In Re Kaupthing Singer Friedlander Limited, (2011) UKSC 48.

¹⁹ Ivanhoe Building Loan Association of Network v. Orr., 295 U.S. 243 (1935).

more than what is owed to him from all parties involved.

NCLAT, in the case of “*Dr. Vishnu Kumar Agarwal v. M/s Piramal Enterprises Limited*”²⁰ (“Piramal Judgment”), held that a financial creditor could not file two separate CIRPs against the corporate debtors or their guarantors for the same set of default. If an application for insolvency is admitted against either the debtor or guarantor, the application for CIRP against the other debtor/guarantors cannot be filed on the same default settings.

Many courts have passed the judgment relying on the decision of the NCLAT in the matter of Piramal Enterprises:

In the case of “*SBI v. Visa International Limited*”, the differing judgment was passed by the member of the NCLAT; it was observed that two CIRPs could not be initiated against the two guarantors about the same set of debts. However, the creditor always has an option to go against either. Such an interpretation goes against the principles of guarantee laid down in ICA that entitle the creditor to initiate proceedings against either the principal borrower or one or more sureties or both, in no specific sequence. According to ‘Section 128 of the ICA’, the surety's liability is joint and several with that of the principal borrower. Co-sureties must participate equally, and if there is more than one surety, they must bear the liability equally unless the contract agreement specifies otherwise.

At this point, it's worth mentioning that the NCLAT held in “*Axis Bank Limited v. Edu Smart Service Private*”,²¹ which was decided before the Piramal Judgment, that the financial creditor should be considered a part of COC. A CIRP was also in progress against the principal debtor in this case (“Edu Comp Solutions Limited”). An application for CIRP was filed before the NCLT, requesting the reconstitution of ‘Edu Smart Services Private Limited's’ CoC by removing the double claims. However, according to the aforementioned ruling, the NCLT refused to allow the relief sought in the abovementioned decision of NCLAT in the Edu Smart case.

In “*IL and FS Financial Services Limited v. Golden Glow*”²², Edelweiss Ltd. filed a claim in the CIRP against the corporate debtor, which was accepted in its whole, and subsequently filed a claim in the CIRP against the personal guarantor. According to the NCLT's Principal Bench in New Delhi, this would result in claim duplication, providing Edelweiss “double proportionate voting rights” in several CoCs. Thus, Edelweiss' claim in the CIRP of the

²⁰ Dr. Vishnu Kumar Aggarwal v. M/s Piramal Enterprises Limited, [CA (AT) No. 346 and 347 of 2018].

²¹ Axis Bank Limited v. Edu Smart Service Private Limited, (2018) ibclaw.in 55.

²² IL and FS Financial Services Limited v. Golden Glow Estates Private Limited, (2019) ibclaw.in 737.

guarantor, which was a duplication of a claim previously permitted in another CIRP, was dismissed.

Indian insolvency laws should take a more realistic approach to deal with the issue in order to prevent creditors from taking undue advantage of the situation. Simultaneous proceedings against both the guarantor and the borrower are permitted due to the co-extensive nature of the guarantor's and borrower's responsibilities. In reality, if CIRP for the borrower has begun, Section 60(2)²³ of the IBC mandates the NCLT to file an insolvency petition against the guarantor. As a result, parallel processes are permitted under the IBC, possibly allowing creditors to double-dip.

(C) Can A Cirp Be Initiated Against The Personal Guarantor While The Cirp Against The Corporate Debtor Is Not Pending?

The 2018 Amendment under the Code enabled the provisions of Section 60 of the Code, which envisaged four circumstances under which the NCLT is granted exclusive jurisdiction in case of applications filed against the personal guarantors:

1. “The adjudicating authority about insolvency for personal guarantors shall be the same bench of NCLT competent to entertain proceedings in case of the corporate debtor.
2. Instances wherein the insolvency proceedings are pending against the corporate debtor.
3. In cases wherein the insolvency proceedings against the corporate debtor, the application against the personal guarantor shall be transferred before such NCLT.
4. The powers provided to DRT in matters of the personal guarantor shall stand transferred to the NCLT²⁴.”

Under Section 60 (2) and (3), the NCLT has been given special jurisdiction in the instance of personal guarantors to the corporate, which allows a financial creditor to file a claim against both the corporate debtor and the guarantor before the same adjudicating body.

Various NCLTs have established opposing viewpoints on this issue. In the case of “*PNB Housing Finance Ltd. v. Mohit Arora*”²⁵, the NCLT Delhi held that in cases where an application for initiation of CIRP against the corporate debtor is pending before the NCLT, the initiation of CIRP against such debtor is not a sine qua non for the maintainability of an IRP

²³ Insolvency and Bankruptcy Code, 2016, S.60 (2).

²⁴ Shivam Singhal, “To File or not to File: Understanding the Jurisdictional Dilemma in Personal Guarantor’s Insolvency Resolution Process”, (2022). Accessed at <https://www.scconline.com/blog/post/2022/02/21/understanding-the-jurisdictional-dilemma-in-personal-guarantors-insolvency-resolution-process/>.

²⁵ 2021 SCC Online NCLT 488.

application under Section 95 against the corporate debtor before such NCLT.

In the matter of “*PNB Housing Finance Ltd. v. Goldy Gupta*”²⁶, the NCLT reached a similar decision. The question, in this case, was “whether a financial creditor can file a CIRP against a personal guarantor in the absence of a resolution/liquidation action against the corporate debtor” the NCLT, Mumbai, did not accept this rationale. According to the Tribunal, an insolvency case seeking a resolution against a personal guarantor is not maintainable unless a CIRP or liquidation application against the corporate debtor is underway. It's also worth mentioning that filing petitions for personal guarantors' resolution without going via CIRP gives the NCLT and the Debts Recovery Tribunal authority over the corporate debtor.

The NCLAT decided in “*State Bank of India v. Mahendran Kumar Jajodia*”²⁷ that starting a CIRP is not a prerequisite for creating an IRP against a Corporate Debtor's Personal Guarantor. The Appellant, in this case, filed an appeal against an order of the NCLT, which refused to entertain an application for the initiation of IRP against the Personal Guarantor on the grounds that it was pre-mature because CIRP against the Corporate Debtor had not yet been initiated.

The Supreme Court has also recently affirmed the NCLAT ruling, giving the financial creditors a green flag to initiate CIRP against the personal guarantors of corporate independent of the pendency of insolvency proceedings against the corporate debtor under the IBC.²⁸

The Supreme Court's decision to dismiss the case makes it very apparent what the law says about starting insolvency procedures against personal guarantors. Thus, It is now settled law that an application to start insolvency proceedings against a personal guarantor cannot be denied only on the basis that the corporate debtor does not have an ongoing insolvency resolution or liquidation proceedings.

IV. CONCLUSION

Provided that the end goal of the IBC is the revival of the company maximisation of the value of the assets of the corporate debtor, it is quite apparent why the judiciary would hold the personal guarantors liable after ignoring their right of subrogation.

While creditors' rights are crucial, personal guarantors' rights must be protected as well. The courts are wrong in assuming that personal guarantees are given in the vast majority of cases by the directors, who typically inflate the company's value for personal gain rather than for the company's benefit. Disregarding the personal guarantor's rights, on the other hand, will deter

²⁶ 2021 SCC Online NCLT 487.

²⁷ State Bank of India v. Mahendra Kumar Jajodia, Company Appeal (AT) Insolvency No. 61 of 2022.

²⁸ Mahendra Kumar Jajodia v. SBI, Civil Appeal No. 1871-1872/2022.

them from participating as guarantors in the future. This will make it more difficult for businesses to borrow money since future creditors will be less willing to lend money, resulting in slower monetary progress and reduced capital infusion. It is undeniably true that company growth has a spiralling effect on the economy, and the role of personal guarantors cannot be eliminated simply by raising creditors' rights.

To resolve procedural and substantive concerns that may develop as a result of simultaneous CIRPs against the primary borrower and the guarantor, relevant revisions to the IBC would be required. Only the provision laid down under Section 60 (2) and (3) providing for NCLT to be the adjudicatory body for the insolvency of both corporate debtor and personal guarantor cannot be sufficient to acknowledge all the questions.

While the SC's judgement in the appeal filed against the Piramal Judgment is undoubtedly something to keep an eye on, required amendments to the IBC and the rules enacted under it would be required to address the challenges raised by such related processes.
