

Decoding Insolvency of Personal Guarantors under IBC

1. Introduction

As a lending practice in India, banks obtain collaterals and, in some cases, personal guarantees from promoter(s) of companies seeking credit facilities. The concept of guarantee is recognized under section 126 of Indian Contract Act and it is a promise to pay or discharge the liability of a third party's obligation on account of its default. A guarantor's liability is co-extensive with the principal debtor, unless otherwise agreed. In essence, lenders are empowered to take action *qua* the guarantors even without exercising legal remedies against the borrowers. Until recently, such action could be taken only through enforcement of a security interest created by the guarantor or by institution of recovery proceedings before debt recovery tribunals (“**DRT**”). With effect from December 1, 2019, creditors can also seek relief under the Insolvency and Bankruptcy Code, 2016 (“**IBC**”) by initiating insolvency resolution process against personal guarantors of recalcitrant debtors. Once the insolvency process fails, creditors can file bankruptcy proceedings against the guarantors under Chapter IV of IBC to recover their dues through realization of the latter's assets. This newsletter aims to evaluate only the insolvency regime for personal guarantors under IBC and discuss some potential challenges.

2. V. Ramakrishnan to Essar Steel – how it all started

Time and again, enforcement of personal guarantee has posed difficulty for creditors. One of the reasons is that recovery of dues through DRTs is inefficient and time-consuming, as they are struggling with huge delays due to insufficient number of presiding members. In fact, recoveries often take up to two years instead of the statutorily mandated six months and lack of consistency exists in decision-making process.¹ Another challenge arises with respect to borrowers who are involved in and undergoing corporate insolvency resolution process (“**CIRP**”). Once an insolvency petition is admitted by a National Company Law Tribunal (“**NCLT**”) a moratorium under section 14² of IBC is declared.

Personal guarantors to these borrowers often try to secure their own assets under the garb of moratorium due to conflicting judicial opinions regarding its effect on them. One school of thought was discussed in the leading case of Sanjeev Shriya v. State Bank of India and Others.³ In this case, the Allahabad High Court, while hearing appeal against recovery order of DRT held that since personal guarantors are significantly involved in a CIRP, they must receive immunity from being proceeded against until completion of the process. This conclusion was drawn on the premise that until a company's debt is crystallized, a guarantor's liability cannot be triggered. But, the Supreme Court took a different view⁴ and held that a moratorium strictly applies to the assets under the ownership and control of the corporate debtor.

¹ Economic Survey of India 2019-20 Volume I (last accessed on May 22, 2020)

² Moratorium is a statutory mandate provided under section 14 of IBC. It puts an embargo on (i) instituting or continuing judicial proceedings against the corporate debtor; (ii) alienation of assets; (iii) enforcement of security interest; and (iv) recovery of any property in possession of the corporate debtor. The underlying purpose is preservation and value maximization of the corporate debtor's estate. It remains in effect from the date of an order issued by the National Company Law Tribunal till completion of CIRP

³ 2017 (9) ADJ 723

⁴ Sicom Investments and Finance Limited vs. Rajesh Kumar Drolia and Another (2017) SCC Online Bom 9725

The above position was clarified by the apex court in an important 2018 case⁵ wherein it had to determine whether section 14, which provides for a moratorium on admission of an insolvency petition, would apply to a personal guarantor of a corporate debtor. In this case, while CIRP was underway against the principal borrower, its guarantor filed an interim application before NCLT contending that section 14 would apply to him as well and, consequently, any proceeding against him and his personal assets would have to be enjoined. The interim application was allowed. On appeal, National Company Law Appellate Tribunal (“NCLAT”) affirmed NCLT’s order and held that the guarantor is an integral part of the resolution process and, therefore, moratorium imposed under section 14 should also apply to him. While setting aside NCLAT’s order, the Supreme Court held that section 14 must be interpreted literally. It observed that a plain reading of this section would clarify that assets of personal guarantors are outside the purview of moratorium. Therefore, creditors have the right to proceed against them before appropriate DRT even during the moratorium. This case meant a big win for creditors who wanted to recover as much of their debt as possible. The aforesaid position was crystallized through a 2018 amendment to IBC when section 14 was amended to the effect that moratorium shall not apply to a “surety in a contract of guarantee to a corporate debtor.” As a consequence, creditors no longer have to worry about enforcement of personal guarantees through recovery proceedings during the period of a borrower’s CIRP.

Another creditor-friendly judgment was pronounced by the Supreme Court⁶ where it had to determine, among other issues, liability of personal guarantors towards Essar Steel’s financial creditors after approval of its resolution plan under section 31(1) of IBC. This section provides that if NCLT is satisfied that the resolution plan as approved by the committee of creditors meets the statutory requirements, it shall pass an order approving the plan, which shall be binding on the debtor and all stakeholders, including guarantors. On July 4, 2019, while deciding on a bunch of issues *qua* Essar Steel’s resolution plan, NCLAT held on the issue of guarantees that rights of creditors against individual guarantees had extinguished. Its reasoning was that once the principal debtor is discharged of all its liabilities on account of the approved resolution plan, the guarantor’s liability would also get extinguished. Essar Steel’s committee of creditors challenged this decision before the Supreme Court and argued that the plan, as approved by the committee, contained specific provisions which allowed creditors to enforce individual guarantees after such approval. It is settled law that once a resolution plan is approved under section 31(1), it is binding on all stakeholders. Therefore, NCLAT’s reasoning that creditors’ right to enforce individual guarantees had extinguished, was wholly illegal in view of the settled position and contrary to the terms of the guarantees. . Assailing NCLAT’s decision as flawed, the apex court relied on section 31(1) and held that once a resolution plan is approved, it is binding on the debtor and other stakeholders, including guarantors. In the present case, the resolution plan specifically provided that the right of creditors to enforce guarantees, either corporate or personal, shall continue after approval. It also clarified that upon approval, claims of guarantors on account of subrogation shall be deemed to be waived. Besides section 31(1), these specific provisions of the resolution plan formed the basis of Supreme Court’s analysis in the present case. Therefore, it is unclear if, as a general rule, creditors are entitled to enforce guarantees after approval of resolution plan. IBC is also silent in this regard. Absent any clarity, a guarantor’s liability towards creditors may be determined on a case-by-case basis.

Subsequently, the Indian government enacted provisions related to insolvency and bankruptcy of personal guarantors towards corporate debtors under IBC. Now, creditors can take simultaneous action against personal guarantors of recalcitrant debtors as well as debtors.

⁵ State Bank of India v. V. Ramakrishnan AIR 2018 SC 3876

⁶ Committee of Creditors of Essar Steel India Limited v. Satish Kumar Gupta and Others 2019 (16) SCALE 319

3. Potential challenges for personal guarantors: While IBC brings hope of improved recoveries for creditors and speedier enforcement of guarantees, it also creates certain difficulties for personal guarantors, discussed below.

3.1 Multiple and concurrent insolvency proceedings: Due to co-extensive liability of borrower and guarantor, creditors can initiate simultaneous insolvency proceedings against both with NCLT. Till now, such concurrent proceedings have not been initiated. However, as of March, 2020, two insolvency petitions were filed under section 95 of IBC before NCLT, Ahmedabad.⁷ Section 95 pertains to initiation of insolvency resolution process by creditors against personal guarantors.

Section 60(1) of IBC provides that jurisdiction shall be on the basis of the registered office location of the corporate debtor. Section 60(2) stipulates that where CIRP of a defaulting company is pending before an NCLT, the insolvency petition for the personal guarantor shall also be filed before the same NCLT. Parallel insolvency matters could create chaos and confusion. For instance, the resolution professional managing the affairs of the corporate debtor will have to work in tandem with resolution professional of the guarantor since claims emerging from the contract of guarantee will be same for both debtors and guarantors. NCLTs will also be burdened with multiple proceedings related to the same debt. For example, a personal guarantor provides guarantees for multiple companies having registered offices at different locations across India, and CIRP is initiated against two companies at Delhi and Mumbai. By virtue of section 60(2), insolvency petition against the guarantor has to be filed before both NCLT Delhi and Mumbai since proceedings against the companies are already underway. It is unclear which proceeding will take precedence and in what manner the repayment plans will be prepared for different creditors across two different insolvency petitions.

3.2 Creditor's double-dipping: In a 2018 case,⁸ NCLAT stated that under section 7 of IBC, there is no bar on financial creditors to initiate simultaneous CIRP against the principal debtor and corporate guarantor or among two corporate guarantors. Yet, contrary to this section, NCLAT held that two petitions for the same set of debt by the same financial creditor should not be admitted. If both petitions were admitted it would amount to double-dipping by the creditor. However, this ratio cannot be applied to personal guarantors since liability of a guarantor and borrower is co-extensive and parallel action is permissible against both parties. In fact, section 60(2) of IBC stipulates that insolvency petition against guarantor shall be filed before the NCLT where CIRP for the borrower has commenced. Effectively, concurrent proceedings can take place under IBC, and, therefore, a possible opportunity for double-dipping by creditors. In fact, presumably creditors may want to take advantage of this in order to recoup their dues.

3.3 Personal guarantor's right of subrogation extinguished: Pursuant to section 140 of the Contract Act, a guarantor has the right of subrogation for the amount of debt paid on behalf of the principal borrower. Essentially, it means that the guarantor steps into the shoes of the creditor; can deal with the debtor and has the right to recover monies paid to the creditor. However, a guarantor does not enjoy the right of subrogation under IBC. NCLAT explained this in a 2018 case,⁹ and held that "*guarantors cannot exercise the right of subrogation conferred upon them in contract law as proceedings under*

⁷ IBBI newsletter January-March 2020. See, <https://www.ibbi.gov.in/uploads/publication/92565ddf81a88161193ec62d99dd7d1c.pdf> (last accessed on May 19, 2020)

⁸ Vishnu Kumar Agarwal v. Piramal Enterprises Limited Company Appeal (AT) (Insolvency) Nos. 346 and 347 of 2018

⁹ Lalit Mishra and Others v. Sharon Bio Medicine Ltd. Company Appeal (AT) Insolvency no. 164 of 2018

IBC are not recovery proceedings. The object of IBC is to revive the company and focus on value-maximization and not to ensure that the credit is available to all stakeholders. Thus, no such recovery can be made by guarantors.” A similar view was taken by the apex court in Essar Steel case discussed above.

The present insolvency regime for personal guarantors is pro-creditor. Guarantors cannot escape their liability. Therefore, it is crucial that they exercise caution and due-diligence before providing guarantees so as to safeguard themselves from future contingencies.

4. Conclusion

The Reserve Bank of India in its Financial Stability Report 2019¹⁰ projected a 0.6% rise in gross non-performing assets ratio for scheduled commercial banks, i.e. from 9.3% in September 2019 to 9.9% in September 2020. During times when lending institutions are burdened with bad loans, a speedier enforcement mechanism for guarantees comes as a welcome step. An examination of the insolvency framework for personal guarantors suggests better enforcement of guarantees, improved recoveries and, hopefully, a strong leverage to creditors against erring guarantors due to the ability to file simultaneous actions against both guarantor and principal debtor. However, personal guarantors need to be cautious as they are stripped off their right to recover monies paid under the contract of guarantee from the borrower. Certain procedural aspects in the enforcement process also require reconsideration to ensure overall effectiveness of the regime.

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¹⁰ See, <https://rbidocs.rbi.org.in/rdocs//PublicationReport/Pdfs/0FSRDECEMBER20198C840246658946159CB3B94E8516F2EC.PDF> (last accessed on May 22, 2020)