

# LEGALFOXES LAW TIMES

## LIABILITY OF GUARANTORS IN THE COURSE OF CORPORATE INSOLVENCY RESOLUTION PROCESS

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### *Abstract*

*The Insolvency and Bankruptcy Code, 2016 is one of the most prolific legislative changes in the last few years, spurring furious litigation, multiple legal interpretations, regular amendments and is ever evolving to deal with the non-performing assets of various financial institutions in India. India as a country of entrepreneurs has a large percentage of companies (whether listed or unlisted) that are owner run (“Promoters”). Historically banks giving loans would always require personal guarantees to be given from Promoters to ensure their “skin in the game”. Now that the over-leverage has come back to bite, the lack of an effective forum to enforce the personal guarantees that very much go hand in hand with the insolvency of the company for which the guarantee has been given, has led legislators to enact provisions relating to personal guarantees. The Code now enables rehabilitation and bankruptcy proceedings against personal guarantors, provided the corporate debtor is subject to pending insolvency or liquidation proceedings before the National Company Law Tribunal (“NCLT”) (“Personal Guarantor”). The Ministry of Corporate Affairs (“MCA”) and Insolvency and Bankruptcy Board of India (“IBBI”) have also notified insolvency rules and regulations.*

**Keywords:** *Insolvency, Guarantors, CIRP, NCLT*

## Introduction

The Insolvency & Bankruptcy Code, 2016<sup>1</sup> was enacted in the backdrop of increasing stress of non-performing assets on bank balance sheets. As corporate debtors have been brought into the insolvency resolution process, banks have invoked guarantees given to them on the debts due from these debtors.

Under the Indian contract Act, 1872<sup>2</sup>, a guarantor's liability is co-extensive<sup>3</sup> with that of the principal debtor<sup>4</sup>. In other words, "a surety's liability to pay the debt is not removed by reason of the creditor's omission to sue the principal debtor. The creditor is not bound to exhaust his remedy against the principal before suing the surety, and a suit may be maintained against the surety though the principal has not been sued<sup>5</sup>." The liability of a principal debtor and the liability of a surety are separate and co-extensive liabilities. Notwithstanding the fact that they may stem from the same transaction, the two liabilities are distinct<sup>6</sup>. Accordingly, it is possible to proceed against either the guarantor or the principal debtor in the first instance, or against both. If the claim is successful against the guarantor, the guarantor then steps into the shoes of the creditor and can proceed against the principal debtor, which is known as subrogation. Given the distinctive nature of the proceedings under the Code, there is a need to examine if the same principles would apply to the processes therein.

## Scrutiny of Liability of Personal Guarantors of a Corporate Debtor during the Corporate Insolvency Resolution Process

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<sup>1</sup> Ministry of Corporate Affairs <http://www.mca.gov.in/Ministry/pdf/TheInsolvencyandBankruptcyofIndia.pdf> (Visited on Apr 5, 10:20 PM)

<sup>2</sup> Legislative Department <https://legislative.gov.in/sites/default/files/A1872-09.pdf> (Visited on Apr 6, 12:27 PM)

<sup>3</sup> Indian Contract Act, 1872 Section 128

<sup>4</sup> Ram Kishun and Ors. v. State of U.P. and Ors. (2012) 11 SCC 511. Decision date- 24.05.2012, Central Bank of India and Ors. v. C.L. Vimla and Ors. (2015) 7 SCC 337. Decision date- 28.04.2015 (India)

<sup>5</sup> Pollock & Mulla, Indian Contract and Specific Relief Act, 728

<sup>6</sup> Hukumchand Insurance Co. Ltd. v. The Bank of Baroda & Others, AIR 1977 Kant 204. Decision date- 05.04.1977 (India)

*“where a corporate insolvency resolution process or liquidation proceeding of a corporate debtor is pending before a National Company Law Tribunal, an application relating to the insolvency resolution or liquidation or bankruptcy of a corporate guarantor or personal guarantor, as the case may be, of such corporate debtor shall be filed before the National Company Law Tribunal.”*<sup>7</sup> Given this, there is legislative clarity that concurrent insolvency proceedings can be maintained in respect of the corporate debtor and a guarantor.

However, there was a lack of clarity on whether proceedings could be initiated under debt recovery laws against a guarantor, while corporate insolvency resolution proceedings were underway against the corporate debtor. In *Sanjeev Shriya v. State Bank of India*,<sup>8</sup> the Allahabad High Court assessed if proceedings of this nature can be instituted. In this case, the State Bank of India instituted proceedings against the personal guarantors of the corporate debtor and was participating in the insolvency resolution process of the corporate debtor. However, their liabilities had not crystallised. In this context, the court held that *“the entire proceeding is still in fluid stage and for the same cause of action, two split proceedings cannot go simultaneously before the Debt Recovery Tribunal (DRT) as well as National Company Law Tribunal (NCLT).”*<sup>9</sup>

The National Company Appellate Law Tribunal (NCLAT) in *State Bank of India v. Ramakrishnan*<sup>10</sup> and *State Bank of India v. Rajendra Kumar*<sup>11</sup> dealt with questions on maintenance of such proceedings in different forum. They held that the moratorium on institution of proceedings on recovery or recovery of debts under section 14 of the Code would cover the guarantor as well as the corporate debtor. However, this moratorium would *“be applicable only to the proceedings against the ‘Corporate Debtor’ and the ‘Personal Guarantor’, if pending before any court of law/Tribunal or authority but the order of ‘Moratorium’ will not be applicable for filing application for triggering ‘Corporate Insolvency Resolution Process’ under Section*

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<sup>7</sup> Insolvency & Bankruptcy Code, 2016 Section 60(2)

<sup>8</sup> *Sanjeev Shriya v. State Bank of India & Ors.*, W.P.(C) No. 30285 of 2017. Decision date- 6.09.2017 (India)

<sup>9</sup> *Ibid*

<sup>10</sup> *State Bank of India v. V. Ramakrishnan*, Company Appeal (AT) (Insolvency) No. 213 of 2017. Decision date- 28.02.2018 (India)

<sup>11</sup> *State Bank of India v. D.S. Rajendra Kumar*, Company Appeal (AT) (Insolvency) Nos. 87, 88, 89, 90 and 91 of 2018. Decision date- 18.04.2018 (India)

7<sup>12</sup>, Section 9<sup>13</sup>, Section 10<sup>14</sup> of the Insolvency and Bankruptcy Code, 2016 against the 'Guarantor' or the 'Personal Guarantor' under Section 60(2).” **In Alpha & Omega Diagnostics (India) Ltd. v. Asset Reconstruction Company of India Ltd**<sup>15</sup>. the NCLAT opined that “in so far as 'guarantor' is concerned, we are not expressing any opinion, as they come within the meaning of 'Corporate Debtor individually', as distinct from principal debtor who has taken a loan.”

The Bombay High Court took a divergent view in **Sicom Investments and Finance Limited v. Rajesh Kumar Drolia**<sup>16</sup> and held that “Section 14<sup>17</sup> is as clear as it can be. On reading Section 14, it is clear that the benefits as well as the liabilities mentioned therein are only that of the corporate debtor and corporate debtor alone. As far as prohibiting the institution of suits or continuation of pending suits or proceedings are concerned, the same applies only against the corporate debtor in insolvency and not a third party such as a guarantor, be it an individual or a corporate guarantor. What is absolutely clear from the Code is that for the guarantor (be it personal guarantor or corporate guarantor), there is no automatic protection. It is only once the insolvency resolution has been initiated either by or against the guarantor (be it personal guarantor or a corporate guarantor), only then the benefit of the moratorium would be available to the guarantor subject of-course to the other provisions of the IBC, 2016.”

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The Insolvency Law Committee noted the decisions of the NCLAT and the Allahabad High Court and expressed its concern that these decisions put the surety's liabilities on hold when the

<sup>12</sup> Initiation of Corporate Resolution Process by Financial Creditor, IBC Laws, (July 01, 2018) <https://ibclaw.in/section-7-initiation-of-corporate-insolvency-resolution-process-by-financial-creditor-chapter-ii-corporate-insolvency-resolution-process-cirp-part-ii-insolvency-resolution-and-liquidation-for-corpor/> (Visited on Apr 7, 01:07 PM)

<sup>13</sup> Application for Initiation of Corporate Insolvency Resolution Process by Operational Creditor, IBC Laws, (July 01, 2018) <https://ibclaw.in/section-9-application-for-initiation-of-corporate-insolvency-resolution-process-by-operational-creditor-chapter-ii-corporate-insolvency-resolution-process-cirp-part-ii-insolvency-resolution-and-liqu/> (Visited on Apr 7, 02:15 PM)

<sup>14</sup> Initiation of Corporate Resolution Process by Corporate Applicant, IBC Laws, (July 01, 2018) <https://ibclaw.in/section-10-initiation-of-corporate-insolvency-resolution-process-by-corporate-applicant-chapter-ii-corporate-insolvency-resolution-process-cirp-part-ii-insolvency-resolution-and-liquidation-for-corp/> (Visited on Apr 7, 03:12 PM)

<sup>15</sup> Alpha & Omega Diagnostics (India) Ltd. v. Asset Reconstruction Company of India Ltd., Company Appeal (AT) (Insol.) No. 116 of 2016. date- 31.07.2017 (India)

<sup>16</sup> Summons for Judgment No. 221 of 2010 in Commercial Suit No. 44 of 2010. Decision date- 09.07.2018 (India)

<sup>17</sup> Moratorium, IBC Laws, (July 01, 2018) <https://ibclaw.in/section-14-moratorium-chapter-ii-corporate-insolvency-resolution-process-cirp-part-ii-insolvency-resolution-and-liquidation-for-corporate-persons-the-insolvency-and-bankruptcy-code-2016-ibc-sec/> (Visited on Apr 07, 04:20 PM)

corporate debtor undergoes a corporate insolvency resolution process. The Committee opined that this “*may lead to the contracts of guarantee being infructuous, and not serving the purpose for which they have been entered into*” and cautioned that promoters who are often guarantors may cause the corporate debtor to file “*frivolous applications to merely take advantage of the stay and guard their assets.*” Given this, they advocated for the introduction of a clarificatory amendment to the Code, excluding guarantors from the scope of the moratorium under section 14 of the Code<sup>18</sup>. Consequently section 14 of the Code has been amended to disapply the moratorium to guarantors.

After this amendment was passed, its applicability was considered by the Supreme Court in an appeal to the NCLAT’s decision in *State Bank of India v. Ramakrishnan*<sup>19</sup>. The Court held that since the amendment has been passed to clarify the issue, this amendment would have retrospective effect. Significantly, it also lent its support to the opinion of the Bombay High Court by holding that it found that the reasoning in *Sicom* commends itself, whereas the reasoning in *Sanjeev Shriya* does not.

Another question that has been considered by courts is whether it is possible to proceed against a corporate guarantor under the Code without proceeding against the principal debtor. In *Ferro Alloys Corporation v. Rural Electrification Ltd.*<sup>20</sup> the NCLAT observed that the Code does not prohibit the ‘Financial Creditor’ from initiating the corporate insolvency resolution process against the guarantor, since a guarantor is included in the definition of ‘Corporate Debtor’ as provided under Section 3(8)<sup>21</sup> of the Code. Referring to various provisions and definitions provided under the Code, the Tribunal observed that “*a guarantee becomes a debt or as soon as the guarantee is invoked against it whereinafter a guarantor (‘corporate guarantor’) becomes a ‘corporate debtor’ in terms of the Insolvency & Bankruptcy Code*”. It further went on

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<sup>18</sup> Insolvency Law Committee, *Report of the Insolvency Law Committee*

<sup>19</sup> *State Bank of India v. V. Ramakrishnan*, Civil Appeal Nos. 3595 and 4553 of 2018. Decision date- 14.08.2018 (India)

<sup>20</sup> *Ferro Alloys Corporation Ltd. & Ors. v. Rural Electrification Corporation Ltd.*, Company Appeal (AT) (Insolvency) No. 92,93 & 148 of 2017. Decision date- 08.01.2019 (India)

<sup>21</sup> (8) Corporate Debtor, IBC Laws, (July 01, 2018) <https://ibclaw.in/section-3-definitions-under-insolvency-and-bankruptcy-code-2016-ibc-2016-part-i-preliminary/> (Visited on Apr 08, 07:37 PM)

to observe that the Code “*does not exclusively delineates and/or prescribes any inter-se rights, obligation and liabilities of a guarantor qua ‘financial creditor’*”. Thus, in absence of any express provision providing for inter-se rights, obligation and liabilities of guarantor qua ‘financial creditor’ under the Code, the same will have to be noticed from the provisions of the Indian Contract Act, which exclusively and elaborately deals with the same.” Thus, the Tribunal after referring to various Supreme Court judgements on the co-extensive liability of guarantor under the Indian Contract Act held, “*it is not necessary to initiate ‘Corporate Insolvency Resolution Process’ against the ‘Principal Borrower’ before initiating ‘Corporate Insolvency Resolution Process’ against the ‘Corporate Guarantors’*.” Without initiating any ‘Corporate Insolvency Resolution Process’ against the ‘Principal Borrower’, it is always open to the ‘Financial Creditor’ to initiate ‘Corporate Insolvency Resolution Process’ under Section 7 against the ‘Corporate Guarantors’, as the creditor is also the ‘Financial Creditor’ qua ‘Corporate Guarantor’.”

Given this, the NCLAT, in *Dr. Vishnu Kumar Agarwal v. Piramal Enterprise Ltd.*<sup>22</sup>, was called on to determine if the corporate insolvency resolution process can be initiated against the corporate guarantor even if the principal borrower is not a corporate person or corporate debtor. The NCLAT reiterated this reasoning and held that it is not necessary for the ‘Financial Creditor’ to initiate the corporate insolvency resolution process against the ‘Principal Borrower’ before initiating it against the ‘Corporate Guarantor’, since “*the creditor is also the ‘Financial Creditor’ qua ‘Corporate Guarantor’*”. Thus, even if the ‘Principal Borrower’ is not a ‘Corporate Person’ and no application can be filed against it under Section 7, the ‘Financial Creditor’ has the freedom to file an application against the ‘Corporate Guarantor’ under Section 7.

In the same case, the NCLAT also considered if the corporate insolvency resolution process could be initiated against two corporate guarantors simultaneously, for the same debt and default. In this regard, the NCLAT held that “*there is no bar in the ‘I&B Code’ for filing simultaneously two applications under Section 7 against the ‘Principal Borrower’ as well as the ‘Corporate*

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<sup>22</sup> Dr. Vishnu Kumar Agarwal v. Piramal Enterprise Ltd., Company Appeal (AT) 346 of 2018. Decision date- 08.01.2019 (India)



*Guarantor(s) or against both the 'Guarantors'. However, once for same set of claim application under Section 7 filed by the 'Financial Creditor' is admitted against one of the 'Corporate Debtor' ('Principal Borrower' or 'Corporate Guarantor(s)'), second application by the same 'Financial Creditor' for same set of claim and default cannot be admitted against the other 'Corporate Debtor' (the 'Corporate Guarantor(s)' or the 'Principal Borrower')."*

A further issue that has arisen in respect of guarantors is their right of subrogation against the corporate debtor that has undergone the corporate insolvency resolution process. Guarantors have contended that since they have a right of subrogation against the debtor, resolution plans that do not provide for payments of guaranteed debts to them would be discriminatory. However, this contention was rejected by the NCLAT. Personal guarantors were shareholders or promoters and a plan that did not provide for payments on account of guarantees to them would not be discriminatory and the "*Insolvency & Bankruptcy Code* seeks to protect creditors of the 'Corporate Debtor' by preventing promoters from rewarding themselves at the expense of creditors and undermining the insolvency processes.<sup>23</sup>" The Supreme Court also declined to interfere with this judgement on appeal<sup>24</sup>.



## **Conclusion**

The liability of guarantors is considered to be co-extensive with, as well as distinctive from the liability of the principal corporate debtor under the Code. Accordingly, both the principal corporate debtor and the guarantor can be proceeded against under the Code. The guarantor can also be proceeded against under different forum, when the corporate debtor is being proceeded against under the Code. In the alternate, the guarantor can be proceeded against under the Code, even when a corporate insolvency resolution process has not been initiated against the principal

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<sup>23</sup> Lalit Mishra & Ors. v. Sharon Bio Medicine Ltd., Company Appeal (AT) (Insolvency) No. 164 of 2018. Decision date- 19.12.2018 (India)

<sup>24</sup> Lalit Mishra & Ord. v. Sharon Bio Medicine Ltd., Civil Appeal No. 1603 of 2019. Decision date- 05.04.2019 (India)

debtor, and even when the principal debtor is not a corporate person. However, twocorporate guarantors cannot be proceeded against simultaneously.

