

Liability of Personal Guarantors Under IBC

INTRODUCTION:

Recently a question arose before the Supreme Court of India in a batch of matters in the case of *Lalit Kumar Jain vs. Union of India & Ors.*,¹ regarding the *vires* and constitutionality of the notification dated 15.11.2019 issued by Government of India ('**impugned notification**'). The impugned notification effected certain provisions of the Insolvency & Bankruptcy Code, 2016 ('**the Code**') in relation to the personal guarantors. Pertinently, Part II of the Code provides the provisions for the insolvency resolution and liquidation of corporate persons, whereas Part III of the Code provides for the insolvency resolution and bankruptcy for individuals and partnership firms.

By way of Amendment in 2018, sub-sections (e), (f) and (g) were inserted in Section 2 of the Code. Section 2 provides the classification of entities on whom the Code would apply. Section 2(e) of the Code² provides that the code shall apply to personal guarantors to corporate debtors, thereby excluding such personal guarantors from the ambit of individuals, which are provided under Section 2(g).

In some of the cases, the impugned notification was challenged before various High Courts across the country and the cases were transferred before the Supreme Court of India, and in some cases the petitioners directly challenged the impugned notification under Article 32 of the Constitution of India. It was contended by the petitioners that the impugned notification was *ultra vires* of Section 1(3) of the Code, since the Central Government notified certain parts of provisions of the Code and limited the application of such provisions to a particular category of person i.e. personal guarantors to corporate debtors. Hence, the impugned notification was liable to be struck down.



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¹ 2021 SCC OnLine SC 396; Transferred Case (Civil) No. 245/2020 decided on 21st May, 2021

² Inserted vide notification dated 15.11.2019 and enforced w.e.f. 01.12.2019.

GROUND FOR ATTACK ON NOTIFICATION DATED 15.11.2019:

The prime grievance of all the writ petitioners was that all the petitioners at one point or other, were guarantors on behalf of the corporate debtors to banks and financial institutions. Hence, in some cases the creditors invoked the personal guarantees given by such guarantors and in other cases, recovery or insolvency proceedings were initiated against such personal guarantors.

The petitioners also challenged the impugned notification stating that the Central Government was trying to enforce the provisions contained in Section 78, 79 and 94 to 187 of the Code in respect of personal guarantors to corporate debtors, which was impermissible, as the abovementioned provisions cannot be made applicable solely to personal guarantors to corporate debtors, when the above provisions are in relation to individuals and partnership firms. Therefore, it was argued that the Code does not envisage the limited application of abovementioned provisions to personal guarantors to corporate debtors.

The petitioners also urged that the impugned notification notifies Part III of the Code, whereas Part III pertains to *individuals* and *partnership firms*. Section 2(g) of the Code provides the definition of the term '*individual*' which means '*individuals, other than persons referred to in clause (e)*'. Section 2(e) talks about personal guarantors to corporate debtors. The petitioners, therefore, contended that reading the provisions contained in Sections 2(e) & (g) and Part III would establish that personal guarantors to corporate debtor were not covered by Part III, which only deals with individuals and partnership firms. Part III of the Code has no provision for initiation of insolvency proceedings against personal guarantors to corporate debtors.

In light of the above, the petitioners, therefore, contended that the action of Central Government was manifestly arbitrary and discriminatory in singling out the personal guarantors to corporate debtors, particularly in view of the factors:

- a) Firstly, there was no intelligible differentia or rational basis in applying the abovementioned provisions to one sub-class of individuals i.e. personal guarantors to corporate debtors, when Part III does not even apply to personal guarantors to corporate debtors; and
- b) Secondly, the provisions of Part III which were notified, provided for a single insolvency resolution process of a personal guarantor, irrespective of the fact that the creditor was a financial creditor or operational creditor. The same is in contravention of Part II of the Code, which puts the financial creditors and operational creditors on different footing.

The petitioners also contended that when a resolution plan is accepted and approved by NCLT, the corporate debtor is discharged of its liability. Therefore, a guarantor whether corporate or personal, whose liability is co-extensive with that of the corporate debtor, would also be discharged.

DEFENCE TAKEN BY UNION OF INDIA:

The Union of India contended that the Legislature wanted to deal with personal guarantors separately from partnership/ proprietorship firms and individuals, and hence, amended Section

60(2) of the Code by amendment of 2018. Consequently, bankruptcy process of a personal guarantor to corporate debtor can also be triggered along with the Corporate Insolvency Resolution Process ('CIRP') of a corporate debtor. The primary objective of the amendment to Section 60(2) was to unify the aforesaid two processes and disputes arising out of such processes, through the same forum.

The Union of India further argued that if the aforesaid bankruptcy process of personal guarantors is not unified with the resolution process of corporate debtor, then the same would result in complete exclusion of the personal guarantors from the insolvency resolution/ bankruptcy mechanism provided in the Code. The same would also result in resolution applicants facing obstacles in running the corporate debtor as a going concern since, personal guarantors being corporate debtor's promoters, directors, etc., were the responsible for the insolvency of the corporate debtor.

It would also help National Company Law Tribunal ('NCLT') to apply the provisions contained in Part III of the Code with regard to personal guarantors for effecting the repayment of the entire debt for which the personal guarantors had furnished the guarantee in the first place. The Union of India further contended that though the process applied by NCLT for corporate debtors would be under Part II and for personal guarantors would be under Part III, however, by bringing both the processes before NCLT would enable the NCLT to have a clear understanding of the extent of the debt owed by the corporate debtor and its resolution process. The same would also enable the NCLT to determine the available assets and resources of corporate debtor as well as its personal guarantors in order to properly achieve the resolution of the corporate debtor.

In terms of Section 128 of the Indian Contract Act, 1872, the liability of a guarantor/ surety is co-extensive, joint and several with that of the principal borrower unless the contrary is provided by the contract. It was, therefore, contended that Section 2 of the Code is not the definition clause of the Code, but provides the classification of different kinds of debtors, and after the amendment of 2018, Section 2(e) to (g) of the Code classified three distinct kinds of entities. Therefore, personal guarantors, though are individuals, however, being directors, promoters, etc. of the corporate debtors itself, furnish various kinds of guarantees for the corporate debtors, and are always responsible for the day to day affairs/ conduct of the corporate debtors. Further, personal guarantors are similar to corporate guarantors, as both furnish guarantees for the corporate debtors, however, personal guarantors being individuals were not included in Part II for the functional and operational reasons. This resulted in an anomaly, as the corporate guarantors can be proceeded against along with the corporate debtor under Part II of the Code, but the same could not be done for personal guarantors.

DECISION OF SUPREME COURT OF INDIA:

The Supreme Court held that the impugned notification was not an instance of legislative exercise amounting to impermissible and selective application of provisions of Code. It further observed that the legislative intent was to treat the personal guarantors differently from other class of individuals provided in the Code. Section 179 of the Code provides that subject to Section 60 of the Code, the adjudicating authority for bankruptcy matters relating to individuals would be Debt Recovery Tribunals. However, the above provision is subject to Section 60, which

provides that adjudicating authority for insolvency matters relating to corporate persons would be NCLT.

Pertinently, Section 60(2) has an overriding effect over Section 60(1), which provides that if a CIRP against a corporate debtor is pending before a NCLT, then any proceeding relating to the insolvency resolution, liquidation or bankruptcy of a corporate guarantor or personal guarantor, as the case may be, would also lie before such NCLT. Further, Section 60(4) of the Code also empowers NCLT with all the powers of Debt Recovery Tribunal as well as powers provided under Part III of the Code. The Court further held that the provisions contained in Section 2(e), Section 5(22), Section 60 and Section 179 of the Code specify the connection of the personal guarantors with the corporate debtors, so as to enable NCLT to have holistic approach about the nature of assets available, during and post insolvency process. The same would also enable the Committee of Creditors to frame realistic plans, keeping in mind the prospect of realising some part of the creditors' dues from the personal guarantors.

The Court also rejected the contention of petitioner regarding the discharge of personal guarantors' liability on acceptance and approval of resolution plan on the basis of its earlier judgment of *State Bank of India vs. V. Ramakrishnan*³. The Court held that Section 31(1) of the Code makes it clear that the guarantor cannot escape payment, since the resolution plan, which has been approved by NCLT, may also include the provisions of payments to be made by such guarantor. Therefore, finality to the insolvency proceedings *per se* does not operate as a discharge of guarantors' liability under the contract of guarantee. The Court, therefore, held that the abovementioned provisions and the amendment of 2018 clearly establishes the legislative intent of unification of the resolution process of corporate debtors as well as bankruptcy process of its guarantors i.e., corporate and personal, before the same adjudicating authority. The Court then upheld the impugned notification and dismissed the writ petitions.

CONCLUSION:

The above judgment upholding the validity of the notification has invariably settled an important issue and removed an obstacle in achieving the objectives of the Code. The judgment is a welcome step towards the unification of the insolvency proceeding of corporate debtor as well as its guarantors, whether it be a corporate guarantor or a personal guarantor, so as to enable Committee of Creditors as well as NCLT in properly adjudicating the insolvency proceeding.

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³ (2018) 17 SCC 394