

UPDATE

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The 'Guarantee' Chronicle

Highlight:

The Hon'ble Supreme Court of India ('SC') on 21 May 2021, in the matter of *Lalit Kumar Jain v. Union of India & Ors.*, upheld the *vires* and validity of a notification dated 15 November 2019 ('**Impugned Notification**') issued by the Central Government ('CG') by which certain provisions of Part III of the Insolvency and Bankruptcy Code, 2016 ('**Code**') were brought into force only with respect to personal guarantors of corporate debtors. In a significant ruling, the SC further held that mere approval of a resolution plan of a corporate debtor would not *ipso facto* discharge a personal guarantor (of a corporate debtor) of his/her liabilities under the contract of guarantee.

Facts:

1. CG has been conferred power under Section 1(3) of the Code by the Parliament to enforce different provisions of the Code at different points in time. Accordingly, the CG has notified various provisions of the Code from time to time. By the Impugned Notification, the CG notified several provisions of the Code, (w.e.f. from 01.12.2019) relating to insolvency process against personal guarantors, namely Section 2(e), Section 78 (except with regard to fresh start process), Sections 79, 94-187 (both inclusive); Section 239(2)(g), (h) & (i); Section 239(2)(m) to (zc); Section 239 (2)(zn) to (zs) and Section 249 of the Code.
2. The notification of the aforesaid provisions dealing with insolvency proceedings of personal guarantors, resulted in several personal guarantors being served with demand notices under the provisions of the Code. Aggrieved by the Impugned Notification, several writ petitions were filed before several High Courts, however, *vide* an order dated 29.10.2020, the SC transferred the said writ petitions to itself to avoid any conflicting decisions.

Abridged analysis:

The constitutional validity of the Impugned Notification was challenged in these transfer writ petitions by several petitioners, primarily on the following grounds:

- (i) **CG cannot modify law through conditional legislation:** The power conferred upon the CG under Section 1(3) of the Code could not have been resorted to for extension of the provisions of the Code insofar as they relate *only* to personal guarantors of corporate debtors. Since, Section 1(3) was an instance of 'conditional legislation', the only function assigned to the executive was to bring the law into operation at such time as it may decide. Therefore, CG had by the Impugned Notification exceeded the power conferred upon it by selectively choosing to notify the aforesaid provisions only for personal guarantors for corporate debtors and not for other individuals and partnership firms.
- (ii) **Impugned Notification does not repeal existing laws relating to insolvency of individuals:** Another objection raised was that the Impugned Notification failed to notify Section 243 of the Code, which repeals

Presidency Towns Insolvency Act, 1909 ('PTI Act') and the Provincial Insolvency Act, 1920 ('PIA'). Before issuance of the Impugned Notification, insolvency proceedings against individuals was governed by the aforesaid statutes. It was contended that by not repealing the said statutes, the Impugned Notification lacked logic and created two contradictory legal regimes for insolvency proceedings against personal guarantors to corporate debtors.

- (iii) **Personal guarantor's liability absolved after approval of resolution plan:** It was contended that once a resolution plan for a corporate debtor is approved, all outstanding claims against the debtor and the corporate debtor, consequently, are extinguished.

Further, it was urged that in accordance with Section 128 of the Indian Contract Act 1872 ('Contract Act'), liability of a guarantor is co-extensive with that of the principal debtor and conclusion of insolvency proceedings against a principal debtor (corporate debtor), *i.e.*, after approval of resolution plan, would amount to extinction of all claims against the personal guarantor.

Final findings:

1. Sufficient legislative guidance for issuing Impugned Notification:

The SC while purposively interpreting the Impugned Notification, held that the issuance of the notification was not *ultra vires* and valid. The SC observed that the Parliamentary intent was to treat personal guarantors differently from other categories of individuals and that the Impugned Notification was neither an instance of legislative exercise, nor amounting to impermissible and selective application of provisions of the Code, since there was no compulsion in the Code that it should be made applicable, at the same time, to all individuals, (including personal guarantors) or not at all.

It was observed that the scheme of the Code always contemplated that assets of a corporate debtor and its personal guarantor could be dealt with in an identical manner during insolvency proceedings. It was for this reason that an amendment was brought in 2018 to the Code, amending Section 2 (e), Section 5 (22), Section 29A, and Section 60, and thereby, defining the term 'personal guarantor' and distinguishing personal guarantors from individuals. Even the un-amended Section 60 of the Code had contemplated that the adjudicating authority in respect of personal guarantors was to be the NCLT (and not DRT as is the case for individuals and partnership firms), therefore, making the intent of the legislature clear in terms of its treatment of personal guarantors.

2. **No over-lapping between PTI, PIA and provisions of the Code:** Placing reliance on Section 238 of the Code, which contains a *non-obstante* clause, the SC stated that the Code has an overriding effect over other prevailing (and contradictory) enactments such as PTI and PIA. Therefore, the result of the Impugned Notification, is that if any proceeding were to be initiated against personal guarantors, it would be under the Code.

3. Approval of resolution plan has no effect on liabilities of personal guarantors:

The SC clarified that the sanction of a resolution plan and finality imparted to it by Section 31 of the Code does not *per se* operate as a discharge of the personal guarantor's (of a corporate debtor) liability, since the same arises out of an independent contract. With regards to the nature and extent of the liability, the same would depend on the terms of the guarantee itself. The SC placed reliance on Committee of Creditors of *Essar Steel (I) Ltd. v. Satish Kumar Gupta* and *State Bank of India v. V. Ramakrishnan & Ors*, wherein it was held that approval of resolution plan would not amount to recourse under Section 133 of the Contract Act, seeking discharge of the liability of the personal guarantor on account of variance in terms of the

contract, without her or his consent. The SC in the *Ramakrishnan* case had held that the language of Section 31 of the Code makes it clear that the approved plan is binding on the guarantor, to avoid any attempt to escape liability under the provisions of the Contract Act.

Conclusion:

Based on the above discussion, it is clear that the current provisions under the Code which deal with insolvency process for personal guarantors for a corporate debtor as notified *vide* the Impugned Notification are legally valid. Further, approval of resolution plan relating to a corporate debtor is an independent contract and does not absolve the obligation of a personal guarantor of their liability.

Practical Implications:

Some of the practical implications of this judgement are:

- (i) A significant win for the lenders, the judgement paves the path for lenders to recover any deficit amounts, not covered by the resolution plan, from personal guarantors of such corporate debtors by initiating independent proceedings against such personal guarantors. Past practice has also shown that it is routine for directors/promoters of companies to act as personal guarantors for loans availed by such companies and wriggle out of their liabilities later on. In the absence of a robust recovery mechanism, lenders especially banks and financial institutions, were subjected to huge losses/haircuts with no alternative means to recover such amounts despite holding personal guarantees from promoters/directors of such entities. However, going forward, such practices are likely to change and directors/promoters would be more prudent whilst providing such personal guarantees at the behest of companies that may expose them to risks of insolvency.
- (ii) Any attempts by promoters to shield their personal assets from business risks, including transfer of personal assets by way of trusts, sale, gifts or otherwise, may come under increased scrutiny for being undervalued or preferential and may be looked into with a cloud of suspicion. Any such transfer of personal assets, up to 2 years prior to the date of application for initiating insolvency proceedings, against such personal guarantors could be scrutinised under relevant provisions of the Code. However, it is necessary that such transfer/transaction should have triggered the insolvency process against such personal guarantor. Practically, proving the same may be an uphill task for lenders. Transactions in good faith and for value would continue to remain protected, while transactions not satisfying the above criteria may be declared void and such property may continue to be treated as part of the bankruptcy estate of the personal guarantor. Efforts should be made to ensure transactions/transfers by promoter groups are well structured and adequately documented to avoid any risk of potential clawback.
- (iii) Interestingly, the SC has not commented upon the practical implications of a scenario where the approved resolution plan specifically notes that upon approval, *all* liabilities of personal guarantors would stand extinguished. It is unclear whether in such situation, a dissenting financial creditor would continue to have the right to proceed against the personal guarantor in distinct and independent proceedings post approval of such resolution plan.

With the ruling of the SC, directors/promoter groups now have an increased skin in the game and would provide guarantees only where they have confidence regarding its repayment.

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