

Liability Of Personal Guarantors Vis-A-Vis Lalit Kumar Jain Vs. Union Of India And Ors.

written by Rajdev Singh | June 14, 2021

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Introduction

On 15th November 2019, a notification was issued by the Ministry of Corporate Affairs which brought into force Part III of the Insolvency and Bankruptcy Code, 2016 ("Code"), as per which insolvency against the personal guarantors to the Corporate Debtor could be initiated. The notification was challenged before various High Courts and on 29th October 2020, the Hon'ble Supreme

Court stayed the High Courts from admitting or hearing any and all writ petitions challenging the said notification and transferred to itself all the matters pending before various High Courts.

The main grounds for challenging the notification were that the Central Government did not have the power to enforce selected parts of the code or create a sub-category of individuals as personal guarantors.

The saga of the treatment of personal guarantors under the Code was given rest recently by way of a judgement *Lalit Kumar vs Union of India*” Transferred case (Civil) no. 245/2020, wherein the bench comprising of Justices L. Nageswara Rao and Ravindra Bhat on 21st May 2021 held that “*since the contract altogether, even if the debtor/borrower is discharged of its debts owed to creditors due to any operation of law i.e. insolvency or liquidation, would not discharge guarantor from its liability*”.

Background

The various issues brought to light by the Petitioner was that on 15th November 2019, the Ministry of Corporate Affairs, in the exercise of the powers conferred by Section 1(3) of the Code, issued a notification enforcing Section 2(e), Section 78, 79, 94-187, 238(2)(g) (h) (i), 239(2)(m) to (zc); 238(2)(zn) to (zs) and Section 249 from 1st December 2019. However, the aforementioned provisions were only enforced as far as the personal guarantors to corporate debtors are concerned.

Another argument by the Petitioners was that the Central Government, under Section 1(3) of the Code, cannot notify parts of the Code or limit the application of provisions to certain categories of persons only and that the power delegated under Section 1(3) is only with regards to when the different provisions of the Code can be brought into effect. Since only the provisions concerning personal guarantors to corporate debtors were brought into force, the Notification was, therefore, ultra vires.

Also, the selective application to personal guarantors was arbitrary and discriminatory. It was pointed out that Part III of the Code governs only “Insolvency Resolution and Bankruptcy for Individuals and Partnership Firms” and personal guarantors are specifically excluded from the ambit of individuals as defined under Section 2(g) of the Code. Furthermore, Section 95 of the code permits a creditor to invoke specific provisions in part III of the code which permits the initiation of the insolvency resolution process against a personal guarantor and accordingly, the notification, which alludes to the contrary, is ultra vires and is liable to be set aside.

Another moot point was that the notification – by applying the code to personal guarantors – only takes away the protection afforded by law; reference was made to Section 128, 133 and 140 of the Indian Contract Act, 1872. It was urged that the liability of the personal guarantor is co-extensive with that of the corporate debtor, except to the extent admitted in the insolvency resolution process itself. This is clear from Section 31 of the Code, which makes the resolution plan approved by the Adjudicating Authority binding on the corporate debtor, its creditor and guarantors.

Supreme Court Ruling

Relying on multiple precedents on similar questions posed over the last few decades, the Court observed that the Central Government is not mandated to bring in effect all the provisions of a statute at the same time. Unless it is specifically prohibited in law, the provision can be brought in force at any point of time and for any category of person that it originally applies to.

"In view of the above discussion, it is held that the impugned notification is not an instance of legislative exercise or amounting to impermissible and selective application of provisions of the Code. There is no compulsion in the Code that it should, at the same time, be made applicable to all individuals, (including personal guarantors) or not at all.

There is sufficient indication in the Code- by Section 2(e), Section 5(22), Section 60, and Section 179 indicating that personal guarantors, though forming part of the larger grouping of individuals, were to be, in view of their intrinsic connection with corporate debtors, dealt with differently, through the same adjudicatory process and by the same forum (though not insolvency provisions) as such corporate debtors.

The notifications under Section 1(3), (issued before the impugned notification was issued) disclose that the Code was brought into force in stages, regard being had to the categories of persons to whom its provisions were to be applied. The impugned notification, similarly, inter alia makes the provisions of the Code applicable in respect of personal guarantors to corporate debtors, as another such category of persons to whom the Code has been extended. It is held that the impugned notification was issued within the power granted by Parliament and in valid exercise of it. The exercise of power in issuing the impugned notification under Section 1(3) is, therefore, not ultra vires; the notification is valid."

The Hon'ble Supreme Court relied on various judgements such as Vijay Kumar Jain v. Standard Chartered Bank 2019 SCC Online SC 103. This Court, while dealing with the right of erstwhile directors participating in meetings of Committee of Creditors, observed that:

"We find that Section 31(1) of the Code would make it clear that such members of the erstwhile Board of Directors, who are often guarantors, are vitally interested in a resolution plan as such resolution plan then binds them. Such plan may scale down the debt of the principal debtor, resulting in scaling down the debt of the guarantor as well, or it may not. The resolution plan may also scale down certain debts and not others, leaving guarantors of the latter kind of debts exposed for the entire amount of the debt. The regulations also make it clear that these persons are vitally interested in resolution plans as they affect them".

In the Committee of Creditors of Essar Steel (I) Ltd. v. Satish Kumar Gupta (2020) 8 SCC 531. (the "Essar Steel case"), this court refused to interfere with proceedings initiated to enforce personal guarantees by financial creditors; it was observed as follows:

"Following this judgment in V. Ramakrishnan case [SBI v. V. Ramakrishnan, (2018) 17 SCC 394], it is difficult to accept Shri Rohatgi's argument that that part of the resolution plan which states that the claims of the guarantor on account of subrogation shall be extinguished cannot be applied to the guarantees furnished by the erstwhile Directors of the corporate debtor. So far as the present case is concerned, we hasten to add that we are saying nothing which may affect the pending litigation on account of invocation of these guarantees. However, NCLAT judgment being contrary to Section 31(1) of the Code and this Court's judgment in V. Ramakrishnan case [SBI v. V. Ramakrishnan, (2018) 17 SCC 394], is set aside."

Taking into consideration the aforementioned rulings, the court held that approval of a resolution plan does not ipso facto discharge a personal guarantor of a corporate debtor of his liabilities under the contract of guarantee. The release or discharge of a principal borrower from the debt owed by it to its creditor due to an involuntary process i.e., by operation of law or due to liquidation or insolvency proceedings does not absolve the surety/guarantor of their liability which arose/arises out of an independent contract. It was held that the notification is legal and valid.

Conclusion

Many professionals think that this judgement will open doors to several insolvencies against the personal guarantor. But on the other hand, the judgement has cleared the position of personal guarantors by extending the provisions of the code to them and also by giving more options to the creditors to initiate simultaneous proceedings against the personal guarantors and recover the dues. The shift in the position through this judgement, besides ensuring strict credit behaviour, will hold personal guarantors accountable and make them cautious while extending guarantees.

Nonetheless, the repercussions are yet to be observed.

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