

Analysis of Initiation of Insolvency Proceedings against Personal Guarantors in light of Lalit Kumar vs. Union of India



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Background

In the case of *Lalit Kumar Jain v. Union of India & Ors.* ([2021 ibclaw.in 61 SC](#)), a two-judge bench of the Supreme Court of India upheld the constitutional validity of the notification bringing into effect such provisions of the Insolvency and Bankruptcy Code, 2016 (“Code”) with respect to personal guarantors of corporate debtors on May 21, 2021. The Supreme Court recognised the legislative objective behind notifying the Code’s provisions in a phased and selective manner.

These provisions of Part III of the Code, which apply only to personal guarantors of corporate debtors, were brought into force by the Central Government through a notification dated November 15, 2019 (“[Notification](#)”). The Insolvency and Bankruptcy (Application to Adjudicating Authority for Insolvency Resolution Process for Personal Guarantors to Corporate Debtors) Rules, 2019 (“[Rules](#)”), as well as the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Personal Guarantors to Corporate Debtors) Regulations, 2019 (“[Regulations](#)”), were also brought into force through separate notifications. The Rules and Regulations established a comprehensive framework for creditors to pursue personal guarantors of corporate debtors in insolvency proceedings. The decision, however, is limited to the constitutional validity of the notification.

Issues framed by the Court

It was contended by the Petitioners that the notification is ultra vires as it suffered from the net of excessive delegation and arbitrariness. According to them, the code's provisions cannot be enforced selectively and in a phased manner only to the extent that they apply to personal guarantors of corporate debtors, and such notification was in violation of section 1(3) of the code. There were several other considerations factored by the Court which are as presented below;

Whether the distribution under section 60 applies to personal guarantors:

Citing the case of *Rajendra K Bhuta vs. Maharashtra Housing and Area Development Authority [2018] ibclaw.in 109 NCLAT*, the Court said that u/s 60(2), the insolvency process or liquidation of three categories, i.e., corporate debtor, corporate guarantors to corporate debtors and personal guarantors to corporate debtors is to be applied distributively which implies insolvency resolution or liquidation process apply to corporate guarantors whereas insolvency or bankruptcy process apply to personal guarantors who cannot be subjected to liquidation.

Whether the overseas assets of personal guarantors could contribute to the Insolvency resolution process:

The Court after a careful examination of section 234 and 235 revealed that the principle of the code has always factored the overseas assets of a corporate debtor or its personal guarantor in a synonymous/identical manner. This is in the context of an insolvency proceeding which primarily deals with issuing letters of request to courts and authorities in other countries for the sole objective of dealing with such assets with their jurisdiction.

Whether NCLT would be the Adjudicating authority in case of personal guarantors:

The Central government and the board are authorised vide the impugned notification to form a framework for allowing pending proceedings against a personal guarantor or corporate debtor which are to be heard by the Adjudicating Authority. The notification's stated purpose is to allow outstanding cases to be resolved in accordance with the Code. Under Section 243, repeal of the personal insolvency laws is spoken of but it has not yet been notified. In the case of a pending resolution or liquidation proceedings against a corporate debtor, Section 60(2) mandates that an application for resolution process or bankruptcy of the corporate debtor's personal guarantor be submitted with the NCLT in charge of the resolution process. If a simultaneous resolution process or liquidation proceeding is underway regarding a corporate debtor for whom the guarantee is provided, the Adjudicating Authority in case of personal guarantors shall be the NCLT.

When any insolvency or bankruptcy process against the personal guarantor is pending in a court or tribunal, and a resolution process or liquidation is commenced against the corporate debtor, the same logic applies under Section 60(3). For instance, If A, an individual, is the subject of a DRT resolution process and has provided a personal guarantee for a debt owing by a firm B, the provision results in the DRT proceedings against A being transferred to the NCLT if a resolution process is begun against B in the NCLT.

Whether there could be separation of personal guarantors from individuals:

Prior to the amendment of 2018 came into effect, the Central Government had ample legislative guidance to differentiate and categorise personal guarantors from other individuals. Sections 5(22), 60, 234, 235, and unamended Section 60 clearly demonstrate this. In *V. Ramakrishnan*, The court discussed the impact of numerous parts of the Code and how they are applicable to personal guarantors.

Whether the applicability of provision Section 60(2) strengthens insolvency resolution process:

The court was well cognizant that the amendment, in so far as the insertion of Section 2(e) and alteration of Section 60(2) are concerned, it was intended to improve the corporate insolvency process. Simultaneously, because the Code did not apply to individuals (which include personal guarantors), the court had no opportunity to take into account what impact would exercise of power under Section 1(3) of the Code would have in bringing such provisions into force in connection with personal guarantors.

Whether the government's conduct in selectively enforcing some provisions of the code (78, 79, 94-187 of the IBC) through the impugned notification in respect of some individuals was a violation of the Parliament's authority:

The preceding analysis clearly shows that Parliament intended to handle personal guarantors uniquely as compared to other types of individuals. The close relationship between such persons and the corporate entities for whom they provided guarantee, along with the likelihood of two distinct processes taking place in different forums, each with its own set of uncertain results and outcomes, led to the classification of personal guarantors as a distinct type of individuals. The fact that the insolvency procedure outlined in Part III is to be applicable to individuals, while the method outlined in Part II is to be applicable to corporate debtors, does not create inconsistency. On the other hand, there seems to be compelling grounds for a common forum for adjudicating insolvency proceedings, notwithstanding the fact that their provisions are disparate.

In light of the foregoing, it was held that the impugned notification is neither a legislative exercise, nor does it lead to an improper and selective implementation of the Code's provisions. There is no requirement in the Code that applicability of the code should be brought to all individuals.

Whether acceptance of a resolution plan in the case of corporate debtors would also discharge the personal guarantor's liability:

In the opinion of the Court, "All creditors and other classes of claimants, including financial and operational creditors, those entitled to statutory dues, workers, etc., who participate in the resolution process, are heard and those in relation to whom the CoC accepts or rejects pleas, are entitled to vent their grievances before the NCLT. *After* considering their submissions and objections, the resolution plan is accepted and approved. This results in finality as to the claims of creditors, and others, *from the company* (i.e. the company which undergoes the insolvency process). The question which the petitioners urge is that in view of this *finality*, their liabilities would be extinguished; they rely on Sections 128, 133 and 140 of the Contract Act to urge that creditors cannot therefore, proceed against them separately".

The reasoning for enabling directors to attend CoC meetings is that the directors' personal guarantee obligation against creditors continues, and an authorised resolution plan can only result in a modification of the value or exposure for the total amount. This court rules out any remedy under Section 133 of the Contract Act to dismiss the surety's responsibility due to a difference in contract's terms without her or his permission.

It is therefore, clear that the sanction of a resolution plan and finality imparted to it by Section 31 does not *per se* operate as a discharge of the guarantor's liability. As to the nature and extent of the liability, much would depend on the terms of the guarantee itself. However, this court has indicated, time and again, that an involuntary act of the principal debtor leading to loss of security, would not absolve a guarantor of its liability.

In light of the foregoing, it was held that approval of a resolution plan does not *ipso facto* discharge a personal guarantor (of a corporate debtor) of her or his liabilities under the contract of guarantee. As held by this court, the release or discharge of a principal borrower from the debt owed by it to its creditor, by an involuntary process, i.e. by operation of law, or due to liquidation or insolvency proceeding, does not absolve the surety/guarantor of his or her liability, which arises out of an independent contract.

Potential Implications

1. Double Dip

In a 2018 judgement, NCLAT held that financial creditors have no prohibition under section 7 of the IBC from pursuing CIRP against both the principal debtor and the corporate guarantor, or between two corporate guarantors. Despite this, NCLAT decided that two claims for the identical set of debts filed by the same financial creditor must be denied. If both claims are granted, the creditor will be accused of double-dipping. Nevertheless, this rational cannot be used and applied in case of personal guarantors. This is because the liability of a personal guarantor and corporate debtor is co-extensive. Simultaneous processes are conceivable under the IBC, which means creditors may be able to benefit from double-dipping. Indeed, creditors may wish to exploit this in order to recover their debts.

2. Violation of Subrogation rights

Initiating bankruptcy processes against personal guarantors potentially violates the guarantor's rights under the Indian Contract Act, particularly the right of subrogation. The guarantor has the right of subrogation under Section 140 of the Indian Contract Act of 1872. The code's objective is to ensure maximisation of asset value of the corporate debtor and not serve as a recovery mechanism. However, the right of subrogation is not absolute, and it is contingent on the availability of resources with the corporate debtor.

Moreover, even in the case of non-availability of subrogation rights, the liability of the guarantor cannot extinguish towards realisation of debt.

3. Duplicity of Claims

It is a well-established legal principle that a creditor can bring legal action against a guarantor

without exhausting his or her rights against the principal debtor. This notion is pursuant to Section 60(2) of the Code, which provides for the continuing of actions against both the corporate debtor and the guarantor at the same time. The NCLAT has ruled that once a corporate debtor or corporate guarantor's CIRP is allowed, the other case must be withdrawn. The NCLAT's reasoning is that it would otherwise result in claim duplication. As a result, CIRP procedures against the borrower/corporate debtor and the corporate guarantor cannot be in operation at the same time.

Conclusion

The RBI forecasted a 0.6 percent increase in the gross NPA ratio for regulated financial institutions in its [Financial Stability Report 2019](#). A faster compliance procedure for guarantees is a desirable move at times when banks are stressed with bad loans. Considering the possibility of simultaneous proceedings against both the guarantor and the principal debtor, an analysis of the insolvency regime for personal guarantors recommends greater implementation of guarantees, higher collections, and, presumably, a significant leverage to creditors against erring guarantors. Personal guarantors, on the other hand, should exercise caution because they have lost their right to reclaim payments made under the guarantee contract from the borrower. Various technical components of the enforcement procedure must also be reconsidered in order to maintain the framework's overall efficacy. All in all, this judgement would pave the way for creditors in better recovery of loans as on the other hand would be troublesome for the guarantors.

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