THE NEW CONUNDRUM: GUARANTOR IN INSOLVENCY REGIME

INTRODUCTION

The concept of CIRP is provided under the IB Code, 2016. As per this concept once the existence of a default is established the Tribunal will initiate a CIRP after consulting the creditors of the company. In such a scenario, question arises as to how the provisions of insolvency or liquidification of a company under the Insolvency and Bankruptcy Code, 2016 treat the guarantor.

The concept of guarantee introduced and explained under Section 126 of the Indian Contracts Act, 1882 puts an obligation on a surety to honor the promise of principal debtor by paying the principal debtor's present of future debt, provided to him by a creditor.[1] In absence of the 4 components in the guarantee contract; (1) A Contract of guarantee, (2) Suretyship, (3) Principal debtor and (4) Creditor[2] the contract would be a simple contract. The presence of 3 parties in the contract extends the *privity of contract* to *tripartite privity of contract*.[3] Further, section 128[4] creates a co-extensive liability between the surety and the debtor so in case a proceeding is initiated against the principal debtor guarantors conduct will be governed by it. Only exception to this is laid down in *"E G. Bankruptcy: Jagannath v. Shivnarayan"*[5] wherein the court said that "*discharge of surety by discharge of law does not discharge the surety."*[6] Here, it would be beneficial to mention that (a) a guarantor is also a creditor of varied degree[7] and (b) the *rights of a surety is co-extensive with that of the principal debtor*.[8] Throughout the course of this paper the researcher will try to understand and analyze the status of guarantor under the Insolvency and Bankruptcy Code. In order to do so the researcher has discussed four points for consideration throughout the entire article.

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[1] Lord Chorley*, Law of Banking* (2nd edn, Pitman 1947).
[2] S.N Gupta, Law Relating to Guarantees with Pro-formas of Bank Guarantees and Indemnity Bonds (6th edn, Pitman 1947).
[3] Ibid.
[4] The Indian Contract Act, 1872 act No. 9 OF 1872, s. 126.
[5] E G. Bankruptcy: Jagannath v. Shivnarayan AIR 1940 Bombay 387.
[6] Ibid.
[7] United Nations Commission on International Trade, *Legislative Guide on Insolvency Law* (New York, 2005), para.1.
[8] *Sanjeev Shriya v. LML Industries* Writ - C No. - 30285 of 2017.

GUARANTORS LIABLITY UNDER MORATORIUM PERIOD

Bombay High Court in the case of *Alpha & Omega Diagnostics (India) Ltd. v. Asset Reconstruction Company of India Ltd. & Ors*[9] dealt with the question, whether a creditor under the insolvency regime can sell the assets of the personal guarantor. The court examined the word 'it" contained in Section 14 of the IBC, 2016 and said that the benefit of moratorium is not available to the personal guarantors of the corporate debtors. Hence, a personal guarantors assets can be disposed of in order to satiate the debt. NCLAT in the case of *Schweitzer Systemtek India Pvt. Ltd. v. Pheonix ARC Pvt. Ltd. & Ors.,*[10] also gave a judgment along similar lines.

The next point is the co-extensiveness of the liability of the guarantor with that of the principal-debtor. It empowers the creditor to proceed against the principal-debtor and the guarantor.[11] The creditor need not necessarily exhaust his remedy against the debtor before approaching the guarantor.[12] The court through *Sanjeev Shriya v. State Bank of India,*[13] interpreted section 60(2) and reaffirmed the right of creditor to proceed against the guarantor of the corporate debtor. The words *"an application relating to the insolvency resolution or bankruptcy of a personal guarantor of such corporate debtor shall be filed before such NCLT"*[14] point out the intention of the legislature to make the guarantor of the corporate debtor equally liable for the repayment of debts accrued. This is in tune with the legislature's objective of speedy recovery of loan.[15]

Next is section 14 of the IBC[16] which makes it clear that whenever a CIRP is instituted against a corporate debtor, the company will go through a 180 (plus 90 days of extension) day period of Moratorium. During the period of Moratorium, *"any action to foreclose, recover or enforce any security interest created by the corporate debtor in respect of its property"*[17] is prohibited. In lieu of the same, it's vital to point out that whenever the guarantor pays the corporate debtors debt, he

[9] Alpha & Omega Diagnostics (India) Ltd. v. Asset Reconstruction Company of India Ltd. & Ors Company Appeal (AT) (Insol.) No. 116 of 2017.
[10] Company Appeal (AT) (Insolvency) No. 129 of 2017.
[11] *Subankhan v. Lalkhan* AIR 1947 Nag. 643.
[12] Ibid.
[13] *Sanjeev Shriya v. LML Industries* Writ - C No. - 30285 of 2017.
[14] The Insolvency and Bankruptcy Code, 2016 No. 31 OF 2016. S.60 (2).
[15] The Insolvency and Bankruptcy Code, 2016 No. 31 OF 2016.
[16] The Insolvency and Bankruptcy Code, 2016 No. 31 OF 2016. S. 14.
[17] The Insolvency and Bankruptcy Code, 2016 No. 31 OF 2016. S. 14(1) (c).

himself acquires a right against the principal debtor. So does this acquisition create a stress on the assets of the corporate debtor? Seemingly, it is prohibited under section 14 of the IBC, 2016 as it states that "*encumbering… of its assets or any legal right or beneficial interest therein; of its assets or any legal right or beneficial interest therein*[18]" A similar question came up for consideration in front of Chennai bench of NCLT in the case of *Mr. V. Ramakrishnan Versus M/s. Veesons Energy Systems Pvt. Ltd. And State Bank of India*[19] where, Veesons Energy Systems Pvt. Ltd. took a debt from State Bank of India and personal guarantor to this loan was Mr. V. Ramakrishnan. After default the creditor approached the personal guarantor directly to sell the latter's property and realize the portion of its debt. NCLT prohibited the State Bank of India from doing so when the period of moratorium was going on because this would entail creating a charge on the assets of corporate debtor. The same would amount to *encumbering the assets of corporate debtor* which is prohibited by Section 14 of IBC.[20] This certain charge would be created by use of Section 140 of the Indian Contracts act which as per the judge presiding over the matter, leaves no room for doubt.[21]

The present conundrum is that: (a) the prohibition of taking a recourse to guarantor and to realize debt from that end makes it implicit that the proceedings against the guarantor in Insolvency and Bankruptcy Code is very restricted, hence, this is defying the principles of Contract and as a result of this a scarcity of trust is created in matters pertaining to guarantee contracts. (b) If one is allowing the *selling off of personal guarantors assets* than the same would go against the objectives of IBC, 2016

JURISDICTION TO DETERMINE GUARANTORS LIABLITY: NCLT OR DRT?

The present case is pertaining to the demand for additional capital for which the State Bank of India agreed to help the corporate entity LML Industries on the provision that guarantors be provided to the bank. The lability of this guarantor arises as soon as the principal debtor defaults in paying back the loan.[22] The principal debtor along with guarantor is now open for demand or litigation by the creditor of the company.

[18] The Insolvency and Bankruptcy Code, 2016 No. 31 OF 2016. S. 14(1) (b).
[19] Mr. V. Ramakrishnan v. M/s. Veesons Energy Systems Pvt. Ltd. And State Bank of India CP/510/IB/CB/2017.
[20] Sanjay Vijaykumar, 'SBI barred from selling assets of guarantor' *The Hindu* (Tamil Nadu, 5November 2017).
[21] Ibid. *See also*, Parvateneni Bhushayya v. Potluri Suryanarayana, AIR 1944 Mad 195.
[22] The Indian Contract Act, 1872 act No. 9 OF 1872, s. 126.

A similar relief emerges from IBC, 2016 where the creditor is duty bound to prove to the existence of a default. Once the same is done the Tribunal initiates CIRP against the debtor company and appoints a Resolution Professional who now is responsible to look after the day to day working of the company.[23] The directors are now duty bound to help the insolvency professional so that the latter can carry out his job smoothly. After the statutory limit of 180[24] days is complete along with any extension provided, the creditors have the right to decide the fate of company by coming up with either a Resolution plan or letting the Company head out for liquidation. This is subject to the scrutiny of NCLT.

These two are completely two sets of legal proceedings. A contract of guarantee focusses upon the breaking of a promise whereas the Code focusses upon existence of a default. The forum for both the relief is different. Contrary to the proceedings under Code which can only be conducted in NCLT, a breach of guarantee contract can be brought into Debt Recovery Tribunal (for short "DRT').

The current proceedings deal with the confusion surrounding Section 14(1) and Section 60(2) of the code. Section 14(1) puts the moratorium in effect which puts every other proceeding against the company into abeyance. Section 60 states that in case an insolvency resolution process is pending before the Tribunal then the insolvency resolution of a personal guarantor is to be filed in the NCLT also.

The Allahabad High Court in the matter of *Sanjeev Shriya v. State Bank of India,*[25] held that in case an insolvency proceeding or a liquidation proceeding is initiated against the principal debtor that the claim of insolvency or bankruptcy against the guarantor of that principal debtor is to be initiated in the NCLT itself.[26] The researchers worry that this might give a chance to a vindictive creditor to not only secure his debt but also to initiate a corporate Insolvency procedure against the borrower. The other consequence of this may be "forum shopping".

Section 17 of the Recovery of Debts Due to Banks and Financial Institutions Act, (RDDBFI Act)[27] empowers the Debt Recovery Tribunal (DRT) to entertain applications from banks or financial

[23] *Sanjeev Shreya v. LML Industries* Writ - C No. - 30285 of 2017.
[24] The Insolvency and Bankruptcy Code, 2016 No. 31 OF 2016. S. 12.
[25] *Sanjeev Shreya v. LML Industries* Writ - C No. - 30285 of 2017.
[26] The Insolvency and Bankruptcy Code, 2016 No. 31 OF 2016. S.60 (2).
[27] The Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (51 of 1993).

institution for "*recovery of debts*"[28]. Section 60(2) of the Insolvency and Bankruptcy Code[29] gives the power to Creditor to initiate a *"corporate insolvency process"*[30] against the guarantor. Given this scenario, if one company decides to act as a guarantor for the other company than both the companies would wound up in CIRP or the liquidation process. The researchers fail to understand as to why DRT would ask the creditors to change the subject matter of their prayer clause and go from asking of *"recovery of dues"* to *"instituting an insolvency resolution process"*.

The argument of Section 238 of the Insolvency and Bankruptcy Code is faulty on the face of it as bars the usage of provisions that are *inconsistent* with the Insolvency and Bankruptcy Code. The aim of the both the above laws are completely different as one aims at *initiation of corporate insolvency process* whereas the other simply aims at *recovery of loans* without putting the existence of a company into question.[31] The nature of both the Acts can be drawn from their longs titles. Where one focusses solely on the *recovery of debts,*[32] the other focusses on a plethora [33]of things, neither of which is the *recovery of debts*. The debt recovery part is a by-product of the insolvency process.

GUARANTORS RIGHT TO DEBT RECOVERY VIA INSOLVENCY PROCEEDDINGS

It ever so often happens that the guarantor helps the principal debtor by absolving his debt but in return he falls short of the money. Recovery of this money becomes a difficult affair. Legally speaking, the concept of Subrogation provided under the Contracts law of India states that the rights of one person can be transferred to another person provided the latter person is instrumental in extinguishing the debt of the former-borrower. The guarantor becomes the creditor of the borrower as he is now succeeds to the right (including the right to realize debt amount) of the previous creditor.[34] This concept emerged from the case of *Morgan v. Seymore*[35] where the court

[28] The Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (51 of 1993) S.17.
[29] The Insolvency and Bankruptcy Code, 2016 No. 31 OF 2016. S.60 (2).
[30] Ibid.
[31] Kumar Saurabh Singh, Rajeev Vidhani, Soumava Chatterjee and Ashwij Ramaiah, 'Liabilities Fluid; Guarantors Protected under IBC: Allahabad HC' (*Khaitan & Co.*, 18 September 2017 <https://www.khaitanco.com/PublicationsDocs/Khaitan%20&%20Co-Ergo-Newsflash-18Sept2017.pdf> last accessed on 5 November 2017.
[32] The Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (51 of 1993), long title.
[33] The Insolvency and Bankruptcy Code, 2016 No. 31, long title.
[34] S.N Gupta, 'Law Relating to Guarantees with Pro-formas of Bank Guarantees and Indemnity Bonds' (6th edn, Pitman 1947).
[35] *Morgan v. Seymore,* (1638) 1 Rep Ch 120.

held that after disposing off the obligations of the principal debtor the guarantor acquires the right to stand in the shoes of the Creditor.[36]

The judicial history of Indian upholds the guarantor's right of subrogation by giving it every legal right of the creditors. An exemplary case of this is *Amrit Lai Goverdhan Lalan v. State Bank of Travancore*[37] in which the court has stated that principle of subrogation is not only subject to the contract of guarantee but also the principle of natural justice. In lieu of the same the court has pointed out that the language of Section 140[38] of the Contracts Act of India holds that the guarantor is *invested with all rights of the creditor against the debtor. There exists to need of transfer in this case.*

The pertinent question which arises here is whether the guarantor under Insolvency and Bankruptcy Code, 2016 is liable to bring CIRP proceedings against the debtor? The answer was given in the case of *Davinder Ahluwalia and Ors. v. Sumit Aviation,*[39] where the personal guarantors of the defaulter company paid 1.05 crores to Punjab National Bank. The principle of subrogation placed the guarantor in the shoes of the creditor. The company again defaulted in paying the guarantors the amount paid towards absolution of the debt created in exchange of paying the amount owed by *MS Sumit Aviation*.[40] The guarantors then approached NCLT under Section 7 of the IB Code. The Tribunal then allowed the Corporate Insolvency Resolution proceedings against the principal debtor as the debtor did commit a default by not paying an amount.

WELCOME DEVIATION FROM THE SICA PRACTICES

The Sick Industrial Companies Act, 1985 of India was introduced for timely detection and rehabilitation of Sick Industry Units. These industries were mentioned under the schedule of *Industries (Development and Regulation) Act, 1951*.[41] The long title suggests that the board was

[36] Ibid.
[37] Amrit Lai Goverdhan Lalan v. State Bank of Travancore, 1968 AIR 1432.
[38] The Indian Contract Act, 1872 act No. 9 OF 1872, S. 140.
[39] Davinder Ahluwalia and Ors. v. Sumit Aviation, IB No. (IB)-229 (ND)/2017.
[40] Ibid.
[41] TCL, 'Provisions of SICA, particularly Section 22 prevails over the provisions for recovery of debts in the RDDB Act' (*TCL*, 5 November 2017) < http://www.tcl-india.net/node/281> last accessed at 5 November 2017.

made to take preventive, ameliorative, remedial and other measures to secure the Sick Unit from liquidation.

Under the SICA regime if a sick company was going through any of the above mentioned rehabilitation procedure then the proceedings under any other forum was suspended. Similarly, KSL *& Industries Ltd., vs Arihant Threads Ltd., & Ors*.[42] Interpreted the law in a purposive manner which created a scenario where if a case proceeding is going on in front of BIFR under the SICA Act then no proceedings in front of any court or tribunal was to be carried.[43] The barring provision took away the rights of creditors to initiate proceedings for *recovery of debts* as such proceedings could only be done with prior permission of BIFR. Though there was no direct mention of barring the jurisdiction of DRT, section 22(1)[44] of the SICA Act which came into force in the year 1985 in contrast to RDDBF Act being made applicable in the year 1993. The wordings of Section 34(2) of RDDBF Act state that "*The provisions of this Act or the rules made thereunder shall be in addition to, and not in derogation of … the Sick Industrial Companies (Special Provisions) Act, 1985".*[45] Due to the presence of the words *"not in derogation of"*[46] gave the judge a scope for purposive interpretation. This shows that SICA prevailed over RDDBFI Act.

As pointed out in the case of *V. Ravi Srinivasan v. Manipal Finance Corporation Limited*[47] such a practice gave rise to a problem as the creditor was not only not allowed to institute to proceedings against the principal debtor but also the guarantor.[48] Once a proceeding under SICA was initiated then the promoters were able to conveniently escape their liabilities.[49] The stay on proceeding against the guarantor ensured that recovery of debt happened from the debtor company. Even in this procedure, priority was given to banks and financial institutions and second preference was

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[42] *KSL & Industries Ltd., vs Arihant Threads Ltd., & Ors*., Special Leave Petition (Civil) No. 5041 OF 2006

[43] Infolex, 'Reference to BIFR of sickness will halt proceedings before the DRT' *(Induslaw,* 5 November 2017), http://www.manupatrafast.in/NewsletterArchives/listing/Induslaw/2014/DECEMBER%202014%20--%20REFERENCE%20TO%20BIFR%20OF%20SICKNESS%20WILL%20HALT%20PROCEEDINGS%20BEFORE%20THE%20DRT.pdf> last accessed at 5 November 2017.

[44] The Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (51 of 1993) S.22 (1).

[45] The Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (51 of 1993) S. 34 (2).

[46] SCC Online, 'Section 22 of SICA prevails over the provisions of recovery of debts in the RDDB Act' (*The SSC Online Blog,* 5 November 2017) <http://blog.scconline.com/post/2014/11/05/section-22-of-sica-prevails-over-the-provisions-of-recovery-of-debts-in-the-rddb-act/> last accessed at 5 November 2017.

[47] LAWS(MAD)-2002-9-18

[48] Ibid.

[49] B. Yerram Raju, 'Our decrepit debt recovery system' *The Hindu,* (India, 19 August, 2015).

paying the worker companies. Any other creditor was supposed to stand patiently in que waiting for his turn to arrive.

Interestingly, the same type of treatment was not accorded to "security" provided by the principal debtor. The landmark judgement on this topic is *Haryana Telecom Ltd. Aluminum Industries Ltd.*[50] the court here held that the bank guarantee (provided as security) by the company cannot be looked at as the property of a company merely because encashment of the same would be covered by the phrase of "execution, distress or the like" as stipulated under Section 22(1) of the Sick Industrial Companies Act.

SICA was made ineffective by bringing in the Sick Industrial Companies (Special Provisions) Repeal Act, 2003 on December 1, 2016.[51] This was done by bringing into action Section 4(b) of the "SICA Repeal Act". Even though still not notified the IB Code sufficiently covers these ambits under Section 60(2). It specifically lays down that the Adjudicating Authority for Part III of the IB Code, 2016 is the Debt Recovery Tribunal. The only exception to this rule is that if an insolvency proceedings is in action against the principal debtor than an insolvency proceeding against the personal guarantor will also be filed in the NCLT.

CONCLUSION AND SUGGESTIONS

In the end of this research the researcher comes to the conclusion that the relationship between the Insolvency and Bankruptcy Code, 2016 and the liability of a guarantor is somewhat unclear and confusing on some fronts. The liability of the guarantor arises by virtue of default committed by the principal debtor also known as corporate debtor under this insolvency regime. The liability of a corporate debtor can only be ascertained when a petition requesting Insolvency proceedings against the corporate debtor is filed under Section 7 of the IBC, 2016 The creditor in this case has the option of approaching the guarantor to pay off the debt.

Confusion Number 1 arises as, if the in one scenario the debtor has to approach NCLT to determine the existence of the debt in the other scenario he can approach the guarantor of the corporate debtor to pay off the debt without even determining the fact whether a default has occurred or not.

[50] Haryana Telecom Ltd. v. Aluminum Industries Ltd. AIR 1964 Raj 76 (77).

[51] Mani Gupta, 'Repeal of SICA' (*Indicorplaw,* 5 November 2017) <https://indiacorplaw.in/2016/11/repeal-of-sica.html> last accessed at 5 November 2017.

Confusion number 2, based on the above mentioned decisions of Courts and Tribunals read along with the IBC, 2016 two points come forward.

(a) No proceedings for debt recovery can be initiated against a corporate debtor when the Moratorium is in process, and

(b) No proceedings against the guarantor of a corporate debtor would come into play as it would create a charge on the property.

This scenario means that the creditor will have to postpone his remedies. On the contrary, apex court has rightly observed in the case of *Industrial Investment Bank of India Lt. v. Bishwanath Jhunjhunwala*[52] that the whole objective of guarantee is defeated if the creditor is asked to postpone his remedies.

Confusion Number 3, the rights available to a creditor to proceed against the personal guarantor of a corporate debtor are many fold. He can either go to DRT, solely for the purpose of debt recovery, or he can file insolvency proceedings against the personal debtor. Which one of the two is to be approached?

One good thing that has happened with the arrival of Insolvency and Bankruptcy Code, 2016 is that the practice of SICA was overhauled and the current regime though not very clear looks to be guarantor friendly unlike the last regime which was solely creditor friendly.

The researcher suggests that the courts should proceed to solve this problem with a holistic approach rather than just disposing off the matter at hand. If the same is not done, then a web of precedents, all of which are correct in their own ambit would make up a not so justiciable world. Since IBC, 2016 is new the same shall be read in consonance with all the other statutes at hand. Even though IBC, 2016 creates an overriding effect under Section 238 of the code, it is best that confusion of any sort is avoided as only clarity in law informs the other person of their boundaries and the manner of their conduct. Otherwise innocent people would be punished as the maxim of *ignorentia juris non excusat* would be applicable on them.

[52] Industrial Investment Bank of India Lt. v. Bishwanath Jhunjhunwala, Civil Appeal No. 4613 OF 2000.

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