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CAN A FINANCIAL CREDITOR INITIATE A CORPORATE INSOLVENCY RESOLUTION PROCESS AGAINST A CORPORATE GUARANTOR?

Introduction

1. A financial creditor may file an application before the Adjudicating Authority (National Company Law Tribunal - NCLT) when a default has occurred for initiating Corporate Insolvency Resolution Process (“CIRP”) against a corporate debtor under Section 7 of the Insolvency and Bankruptcy Code, 2016 (“IBC”).
2. Whether the ‘corporate debtor’ in Section 7 of IBC would mean and include a corporate guarantor as well and whether CIRP can be initiated against the guarantor in respect of payment of an amount due where the principal borrower has defaulted has been deliberated upon.

The legal position

1. “Corporate debtor” is any corporate person who owes a debt to any person (section 3(8) of IBC) whereas a debt is a liability in respect of a claim which is due from any person (section 3(11) of IBC).
2. Default also similarly means non-payment of the debt which has become due and payable and has not been so paid by the debtor or the corporate debtor (Section 3(12) of IBC).
3. Although “corporate guarantor” has not been specifically defined in IBC, Section 5(22) defines a “personal guarantor” as an individual who is the surety in a contract of guarantee to the corporate debtor.
4. Therefore, the intent of the legislature needs to be construed to ascertain whether NCLT is the proper forum and CIRP a proper proceeding for adjudication of a dispute between a lender and a guarantor.
5. The issue of whether the definition of corporate debtor under IBC would include guarantor of the corporate debtor in relation to the specific claim or the cause of action has been the subject matter of discussion in various recent decisions.

Judicial Pronouncements

A. Laxmi Pat Surana vs. Union Bank of India (2021) 8 SCC 481

1. In *Laxmi Pat Surana*, the financial creditor demanded repayment of the outstanding dues from the principal borrower as well as the guarantor in respect of a loan that was availed of by the principal borrower.
2. The principal borrower was a proprietorship firm against which CIRP proceedings cannot be initiated before the NCLT within the scope of Section 7 of IBC.
3. On the failure of the principal borrower to make the payment, the financial creditor proceeded against the corporate guarantor under Section 7 of IBC.
4. The guarantor essentially contended that it was not liable to make the payment as it did not owe any debt to the financial creditor and further that it was not a “corporate debtor” and hence, an application under Section 7 of IBC would not lie against the guarantor.
5. NCLT rejected such contention and held that the guarantor was coextensively liable to repay the dues of the principal borrower.
6. An appeal was filed before the National Company Law Appellate Tribunal (“NCLAT”) which affirmed the view of the NCLT.
7. Against the NCLAT decision, the guarantor filed an appeal before the Supreme Court where the following observations were made:
 - Under Section 7 of IBC, the corporate debtor may be the principal borrower as well as the guarantor who assumes the status of a corporate debtor as soon as the principal borrower commits the default.



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- Under Section 5(8)(i) of IBC, the claim of a financial creditor would include the liability in relation to a guarantee offered by a corporate person which would thus also cover the right of the financial creditor to proceed against a corporate person who stands as a guarantor against any default in of the principal borrower in relation to the specific terms of the contract/transaction entered into between the lender (financial creditor) and the principal borrower.
 - The amendment of 2018 to IBC introduced Section 5(5-A) which defines the expression corporate guarantor. Within the scope of such definition, it cannot be held that the intent of the legislature was to extricate the guarantor of its liability that arises in case of default by the principal borrower.
 - Section 128 of the Indian Contract Act, 1872 provides that the obligation of a guarantor is coextensive with the principal borrower. Such meaning can also be read in the context of provisions of IBC.
8. The Court also relied on the Insolvency Law Committee Report, 2020 which provided that a creditor may proceed either against the debtor or the surety or both jointly.
 9. The appellant had raised the argument of whether CIRP proceedings can be initiated against a corporate guarantor where the principal borrower was not a corporate person (proprietorship firm in this case). The Court relied on Section 3(7) of IBC which extends the scope of the definition of corporate person to other statutes as well, which define the role of a guarantor. The Court held that within the meaning of Section 3(7), a guarantor could certainly be regarded as the corporate debtor even when the principal borrower is not a corporate person.
 10. It was held that the liability of the guarantor is joint and severable with the principal borrower and hence the creditor has the right to proceed against the principal borrower and the guarantor in equal measure and such right gets triggered as soon as the principal borrower defaults in repayment of the dues.
 11. The Court also held that the purpose of a Section 7 application under the IBC is not recovery of dues but insolvency resolution of a corporate debtor who is unable to pay off its debts. Thus, the guarantor or the principal borrower have the option of repayment of the debt to avoid CIRP proceedings.

B. *K. Paramasivam vs. Karur Vysya Bank Ltd. (2022 SCC OnLine Sc 1163)*

1. In *K. Paramasivam*, the same issue was raised by the corporate guarantor when the financial creditor filed a Section 7 application against the guarantor. The Supreme Court relied on the observations and decision in *Laxmi Pat Surana* and held that the three-judge bench decision would be binding.
2. Here, again the Court held that CIRP proceedings can be initiated against a corporate entity who has given a guarantee securing the dues of the lender. Once the borrower commits default, the guarantor becomes the corporate debtor and Section 7 would accordingly become applicable. The Court also held that it was open to the financial creditor to proceed against the guarantor without first suing the principal borrower.

C. *Mahendra Kumar Jajodia vs. State Bank of India (2022 SCC OnLine SC 908)*

3. In *Mahendra Kumar Jajodia*, the Supreme Court dismissed the appeals on a similar question against the decision of the NCLAT holding that for the purpose of CIRP or liquidation proceedings, corporate persons would include corporate debtors and personal guarantors. The Supreme refused to entertain the appeals since it found no reason to set aside the decision of the NCLAT.

Conclusion

Thus, the courts have clearly held that a corporate guarantor may be treated as a corporate debtor for the purposes of Section 7 of the IBC irrespective of whether the principal borrower is a corporate entity or not and also irrespective of whether the financial creditor has first sued the principal borrower.