

Business Standard

Guaranteeing personal guarantees

Through its recent judgment the apex court has rescued the institution of surety

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In a landmark judgment on November 9, the Supreme Court disposed of a batch of 384 petitions (Dilip B Jiwrajka vs Union of India & Others), affirming the constitutionality of provisions in the Insolvency and Bankruptcy Code (IBC) related to the insolvency resolution of personal guarantors to corporate debtors (PGCDs). This decision should expedite the disposal of over 2000-plus applications pending with the Adjudicating Authority for initiation of insolvency resolution of PGCDs, with an underlying debt of Rs 1.64 trillion. This is also likely to open the floodgates for similar applications from creditors who have been waiting in the wings for years.

This may not happen if fresh petitions emerge, challenging some other provision relating to PGCDs, as history suggests. Some of the recently disposed-of 384 petitions emerged within six months of the disposal of a similar batch (*Lalit Kumar Jain vs. Union of India & Others*) in 2021, where the Supreme Court upheld the notification bringing into force the provisions relating to PGCDs. Notably, every substantive IBC provision concerning corporate debtors (CDs) and PGCDs,

including amendment Acts, has faced constitutional challenges at the highest court. However, the IBC has thus far emerged unscathed.

The deluge of petitions emanates primarily from the hesitation to repay debts when due. Though the IBC is not for recovery of debt, the process triggers on failure to repay a threshold amount of debt. Under the law, the liability of a PGCD is co-extensive with that of the CD. Since both are jointly and severally liable to repay the debt along with interest, the creditor may trigger an IBC process either against the CD and/ or the PGCD.

The IBC process has consequences for the promoters, who are typically PGCDs also. On commencement of the process, the CD moves away from the possession and control of the promoters. If the process yields a resolution plan, the CD most often moves further to a resolution applicant, as the existing promoters may either be ineligible to submit a resolution plan or fail to submit the most competitive resolution plan. If it yields liquidation, the CD disappears. In either case, the CD does not remain with the existing management and promoters.

Let us see the kind of stake involved. Till September 2023, about 3,000 CDs, who owed in aggregate Rs 22 trillion to creditors, have completed the corporate insolvency resolution process. The resolution plans and liquidations have realised 32 per cent and 4 per cent, respectively, of the amount due to creditors, with an average haircut of 84 per cent. It is natural for the creditors to explore further realisations from the PGCDs.

The insolvency resolution process for PGCDs facilitates negotiation of a repayment plan, under the supervision of a resolution professional. Upon the failure of the plan, the parties are entitled to initiate a bankruptcy process. This process entails the sale of the assets of the PGCD, leaving a single dwelling unit of value up to Rs 10 lakh in rural areas/ Rs 20 lakh in urban areas, and some other essential assets.

Until the process is complete, the PGCD suffers from certain disqualifications, such as acting as a public servant or being elected to a public office. These provisions are, however, benign compared to those in the erstwhile individual insolvency enactments.

The IBC process requires retrieving the value lost by the CD as well as the PGCDs through irregular transactions. This occasionally invites legal action against the promoters/ PGCDs. Some promoters-cum-PGCDs, who have defaulted, or wish to default, have been repeatedly challenging different IBC provisions, on some excuse or another, to evade the IBC process and its consequences. The resolution of PGCDs is crucial for various reasons. First, a CD may seek credit to commence a business. A creditor, however, may not extend credit to such a CD, as it is yet to

have a business. It may be willing to extend credit if promoters guarantee to repay it if the CD gets into stress. If recourse to the guarantors is not available, the guarantee loses meaning and significance. No creditor would lend on a guarantee; consequently, both business and credit markets would suffer.

Second, the resolution of the CD is intertwined with that of its PGCDs. The decision to liquidate or rescue a CD has a bearing on the repayment plan and vice versa. The PGCD would not have recourse to the CD if it has to repay the debt after the IBC process liquidates the CD or the CD changes hands. Third, it is discriminatory if only corporate guarantors undergo the IBC process, while PGCDs do not. As a result, creditors will demand corporate guarantees, while promoters will supply personal guarantees.

In Lalit Kumar Jain, the PGCDs contended that they are individuals. The notification extending the IBC process to PGCDs only and not to all individuals is ultra vires. They also contended that the approval of a resolution plan of CD was a discharge of their liabilities. Disagreeing with their contentions, the Supreme Court upheld the notification.

In Dilip B Jiwrajka, the PGCDs attacked the constitutionality of the IBC process for PGCDs. The process envisages a resolution professional (RP) to examine the insolvency application and, based on the same, to submit a report to the Adjudicating Authority, recommending the acceptance or rejection of the application. The law is considered flawed as it does not explicitly require the RP to observe the principles of natural justice (PNJ). The apex court did not find a need for PNJ since the RP is only a facilitator. While upholding the constitutionality, it, however, read the requirement of PNJ into the statute for accepting/rejecting the application.

IBC serves as a “swachhta” drive, making non-repayment of debt an untenable option. Ownership of a CD is no longer a “divine” right and “unclean” hands cannot retain it through resolution plans. Nor can PGCDs avoid their personal liability. The outcome is evident in a shift in debtor behaviour, as evidenced by a decline in the NPA of banks from 14.8 per cent in September 2018 to 3.9 per cent by March 2023. The best use of the IBC is not using it at all!

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