ILLUSTRATION: BINAY SINHA

What is a personal guarantee really worth?

Beyond the face value of the promise, recovery, incentives and the counterfactual matter

The numbers are startling. Claims of ₹22,000 crore against a personal guarantor, set against a repayment plan of ₹6 crore. At first sight, the arithmetic seems to tell a simple story: A personal guarantor has walked away from thousands of crores of debt by paying virtually nothing. But this conclusion rests on an incomplete appreciation of what a personal guarantee is. This piece confines itself to that question, leaving for another day the merits of the matter, once it is decided by the five-member Bench of the Adjudicating Authority.

A guarantee is a commitment by a person to meet an obligation if the principal debtor fails to do so. It creates a personal liability without, by itself, creating a pool of assets against which that liability is secured. Suppose a promoter gives a personal guarantee for ₹10,000 crore in corporate borrowing. The guarantee may make the promoter personally liable for the entire amount. But if, when the guarantee is enforced, the promoter has only ₹50 crore of unencumbered, realisable assets, the guarantee cannot magically produce ₹10,000 crore. The insolvency process can distribute only what can actually be realised from the guarantor's estate. Hence, a repayment plan must be assessed against the resources of the guarantor and the alternatives available to creditors, and not against the face value of the guarantee.

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There is another point that is easily lost in the public debate. A repayment plan of the personal guarantor addresses the guarantor's liability. It does not mean that the underlying corporate borrowing was itself ₹22,000 crore borrowed personally by the guarantor and that ₹22,000 crore of lender money has simply disappeared in exchange for ₹6 crore. The corporate borrowers remain relevant to the creditor's overall recovery. The lender may have security over corporate assets and may have recourse against other guarantors, depending on the structure of the transaction and applicable law. Accordingly, the recovery from one source of liability must be distinguished from the recovery of the underlying debt as a whole.

Therefore, every shortfall is not a "haircut". If a lender has a ₹10,000 crore claim against a corporate borrower and ultimately receives ₹6,000 crore, calling the ₹4,000 crore shortfall a haircut may be appropriate. However, if the lender has a ₹10,000 crore claim against a guarantor whose entire realisable estate is worth ₹100 crore, then it is misleading to say that the lender has "given up" ₹9,900 crore merely because the guarantor's repayment plan provides ₹100 crore. The relevant question cannot be how much was claimed but how much could reasonably have been recovered.

Consequently, a repayment plan should not be judged by comparing its payout with the face value of the guarantee. The right benchmark is the recovery that creditors could reasonably expect from the guarantor's estate under the available alternatives. If rejection of a plan leads to bankruptcy but produces no greater realisation, rejecting the plan does not make creditors richer. It may simply replace a low recovery with an even lower one after additional cost and delay. That does not mean that every low-value repayment plan deserves acceptance. It means that the counterfactual matters.

None of this diminishes the importance of personal guarantees to credit markets. It provides an additional means of recourse. The lender is no longer confined to the corporate debtor and its assets. Depending on the circumstances, there may also be collateral, other guarantors and other sources of recovery. More importantly, a personal guarantee works before default occurs. A promoter who knows that failure of the company may expose personal wealth to creditor claims has a different incentive from a promoter who bears no such exposure. The guarantee discourages excessive risk-taking, mitigates moral hazard, and aligns the promoter's interests more closely with those of the lender and the company. Thus, a guarantee has two kinds of value. Its ex-post value is the additional recovery it can provide after default. Its ex-ante value is the discipline it creates before default. The second can be substantial even when the first ultimately turns out to be small.

A ₹10,000 crore guarantee from a person with ₹10,000 crore of readily realisable, unencumbered assets is obviously a very different proposition from a ₹10,000 crore guarantee from a person whose net realisable wealth is only ₹100 crore. The legal liability may be identical. The economic value of the guarantee is not.

This has an important implication for how guarantees should be assessed. A lender should ask what the guarantor's net worth is, how much of it is liquid and readily realisable, how much is already encumbered, and what other guarantees and liabilities exist. It should also consider potential competing claims, the guarantor's income and future capacity to pay, and, above all, what would actually be available if the guarantor were to enter insolvency. These questions are most valuable when asked at the time of sanction, when the guarantee should be properly valued.

There is a lesson for promoters, too, simply because a personal guarantee is a legally enforceable commitment. Its value cannot be dismissed because the guarantor's present assets are insufficient to meet the liability. Depending on the applicable legal and insolvency framework, the guarantee may have consequences extending beyond the assets immediately available at the time of enforcement. A promoter who signs a personal guarantee is taking on genuine economic risk.

Time to value guarantees better. The larger lesson from this episode is, therefore, what a personal guarantee represents. A guarantee is not magic collateral; it is not meaningless paper either. It is simultaneously a risk-allocation mechanism, an incentive mechanism, and an additional source of recourse.

Its face value tells us the extent of the promise. Its recovery value depends on the assets and circumstances of the guarantor, and its incentive value may operate long before default. What that guarantee was actually worth, before distress and after distress, therefore, becomes the right question. It is by that measure that personal guarantees should be understood, priced and judged.

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