Extinguishing Guarantees: Dilemma of Dissenting Financial Creditors under the IBC, 2016

The IBC nowhere puts an embargo on the creditors to recover their dues (apart from what has been received under the Resolution Plan) from the guarantors of the Corporate Debtor (CD). Further, the Supreme Court in the case of SBI vs. V. Ramakrishnan and Ors. has observed that simultaneous proceedings can be initiated against both - the principal borrower and the guarantors. However, what will be the way-out for dissenting creditors, if the CoC, in exercise to its commercial wisdom under the IBC, approves the Resolution Plan extinguishing Personal Guarantor (s) to the Corporate Debtor from all its liabilities? As hair cut is order of the day in insolvency processes, is it justified to bar dissenting creditors from initiating insolvency proceedings against the Personal Guarantors? In light of various judgments of NCLAT and the Supreme Court, the authors have deliberated upon this crucial issue, highlighted practical difficulties and suggested remedies. ***Read on to know more…***

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Insolvency and Bankruptcy Code, 2016 (IBC) was enacted with the objectives of resolving the insolvency of a corporate person in a time-bound manner by maximizing the value of assets of such persons, promoting entrepreneurship, availability of credit, and balancing the interest of all the stakeholders. The proceeding under the IBC aims to resolve the insolvency of the company and not to recover the dues of the creditors.[1] This is further supplemented by the fact that the creditors in the resolution process usually take haircuts in realization of their dues. The IBC nowhere puts an embargo on the creditors to recover their dues (apart from what has been received under the Resolution Plan) from the guarantors of the Corporate Debtor (CD). In fact, the Supreme Court in the case of *SBI vs. V. Ramakrishnan and Ors.*[2] has observed that simultaneous proceedings can be initiated against both - the principal borrower and the guarantors, under the IBC realizing the coextensive nature of the contract of guarantee under the Indian Contract Act, 1872.

This has been further reiterated by the Supreme Court in the case of *Lalit Kumar Jain vs. Union of India*[3] which

1. Ravi Iron Ltd. v. Jia Lal Kishori & Ors. (Civil Appeal No. 3068 of 2022) & S.S. Engineers & Ors. v. Hindustan Petroleum Corporation Ltd. (Civil Appeal No, 4583 of 2022).
2. 2018 (17) SCC 394; Civil Appeal No. 4553 of 2018.
3. Transfer Case (Civil) No. 245/2020 at 111.

provides that the approval of the Resolution Plan does not ipso facto release the Personal Guarantor to Corporate Debtor (PG to CD) from their liability under the contract of guarantee thereby implying that the right to recover the balance dues of the creditors remains and does not get extinguished once the plan is approved. Furthermore, it is to be noted that a sanctioned Resolution Plan cannot be construed as a variation in terms of the contract between the principal borrower and creditor, thereby discharging surety from the liability as per Section 134 of the Indian Contracts Act.[4]

In this regard, there have been instances wherein under the resolution plan, the right of recovery against the personal guarantors arising out of the guarantee contract was curbed at the instance of the assenting financial creditors (AFCs).[5] The moot question that arises here is "whether an approved Resolution Plan can contain a clause for extinguishment of security interest owned against corporate guarantor/personal guarantor/third party for recoveries and if yes, what is the fate of rights of the dissenting financial creditors (DFCs) who have not approved such extinguishment?" The issue has been deliberated and discussed at length at multiple forums including the Supreme Court and NCLAT.

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In the case of *SVA Family Welfare Trust & Anr. vs. Ujaas Energy Ltd. & Ors.*[6] , the NCLAT has observed that the security interest of the DFC by virtue of the personal guarantee of the ex-director can be dealt with in the Resolution Plan. The appeal in the instant case was filed by the Successful Resolution Applicant (SRA) whose Resolution Plan was rejected by the Adjudicating Authority (AA) on the ground that the Committee of Creditors (CoC) under the garb of the Resolution Plan cannot release the personal guarantee by receiving a consideration in lieu of such relinquishment and thus, the Resolution Plan was stated to be in violation of Section 30(2)(e) of the IBC. Further, the Appellate Tribunal (NCLAT) also observed that the use of expressions 'per se' and 'ipso facto' in the judgement of *Lalit Kumar Jain vs. Union of India*[7] indicates that the approval of a Resolution Plan does not extinguish the liability of the Personal Guarantors from their obligations to the creditors. It was further observed that the use of such expressions also indicates that there might be certain situations where some relevant clauses in the Resolution Plan can be inserted to discharge the liability of the personal guarantors. Lastly, reversing the order of the NCLT and basis Regulation 37(d) of CIRP Regulations (which provides for satisfaction or modification of any security interest under a Resolution Plan)[8] , it held that the decision of the CoC to accept the value for relinquishment shall be considered as commercial wisdom which cannot be challenged. This reasoning of the Appellate Tribunal was upheld by the Supreme Court in the case of *Bank of Baroda vs. Ujaas Energy Limited & Ors.*[9]

Thereafter, the above issue was deliberated again by the NCLAT in the matter of *Puro Naturals JV vs. Warana Sahakari Bank and Ors.*[10] In the instant case, the Resolution Plan provided for the extinguishment of securities and personal guarantees for consideration to the secured creditors without the consent of DFC. The NCLAT observed that the plan envisaged that after payment of a certain amount, the debt of Secured Financial Creditors would stand assigned to SRA and that the securities and guarantees would get extinguished. It was further observed by the Appellate Tribunal that the plan was well deliberated by the CoC before approval and that it had consciously dealt with securities and personal guarantees given to Financial Creditors (FCs) including that of DFCs. The NCLAT referred *SVA Family Welfare Trust & Anr. v. Ujaas Energy Ltd. & Ors*[11] and held that the extinguishment of securities and personal guarantee in the resolution plan is in compliance with Section 30(2)(e) of the IBC.

Although, the above judgements have answered the moot problem raised by the authors, the plight of DFCs

4. Gouri Shankar Jain Vs. Punjab National Bank & Anr, W.P. No. 10147 (W) of 2019 at ¶35.
5. Naveen Kumar Sood RP of Ujaas Energy Ltd, IA/190(MP)2021 & IA/165(MP)2022 in CP(IB) 9 of 2020.
6. Company Appeal (AT) (Insolvency) No. 266 of 2023.
7. Supra Note 3.
8. The Insolvency and Bankruptcy (Corporate Insolvency Resolution Process) Regulations, 2016, Regulation 37(b)
9. Civil Appeal No. 6602 of 2023.
10. Company Appeal (AT) (Insolvency) Nos. 651, 661-663 and 1005 of 2023.
11. Supra Note 6.

continues to exist, whose fate to recover their dues remains at the mercy of AFCs, which are as follows:

"In light of judgements on the issue of Extinguishing Guarantees, Dissenting Financial Creditors (DFCs) are likely to be in an adverse situation wherein they receive less/zero amounts from the guarantors."

1. As a potential impact of the above judgments, the DFCs are likely to be in an adverse situation wherein they receive less/zero amounts from the guarantors. This is because they will not have any recourse to invoke guarantees (be it corporate guarantee or personal guarantee) on account of commercial wisdom exercised by the AFCs. The authors opine that AFCs cannot be allowed to infringe upon the payment rights of the DFCs, which undermines the interest of DFCs, thereby derailing from one of the objectives of the IBC which is to balance the interest of all stakeholders. Furthermore, as evident from both the cases referred to above, the plan value is much lower in comparison to debts of the Secured Financial Creditors (SFC). In the event of distribution, the SFCs will not get their full dues realized as the payments such as CIRP cost, and payment to Operational Creditors (including workmen dues, as in the event of liquidation) shall take priority. Thus, curbing the right to recover its balance dues from the guarantors seems unjustified on the part of AFCs.

2. The legal right to pursue against either of the parties (principal borrower and guarantor) cannot be allowed to be waived/extinguished merely through the purported commercial wisdom of CoC. The extinguishment of the guarantee deprives a creditor (DFC in particular) of their *right to payment* without their consent which has been conferred under Section 128[12] of the Indian Contract Act which provides that the liability of the guarantor and the borrower is co-extensive. In this regard, the Supreme Court in the case of *Maharashtra State Electricity Board, Bombay vs. Official Liquidator, High Court, Ernakulam*[13] has held that even if the principal borrower of the loans has gone into liquidation, the same shall not affect the liability of the guarantor. Thus, a resolution plan absolving the guarantors of their liability is prejudicial to the interest of creditors who, on the security provided by the guarantor, had extended the loan, especially when dissenting to approve such a plan.

3. Ideally, the commercial wisdom of the CoC should be confined to matters exclusively pertaining to the CD and such authority cannot be exercised to overstep such boundaries to extinguish the liability arising out of the contract of guarantee. NCLAT in the case of *UV Asset Reconstruction Company Limited vs. Electrosteel Castings Limited*[14] while dealing with the issue raised by the Appellant that *"whether debt of personal guarantor or third party which arises out of different contract shall also automatically extinguished after approval of the resolution plan"* has stated that extinguishment of debt post approval of the plan has to be qua the CD only and cannot be stretched to include extinguishment of debts guaranteed by third party.

"Assignment of debts of the financial creditors under the Resolution Plan to the SRA with/without any consideration, would also hinder the right of DFCs to recover their balance dues separately."

4. Further, the authors are of the opinion that the assignment of debts of the financial creditors under the resolution plan to the SRA with/without any consideration, would also hinder the right of DFCs to recover their balance dues separately. Also, as a matter of fact, the assignment of loans is a form of contract that has to satisfy the principles of the Indian Contract Act, 1872. The plan providing for the assignment of all the debts of the FCs including that of DFCs will lack consensus ad idem and violates the basic principle of the Contract Act, i.e., mutual consent, which affects the plan compliance with Section 30(2)(e) of the IBC. Moreover, NCLAT in *Vikas Agarwal vs. Asian Colours Coated Ispat Limited*[15] has upheld the plan which provided for the assignment of debt to the SRA excluding the right to

[12] The Indian Contract Act, 1872, § 128, No. 9, Acts of Imperial Legislative Council (1872) (Ind.).

[13] AIR 1982 SC 1497.

[14] Company Appeal (AT) (Insolvency) No. 975 of 2022.

[15] Company Appeal (AT) (INS.) No. 1104 of 2020.

go against the guarantors separately by the Financial Creditors and has observed that retaining such right shall not be in violation of Section 30(e) of the IBC or Section 6(e) of the Transfer of Property Act, 1882.

5. Also, according to Section 134 of the Indian Contract Act, the liability of the guarantor gets discharged if the creditor himself discharges the principal borrower from the liability. The key ingredient of Section 134 is the discharge of the debtor/ principal borrower through a voluntary act of the creditor and not due to the operation of law.[16] Thus, any scheme or resolution plan becomes a statutory scheme once it gets approval from the NCLT and is therefore considered an act of operation of law.

6. Furthermore, the authors are of the opinion that the effect of Regulation 37(d) of the CIRP Regulations should be confined only to the security interest that is given by the CD for the benefit of the third parties and not for the securities given for CD. If the same is not restricted, the right to proceed against the guarantors under the IBC or any other recovery legislations may become impracticable, contradicting the judgement of the Supreme Court in the case of *SBI vs. V. Ramakrishnan.*[17]

7. Furthermore, if it is deemed that the interests of the DFCs can be curtailed for a larger economic benefit, one must consider the other objective of the IBC, which emphasizes balancing the interests of all stakeholders. The doors for creditors who did not assent to such extinguishment/assignment are completely shut from recovering the amount from the guarantors which does not balance the interest of the DFCs with that of AFCs. Thus, it should be impermissible for AFCs to interfere with the payment rights of DFCs which could compromise the interests of the latter.

8. Moreover, curtailing the right to recover dues from guarantors will impair another objective of the IBC, i.e., to improvise the availability of credit. In India, lenders predominately provide loans after obtaining a guarantee from the promoters. Furthermore, NCLAT in the case of *Vikas Agarwal vs. Asian Colours Coated Ispat Limited*[18] has also observed that "the IBC is not for resolution of PG, and it may not be out of context to note that the financial creditors sanction huge credit facilities to the CD based on several protections including personal guarantees of the promoters". The Appellate Tribunal also observed that "resolution of debts is only to the extent of obligations against the Company, and this will not take away the rights of the financial creditors to proceed against the PGs"[19]. Therefore, if something under the resolution plan prohibits/ bars a lender from recovering the loan (option of recovering from guarantors in case of default), they may be hesitant to provide the loans in future, which may adversely impact on overall credit ecosystem thereby defeating the objective of the IBC.

"NCLAT in the case of *Vikas Agarwal vs. Asian Colours Coated Ispat Limited* observed that resolution of debts is only to the extent of obligations against the Company, and this will not take away the rights of the financial creditors to proceed against the PGs."

9. Also, it is to be considered that Section 29A (h) of the IBC debars a person to be a resolution applicant if he/ it has extended a guarantee to the CD against which an insolvency application has been admitted and such guarantee is invoked and remained as unpaid either in full or in part. This indirectly implies that the IBC originally envisaged payment of full amounts by the guarantors. An artificial extinguishment and free exit to contracting parties without fulfilling their contractual liabilities[20] by Resolution Plan goes against the spirit of the IBC. Thus, such a right cannot get extinguished under the resolution plan for a nil amount or for some consideration over and above the plan value which has been agreed by the AFCs.

10. One of the possible outcomes of extinguishing the liability under the Resolution Plan is that it might negate the effect of Section 32A of the IBC, which does not bar any action to be taken against the person apart from the CD or the SRA, as the cause (i.e., liability under the guaranteed agreement) will not

16. Prashant Shashi Ruia vs. State Bank of India, R/Special Civil Application No. 11199 of 2019.

17. Supra Note 2.

18. Supra Note 15 at 88.

19. Ibid at 50.

20. Ibid at 49.

subsist post extinguishment. Additionally, Section 14 of the IBC which provides for moratorium to the CD does not protect the guarantors during such period. By virtue of extinguishment of liability under the plan, the judgement provides protection to the guarantors, what otherwise they would not have had such clause for extinguishment was not provided under the plan.

11. Further, the authors understand that the judgement does not cover the situation wherein the majority members in the CoC are unsecured or are private parties (corporates) who might vote for such extinguishment/assignment with/without receiving any consideration against such extinguishment/ assignment which can leave the DFC remediless.

12. Conclusively, the extinguishment or effacement of third-party security held by the creditors under the Resolution Plan raises serious concerns about the fairness of the process. It is difficult to fathom why a Successful Resolution Applicant will take such a step and what benefit accrues to him by impinging on someone else's right.

Further, the authors are also aware of the judgements of the Supreme Court in the case of *Laxmi Pat Surana vs. Union Bank of India & Anr.*[21] as well as *Ebix Singapore Private Limited v. CoC of Educomp Solutions Limited & Anr*[22]. In the former, the court had emphasized that IBC is a self-contained law, and in the latter, the court had mentioned about the coercive mechanism of IBC wherein seeking recourse to the Contract Act would be antithetical to IBC. Summarizing, the court had said that the contractual principles and common law remedies, which do not find a tether in the wording or intent of IBC cannot be imported and remedies that are specific to the Contract Act cannot be applied de-hors the over-riding principle of IBC.

However, the coercive element in the aforesaid judgements is for participants inside the process for matters pertaining solely to the CD. Coercion cannot be applied to existing rights outside of the IBC.

"It is recommended that if the plan is providing either for extinguishment of liability of guarantors or for assignment of debts backed by a guarantee, without 100% approval of the CoC, such plan should be deemed as non-compliant under the IBC."

Considering the above arguments, it is to be understood that the Resolution Plan cannot extinguish the debt secured by a personal or corporate guarantee without obtaining 100 percent approval from the CoC. Therefore, it is recommended that if at all the plan is providing either for extinguishment of liability of guarantors or for assignment of debts backed by a guarantee, without the hundred percent voting of the CoC, such plan should be deemed as non-compliant under the IBC.

[21] Civil Appeal No. 2734 of 2020.

[22] Civil Appeal No. 3224 of 2020.