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Insolvency Law

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Supreme Court upholds the constitutional validity of the notification of provisions relating to insolvency and bankruptcy of personal guarantors

Introduction

On May 21, 2021 a two-judge bench of the Supreme Court of India in the case of ***Lalit Kumar Jain v. Union of India & Ors***.[1], upheld the constitutional validity of the notification bringing into effect certain provisions of the Insolvency and Bankruptcy Code, 2016 ("**Code**") with respect to personal guarantors of corporate debtors. In doing so, the Supreme Court recognised the legislative intent behind notifying the provisions of the Code in a staggered and selective manner.

Background

The Central Government vide its notification dated November 15, 2019 ("**Notification**") brought into force certain provisions of Part III of the Code, applicable only to personal guarantors to corporate debtors[2]. Additionally, by way of separate notifications, the Insolvency and Bankruptcy (Application to Adjudicating Authority for Insolvency Resolution Process for Personal Guarantor to Corporate Debtors) Rules, 2019 ("**Rules**") and the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Personal Guarantors to Corporate Debtors) Regulations, 2019 ("**Regulations**") were also brought into force. The Rules and Regulations provided the detailed mechanism permitting creditors to initiate insolvency proceedings against personal guarantors to corporate debtors. However, the judgment is confined to the constitutional validity of the Notification only.

Issues before the Supreme Court

The Petitioners challenged the *vires* of the Notification on the grounds that it suffered from the vice of excessive delegation, arbitrariness and non-application of mind. The Petitioners contended that the powers conferred upon the Central Government under Section 1(3) of the Code could not be interpreted as to allow it to selectively notify the provisions of the Code only as far as they relate to personal guarantors to corporate debtors and as such the Notification was *ultra vires* the proviso to Section 1(3) of the Code.

[1]Transferred Case (Civil) No. 245 of 2020 along with connected matters.
[2] The Notification brought into force Sections 2(e), 78, 79, 94-178, 239(2)(g), (h) & (i), 239(2)(m) to (zc), 239(2)(zn) to(zn) and 249.

The Petitioners contended that the Notification also did not bring into force Section 243 of the Code, which would have repealed the extant legislation governing personal insolvency. This created an anomalous situation where two regimes were applicable to govern the insolvency of personal guarantors – one under the Code, and the other under the Presidency Towns Insolvency Act, 1909 and the Provincial Insolvency Act, 1920.

The Petitioners also argued that once a resolution plan is accepted, the liability of the corporate debtor is discharged and consequently, so is the liability of the personal guarantor as it is co-extensive with that of the corporate debtor. The Notification took away this protection granted to the personal guarantors under Sections 128, 133 and 140 of the Indian Contract Act, 1872 — creditors could claim in the insolvency resolution process of the personal guarantor without accounting for the amount already recovered by them in the corporate insolvency resolution process of the corporate debtor.

Other contentions included (a) lack of a rational basis for singling out personal guarantors to corporate debtors, and (b) treating unequals equally by providing a single procedure for all creditors (financial or operational) for the insolvency resolution of a personal guarantor to a corporate debtor.

Findings of the Supreme Court

Authority of the Central Government to notify certain provisions: The Supreme Court rejected the Petitioners' contention that the Central Government has no authority to bring into force the provisions of the Code only insofar as personal guarantors to corporate debtors are concerned. The Supreme Court, after considering the dates on which various provisions of the Code were notified, observed that the Central Government had followed a stage-by-stage process of bringing the provisions of the Code into force, having due regard to the similarities and dissimilarities of the subject matter of the provisions and the objective of the Code.

Application of mind: The Supreme Court did not agree with the Petitioners that Section 2(e), dealing with application of the Code to personal guarantors to corporate debtors, which was amended to take retrospective effect, suffered from non-application of mind. The Supreme Court noted that there is sufficient indication in the Code, being Sections 2(e), 5(22), 60 and 179, that personal guarantors were to be dealt differently compared to other individuals.

Different Fora: The Supreme Court recognised the Parliament's intent to treat personal guarantors differently from other individuals due to the connection between personal guarantors and corporate debtors and the possibility of having two separate processes before two different fora i.e., the National Company Law Tribunal and the Debt Recovery Tribunal. Reliance was placed on the report of the Working Group[3] which recognized a nexus between a personal guarantor and a corporate debtor as opposed to individuals and partners in firms.

Additionally, Sections 234 and 235 (though not notified) reveal that the scheme of the Code always contemplated that overseas assets of a corporate debtor or its personal guarantor could be dealt with in an identical manner during insolvency proceedings.

As for the Petitioners' contention that the failure to notify Section 243 would result in a situation where insolvency proceedings against personal guarantors to corporate debtors could be initiated before different fora under different enactments, the Supreme Court observed that as a consequence of the *non obstante* clause in Section 238 of the Code, the Code has an overriding effect over other enactments in force for the time being.

[3] Constituted by the Insolvency and Bankruptcy Board of India ("**IBBI**") under the chairmanship of Mr. Amarjit Singh Chandiok, Senior Advocate and President, INSOL India, by an office order dated June 13, 2017, to recommend the strategy and approach for implementation of the provisions of the Code, dealing with insolvency and bankruptcy in respect of (i) guarantors to corporate debtors i.e. personal guarantors, and (ii) individuals having business, and submit a report along with the draft rules and regulations.

Therefore, insolvency proceedings against personal guarantors of corporate debtors would only be governed by the Code.

Liability of the personal guarantor not discharged: The Supreme Court held that sanction of a resolution plan and the finality of the same in view of Section 31 of the Code does not discharge the personal guarantor's liability since the same was because of an involuntary act i.e., by operation of law, liquidation or insolvency.

In its earlier judgement in ***SBI v. V. Ramakrishnan***[4] the Supreme Court had held that the guarantor cannot escape liability under Section 134 of the Indian Contract Act, 1872 since a resolution plan which has been approved may well include provisions for payments to be made by the guarantor. Therefore, approval of a resolution plan by itself does not discharge the guarantor of liability. This position was upheld by the Supreme Court once again.

The Supreme Court went on to hold that courts have time and again held that that the involuntary acts of the principal debtor leading to the loss of security does not absolve the liability of a guarantor. Therefore, the liability of the guarantor would continue, and the creditor can still realize the same from the guarantor in terms of Section 128 and 134 of the Indian Contract Act, 1872.

Conclusion

In upholding the constitutional validity of the Notification, the Supreme Court has adopted a pragmatic approach, choosing to give effect to the legislative intent behind the Code and the priorities set by the Code over a technical challenge to its provisions. The Supreme Court has also chosen to treat the drafting incongruities as not taking away from the overall object of the Code – a consistent trend that the Court has displayed when interpreting the Code's provisions, and more generally economic legislation.

Further, the Supreme Court appears to have cemented the liability of personal guarantors, a step further from its position in *V. Ramakrishnan.* The Supreme Court has made it clear that guarantors to corporate debtors would continue to be liable under the contract of guarantee, irrespective of discharge of the corporate debtor's liability under the resolution plan, even if the resolution plan does not include any provisions for payments to be made by the guarantor.

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[4] (2018) 17 SCC 394.

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