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Landmark Ruling of the Supreme Court on Personal Guarantors under IBC will shape the Future of Lender-Creditor Dynamics

In instances involving substantial values, specifically those with admitted claims surpassing INR 1000 crores, the aggregate admitted claims amounted to a staggering 8.78 lakh crores as of September 2023 (as reported in the IBBI Quarterly Report). Even if as per rough estimates, it is assumed that 70% of it secured by personal guarantees, this will be a substantial amount which banks in India may be looking to recover from the personal guarantors.

Part III of the Insolvency and Bankruptcy Code, 2016 **(the Code)** focuses on the processes of insolvency resolution and bankruptcy applicable to individuals and partnership firms. As of now, the provisions of the Code apply only to personal guarantors of corporate debtors. The provisions were brought into effect by way of notification[1] dated November 15, 2019 issued by the Union Government in the Ministry of Corporate Affairs. The notification was challenged before the Supreme Court in the case *of* ***Lalit Kumar Jain v Union of India***, where a two-Judge Bench inter alia, held that the liability of a guarantor is not discharged merely on the discharge of the corporate debtor. An exceptional aspect of the personal insolvency process is the prompt initiation of an interim moratorium upon the filing of an application by either a creditor or debtor. However, the decision on admitting or rejecting the application is deferred until after the submission of a report by the resolution professional appointed by the adjudicatory authority.

As far as lenders/debtors initiating insolvency process under the provisions of the Code is concerned:

- During the year 2023, more than 300 applications for personal insolvency were filed.
- As per IBBI data[2], a total of 7058 cases of CIRP were admitted till September 30, 2023. As against this, as of September 2023, a total 2289 case of personal insolvency involving debt of INR 163916.83 crores have been filed since 2019. From these, 284 cases involving an amount of INR 17974.24 crores have been filed by personal guarantors and 2005 cases involving amount of INR 145942.59 were filed by Creditors.

Hence, an approximate total debt of INR 163,916.83 crores is implicated in personal insolvency proceedings under the Code. Progress in these cases has been limited, primarily due to the ongoing consideration by the Supreme Court of India regarding the constitutional validity of the provisions related to personal insolvency under the Code. In a pivotal ruling in May 2021, the Supreme Court, in the case of *Lalit Kumar Jain vs Union of India*, validated the Central Government's authority to enforce specific sections related to personal guarantors in the context of corporate debtors. Importantly, the judgment clarified that the approval of a resolution plan does not automatically absolve personal guarantors of their liabilities, emphasizing that the surety's obligation remains despite the principal borrower's discharge under IBC.

Challenges to the constitutional validity of personal insolvency provisions under IBC were widespread, alleging violations of natural justice principles. Addressing these concerns, the Supreme Court in its November 9, 2023 ruling has upheld the

[1] The notification brought into force Section 2(e), Section 78 (except with regard to fresh start process), Section 79, Section 94 to 187, Sections 239(2)(g), (h) and (i), Sections 239(2)(m) to (zc); Section 239(2)(zn) to (zs) and Section 249.
[2] https://ibbi.gov.in/uploads/publication/b4ce3516920836e9ff9b1e816137bf97.pdf

validity of sections 95 to 100 of the Code, offering clarity on critical issues. Notably, it underscored the non-adjudicatory role of the insolvency professional, emphasizing their role as recommenders rather than authoritative decision-makers.

The judgment's significance is underscored by the imminent resolution of 392 pending petitions related to personal insolvency before the Supreme Court. With a staggering total debt of approximately INR 163,916.83 crores involved in personal insolvency cases, largely owed to public sector banks, the ruling is poised to expedite the adjudication of these petitions.

Why Lenders Stand to Gain: Accelerating Adjudication and Encouraging Settlements

It is noteworthy that, in accordance with the framework outlined in the IBC for personal insolvency—currently applicable to guarantors of corporate debtors—upon the submission of a personal insolvency application, an interim moratorium is triggered. Contrary to common perception, this interim moratorium specifically restricts action against creditors and does not extend to the personal guarantor. The moratorium specifically pertains to legal actions or proceedings related to outstanding debts, preventing creditors from initiating any legal actions or proceedings in this regard.

Post filing of the application, the Adjudicatory Authority is expected to appoint the Resolution Professional within 14 days. The Resolution Professional (RP) so appointed has to collect information from the relevant parties and submit report within ten days of his appointment and submit a report to the Adjudicating Authority recommending approval or rejection of the application. After this report, the Adjudicating Authority is required to pass an order either admitting or rejecting the application within fourteen days from the date of submission of the report by RP. After admission of the application by the Adjudicating Authority, the insolvency process commences which is required to be completed within 120 days. The process may result in either approval of the repayment plan or failure of the process by rejection of the repayment plan by the Creditors. This is followed by the Bankruptcy process in the event that no repayment plan gets approved or the approved repayment plan is violated by the persona guarantor.

From the Lenders' perspective

From the lenders' perspective, the judgment removes uncertainty surrounding the personal insolvency process, promising faster resolution of pending applications. The stigma attached to insolvency often compels individuals to avoid this route. The admission of such applications places additional pressure on personal guarantors to either settle debts or propose viable repayment plans.

The time-bound nature of the insolvency process offers a more efficient alternative to the Debt Recovery Tribunal (DRT) processes, especially when creditors lack substantial securities. The judgment's clarification on the role and limitations of insolvency professionals adds a layer of predictability to the process.

Significantly, this judgment should encourage personal guarantors to contemplate settlements during insolvency proceedings. Insolvency and bankruptcy are still viewed as stigmatizing in society, and moreover, they result in disqualifications under various laws, including eligibility for holding public or electoral positions. An undischarged insolvent also suffers many restrictions including power to enter into a contract or hold any directorship or travel overseas.

For secured creditors, participation in the insolvency process is optional, allowing strategic choices for securing unsecured portions of their claims.

Nevertheless, before banks embark on personal insolvency proceedings, careful preparation is essential. Initiating such proceedings, even when holding securities from personal guarantors, may disrupt their recovery actions under the Debt Recovery Tribunal **(DRT)** or the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest **(SARFAESI)** Act. Additionally, the bank needs to devise a strategy for participating in insolvency proceedings concerning their secured debt, as doing so may necessitate surrendering their right to enforce securities in exchange for voting rights within the committee of creditors. In cases where banks lack significant voting power in the committee, they may find themselves at a disadvantage. In the Indian context, personal guarantees unsecured by collateral from the guarantor provide minimal reassurance to lenders. The only recourse available to lenders is the option to file recovery applications against both the borrower and such guarantors, with the expectation that the resulting pressure might yield results or that they might identify assets for executing the final decree. However, these cases often remain in a prolonged state of pending at the execution stages for years, primarily due to the lack of information regarding assets held in the name of such guarantors, resulting in a lack of conclusive outcomes. Thus, an effective personal insolvency regime may work for the benefit of lenders in such situations. However, Banks will have to do their homework before they initiate personal insolvency proceedings as if they initiate personal insolvency proceedings even where they hold securities from the

personal guarantors, their recovery action under DRT or SARAESI Act may get struck in the process. The Bank may also have to work out their strategy for taking part in the insolvency proceedings as regards their secured debt as in such a situation they will be required to relinquish their right to enforce securities to get voting right in the committee of creditors. Banks may be at receiving end in cases where they do not hold controlling voting right in the committee of creditors.

Critical observations of the Hon'ble Supreme Court

While judgement of the Supreme Court is a significant step toward effective debt recovery, it necessitates careful strategy development by banks for initiating personal insolvency proceedings, balancing their participation in the process against secured debts.

The following are the critical observations of the Hon'ble Supreme Court[3] in its judgement of November 9, 2023 on the issue of personal insolvency under the Code:

Challenge to the constitutional validity	
Points of Arguments	**Legal Position Clarified by the Court**
The provisions were challenged on the ground that there is need for jurisdictional determination of existence and continuity of a debt before the resolution professional is appointed for submission of report under section 99 and that in the absence of requirement for a hearing before the adjudicating authority prior to the appointment of a resolution professional, the provisions of Sections 95 to 100 would be arbitrary and violative of Article 14.	▪ It was clarified by the Court that the lack of explicit mention of a hearing in a provision does not automatically make it unconstitutional and when a statute is silent on a specific aspect, like a hearing, and there is no explicit prohibition, the courts may imply or read in such a requirement. ▪ The Court further clarified that the adjudicating authority is duty bound to hear the person against whom an application has been filed under Section 94 or Section 95 before admission or rejection of the application.
As regards the issue of judicial power conferred on the resolution profession under Section 99 of the Code	▪ The Court held that the aim of vesting such powers in the resolution professional combined with his duty to keep such information confidential meets the proportionality test devised for privacy under Article 21 of the Constitution. ▪ As regards the role, it clarified that appointment of a resolution professional is for the purpose of a facilitative exercise which eventually ends in a report either recommending the acceptance or rejection of the application. ▪ The resolution professional in exercise of their duty under Section 99 may not embark on a roving enquiry into the affairs of the debtor or personal guarantor. ▪ The information sought by the resolution professional from the debtor, the creditor, or third parties must be relevant to the examination of the application of IRP. ▪ In this process, the debtor would inevitably be furnished with a fair opportunity by the resolution professional.
The impact of a moratorium under Section 14 of Part II vis-a-vis interim moratorium under Section 96 of Chapter III of Part III	

[3] Writ Petition (Civil) No 1281 of 2021 - *Dilip B Jiwrajka Vs Union of India & Ors.*

- While clarifying the impact of the interim moratorium under Section 96 of the Code, the Court clarified that the purpose of the moratorium under Section 96 is protective. The Court also clarified that the crucial words which are used both in clause (b)(i) and clause (b)(ii) of sub-section (1) of Section 96 are "in respect of any debt" and these words indicate that the interim-moratorium which is intended to operate by the legislature is primarily in respect of a debt as opposed to a debtor. Clause (b) of sub-section (1) indicates that the purpose of the interim moratorium is to restrain the initiation or the continuation of legal action or proceedings against the debt.

The Role of the Adjudicating Authority

- While clarifying the role of the adjudicatory authority under Part III of the Code, the Court held that the adjudicatory function of the adjudicating authority under Part III commences after the submission of a recommendatory report by the resolution professional. This is evidently different from the CIRP and the adjudicating authority steps in under Part II. This is based on an intelligible differentia between the nature of the insolvency resolution process in the case of a corporate debtor, on one hand, and individuals or partnerships, on the other.

Applicability of the Principles of Natural Justice (PNJ)

- While elaborating the ambit of PNJ, the Hon'ble Court held clarified that the nature of natural justice is liable to vary with the exigencies of the situation and in a given situation, it may extend to a full-fledged evidentiary hearing while, on the other hand, the principles of natural justice may require that a bare minimum opportunity should be given to an individual who is liable to be affected by an action, to furnish an explanation to the allegations or the nature of the enquiry.

Role of the Resolution Professional as a facilitator is to collate facts

- The Court clarified that the process which takes place before the resolution professional is not an ex-parte process in the absence of a debtor against whom the insolvency resolution process is sought to be initiated. The resolution professional cannot decide that issue in the absence of an opportunity to the debtor to furnish an explanation and to produce material evidencing the payment of the debt.
- It was also clarified that the resolution professional, after carrying out the process, would submit a report either recommending the acceptance or rejection of the application together with the reasons in support of the report.
- The Court rejected the argument that there could be any element of bias in a report submitted by an RP who is nominated by the creditor.

A right of representation has been provided under Section 99(2)

- The Court clarified that the power to seek information or, for that matter, to seek an explanation is related to the nature of the application which has been submitted under Section 94 or Section 95 as such the right to file the representation by the debtor is sufficient compliance of audi alterum partem requirements.
- It was also clarified that the provisions of subsection (3) operates only in relation to the recommendatory function of the resolution professional. That provision cannot operate to bind the adjudicatory function of the adjudicating authority when it exercises its jurisdiction under Section 100.

Conclusion

In conclusion, the Supreme Court's ruling not only shapes the future of personal guarantor insolvency but also streamlines the path for lenders, ensuring a more predictable and accelerated resolution of pending cases. It prompts a strategic rethink for banks, emphasizing the need for preparedness and well-thought-out policies in navigating the evolving landscape of personal insolvency under IBC.

We hope you have found this information useful. For any queries/clarifications please write to us at insights@elp-in.com or write to our authors:

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