



Guarantor Liability under IBC and Contract Act – Critical Gaps in the application of Principle of Subrogation

INTRODUCTION

The question of whether a guarantor is discharged from liability when a resolution plan for the principal debtor is approved under the Insolvency and Bankruptcy Code, 2016 (IBC), has garnered a significant judicial debate. The recent Supreme Court judgment in *BRS Ventures Investments Ltd. vs. SREI Infrastructure Finance Ltd. and Anr*¹. has provided clarity on this issue, emphasizing the co-extensive nature of the liability of guarantors and principal borrowers. However, the principle of subrogation, as detailed in Sections 140 and 141 of the Indian Contract Act, 1872, encounters a significant challenge under the IBC framework.

This article delves into the evolving jurisprudence on the discharge of guarantors, examining the implications under the Indian Contract Act, 1872, and exploring the scenarios under the IBC before and after the approval of a resolution plan. The doctrine of subrogation, which allows guarantors to step into the shoes of creditors upon fulfilling the principal debtor's obligations, faces a critical gap under the IBC. Specifically, when both the principal borrower and guarantors are subjected to insolvency proceedings, the "Clean Slate" concept of the IBC discharges the corporate debtor of all liabilities, leaving guarantors without recourse to recover amounts paid on behalf of the debtor.

This inconsistency highlights the need for a legal and policy re-evaluation to align subrogation rights under traditional contract law with the objectives of the IBC, ensuring equitable treatment of guarantors while achieving effective insolvency resolution.

EVOLUTION OF JURISPRUDENCE

In the case of *Maharashtra State Electricity Board v. Official Liquidator, High Court of Ernakulam*², the Supreme Court of India established crucial principles regarding the liability of guarantors. Though the case was in the context of nature of bank guarantee, nonetheless, the principle laid down is relevant in the current context. The Court held that the bank guarantee provided by Canara Bank to the Maharashtra State Electricity Board (MSEB) was unequivocal and unconditional, requiring payment upon demand without necessitating proof of default by the principal debtor, Cochin Malleables (P) Ltd., which was in liquidation. This guarantee constituted a contract of guarantee rather than indemnity, making it independent of the liquidation proceedings. The court emphasized that under Section 128 of the Indian Contract Act, 1872, the liability of the guarantor is co-extensive with that of the principal debtor unless specified otherwise, and the liquidation of the principal debtor does not absolve the guarantor of liability. The ruling referenced comparative jurisprudence, including *Jagannath Ganeshram Aggarwala v. Shivnarayan Bhagirath* and *In re Fitzgeorge Ex parte Robson*, to reinforce that a guarantor's liability persists despite the principal debtor's insolvency. The court also affirmed that after payment, the guarantor retains the right to seek reimbursement from the securities provided by the principal debtor, highlighting the independent nature of the guarantee, the supply contracts, and the securities involved.

The evolution of jurisprudence regarding the discharge of guarantors under insolvency proceedings has been shaped by several landmark judgments.

In *Lalit Kumar Jain vs. Union of India & Ors*³. (*Supreme Court, 2021*), the Supreme Court addressed the implications of an approved resolution plan on the liability of guarantors. The Court held that the liability of guarantors remains intact

¹ BRS Ventures Investments Ltd. Vs. SREI Infrastructure Finance Ltd. & Anr. [Civil Appeal No. 4565 of 2021]

² (1982 AIR 1497, 1983 SCR (1) 561)

³ TRANSFERRED CASE (CIVIL) NO. 245/2020 Lalit Kumar Jain vs Union of India

despite the resolution plan's approval, as the contract between the creditor and guarantor is independent of the resolution process of the principal borrower.

The National Company Law Appellate Tribunal (NCLAT) has further refined this understanding in various cases, such as *SVA Family Welfare Trust & Anr. vs. Ujaas Energy Ltd. & Ors. (NCLAT, 2023)*, where it was held that the security interest of dissenting financial creditors, including personal guarantees, could be addressed within a resolution plan. Additionally, the NCLAT in *Roshan Lal Mittal and Ors. vs. Rishabh Jain and Ors. (NCLAT, 2023)* affirmed that resolution plans do not automatically absolve personal guarantors of their liabilities.

LIABILITY OF GUARANTOR UNDER THE INDIAN CONTRACT ACT, 1872

Section 128 of the Indian Contract Act, 1872, establishes that the liability of a surety (guarantor) is co-extensive with that of the principal debtor unless otherwise stipulated in the contract. This means that the surety can be held liable for the debt to the same extent as the principal debtor. However, Sections 133 to 139 outline the circumstances under which a surety may be discharged from liability, such as variance in contract terms without the surety's consent or release of the principal debtor by the creditor.

The concept of subrogation under the Indian Contract Act, 1872, is primarily addressed in Sections 140 and 141. These sections outline the rights of a surety upon fulfilling the obligations of the principal debtor.

Section 140: Rights of Surety on Payment or Performance

Section 140 of the Indian Contract Act, 1872, stipulates that when a surety pays a debt or performs a duty that the principal debtor is liable for, the surety is entitled to all the rights the creditor had against the principal debtor. This means the surety can claim the same remedies and securities that the creditor had against the debtor. This principle is rooted in natural justice and equity, ensuring that the surety, who has fulfilled the debtor's obligation, can seek reimbursement from the principal debtor.

Section 141: Surety's Right to Benefit of Creditor's Securities

Section 141 complements Section 140 by providing that a surety is entitled to the benefit of every security which the creditor has against the principal debtor. If the creditor loses or disposes of the security, the surety's liability is proportionately reduced.

The principle of subrogation is based on ensuring that a person who fulfils another's obligation (the surety) is not left at a disadvantage. It aims to prevent unjust enrichment of the principal debtor at the expense of the surety.

A leading judgment that elaborates on this principle is *Economic Transport Organization v. Charan Spinning Mills (P) Ltd⁴. (2010)*. The Supreme Court of India explained that the doctrine of subrogation allows the surety to step into the shoes of the creditor and exercise all the rights that the creditor had against the principal debtor. This includes the right to securities and claims, ensuring the surety can recover the amount paid from the debtor.

SCENARIO UNDER IBC AND POST APPROVAL OF RESOLUTION PLAN

Under the IBC, the liability of guarantors is not extinguished by the mere approval of a resolution plan for the corporate debtor. The Supreme Court's ruling in *Lalit Kumar Jain* clarified that the approval of a resolution plan discharging the principal borrower does not absolve the guarantor of their liabilities. Section 31 of the IBC states that an approved resolution plan binds the corporate debtor and its stakeholders, including guarantors.

The IBC also allows for simultaneous or separate proceedings against the corporate debtor and guarantor, as outlined in Section 60(2) and (3). This provision ensures that creditors can pursue claims against guarantors even if the corporate debtor's insolvency proceedings are ongoing.

SUMMARY OF THE SUPREME COURT'S OBSERVATIONS IN BRS VENTURES INVESTMENTS LTD. VS. SREI INFRASTRUCTURE FINANCE LTD. AND ANR.

In *BRS Ventures Investments Ltd. vs. SREI Infrastructure Finance Ltd. and Anr. (Supreme Court, 2024)*, the Hon'ble Supreme Court ruled that the payment of a sum under the resolution plan of a corporate guarantor does not extinguish the liability of the principal borrower to repay the entire loan amount, after deducting the amount recovered from the guarantor. The

⁴ CIVIL APPEAL NO.5611 OF 1999 Decided on 17.02.2010

Court emphasized that a guarantor's obligation to repay the loan to the creditor is separate and distinct from the borrower's obligation. Furthermore, the assets of a subsidiary company cannot be included in the resolution plan of the holding company.

Summary of Court Observations in BRS Ventures Case

- **Co-Extensive Liability:** The Supreme Court reiterated that the liability of the guarantor is co-extensive with that of the principal debtor.
- **Independent Contract:** The contract between the creditor and guarantor is independent of the contract between the creditor and the principal debtor.
- **Simultaneous Proceedings:** The IBC allows for simultaneous proceedings against both the principal debtor and the guarantor.
- **No Discharge of Principal Borrower:** Approval of a resolution plan in the CIRP of the corporate guarantor does not discharge the principal borrower from its debt obligations.
- **Subrogation Rights:** The right of subrogation, allowing the guarantor to step into the shoes of the creditor upon payment, is limited to the extent of the payment made by the guarantor.

Judgments Upheld

The Supreme Court upheld the decision of the NCLAT in *Kanwar Raj Bhagat vs. Gujarat Hydrocarbons and Power SEZ Ltd. and Anr*⁵. (NCLAT, 2021), which affirmed that the liability of the guarantor remains even if the principal borrower's debt is discharged under a resolution plan. Conversely, it overruled any interpretation suggesting that a resolution plan's approval automatically discharges the guarantor's liability.

International Perspectives on Subrogation Rights

The doctrine of subrogation, which allows a guarantor who has paid off the debt to step into the shoes of the creditor, is well-established in jurisdictions like the UK, USA, and Europe. The decision in *Duncan Fox & Co. v. North & South Wales Bank (1880-1881) LR 6 App Cas 1 by the House of Lords*, as explained by Lord Selbourne, L.C., distinguished three kinds of cases relevant to the context of guarantees and subrogation rights:

- **Contractual Agreement Including Creditor:** These are instances where there is an explicit agreement forming the relationship of principal and surety, with the creditor being a party to the agreement. In these cases, the guarantor (surety) agrees with the creditor to fulfill the obligation of the principal debtor in the event of default.
- **Agreement Between Principal and Surety Only:** In these situations, the agreement to act as a surety exists solely between the principal debtor and the surety, without the creditor being a party to the contract. The creditor is a stranger to this agreement.
- **Primary and Secondary Liability:** These cases involve a primary and secondary liability for the same debt, where the debt is fundamentally owed by one party (the principal debtor), but another party (the secondary liable party) would be entitled to reimbursement from the principal debtor if they were compelled to pay the debt. This does not constitute a contract of suretyship in the strictest sense.

In all three scenarios, the person discharging the debt (whether under a formal contract of suretyship or a secondary liability) is entitled to be subrogated to the rights of the creditor. Subrogation allows the party who has paid the debt to "step into the shoes" of the creditor and claim the benefit of any security held by the creditor. Lord Selbourne clarified that while the first class (strict suretyship) clearly falls within traditional suretyship principles, the second and third classes, although not strictly suretyship, still afford the payer certain subrogation rights. Specifically, in the third class, the payer has a right to be placed in the creditor's position regarding any securities or claims, even without a formal contract of suretyship.

The 1976 study by the Commission of the European Communities on "**The law of Suretyship and Indemnity in the United Kingdom of Great Britain and Northern Ireland and Ireland**" provides an extensive overview of the legal frameworks

⁵ COMPANY APPEAL (AT)(INSOLVENCY) NO.1096 OF 2020

governing suretyship and indemnity. A contract of guarantee, as analysed in the context of the Commission of the European Communities' study, is fundamentally a promise by the guarantor to be liable for the principal debtor's obligation to the creditor. The key element here is that the principal debtor's primary liability to the creditor must either exist at the time of the guarantee or be anticipated to arise in the future. This underscores the nature of a guarantee as a secondary obligation contingent upon the default of the principal debtor.

The principles laid out in *Duncan Fox & Co. v. North & South Wales Bank* by the House of Lords highlight that the guarantor's liability depends on the existence of a primary liability. Lord Selbourne, L.C. categorized different types of liabilities and underscored that even in cases where there isn't a traditional contract of suretyship, the guarantor would still be entitled to subrogation rights upon fulfilling the debt. In essence, the primary liability to the creditor must exist or be anticipated to establish the validity and enforceability of a contract of guarantee. This requirement is crucial because it delineates the scope of the guarantor's liability and provides clarity on when the guarantor's obligations are triggered.

This analysis has significant implications for the liability of guarantors and their rights upon discharging a debt. It underscores the broad scope of subrogation rights, allowing guarantors and others similarly situated to claim the benefit of securities held by the creditor, ensuring they are not left without remedy after fulfilling the principal debtor's obligations. This principle is critical in protecting the interests of guarantors, emphasizing that their right to recourse extends beyond strict contractual definitions, encompassing a wider range of equitable considerations.

However, insolvency laws in these jurisdictions also recognize scenarios where subrogation rights may be curtailed to prioritize the corporate debtor's revival. For instance, the UK's Insolvency Act, 1986, and the US Bankruptcy Code provide mechanisms to balance the interests of creditors, guarantors, and debtors in insolvency proceedings.

Leading Judgments in Different Jurisdictions

- **UK:** *In re Fitzgeorge Ex parte Robson*, [1905] 1 K.B. 462: Affirming that discharge of the principal debtor by operation of law does not release the surety from their obligation.
- **USA:** *Stearns v. US*⁶ reinforced that a guarantor who pays the debt is subrogated to the rights of the creditor against the principal debtor.
- **Singapore:** *United Overseas Bank Ltd v Lippo Marina Collection Pte Ltd*⁷ upheld that subrogation rights apply when the guarantor has paid the debt owed by the principal debtor.
- **Europe:** Various rulings under the European Union Insolvency Regulation maintain the co-extensive liability of guarantors.

Key Judgments and Principles from Indian Courts

- *Jagannath Ganeshram Aggarwala v. Shivnarayan Bhagirath*, AIR 1940 Nag 170: Establishing that a surety's liability persists despite the principal debtor's discharge due to insolvency.
- *State Bank of India Vs. V. Ramakrishnan & Anr.* – Supreme Court: The Supreme Court held that Section 14(3) of the IBC, which states that the moratorium does not apply to sureties, is retrospective.
- *Laxmi Pat Surana Vs. Union Bank of India & Anr.* – Supreme Court: The Supreme Court held that the liability of a guarantor under IBC is co-extensive with that of the principal debtor, reinforcing that CIRP can be initiated against the guarantor regardless of the principal borrower's corporate status.
- *Mr. Vikas Aggarwal Vs. Asian Colour Coated Ispat Ltd. and Ors.* – NCLAT, New Delhi: The Tribunal ruled that a resolution plan could vary and modify the rights of creditors and guarantors, including the extinguishment of subrogation rights of personal guarantors.
- *Edelweiss Asset Reconstruction Company Ltd. vs. V Mahesh IRP Vasan Health Care Pvt. Ltd. and Anr.*⁸ – NCLAT - the NCLAT addressed the rejection of a claim based on a corporate guarantee issued by Vasan Healthcare Pvt. Ltd. The Tribunal found that the Interim Resolution Professional (IRP) and the Adjudicating Authority had

⁶ *Stearns v. United States*, 291 U.S. 54 (1934).

⁷ *United Overseas Bank Ltd v Lippo Marina Collection Pte Ltd* [2019] SGHC 23.

⁸ Company Appeal (AT) (CH) (INS) No. 226 of 202

erroneously rejected the claim on technical grounds, such as the guarantee not being reflected in the books of accounts. The NCLAT ruled that the existence of the corporate guarantee was established and directed the Resolution Professional to admit the appellant's claim.

- *Intec Capital Ltd. vs. Shwet Biotech Pvt. Ltd.*⁹. (NCLAT, 2023): The NCLAT held that CIRP can be initiated against a corporate entity that has given a guarantee to secure the dues of a non-corporate entity, as a financial debt accrues to the corporate person in respect of the guarantee given once the borrower defaults.
- *SVA Family Welfare Trust & Anr. Vs. Ujaas Energy Ltd. & Ors*¹⁰. – NCLAT, New Delhi: The National Company Law Appellate Tribunal (NCLAT) ruled that personal guarantees can be relinquished in a resolution plan if the financial creditors agree to accept a particular value for the relinquishment. This decision emphasized the commercial discretion of the Committee of Creditors (CoC).
- *Roshan Lal Mittal and Ors. v. Rishabh Jain and Ors*¹¹. – NCLAT, New Delhi: NCLAT reaffirmed that a resolution plan does not automatically discharge the personal guarantors from their obligations, referencing the Supreme Court judgment in *Lalit Kumar Jain vs. Union of India & Ors.*
- *Puro Naturals JV vs. Warana Sahakari Bank & Ors*¹². (NCLAT, 2023): NCLAT held that a resolution plan providing for the extinguishment of security interest and guarantees of financial creditors, including dissenting financial creditors, is not contrary to the provisions of Section 30(2) of the IBC and CIRP Regulations.
- *State Bank of India vs. Ms. Savita Satish Gowda*¹³ (NCLT Mumbai Bench): The NCLT held that it retains jurisdiction to entertain petitions related to personal guarantees of a corporate debtor even after the approval of the resolution plan.
- *Lalit Mishra & Ors. vs. Sharon Bio Medicine Ltd. & Ors*¹⁴. (NCLAT): The NCLAT emphasized that it was not the legislature's intention to benefit personal guarantors by excluding legal remedies available to creditors for recovering legitimate dues through personal guarantees. (Appeal against the judgment also dismissed by the Supreme Court)
- *J.C. Flowers Asset Reconstruction Pvt. vs. Deserve Exim Pvt. Ltd*¹⁵. (NCLAT, 2023): The NCLAT held that the date of default by the guarantor arises only when a demand is issued by the bank to the corporate guarantor, and not before.
- *Sudip Bijoy Dutta Vs. State Bank of India*¹⁶ – NCLAT New Delhi: The Tribunal ruled that a personal guarantee remains enforceable even if the guarantor acquires foreign citizenship post the execution of the guarantee.
- *UV Asset Reconstruction Company Ltd. vs. Electrosteel Castings Ltd*¹⁷(NCLAT, 2024): The NCLAT held that the approval of a resolution plan does not ipso facto discharge a personal guarantor or third party from their liabilities.
- *State Bank of India vs. Mahendra Kumar Jajodia*¹⁸ (NCLAT, 2022): NCLAT held that proceedings under Section 95 of the IBC can be initiated against a personal guarantor even if no proceedings are pending against the corporate debtor before the NCLT. (Appeal against the judgement of NCLAT was also rejected by the Supreme Court).

⁹ Comp. App. (AT) (Ins) No. 1403 of 2022

¹⁰ Company Appeal (AT) (Insolvency) No. 266 of 2023

¹¹ Company Appeal (AT) (Insolvency) No. 1558 of 2023 & I.A. No. 5563, 5596 of 2023

Decided on 07-Dec-23

¹² Company Appeal (AT) (Insolvency) Nos.661-663 of 2023

¹³ A No. 2733 of 2021 in CP(IB)-1062/MB/2021

¹⁴ Company appeal Insolvency no. 164 of 2018

¹⁵ Company Appeal (AT) (Insolvency) No.486 of 2023

¹⁶ Company Appeal (AT) (Insolvency) No. 807 of 2021

¹⁷ Company Appeal (AT) (Insolvency) No. 975 of 2022 -Decided on 24-Jan-24

¹⁸ Company Appeal (AT) Insolvency No. 60 of 2022

The jurisprudence surrounding the discharge of guarantors under the IBC underscores the principle that guarantors' liabilities are not automatically extinguished by the approval of a resolution plan for the principal borrower. This ensures that creditors retain their rights against guarantors. However, the evolving interpretations and the necessity for balancing various stakeholders' interests highlight the complex interplay between insolvency resolution and contractual obligations of guarantors. The recent judgments, including those from the NCLAT and the Supreme Court, continue to refine and clarify these principles, ensuring a fair and equitable insolvency framework in India.

CONCLUSION

The intersection of the Indian Contract Act, 1872 and the IBC creates a complex landscape for the discharge of guarantors. While the IBC aims to streamline insolvency processes and ensure creditor recoveries, it also raises critical questions about the rights and remedies available to guarantors. The evolving jurisprudence underscores the need for clear legal frameworks to balance the interests of creditors, debtors, and guarantors, ensuring that guarantors are not left without recourse when both they and the principal debtor are subjected to insolvency proceedings.

The principle of subrogation, enshrined in Sections 140 and 141 of the Indian Contract Act, 1872, ensures that a surety who discharges a debt or obligation of the principal debtor is vested with all the rights of the creditor against the debtor. This principle, rooted in equity and natural justice, is intended to prevent unjust enrichment of the principal debtor at the expense of the surety.

However, under the IBC, a significant gap has emerged. When both the principal borrower (corporate debtor) and the guarantor are subjected to insolvency proceedings, the IBC's emphasis on the "Clean Slate" principle effectively discharges the corporate debtor of all liabilities upon resolution. This leaves the guarantor, whose insolvency process might have resulted in payment of a part or all of the debtor's obligations, in such a situation the guarantor would be without the ability to recover from the now-discharged corporate debtor. In cases where creditors recover amounts from both the principal debtor and the guarantor, the guarantor is deprived of the benefits of subrogation. This is because the corporate debtor, upon resolution under the IBC, is absolved of its previous obligations, and the guarantor cannot seek reimbursement from the debtor. This discrepancy highlights a critical gap in the application of subrogation principles as laid down in traditional contract law and the provisions of the IBC.

The principle laid down in *Lalit Kumar Jain v. Union of India* and *Economic Transport Organization v. Charan Spinning Mills (P) Ltd.* underscore the need for addressing this inconsistency. The IBC's overriding effect, under Section 238, ensures the primacy of its provisions, yet it inadvertently undermines the equitable rights of guarantors. This issue necessitates a legal and policy re-evaluation to align the rights of subrogation under contract law with the objectives of the IBC, ensuring fair treatment of guarantors while achieving the insolvency resolution goals.

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