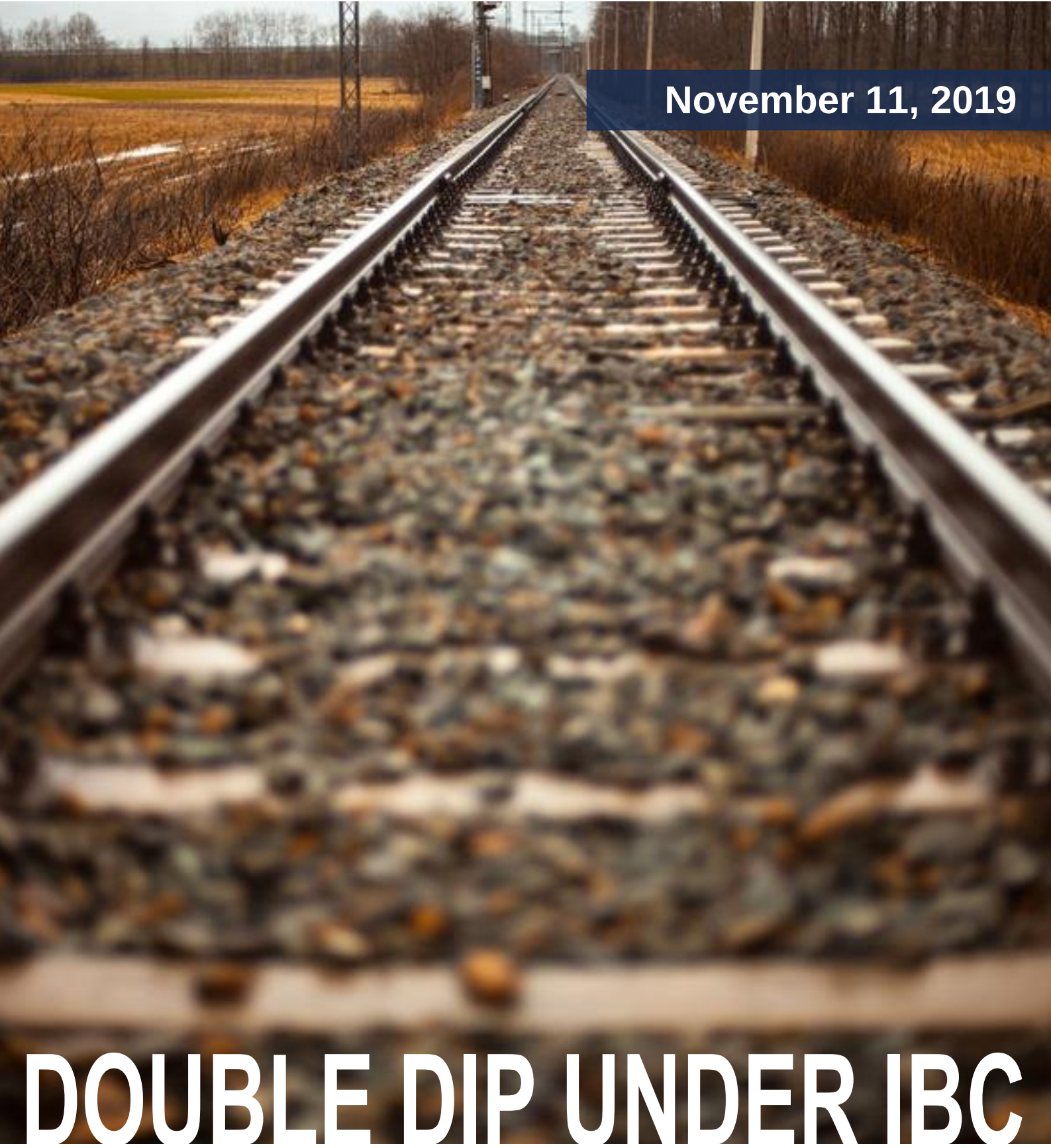

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DOUBLE DIP UNDER IBC

- A TOUGH CHOICE FOR LENDERS

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Introduction

In financing transactions, one of the most conventional means of securing the payment obligations of a corporate borrower is to obtain a guarantee from the promoters or holding/ group companies of such borrower. Guarantee contracts are governed by the provisions of the Indian Contract Act, 1872 ("**Contract Act**"), which in unequivocal terms lays down that a guarantor's liability is co-extensive with that of the principal debtor[1] in as much as the lender may proceed against either the principal debtor, or the guarantor, *or both, in no particular sequence*[2]. This may indeed be limited by the terms of the contract. However, most guarantee contracts executed in favour of banks and financial institutions in India do not limit such recourse of the lender.

In the context of guarantee arrangements, one of the highly debated issues under the Insolvency and Bankruptcy Code, 2016 ("**IBC**") currently is whether a lender can make simultaneous claims in the corporate insolvency resolution processes ("**CIRP**") against the principal borrower as well as the corporate guarantor. A related issue is whether, once an application filed by a lender for initiating CIRP against either the principal borrower or the corporate guarantor or one of the corporate guarantors has been admitted, such lender can file an application for initiating CIRP in respect of the other entity(ies) based on the same debt.

Earlier this year, the National Company Law Appellate Tribunal ("**NCLAT**") in the case of *Dr. Vishnu Kumar Agarwal* v. *M/s Piramal Enterprises Limited*[3] ("**Piramal Judgment**"), held that if, for the same set of claim, an application has been admitted against one of the corporate debtors (i.e. principal borrower or corporate guarantor(s)), second application by the same financial creditor, for the same set of claim and default, cannot be admitted against the other corporate debtor. Further, it was held that, for the same set of debt, a claim cannot be filed by a financial creditor in two separate CIRPs of the principal borrower and the corporate guarantor. However, an appeal has been filed against the Piramal Judgment before the Supreme Court of India, which is currently pending.

This paper analyses the Piramal Judgment in view of the principles of guarantee contracts and the treatment of guarantees in an insolvency scenario.

Analysis

Principles of Guarantee Contracts

One of the most significant characteristics of a guarantee contract is the co-extensive liability of the principal debtor and the guarantor in terms of section 128 of the Contract Act. This implies that the liability of a guarantor is immediate and is not deferred until the creditor exhausts its remedies against the principal debtor[4].

The Supreme Court in *Ram Kishun v. State of U.P.*[5] observed as follows:

> "*There can be no dispute to the settled legal proposition of law that in view of the provisions of Section 128 of the Indian Contract Act, 1872 (hereinafter called the 'Contract Act'), the liability of the guarantor/surety is co-extensive with that of the debtor. Therefore, the creditor has a right to obtain a decree against the surety and*

[1] Section 128 of the Contract Act.
[2] *Maharashtra State Electricity Board* v. *Official Liquidator*, AIR 1982 SC 1497; *Bank of Bihar Limited* v. *Damodar Prasad*, AIR 1969 SC 297; *Central Bank of India* v. *C.L. Vimla*, Civil Appeal No. 4043 of 2015, Supreme Court (order dated April 28, 2015).
[3] *Dr. Vishnu Kumar Agarwal* v. *M/s. Piramal Enterprises Limited*, Company Appeal (AT) (Insolvency) No. 346 and 347 of 2018, NCLAT (order dated January 8, 2019).
[4] *State Bank of India* v. *Saksaria Sugar Mills Limited*, AIR 1986 SC 868.
[5] *Ram Kishun* v. *State of U.P.*, (2012) 11 SCC 511.

the principal debtor. The surety has no right to restrain execution of the decree against him until the creditor has exhausted his remedy against the principal debtor for the reason that it is the business of the surety/guarantor to see whether the principal debtor has paid or not. The surety does not have a right to dictate terms to the creditor as how he should make the recovery and pursue his remedies against the principal debtor at his instance."

The very objective of obtaining a guarantee would be defeated if the creditor was asked to postpone its remedies against the guarantor and the guarantee would become redundant if the rights of the creditor were limited by curtailing the creditor's right to proceed against the guarantor only after remedies were exhausted against the principal debtor[6].

Treatment of Guarantees under the IBC

Since the enactment of the IBC, the jurisprudence on treatment of the guarantor of a corporate borrower undergoing CIRP has continuously evolved.

Section 14 of the IBC provides for the imposition of a moratorium prohibiting institution/ continuance of suits or proceedings against the corporate debtor as well as any action to recover or enforce any security interest created by the corporate debtor in respect of its property. In this regard, contradictory views were taken by various tribunals and courts on whether the moratorium imposed under section 14 of the IBC is applicable to the guarantor of a corporate debtor undergoing CIRP as well[7].

Subsequently, the Insolvency Law Committee ("**ILC**"), was constituted by the Ministry of Corporate Affairs to conduct a detailed review of the IBC. In its recommendations, the ILC stated that a clarification by way of an explanation in section 14 of the IBC should be added to state that all assets of the guarantors will be outside the scope of moratorium imposed under the IBC.

Accordingly, pursuant to the Insolvency and Bankruptcy Code (Second Amendment Act), 2018 ("**2018 Amendment**"), an explanation was introduced in section 14 of the IBC stating that the moratorium shall not be applicable to the guarantor of a corporate debtor. Subsequent to the 2018 Amendment, it has been held in various cases that the order of moratorium under section 14 of the IBC will be applicable only to the proceedings against the corporate debtor, and not against a guarantor[8].

In order to appreciate the rationale for the 2018 Amendment, reference may be made to the observations of the ILC in its report, dated March 26, 2018 ("**ILC Report**"). In the ILC Report, it was noted that a literal interpretation of section 14 of the IBC is prudent, and a broader interpretation may not be required in the context of the co-extensive liability of the principal debtor and the guarantor as per the Contract Act. The ILC observed that the principles of guarantee under the Contract Act must be respected even during a moratorium and an alternate interpretation may not have been the intention of the IBC, as is clear from a plain reading of section 14 of the IBC.

Post the 2018 Amendment, there remains no ambiguity regarding the legislative intent that the moratorium should not extend to the guarantor of a corporate debtor and that a creditor can proceed against the guarantor during the CIRP of the principal borrower.

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[6] *Bank of Bihar Limited* v. *Damodar Prasad*, AIR 1969 SC 297.

[7] In *State Bank of India* v. *V. Ramakrishnan and Veeson Energy Systems*, Company Appeal (AT) (Insolvency) No. 213/2017, NCLAT, (order dated February 28, 2018) and *Sanjeev Shriya* v. *State Bank of India*, 2017 (9) ADJ 723, it was held that moratorium applies to the surety of a corporate debtor. However, in *State Bank of India* v. *V. Ramakrishnan*, AIR 2018 SC 3876 it was held that moratorium on a corporate debtor does not apply to its surety.

[8] *State Bank of India* v. *D.S. Rajendra Kumar*, Company Appeal (AT) (Insolvency) No. 87-91 of 2018; *ICICI Bank Limited* v. *Vista Steel Private Limited*, Company Appeal (AT) (Insolvency) No. 13 of 2018, NCLAT (order dated May 2, 2018).

Further, sections 60(2) and (3) of the IBC provide that the insolvency/ liquidation proceedings of a principal (corporate) debtor and its (corporate or personal) guarantor would be dealt with by the same bench of the National Company Law Tribunal ("**NCLT**"). Earlier, section 60 of the IBC provided a link only between the insolvency resolution/ liquidation of the corporate debtor and the bankruptcy process of its personal guarantor. Whilst recommending the amendment in section 60, it was noted in the ILC Report that the said amendment was to provide a link between the insolvency resolution/ liquidation of the corporate debtor and the corporate guarantor as well. This also demonstrates the intention of the legislature that a financial creditor can initiate simultaneous proceedings against the principal borrower and the corporate guarantor.

'*Double Proof*' v. '*Double Dip*'

The rule against double proof is one of the long-standing principles of insolvency law. This rule, also known as the rule against double dividend, prevents *a double proof of the same debt being made against the **same** estate*, leading to the payment of a double dividend out of one estate[9]. This rule, however, does not prevent *a double proof of the same debt against two **separate** estates*, which is also referred to as 'double dip'.

The United Kingdom Supreme Court, in *Re Kaupthing Singer and Friedlander Limited* ("**Kaupthing Singer case**"), discussed the interplay between these rules and observed as follows:

> "*In the simplest case of suretyship (where the surety has neither given nor been provided with security, and has an unlimited liability) there is a triangle of rights and liabilities between the principal debtor (PD), the surety (S) and the creditor (C). PD has the primary obligation to C and a secondary obligation to indemnify S if and so far as S discharges PD's liability, but if PD is insolvent S may not enforce that right in competition with C. S has an obligation to C to answer for PD's liability, and the secondary right of obtaining an indemnity from PD. C can (after due notice) proceed against either or both of PD and S. If both PD and S are in insolvent liquidation, C can prove against each for 100p in the pound but may not recover more than 100p in the pound in all. […]*
>
> *The much-quoted example given by Mellish LJ may seem surprising, since in a suretyship situation there are on the face of it two debtors and one creditor. But the surety is also potentially a creditor of the principal debtor, because of his right to an indemnity. The effect of the rule is that so long as C has not been paid in full, S may not compete with C either directly by proving against PD for an indemnity, or indirectly by setting off his right to an indemnity against any separate debt owed by S to PD.*" (emphasis supplied)

To understand the triangle of rights and liabilities referred to in the Kaupthing Singer case in the context of a liquidation scenario, let us consider the following situations involving a creditor (C), a principal debtor (PD) and a guarantor (G) where PD and G are both in liquidation[10]:

1. C can file a proof of claim in the liquidations of both PD and G, however, C cannot recover in all more than the amount due in respect of the loan given to PD.
2. G's liquidator can file a proof of claim in the liquidation of PD (under an express or implied right of indemnity which a guarantor has against the principal debtor[11]) only if G has paid C in full towards the loan given to PD.

[9] *In the matter of Kaupthing Singer and Friedlander Limited (in administration) and in the matter of the Insolvency Act 1986*, (2011) UKSC 48.

[10] Discussed in Re Polly Peck International Plc, (1996) 2 All ER 433.

[11] Pursuant to section 145 of the Contract Act, in every contract of guarantee there is an implied promise by the principal debtor to indemnify the guarantor and the guarantor is entitled to recover from the principal debtor whatever sum he has paid under the guarantee to the creditor.

3. G's liquidator cannot file a proof of claim in the liquidation of PD in any way that is in competition with C if G has not paid C in full towards the loan given to PD.

The situation in (1) above is what would constitute a 'double-dip' and has been held to be permissible in the Kaupthing Singer case. Further, the situation in (3) is a consequence of the rule against 'double proof'.

Piramal Judgment and its Ramifications

In the Piramal Judgment, the primary issue was the maintainability of two separate applications for initiating CIRPs against two corporate guarantors based on same sets of claim, debt, default and record.

The NCLAT held that, once a CIRP is initiated against one of the corporate debtors (either the principal debtor or the corporate guarantor) on the basis of the claim of a financial creditor, the same financial creditor cannot file a second application for initiating CIRP against the other corporate debtor for the same set of claim and default. The NCLAT appears to have reached the aforesaid conclusion on the premise that, for the same set of debt, a claim cannot be filed by the same financial creditor in two separate CIRPs – which is essentially a 'double dip' permissible under insolvency laws as discussed above. However, the reasoning for arriving at such a premise in the first place has not been discussed in the Piramal Judgment.

Relying on the decision of the NCLAT in the Piramal Judgment, similar orders have been passed by various NCLTs[12].

In the case of *State Bank of India* v. *Visa International Limited*[13], in the dissenting judgment passed by the Member (Technical) of the NCLAT it was observed that in light of the Piramal Judgment, there cannot be two CIRPs in relation to the same debt against the two guarantors[14], however, the financial creditor has the *option to proceed against any one of the two guarantors*. Such a conclusion clearly militates against the contractual principles of guarantee which entitle the creditor to proceed against either the principal borrower, or one or more guarantors, or both, in no particular sequence[15]. Even under section 146 of the Contract Act, the liability of the surety is co-extensive with the principal debtor, and is joint and several[16]. Co-sureties are liable to contribute equally, and in case there is more than one surety/guarantor, they have to share the liability equally unless the agreement of contract provides otherwise[17].

At this juncture it is pertinent to note that, in *Axis Bank Limited* v. *Edu Smart Service Private Limited* ("**Edu Smart case**"),[18] which was decided prior to the Piramal Judgment, the NCLAT had held that the financial creditor (Axis Bank Limited) should be treated as a member of the committee of

[12] *State Bank of India* v. *Adhunik Steels Limited*, C.P. (IB) No. 800/KB/2018, NCLT Kolkata bench (order dated September 4, 2019); *Dena Bank* v. *West Haryana Highways Projects Private Limited*, C.P. No. IB 1767(PB)/2018, NCLT Principal bench, New Delhi (order dated August 9, 2019); *International Finance Corporation* v. *Punj Llyod Upstream Limited*, C.P. No. IB 1322(PB)/2018, NCLT Principal bench, New Delhi (order dated May 13, 2019); *ICICI Bank Limited* v. *Hyderabad Ring Road Project Private Limited*, C.P. No. IB 1152(PB)/2018, NCLT Principal bench, New Delhi (order dated May 23, 2019); *Alchemist Asset Reconstruction Company Limited* v. *Sima Hotels and Resorts Limited*, CP(IB)2528/NCLT/MB/2018, NCLT Mumbai bench (order dated May 8, 2019).

[13] *State Bank of India* v. *Visa International Limited*, Company Appeal (AT) (Insolvency) No. 179 of 2019, NCLAT (order dated September 25, 2019).

[14] The lead judgment delivered by the Member (Judicial) also arrived at the same conclusion.

[15] *Chokalinga Chettiar* v. *Dandayunthapani Chattiar*, AIR 1928 Mad 1262.

[16] *The Kerala State Financial Enterprises Limited, Kallara Branch* v. *Syamala T.*, W.A. No. 1743 of 2009 (E), Kerala High Court (order dated June 19, 2018)

[17] *Ibid*.

[18] *Axis Bank Limited* v. *Edu Smart Service Private Limited*, Company Appeal (AT) (Insolvency) No. 304 of 2017, NCLAT (order dated August 14, 2018).

creditors ("**CoC**") of the corporate guarantor (Edu Smart Services Private Limited). Here too, a CIRP was ongoing against the principal debtor (EduComp Solutions Limited). On the basis of the Piramal Judgment, an application was filed before the NCLT, New Delhi, Principal Bench, praying for reconstitution of the CoC of Edu Smart Services Private Limited by excluding the double claims. However, the NCLT did not allow the prayer in view of the aforesaid decision of the NCLAT in the Edu Smart case[19].

In contrast to this is the case of *IL and FS Financial Services Limited* v. *Golden Glow Estates Private Limited*[20], where Edelweiss Asset Reconstruction Company Limited had filed a claim in the CIRP of the principal debtor, which had been admitted *in toto,* and then also filed a claim in the CIRP of the corporate guarantor. It was observed by the NCLT, New Delhi, Principal Bench, that the same would result in duplication of claims and thus Edelweiss would enjoy double proportionate voting rights in different CoCs. In light of the Piramal Judgment, the claim filed by Edelweiss in the CIRP of the corporate guarantor, being a repetition of the claim, which was already admitted in another CIRP, was set aside.

Concluding Remarks

As noted in the ILC Report, the hallmark of a guarantee contract is the lender's remedy against both the principal borrower and the guarantor, without an obligation to exhaust the remedy against one of them before proceeding against the other.

Whilst acknowledging that IBC is a special law having an overriding effect, in our view, such a fundamental principle of contract law cannot be flouted without the same finding a basis in the letter of the law. There is no provision in the IBC which restrains a financial creditor from initiating CIRPs simultaneously against the principal borrower and the guarantor or filing a claim in the CIRPs of both the principal borrower and the guarantor.

On the contrary, pursuant to the 2018 Amendment, it has been made abundantly clear that the order of moratorium under section 14 of the IBC will not be applicable against the guarantor. To say that a financial creditor cannot have two simultaneous claims for the same debt against the principal debtor and the corporate guarantor, would render the aforesaid amendment redundant. If the legislative intent was to prevent a 'double dip' in an insolvency, the 2018 Amendment in respect of section 14 of the IBC would have excluded such proceedings under the IBC.

It is important to appreciate that the availability of simultaneous remedies against the principal borrower and the guarantor is, in most cases, the basis on which the loan may have been given and that lenders having to choose between the principal debtor and the guarantor to go after, is a risky proposition.

We would certainly need necessary amendments in the IBC to address procedural and substantive issues which may arise on account of simultaneous CIRPs against the principal borrower and the guarantor. Certain procedural coordination mechanisms, as recommended by the Working Group on Group Insolvency in its report dated September 23, 2019, could be made applicable to such scenarios as well.

Currently, sections 60(2) and (3) of the IBC provide that the insolvency/ liquidation proceedings of a principal (corporate) debtor and the insolvency/ liquidation/ bankruptcy proceedings its (corporate or personal) guarantor would be dealt with by the bench of the NCLT dealing with the insolvency/ liquidation proceedings of such principal (corporate) debtor. However, merely this provision would not be sufficient to address all issues, for instance, where a guarantor has

[19] *DBS Bank* v. *Edu Smart Service Private Limited*, Company Application No. CA-367(PB)/2017 in IB-102(PB)/ 2017, NCLT Principal bench, New Delhi (order dated April 11, 2019).
[20] *IL and FS Financial Services Limited* v. *Golden Glow Estates Private Limited*, Company Application No. CA-918 (PB)/2019 in IB-1038(PB) 2018, NCLT Principal bench, New Delhi (order dated August 6, 2019).

guaranteed loans of multiple principal (corporate) debtors there is no clarity on which NCLT would have jurisdiction given that different NCLTs may have jurisdiction over the multiple principal (corporate) debtors depending on where their registered offices are situated.

Whilst the decision of the Supreme Court in the appeal filed against the Piramal Judgment is certainly something to watch out for, necessary amendments would be required in the IBC and the regulations framed thereunder to address the issues arising out of such linked proceedings.

This paper has been written by Aastha (Partner) and Shradha Rakhecha (Associate).

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