

India's Supreme Court blesses personal guarantor insolvency provisions

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In the recent case of [Dilip B. Jiwrajka v. Union of India](#) (Writ Petition (Civil) No. 1281 of 2021), the Constitutional Bench of the Supreme Court (the “SC”) upheld the constitutionality of Sections 95 to 100 of the Insolvency and Bankruptcy Code, 2016 (“IBC”). These provisions address insolvency resolution and bankruptcy for individuals and partnership firms under Part III of Chapter III of the IBC, which deals with the insolvency resolution process (“IRP”).

This update dissects the foregoing judgment and delves into its implications.

IRP scheme

As per [Sections 94 and 95](#) of the IBC, a debtor or creditor can initiate the IRP by filing an application, which, eventually, triggers an interim moratorium mandating the adjudicating authority to appoint a resolution professional (“RP”). The RP, thereafter, must examine the application and issue a [reasoned report](#) to the adjudicating authority with his/ her recommendations to either approve or reject the application. This report is also given to both, the debtor, and the creditor. Subsequently, the adjudicating authority can decide whether to accept or reject the application. If the application is accepted, the adjudicating authority can require the debtor and the creditor to commence negotiations to settle the matter; and, if it is rejected, the creditor may file for bankruptcy of the debtor. The interim moratorium concludes on the date of admission and a statutory moratorium takes effect.

Petitioners' contentions

In this case, the petitioners argued that the judicial determination of the existence of a debt should be done before the commencement of the IRP and appointment of the RP, or at least before the RP takes any action, as failure to do so would amount to violation of the principles of natural justice. To support this contention, it was pointed out that the existence of a debt is a jurisdictional fact, and without ascertaining this upfront, irreversible consequences can follow, including an interim moratorium, appointment of the RP, etc. In addition, the appointment and actions of the RP, who has extensive powers to seek information from the guarantors and other the third parties, can substantially impact the debtor's creditworthiness.

Respondents' contentions

In response, the respondents argued that inserting an adjudicatory stage at the time of the RP's appointment in an IRP would hinder its time-bound nature. They highlighted the more severe consequences of the Corporate Insolvency Resolution Process (“CIRP”) under Part II of the IBC (which includes provisions of a more drastic moratorium and excludes debtors from the management) and stressed that an IRP under Part III focuses on a repayment plan, which warrants an early appointment of the RP to accumulate information related to the loan. This process distinction, based on intelligible differentia, aligns with the requirements of Article 14 of India's Constitution.

The SC's ruling

The SC examined the issue in a two-fold manner. Firstly, it conducted a comparative analysis of Part II and Part III of the IBC, contrasting their individual stages, the role of the RP, the impact of the respective moratoriums, and the involvement of the adjudicatory authority. Secondly, the SC evaluated the provisions of the IRP considering the principles of natural justice. In doing so, the SC made the following observations:

- (i) **Role of the RP:** The SC noted that in a CIRP the interim RP is appointed after the admission of an application to manage the affairs of the corporate debtor and to exercise the powers of the board of directors. Conversely, in an IRP, the RP is appointed at the stage of filing the application. The RP's duties encompass examining the application and submitting a recommendatory and non-binding report to the adjudicating authority. The RP is authorized to seek additional information or explanations from the debtor, creditor, or third parties on matters relevant to the application. When a creditor initiates the application, the RP may demand proof of repayment of debt from the debtor. Notably, the RP possesses significantly lesser powers in an IRP as compared to a CIRP. The RP is not authorized to take over the assets or the business but only assumes a facilitative role.

In this context, the RP's functions are predominantly administrative and non-adjudicatory, focusing on information gathering and verifying creditors' claims. Consequently, no judicial adjudication occurs until the adjudicatory authority intervenes following the submission of the report.

Imposing a requirement for judicial adjudication at the stage of appointment of the RP would undermine the significance of submitting the report to the adjudicating authority and would essentially entail rewriting the statute, an action impermissible in the exercise of judicial review. Furthermore, subjecting every alleged default, even one involving minimal amounts such as INR1,000 (Indian Rupees One Thousand), to judicial determination would overwhelm the adjudicating authority.

- (ii) **Moratorium:** The moratorium under a CIRP operates on the order of an adjudicating authority. It halts the institution of fresh suits or continuation of pending suits or proceedings against the corporate debtor on the admission of the application. It restrains the transfer, encumbrance, alienation, or disposal by the corporate debtor of any of its assets or any legal right or beneficial interest therein. In contrast, the submission of an application under an IRP initiates an interim moratorium. The interim moratorium temporarily halts legal actions related to the debt. Importantly, the IRP moratorium pertains to the debt rather than the debtor. Therefore, the purpose of the moratorium under IRP is protective, which aims to shield the corporate debtor from the initiation or continuation of legal actions concerning the debt.
- (iii) **Natural Justice:** In an IRP, there is no breach of natural justice because the debtor is afforded an opportunity to participate in the examination process of the application, as conducted by the RP. The recommendatory report by the RP is formulated after considering information or explanations provided by the debtor, especially concerning the proof of debt repayment or additional details related to the application. Additionally, the adjudicating authority is required to undertake an independent assessment and ensure that the debtor receives a fair opportunity to dispute the debt, including those registered by the creditor with an information utility.

- (iv) **Constitutionality:** As regards Article 21 of India's Constitution, the SC observed that the Insolvency and Bankruptcy Board of India (Insolvency Professionals) Regulations, 2016 ensure confidentiality, aligning with the privacy principles established in the case of *K.S. Puttaswamy v. Union of India* (AIR 2017 SC 4161). The SC justified the collection of personal financial information, considering it a part of the legitimate aim to establish a comprehensive framework for individual insolvency. In relation to Article 14 of India's Constitution, the SC noted the intelligible differentia between a CIRP and an IRP and emphasized that the IBC cannot operate retroactively.

Our comments

To obtain loans, promoters and their related entities often furnish personal guarantees to lenders, including, banks and financial institutions. According to an Insolvency and Bankruptcy Board of India [report](#), as of September 30, 2023, two thousand two hundred and eighty-nine (2,289) cases have been filed at various tribunals against personal guarantors claiming a corporate debt of just under INR1.7 trillion, with the majority of the cases involving promoters of corporate debtors.

Based on this ruling, banks will, not only, pursue existing cases vigorously but be emboldened to initiate new IRP applications against personal guarantors. We also anticipate an increase in recovery from personal guarantors (currently at just 5.22%) following this judgment.

Initiation of IRP proceedings may also result in more settlements because of the associated stigma. Additionally, bankrupt individuals face various disqualifications, such as holding directorships or public office, which will enhance the negotiating power of lenders vis-a-vis defaulters and will act as a deterrent against promoters offering impractical personal guarantees.

On the flip side, considering that this ruling has come after four (4) years, lenders may encounter challenges in tracing and securing assets of personal guarantors as they may have been transferred or disposed of during this time.

Going forward, it may be important for lenders, on a case-to-case basis, to consider incorporating a negative lien on the assets of borrower/ guarantors in their loan agreements, thereby restricting the borrower/ guarantor from disposing of or creating encumbrances on the assets without obtaining the consent of the lender.

In furtherance of the SC's ruling, the [Kerala High Court](#) has recently clarified that the interim moratorium in an IRP shall commence when the application is numbered by the IBC tribunal, which clearly highlights that courts are deadly serious about enforcing the IRP provisions and the IBC.