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# THE INCREASING CONUNDRUM FOR GUARANTOR IN THE INSOLVENCY SYSTEM

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## ABSTRACT

This article aims to address the following topics and also incorporates the definition of a financial creditor, the contract of guarantee and its principles, the idea of a corporate guarantor, and the relevant provisions of the Insolvency and Bankruptcy Code & Contract Act that address the contract of guarantee and the guarantor's position<sup>1</sup>. The paper also additionally wraps up by summarizing the relevant case laws and decisions together with my introspection on the matter. Since the corporate guarantor acts as the debtor's surety in the event of failure, it is imperative that their interests be appropriately protected. Since the Insolvency and Bankruptcy Code is based on the idea of protecting the interests of all parties concerned, guarantors' or sureties' rights should not be disregarded.<sup>2</sup> The original agreement between the major debtor and the creditor gives rise to a secondary agreement known as the contract of guarantee. Understanding the scope of the contract of guarantee under the Insolvency and Bankruptcy Code is the aim of this study. In order to simplify India's insolvency process, the IBC was put into effect in 2016. India's insolvency laws and regulations saw numerous changes as a result of the IBC. Since IBC was passed, there has also been a continuous change in how guarantors of corporate debtors undergoing bankruptcy proceedings are treated. Through this study I've attempted to comprehend the same and examine with the extent of guarantee contract.

**Keywords:** Guarantor, Principal Debtor, Contract, Guarantee, Moratorium, Insolvency, Debts, and Creditors.

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<sup>1</sup> Act of 1872, Act No. 9 of the Imperial Legislative Council, Indian Contract Act.

<sup>2</sup> Act of Parliament, 2016; Insolvency and Bankruptcy Code, No. 31.

**Introduction:**

Once a default has been proven, the Tribunal will consult the company's creditors before starting a CIRP in line with Insolvency Bankruptcy Code of 2016. In this situation, it is unclear how the 2016 Insolvency and Bankruptcy Code's clauses pertaining to a company's liquidation or insolvency will treat the guarantee. There has been much court discussion about whether a guarantor is released from liability after accepting a resolution plan for Principal Debtor under the Insolvency and Bankruptcy Code, 2016 (IBC). The case of BRS Ventures Investments Ltd. vs. SREI Infrastructure Finance Ltd. and Anr. was heard by the Apex Court and has rendered a decision and clarified this matter by highlighting the co-extensive nature of principle borrowers' and guarantors' obligation. But within the IBC framework, the subrogation principle explained in The Indian Contract Act of 1872, Sections 140 and 141 faces a major obstacle and scrutinizing the situations under the IBC both prior to and during the resolution plan's adoption.

The IBC creates a significant hole in the subrogation theory, which permits guarantors to assume the role of creditors after the principal debtor has fulfilled their obligations. In particular, when the guarantors and principal borrower are subject to the "Clean Slate" principle of the IBC releases the corporate debtor from all obligations in the event of insolvency proceedings, leaving guarantors without the ability to recoup money paid on the debtor's behalf.

In order to provide fair treatment for guarantors and a successful bankruptcy resolution, this discrepancy emphasizes the necessity of a legislative and policy review to harmonize subrogation rights under conventional contract law with the goals of the IBC.

The 1872 Indian Contract Act, Section 126 addresses contracts of 'Guarantee'. An agreement to fulfil a third party's promise or absolve them of obligation in the case of a default is known as a contract of guarantee.

Insolvency and Bankruptcy Code passed in the year 2016 is applicable to both individuals and companies. It ensures that the process of resolving insolvency has a time constraint. The creditors have control over the debtor's assets in the event of a repayment default, and they have 180 days to decide how to resolve the insolvency.<sup>3</sup> To guarantee a continuous resolution phase, the Code also shields debtors from resolution claims made by creditors during this

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<sup>3</sup> Ibid

period. In order to create a single platform for addressing insolvency for creditors and debtors of all kinds, the Code also incorporates elements found in the current statutory structure.

The researcher will attempt to comprehend and look into the guarantor status in accordance with the Bankruptcy and Insolvency Code throughout this task. The researcher has addressed numerous topics in the article to achieve this.

### **Literature Review:**

In the article by Namrata Dubey, ILNU Ahmedabad. The interpretation of guarantor's liability under the IBC has been greatly influenced by judicial precedents. Courts have ruled that personal guarantors are exempt from the moratorium under Section 14, allowing creditors to seize money from their assets. This stance was reaffirmed in the suit of Asset Reconstruction Company v. Alpha & Omega Diagnostics<sup>4</sup>. In addition, the NCLAT decided in Sanjeev Shriya v. SBI<sup>5</sup> that creditors have the power to file for bankruptcy against both guarantors and debtors. When deciding whether NCLT or DRT has jurisdiction over claims against guarantors, there are inconsistencies. Although the IBC improves the rights of creditors, issues with forum shopping and the abuse of actions against guarantors still exist. To guarantee a balanced insolvency regime, these deficiencies must be filled.

### **Objective of Study:**

Given the current state of the Insolvency Bankruptcy Code 2016, the main hypothesis of the given study is that, given the onset of the guarantor's corporate insolvency proceedings, the guarantor's right to pursue insolvency in order to collect the debts and the actions taken against the personal guarantor under the IBC, one should understand the insolvency process.

### **Research Methodology:**

Given that insolvency proceedings have an effect on the guarantors and debtor's liabilities and the research is both descriptive and exploratory in nature.

### **Evolution the of legal doctrine:**

During the suit of Official Liquidator v. Maharashtra State Electricity Board<sup>6</sup>, the Indian Supreme Court established significant rules on the liability of guarantors with the High Court's decision. Even though the case dealt with the nature of bank guarantees, the established concept

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<sup>4</sup> No. 116 of 2017 Company Application (AT) (Insol.)

<sup>5</sup> AIR CC 1583 in 2018

<sup>6</sup> SCR (1) 561, 1983

is still relevant today. The court determined that Canara Bank's bank guarantee to the Maharashtra State Electricity Board (MSEB) was clear-cut, unconditional, requiring payment upon demand without requiring evidence of default from the main debtor, Cochin Malleables (P) Ltd., which was in liquidation. Since, assurance was a contract of guarantee rather than indemnity, it was distinct from the liquidation process.

The judicial system emphasized that the guarantor's responsibility under Section 128 of the Indian Contract Act, 1872, is equal to that of the principal debtor, unless otherwise specified, and that the major debtor's liquidation does not remove the liability of guarantor. In context of the principal debtor's insolvency, the court upheld that a liability of the guarantor continues even when applying similar precedents, such as in *re Fitzgeorge Ex parte Robson* and *Jagannath Ganeshram Aggarwala v. Shivnarayan Bhagirath*. Emphasizing the independent nature of the guarantee, the supply contracts, and the assets involved, the judicial system and also upheld the authority of the guarantor in order to pursue reimbursement from securities supplied by the principal debtor following payment.

The impact of an authorized resolution plan on guarantors' liabilities was examined by the Apex Court in the suit of *UOI & Ors. v. Lalit Kumar Jain*. Because the arrangement between the creditor and guarantee is distinct from the resolution procedure for the principal borrower, Court determined adoption of the resolution plan has no bearing on the guarantor's liability. This decision has affected the evolution of jurisprudence concerning the discharge of guarantors during insolvency proceedings.

#### **Guarantors' Obligation throughout the Period of Moratorium (IBC, 2016 Section 14):**

During case of *India's Asset Reconstruction Company Ltd. & Ors. v. Alpha & Omega Diagnostics (India) Ltd.*<sup>7</sup>, Under the insolvency process, the Bombay High Court considered whether a creditor might sell to assets of personal guarantor. After examining word "it" in IBC, 2016 Section 14, The court concluded that corporate debtor's personal guarantors are not eligible for a moratorium, indicating that their assets may be liquidated to satisfy the debt. *ARC Phoenix Pvt. Ltd. & Ors. v. Schweitzer Systemtek India Pvt. Ltd.*,<sup>8</sup> the other Adjudicating authority i.e. NCLAT issued a similar decision.

The co-extensiveness of both guarantor and the substantial liability of debtor is the following point. As, it allows the creditor to file a lawsuit against the guarantor as well as the principal

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<sup>7</sup> BOMBAY 247, AIR 2016

<sup>8</sup> Insolvency Company Appeal (AT) No. 129 of 2017

debtor. It is not required for creditor to contact the guarantor after exhausting all other options against the debtor. In *Sanjeev Shriya v. State Bank of India*<sup>9</sup>, the court read section 60(2) and upheld the authority of the creditor to sue for the corporate debtor's guarantor.

"NCLT"14 must receive an application concerning the bankruptcy or insolvency resolution of a personal guarantor of such a corporate debtor." This supports the legislature's goal of a speedy loan recovery by indicating that both guarantor & corporate debtor are to be held equally liable for the recovery of accrued obligations. After this, Section 14 of the IBC makes it quite evident that a corporation will be subject to a 180-day moratorium (plus an extra 90 days for an extension) whenever a CIRP application is filed against a corporate debtor. During period of moratorium, pertaining no action may be being taken to enforce, reclaim, foreclose on any stake in securities held by the corporate debtor has created over its assets.

Current dilemma is that: (a) the Insolvency and Bankruptcy Code's restriction over using a guarantor and realizing debt in this way implies that the guarantor is subject to very limited proceedings, which goes against the fundamentals of contracts and, consequently, creates a lack of trust in matters relating to guarantee contracts. (b) It would be against the goals of IBC, 2016 to permit the sale of personal guarantors' assets.

### **Liability of the Personal Guarantor:**

Also, additionally starting the new regime allows creditors to initiate legal suit against corporate debtor to start bankruptcy procedures against individual guarantors. These situations would undoubtedly have an effect on the Code's current structure because legal action may be filed concurrently against the personal guarantors and corporate debtor, which may cause confusion and ambiguity. It is yet unknown if the personal guarantor and the corporate debtor's resolution specialists would work together or separately to prevent any creditor from engaging in double dipping. Even if the Guarantor Code's existing precedents only apply to corporate guarantors, like ideas are probably going to have an impact on the developing body of law pertaining to guarantors of individual.

During, *Piramal Enterprises Ltd. v. Dr. Vishnu Kumar Agarwal*<sup>10</sup>, National Company Law Appellate Tribunal ruled that while the Code does not prohibit filing two Section 7 applications against the main i.e. principal creditor as well as the corporate guarantee or guarantors simultaneously, if a creditor's application against one of the corporate debtors (the principal

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<sup>9</sup> Ibid

<sup>10</sup> No. 394 of 2021, Company Appeal (AT) (Insolvency)

borrower or the corporate guarantor) is granted on a specific set of claims, the creditor's application against the other corporate debtor (i.e., the principal borrower or corporate guarantor) would be denied because default and the same set of claims are not allowed to be accepted. As said earlier, even in the event that corporate guarantors were the subject of the verdict, it is logical to presume that personal guarantors might also be governed by the same legislation. Put another way, it's uncertain if a creditor will bring legal action against personal guarantors for the same set of debts that a business debtor is presently dealing with insolvency proceedings. Therefore, regardless of its economic significance, the creditor must drop its claim against the borrower or guarantor and restrict it to the party against whom the claim was filed and the bankruptcy proceedings were purportedly started first.

Having said that, it can be seen that in *Satish Kumar Gupta v. Essar Steel India Limited*<sup>11</sup>, Committee of Creditor's case, A few unresolved Code-related matters were handled by Supreme Court in *SBI v. V. Ramakrishna*<sup>12</sup>, Supreme Court maintained its previous ruling that recognized the creditor's authority to use personal guarantee contracts as a last resort to recover the amount owed to it during insolvency proceedings. The Code and the law of guarantors were also covered in this ruling. According to the Apex Court's decision in *Essar Steel* (above), a personal guarantor's insolvency may occur concurrently with that of a corporate debtor. There are countless additional questions around this new system, and it is vital that the government take responsibility and handle this situation. This seems to go against the NCLAT's decision in the *Piramal Enterprises* case.

In accordance with Section 128, Indian Contract Act 1872, the surety's and the principal debtor's liabilities are the same. In the *Biswanath v. Industrial Investment Bank of India Ltd*<sup>13</sup>. *Jhunjhunwala* case, Apex Court analysed meaning of "co-extensive liability" and categorically stated that obligation of principal debtor cannot be substituted by a surety. Consequently, unless the contract specifies if not, a creditor is not required to start recovery prior to taking action against the principal debtor & measures against the surety.

### **The liability of determining which has jurisdiction—NCLT or DRT:**

The Guarantor becomes liable as soon as the principal debtor stops making loan payments. The company's creditor may now demand payment from or pursue legal action in opposition to the major debtor and guarantor. The IBC, 2016 provides a comparable remedy in which the

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<sup>11</sup> 2019 CIVIL APPEAL NO. 8766-67

<sup>12</sup> Ibid

<sup>13</sup> 9 SCC 478 (2009)

creditor must demonstrate the presence of a default. Following completion, the Tribunal designates a Resolution Professional to oversee the daily activities of the business and starts CIRP against the debtor company. The directors are now expected to support the insolvency expert in order for him to perform his duties efficiently. A contract with a violation of guarantee may be brought before the Debt Recovery Tribunal (abbreviated “DRT”), in contrast with processes under code, which is exclusive to NCLT. The creditors have the power to determine the company’s future by either approving liquidation or developing a strategy for settlement following the 180-day statutory period and any extension granted have passed. These two sets of court cases are subject to NCLT’s examination.

These two actions are entirely distinct from one another. Whereas the Code concentrates on the presence of a default, a deed of guarantee concentrates upon breach of a promise. The two types of relief have different forums. In contrast to the NCLT’s proceedings under the Code, the Debt Recovery Tribunal has the power enforce action for a guarantee contract violation. The current initiatives focus on the inconsistency between Sections 14(1) and 60(2) of the code.<sup>14</sup>All further legal action against the corporation is suspended by the halt that Section 14(1) imposes.

### **Rights of Guarantee to Recover Debt:**

Occasionally, guarantor assists major debtor through waiving his obligation, but in return, he is unable to provide the funds. Recovering this money becomes a challenging task. According to the legal doctrine of subrogation as outlined in the laws of contracts in India, the rights of one individual can be transferred to another as long as the latter party plays a key role in eradicating previous borrower’s obligation. The guarantor now becomes the creditor of the borrower since he inherits the powers of previous creditor, including the authority to collect the loan balance.

Regarding the matter of *Sumit Aviation v. Davinder Ahluwalia and People*, Punjab National Bank received 1.05 crores from the personal guarantors of the defaulting company. Guarantor assumed the role of the creditor under subrogation concept. Again, the company failed to pay back the guarantors for the funds used to pay off the debt that was created in exchange for MS Sumit Aviation’s payment. The guarantors then proceeded to the NCLT in compliance with The Corporate Insolvency Resolution proceedings were approved by Tribunal in accordance with Section 7 of the IBC, 2016.

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<sup>14</sup> The 2016 act No. 31 Insolvency and Bankruptcy Code

**Critical analysis & Suggestions:**

The rulings by Apex Court in various cases like *Lalit Kumar Jain v. Union of India*<sup>15</sup> emphasizes the essential principle of Indian contract law, which states that both the major debtor and the guarantor have coextensive liabilities, a creditor may pursue legal action against both of them at the same time or against each of them separately. Since creditors are given the protection of several options for debt recovery, which gives them a great deal of power and flexibility, this idea is crucial to preserving the integrity of credit markets. It aims to bridge a possible gap where debtors can use the insolvency process against their guarantors to try to avoid responsibility. The Court appears to have significantly bolstered the position of financial creditors under the IBC by confirming that a corporate guarantor's CIRP does not eliminate the corporate debtor's liabilities and vice versa.

The researcher suggests that first, while the moratorium is in place, no debt recovery actions will be taken against a corporate debtor, and no actions will be taken against a corporate debtor's guarantor as doing so would result in a charge on the property. According to this study, the creditor would have to delay the remedies and resulting ambiguity.<sup>16</sup> The establishment of the new regime is an accepted legislative effort because it aims to increase productivity, maximize the value of assets, and improve the settlement process. However, it appears that lawmakers have fallen into the usual pit of ambiguities and is therefore struggling to discuss the insolvency theory's dynamics and uncertainties. The apex court had observed that if the creditor is asked to delay his remedy, the entire goal of the contract of guarantee is defeated. This means that it is better to avoid any kind of misunderstanding because only legal clarification will ensure the limits of each party.

**Conclusion:**

Researcher concludes that there are several unclear and ambiguous aspects of the link between a guarantor's duty and the 2016 Bankruptcy and Insolvency Code. When the major debtor, also known as a corporate debtor, defaults, the guarantor becomes liable under this insolvency plan. The obligations of corporate debtor can only be decided upon the submission of a petition for insolvency proceedings against the corporate debtor under Section 7 of the IBC, 2016. In given situation, creditor may choose to approach the guarantor in an attempt to resolve the debt. In case there is a default by principal debtor the guarantor is held accountable under this

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<sup>15</sup> 3 S.C.R. 1075 [2021]

<sup>16</sup> The Second Amendment to the Insolvency and Bankruptcy Code Act of 2018



insolvency law. Only when a motion for insolvency proceedings is filed against corporate debtor in accordance with Section 7 of the IBC, 2016 will responsibility of the debtor be determined. In order to collect loan payments in this situation, the creditor may choose to contact the guarantor. While conducting this study, the author noticed two important things. These arguments are predicated on court and tribunal decisions as well as the IBC. Instead of merely dismissing the issue at hand, the researcher recommends that the courts take a comprehensive approach to solving this problem. A network of precedents, each correct in its own right, would constitute a less justiciable world if the same thing is not done.

IBC, 2016 must be read in accordance with all other applicable statutes because it is not an age-old law. Even if IBC, 2016 creates an overriding impact in accordance with Section 238 of IBC, it is crucial to avoid any uncertainty because only legal clarity can tell the other person of their boundaries and how to respond. Otherwise, innocent people would be punished because they would be subject to the principle of *ignorentia juris non excusat* i.e ignorance of law is not an excuse.

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