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# ACCOMMODATION GUARANTORS AND THE BLUNT EDGE OF SECTION 238 IBC: LIMITS OF CONTRACTUAL JUSTICE

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## ABSTRACT

The Insolvency and Bankruptcy Code, 2016 (IBC) enforces an insolvency framework applicable to personal guarantors of corporate debtors with disregard to their protections under the Indian Contract Act, 1872 (ICA), on account of the overriding provisions of Section 238 of the IBC. The framework's constitutional validity was affirmed by the Supreme Court in *Lalit Kumar Jain v. Union of India* (2021), wherein the court held that personal guarantors, being insiders with managerial control and information asymmetry along with commensurate benefit from the transaction, were justified in coming under the purview of this legislation. This paper challenges the said legal presumption, arguing that the assumption underlying this position is inaccurate and misleading.

IBC adopts a monolithic approach to defining the personal guarantor category, treating both the promoter-guarantor with managerial control over the debtor enterprise and the relationship-driven guarantor, who gives a guarantee for reasons other than exercising such control, under one common legal standard. Such blanket application of Section 238 of IBC results in a structural imbalance, where the latter type of guarantors are denied the benefits of ICA defense mechanisms, including the co-extensiveness clause under Section 128 and discharge clauses under Sections 133 to 141, but remain liable for obligations surviving under the Section 31(1) proviso. This paper refers to such structural inequality as the "Contract of Subjugation."

This paper examines comparative frameworks established under the UK, US and UNCITRAL Legislative Guidelines on Insolvency Law. It further relies on Articles 14 and 21 of the Indian Constitution. In light of these, the paper argues that personal guarantors should be classified into insiders and non-insiders. This will pave way for several amendments, such as providing for ICA defences for non-insiders, pre-execution disclosure requirements and modifications in the moratorium provision so that primary residence of relationship-driven guarantors cannot be taken over during insolvency proceedings.

**Keywords:** Personal Guarantors, Contract of Subjugation, Suretyship, Section 238 IBC.

## I. INTRODUCTION

The Insolvency and Bankruptcy Code, 2016 (IBC) imposes an extremely strict legal framework upon the personal guarantors of corporate debtors, thus rendering the contractual rights of such guarantors under the Indian Contract Act, 1872 (ICA) subordinate to Section 238 of the IBC. The constitutionality of such legal framework was upheld in the case of *Lalit Kumar Jain v. Union of India* (2021),<sup>1</sup> where the court affirmed the legislative presumption that personal guarantors are always insiders with a managerial role, having asymmetric knowledge regarding the corporate debtor and hence reaping sufficient advantage from the credit granted. This paper challenges the soundness of this presumption.

The personal guarantee is an inherently controversial form of a credit transaction. By signing a personal guarantee, one commits to ensuring credit is repaid and accepts the potential to face substantial liability. Such guarantee can be interpreted as a contract in which a private individual pledges his/her fortune to cover the potential debts of a company. Although the Indian Contract Act 1872 (ICA) traditionally regulated the relations between the creditor and surety, prior to enactment of the Insolvency and Bankruptcy Code 2016 (IBC), the insolvency laws were quite disparate. However, as of the moment, the entire process is covered by a single set of legal regulations.<sup>2</sup>

The key point of the insolvency framework is the provision established in Section 238 of the IBC, which renders all contrary provisions irrelevant to the extent of their inconsistency with the law. According to the judgment given in the case of *Lalit Kumar Jain v. Union of India*, the section makes Section 109 of the Indian Contract Act (ICA) and any other similar provisions concerning personal guarantees inapplicable to the cases involving corporate guarantors. Thus, the guarantors whose agreement was signed under duress and/or family pressure lose protection provided under the ICA and face being in a “Contract of Subjugation.”

The rationale behind the aforementioned presumption is that the personal guarantors should always be key managerial persons having sufficient information regarding the corporate debtor in question and thus voluntarily taking on the risks associated with guaranteeing credit provided to the debtor. It is true to a certain extent, since the promoters of major corporations indeed can be regarded as key managers. However, the vendors or family members who had signed a

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<sup>1</sup>*Lalit Kumar Jain v Union of India* 2021 SCC Online SC 396

<sup>2</sup>Indian Contract Act 1872 (India), s 126.

guarantee at banks' insistence do not necessarily fit the described model.

## II. THE ARCHITECTURE OF PERSONAL GUARANTOR INSOLVENCY

Personal guarantors to corporate debtors form a distinct sub-category of individual debtors under the IBC, distinguished by their nexus to a corporate liability. The personal guarantor regime was activated by notifications issued in 2019,<sup>3</sup> applying Part III of the Code to this class with the National Company Law Tribunal (NCLT) as the designated Adjudicating Authority<sup>4</sup> a deliberate structural choice reflecting the legislature's perception that the guarantor's fate is inextricably linked to the corporate insolvency resolution process (CIRP). Part III governs both insolvency resolution and bankruptcy of individuals,<sup>5</sup> with an automatic interim moratorium under Section 96 upon admission of any application.<sup>6</sup>

The most contested feature of the regime is the survival of guarantor liability after approval of a resolution plan. Section 31(1) makes an approved plan binding on all stakeholders, including guarantors.<sup>7</sup> A proviso, however, preserves creditor recourse against guarantors for amounts not recovered under the plan.<sup>8</sup> This produces a striking asymmetry: even where the resolution plan provides creditors only thirty or fifty percent of their dues, the guarantor remains liable for the full balance, since Section 238 displaces the ICA's co-extensiveness principle<sup>9</sup> that would ordinarily reduce the guarantor's obligation in tandem with the principal debt.

## III. CONTRACT LAW AND THE CONTRACT OF SUBJUGATION

Pursuant to the Indian Contract Act (ICA), the guarantee is classified as an ancillary agreement wherein its legal standing and terms of application are rooted in the primary agreement. Section 133 serves to relieve the surety in case there is a substantial change in the primary agreement without the consent of the surety.<sup>10</sup> On the other hand, Section 141 protects the securities of the creditor in favor of the surety,<sup>11</sup> whereas Section 140 gives the right of subrogation after

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<sup>3</sup>Insolvency and Bankruptcy (Application to Adjudicating Authority for Insolvency Resolution Process for Personal Guarantors to Corporate Debtors) Rules 2019 (India).

<sup>4</sup>Insolvency and Bankruptcy Code 2016 (India), s 60(2).

<sup>5</sup>Insolvency and Bankruptcy Code 2016 (India), ss 94-187.

<sup>6</sup>Insolvency and Bankruptcy Code 2016 (India), s 96.

<sup>7</sup>Insolvency and Bankruptcy Code 2016 (India), s 31(1).

<sup>8</sup>Insolvency and Bankruptcy Code 2016 (India), s 31(1).

<sup>9</sup>Indian Contract Act 1872 (India), s 128.

<sup>10</sup>Indian Contract Act 1872 (India), s 133.

<sup>11</sup> Indian Contract Act 1872 (India), s 141.

payment.<sup>12</sup> Section 139 releases co-sureties on account of the discharge of one of them.<sup>13</sup> These sections form the “protective architecture” of suretyship, as referred to in this research, which refers to an integrated structure of doctrines that guarantee that the surety does not shoulder any more risks than those which they knowingly accepted.

Section 238 breaks down this arrangement where the IBC process comes into play. A resolution plan is, by its very nature, a change in the manner in which the corporate debtor fulfils its obligations, exactly the kind of change that relieves a guarantor from liability under Section 133. However, in an IBC scenario, the guarantor finds himself under two contradictory forces on one hand being tied to the resolution plan through Section 31(1) of the IBC while losing out on the contractual benefit he would otherwise gain under Section 133 through ICA. The private contractual arrangements entered into by the guarantor initially and relied upon subsequently find themselves undermined in hindsight by legislation never envisaged earlier. As termed by this paper, this results in the creation of a “Contract of Subjugation.”

#### **IV. THE INVOLUNTARY GUARANTOR: THE CASE FOR DIFFERENTIATION**

##### **A. A TAXONOMY OF PERSONAL GUARANTORS**

A further detailed categorization is essential to conduct the analysis properly and cannot be done within the scope of the current IBC framework. One way to categorize is to divide into three broad classes. The first one is the promoter-guarantor, which usually involves the founder or the person controlling the shares of the company who provides the guarantee at the time of financing with knowledge of the business of the corporate debtor. This class of guarantee falls most closely within the purview of the legislature's primary purpose.

The second is the director-guarantor, where the person holding a directorship of the company does not have the same control or knowledge of the company's finance but executes a guarantee to fulfil the obligation of the lender.

Lastly, the third category of guarantors would include what can be called relationship-driven guarantors. It involves people providing guarantees not because they exercise some kind of authority in managing the corporate debtor's affairs but because such guarantees are required

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<sup>12</sup> Indian Contract Act 1872 (India), s 140.

<sup>13</sup> Indian Contract Act 1872 (India), s 139.

to preserve a relationship. The most obvious reason would be that a supplier needs the guarantee to secure its order, and a minority shareholder providing the guarantee only because of the majority's pressure can fall into this category.

## **B. THE INFORMATIONAL ASYMMETRY ASSUMPTION AND ITS LIMITS**

The Insolvency Law Committee's Report, 2018 expressed the legislative purpose in clear terms: personal guarantors generally enjoy knowledge of the books and conduct of the business of the corporate debtor and have enjoyed the credit extended to the corporate debtor.<sup>14</sup> Under this approach, there is sufficient incentive created for the guarantor to observe the debtor's state of finances and take remedial action where necessary. This reason makes sense for promoter guarantors but fails to apply in the case of relationship-based guarantors. The person who provides a guarantee on behalf of his buyer cannot have any information about the management accounts or minute books of the borrower, which means that this guarantee is not based on an assessment but a need. Even the Committee recognized the necessity for such discrimination.

The UNCITRAL Legislative Guide identifies a balance between risk and gain as one of the principles underlying an equitable handling of guarantors in an insolvency proceeding.<sup>15</sup> If the guarantor does not receive any gain, or information concerning the principal transaction that he guarantees, then the balance principle will be violated by forcing him/her to undergo the full rigors of the personal guarantor provisions under the IBC legislation.

## **C. CONSTITUTIONAL DIMENSIONS**

The constitutional validity of the personal guarantor regime was upheld in *Lalit Kumar Jain* on the basis that personal guarantors form a distinct and identifiable class for the purposes of Article 14 of the Constitution.<sup>16</sup> This paper advances a narrower, internal challenge: within the class of personal guarantors, the legislature has failed to distinguish between those who possess the informational and control characteristics that justify a rigorous regime and those who do not. Article 14 jurisprudence condemns the treatment of unlike cases alike as much as it condemns the treatment of like cases differently; the conflation of promoter-guarantors and relationship-driven guarantors raises a serious question of legislative proportionality.

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<sup>14</sup>Insolvency and Bankruptcy Board of India, Report of the Insolvency Law Committee (March 2018) 62.

<sup>15</sup>UNCITRAL Legislative Guide on Insolvency Law (United Nations 2004) pt III, paras 19-20.

<sup>16</sup>Constitution of India 1950, art 14.

Article 21, protecting the right to life and personal liberty,<sup>17</sup> has been construed to encompass the right to livelihood and protection against arbitrary deprivation of property. For the relationship-driven guarantor who may be a small vendor or a middle-income family member invocation of the IBC personal guarantor regime can result in loss of a home, a business, or lifetime savings. Where such consequences flow from a guarantee executed without genuine informed consent and without the informational advantage that justifies the risk allocation, the Article 21 implications deserve serious examination that the Supreme Court has not yet provided.

## **V. COMPARATIVE PERSPECTIVES**

The United Kingdom's Insolvency Act 1986 preserves the guarantor's contractual rights, including defences arising from variation of the principal contract, impairment of security, and co-surety release, even in the context of corporate insolvency proceedings. There is no direct equivalent of Section 238's override. The UK approach has been criticised for insufficiently incentivising promoter-guarantors to engage constructively in resolution, but it has the countervailing virtue of protecting non-insider guarantors who executed guarantees in reliance on the general law.

The United States Bankruptcy Code places significant weight on the "fresh start": individuals should, after discharging debts in bankruptcy, be able to resume their economic lives without the indefinite burden of pre-petition obligations. The IBC's discharge provisions under Section 179<sup>18</sup> are considerably more constrained, particularly for guarantors subjected to creditor-initiated proceedings rather than voluntary petition. The Indian legislature's relative reluctance to embrace the fresh-start philosophy reflects a creditor-centric orientation that, while comprehensible given deep-rooted non-performing loan problems, imposes disproportionate costs on the most vulnerable category of guarantors. The World Bank's Principles for Effective Insolvency and Creditor/Debtor Regimes explicitly recommend calibrating guarantor liability to the nature and extent of the guarantor's engagement with the principal transaction, with particular sensitivity to non-insider guarantors.<sup>19</sup>

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<sup>17</sup>Constitution of India 1950, art 21.

<sup>18</sup>Insolvency and Bankruptcy Code 2016 (India), s 179.

<sup>19</sup>World Bank, Principles for Effective Insolvency and Creditor/Debtor Regimes (2021 edn) Principle C12.

## VI. TOWARDS REFORM

### A. STATUTORY CLASSIFICATION

The most direct reform would introduce a statutory classification distinguishing *insider guarantors* those holding managerial positions, significant shareholding, or informational access to the corporate debtor from *non-insider guarantors* those executing guarantees primarily in the context of commercial relationships, familial obligations, or lender requirements without managerial agency over the debtor. Such a classification, modelled on the IBC's existing "related party" definition<sup>20</sup> and the Companies Act's key managerial personnel concept, would permit the full rigour of the personal guarantor regime to apply to insider guarantors while preserving ICA defences for non-insider guarantors. A corresponding qualification to Section 238 would be required, and the Section 31(1) proviso would need amendment to cap non-insider guarantor liability at the proportion of the debt actually admitted and voted on in the CIRP.

### B. MANDATORY PRE-EXECUTION DISCLOSURE

A further reform operating at the pre-contractual stage would require creditors, before executing any personal guarantee in favour of a corporate debtor, to provide the guarantor with a standardised disclosure document specifying: the nature and quantum of the guaranteed liability; the financial condition of the principal debtor as disclosed in the most recent audited accounts; the effect of the IBC personal guarantor regime on the guarantor's contractual defences; and the potential consequences of the corporate debtor's insolvency for the guarantor's personal assets. Failure to provide the prescribed disclosure would render the guarantee voidable at the guarantor's election. This proposal draws on consumer credit disclosure requirements in financial regulation and is consistent with the free consent principle under Section 14 of the ICA.<sup>21</sup> It would not prevent execution of guarantees by informed guarantors, but would ensure the election is, in fact, informed.

### C. MORATORIUM RECALIBRATION AND JUDICIAL DEVELOPMENT

A targeted moratorium reform would extend protection under Section 96 to cover the principal

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<sup>20</sup>Insolvency and Bankruptcy Code 2016 (India), s 5(24A).

<sup>21</sup>Indian Contract Act 1872 (India), s 14.

residence of relationship-driven guarantors for the duration of both the CIRP and the personal insolvency process, suspending that protection only upon a finding that the guarantor is an insider. Precedent for such calibration exists within the Code itself: Section 10A, introduced during the COVID-19 pandemic to suspend CIRP filings for defaults in a specified period,<sup>22</sup> demonstrates legislative willingness to adjust the Code's rigour to circumstances.

Pending legislative action, courts can invoke the doctrine of unconscionability recognised by the Supreme Court as a basis for refusing enforcement of oppressive contracts<sup>23</sup> to shape remedies in guarantee enforcement proceedings. In appropriate cases, courts could refuse to enforce the full quantum of a guarantee where the guarantor received no material benefit from the principal transaction and executed the guarantee under commercial compulsion. An emerging good faith obligation on creditors could additionally require disclosure to the guarantor of material information about the principal debtor's financial condition both at the time of execution and during the CIRP partially redressing the informational asymmetry that characterises the relationship-driven guarantor's position and underpins the structural inequity examined throughout this paper. The Resolution Professional's duties under Section 99 could be extended to cover a review of whether adequate disclosure was provided, with findings communicated to the Adjudicating Authority at the admission stage.<sup>24</sup>

## VII. CONCLUSION

The regulation of personal guarantors under the IBC represents a unique and necessary innovation within the realm of Indian insolvency law. Including personal guarantors of corporate liabilities within the ambit of insolvency laws represents best international practices and is also in the public interest in terms of upholding credit market integrity and resolving non-performing loans efficiently. Nonetheless, the present system operates on the erroneous assumption that all personal guarantors must be considered as insiders who possess management agency and informational advantages a notion that is empirically flawed and analytically untenable.

Unlike the promoters of companies, who constitute the main target group for legislation, a relationship-driven or involuntary guarantor does not enter into the agreement voluntarily; he

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<sup>22</sup>Insolvency and Bankruptcy Code 2016 (India), s 10A (introduced by the Insolvency and Bankruptcy Code (Amendment) Ordinance 2020).

<sup>23</sup>*P Dwaraka Das v State of Madhya Pradesh* 1999 (3) SCC 500

<sup>24</sup>UNCITRAL Legislative Guide on Insolvency Law (United Nations 2004) pt IV, Recommendation 12.

enters into it due to social or commercial pressure. His vulnerability to the provisions of the IBC in relation to the personal guarantor, the disapplication of his defences under ICA through section 238 and liability even after a resolution plan, which could be greater than what he did for the underlying business deal itself, and is contrary to the principle of contractual fairness makes him disproportionately vulnerable.

The introduction of an insider and non-insider classification, together with the application of ICA defences for the latter type, along with prior disclosures before execution and the introduction of a modified moratorium regime to shield domestic assets, represents the way forward towards redressing this systemic injustice. Indeed, personal guarantees occupy the interface of private contracting and public insolvency policy considerations. At the intersection, one must strive to reconcile the necessity of upholding credit market discipline irrespective of personal suffering of an individual with avoiding forcing individuals to forego legitimate contractual interests simply for the benefit of creditors.