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INSOLVENCY PROCEEDINGS MAY BE INVOKED AGAINST CORPORATE GUARANTOR BEFORE PROCEEDING AGAINST THE PRINCIPAL DEBTOR

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On 8 January 2019, the National Company Law Appellate Tribunal (NCLAT) delivered a landmark judgment in Ferro Alloys Corporation Limited v Rural Electrification Corporation Limited (Comp. App (AT) (Ins) No. 92 of 2017) and other connected appeals. The subject matter of the judgment addresses the question whether a corporate insolvency resolution process can be initiated against the corporate guarantor without initiating the insolvency process against the principal debtor under Section 7 of the Insolvency and Bankruptcy Code 2016 (Code). The NCLAT held that insolvency proceedings against the corporate guarantor may be undertaken without initiating proceedings against the principal debtor.

Facts

In the present case, Rural Electrification Corporation Limited (REC), served as a financial creditor and had sanctioned a loan amounting to Rs. 517.90 crores to FACOR Power Limited, the principal debtor. Ferro Alloys Corporation Limited (Ferro Alloys) was the corporate guarantor of the said loan and had, therefore, undertaken to guarantee all amounts payable by FACOR Power Limited to REC. When FACOR Power Limited failed to repay the loan, REC invoked the corporate guarantee on 27 October 2015. Thereafter, on the failure of REC to repay the loan, REC filed an application before the National Company Law Tribunal, Kolkata (NCLT) to initiate corporate insolvency resolution proceedings against Ferro Alloys. NCLT passed an order in favour of REC under Section 7 of the Code and appointed an interim resolution professional. Ferro Alloys filed an appeal before the NCLAT against the NCLT order. Thereafter, 2 other appeals were filed on behalf of a consortium of banks (Lenders Consortium) and the shareholders and promoter of Ferro Alloys.

Arguments

The appellants submitted that while the Code includes the concept of a 'personal guarantor', it does not recognize the concept of a corporate guarantor . Therefore, an insolvency proceeding cannot be initiated against a corporate guarantor. Without conceding that a 'corporate guarantor' is subsumed within the definition of a 'corporate debtor', the appellants further contended that an insolvency proceeding cannot be first initiated against the corporate guarantor without proceeding and exhausting the relief provided against the principal debtor.

On the other hand, REC submitted that the corporate guarantee provided by Ferro Alloys was unconditional, joint and several and co-extensive with that of the principal debtor and could be invoked even without exhausting the remedies against the principal debtor. It was further argued that a corporate guarantor becomes a corporate debtor as soon as a guarantee agreement is invoked. REC also argued that on a joint reading of Section 3(8) of the Code (which defines a 'Corporate Debtor' as "a corporate person who owes a debt to any person") and Section 5(8) of the Code (which defines 'Financial Debt' as inter-alia, including "the amount of any liability in respect of any of the guarantee") confirms that a corporate person who owes a debt in the form of a liability in respect of a guarantee would be included in the definition of a "corporate debtor" under section 3(8) of the Code.

Judgment

NCLAT held that:

- A joint reading of the definitions of corporate person, corporate debtor, debt, claim, financial debt, operational debt, financial creditor, and default provides that "a guarantee becomes a debt or as soon as the guarantee is invoked whereinafter a guarantor ('corporate guarantor') becomes a 'corporate debtor'" in terms of the Code. In providing its judgment, NCLAT referred to Bank of Bihar Limited v Dr. Damodar Prasad & Anr ((1969) 1 SCR 620) (Bank of Bihar Case), which held that the liability of the surety under Section 128 of the Indian Contract Act, 1872 (Contract Act) is coextensive with that of the principal debtor. In addition, NCLAT also relied on Ram Bahadur Thakur v Sabu Jain Limited (1981 (51) Comp Cas 301) and Kesoram Industries and Cotton Mills v Commissioner of Wealth Tax ((1966) 59 ITR 767) to support its position.

- The Code does not bar a 'financial creditor' from initiating 'corporate insolvency resolution process' against the 'guarantor', who comes within the meaning of 'corporate debtor'. In absence of any express provisions prescribing inter-se rights, obligation and liabilities of a guarantor qua a 'financial creditor', it was held that same may be taken from the provisions of the Contract Act.

- It is always open to a 'financial creditor' to initiate resolution process under Section 7 of the Code against a 'corporate guarantor', as the creditor is also the 'financial creditor' qua 'corporate guarantor'. Here, NCLAT relied on the Bank of Bihar Case and State Bank of India v Indexport Registered ((1992) 3 SCC 159), wherein it has been held that the liability of surety is not to be deferred until the creditor exhausts his remedies against the principal debtor.

Decision

- The appeal at the instance of Ferro Alloys through its board of directors (suspended) is not maintainable in view of the judgment in Innoventive Industries Limited v. ICICI Bank ((2018) 1 SCC 407), wherein the Supreme Court held that the board of directors (suspended) have no right to move an appeal on behalf of the 'corporate debtor', although it is open to the director(s) or shareholder(s) to challenge the same.

- The appeal filed on behalf of the Lenders Consortium claiming that the lenders are the first charge holders of Ferro Alloys was dismissed on the ground that the Lenders Consortium can file claims after admission of an application under Sections 7, 9, or 10 of the Code and the same is to be looked into by the 'resolution professional'.

- The appeal filed on behalf of the promoter and shareholder is dismissed on merits.

Comment

The NCLAT has followed and reaffirmed a long line of precedents under Indian and foreign contract and insolvency laws, which hold that a creditor may proceed against the guarantor on failure of the principal debtor to repay the loan upon demand by the creditor without exhausting his remedies against the principal debtor. If the argument of the appellants had been accepted, it would not only amount to rewriting the contract, but also reading provisions into a statute which is impermissible. The observation of the Supreme Court that imposing a condition upon the creditor to exhaust the remedies against the principal debtor would completely defeat the object of the corporate guarantee, was also rightly noted by the NCLAT. Further, in view of the Insolvency and Bankruptcy Code (Second Amendment) Act, 2018 amending the Code to bring in Section 5A (which defined 'corporate guarantor' as a corporate person who is the surety in a contract of guarantee to a corporate debtor), the argument that the Code does not recognize the concept of a 'corporate guarantor' becomes redundant with effect from 6 June 2018, i.e. the date the amendment came into force.

Khaitan & Co represented Rural Electrification Corporation in the appeals.

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