

Insolvency and Bankruptcy Hotline

September 15, 2017

GUARANTORS AND THE MORATORIUM UNDER THE BANKRUPTCY CODE: AN ON-GOING BATTLE

- Allahabad High Court stays proceedings against guarantor of Corporate Debtor in the Debt Recovery Tribunal;
- Recent pronouncements provide contradictory positions with regard to the scope of moratoriums under the Insolvency and Bankruptcy Code, 2016 (“Code”);
- During the moratorium, creditors unable to enforce a contract of guarantee.

INTRODUCTION

The present ruling arises in a writ petition filed by directors of a corporate debtor challenging an order of a DRT. In terms of the order challenged, DRT permitted proceedings against the directors, while staying the proceeding against the Company (DRT Order). The High Court, in exercise of its writ jurisdiction, by the present order under analysis, however, set aside the order of the DRT and has stayed proceedings against the directors as well.

In *Sanjeev Shriya v. State Bank of India & Ors.*,¹ the Allahabad High Court (“Court”) has held that the proceedings against a guarantor of a Corporate Debtor before a Debt Recovery Tribunal (“DRT”) must be stayed in light of on-going proceedings against the Corporate Debtor before the National Company Law Tribunal (“NCLT”).

FACTUAL BACKGROUND

- In 2005, the petitioners, who are also directors of M/s L.M.L. Limited, Kanpur (“Company”), executed a deed of guarantee in favour of State Bank of India (“SBI”) for a loan granted by SBI to the Company (“Deed”).
- In 2007, the Company was declared as a “Sick Industrial Company” by the Board of Industrial and Financial Reconstruction.
- In 2017, SBI filed an application under S. 19 (3) of the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (“1993 Act”) before the DRT in Allahabad for the recovery of Rs. 72,75,29,053.71 against the Company as the principal borrower and the petitioners in their capacity as guarantors (“Original Application”). On March 30, 2017, the DRT passed an interim order requiring the guarantors to disclose particulars of assets as specified by SBI.
- Subsequently, the Company approached the NCLT under S. 10 of the Insolvency and Bankruptcy Code, 2016 (“Code”) to initiate a Corporate Insolvency Resolution Process (“CIRP”). The NCLT, vide its order dated May 30, 2017, admitted the application and, *inter alia*, declared a moratorium on the institution or continuation of suits and/or proceedings against the Company (“NCLT Order”).²
- Based on the NCLT Order, the Guarantors sought stay of the proceedings before DRT. It was contended that since the matter was pending before NCLT and NCLT had exclusive jurisdiction and further in light of the moratorium in terms of the NCLT Order, proceedings before DRT vis-a-vis the guarantors should also be stayed by DRT.
- On June 6, 2017, the DRT passed an order whereby it kept the proceedings against the Company in abeyance but proceeded against the petitioners as guarantors. The DRT Order was challenged in a writ petition as guarantors contended that DRT had exceeded its jurisdiction.

ISSUE

Accordingly, the issue before the Allahabad High Court was whether a financial creditor could be allowed to pursue proceedings under the 1993 Act before the DRT against the guarantors, when the NCLT had already declared a moratorium under S. 14 of the Code vis-a-vis the Company.

CONTENTIONS

The Petitioners argued that:

- the proceedings before the DRT were without jurisdiction in light of the moratorium under the Code, and that provisions of the Code would prevail over the provisions of the 1993 Act;
- the DRT could not validly adjudicate claims against the guarantor when the claim in relation to the debt was itself to be determined;
- the action by the DRT would be contradictory to the object of the Code, which seeks to consolidate proceedings and avoid multiple proceedings before different forums;

On the other hand, the Respondents submitted that:

- the Code does not place any restriction on proceedings against the guarantor independently, as the rights of the Respondents flow directly from the Deed of Guarantee;
- there is no overlap between DRT proceedings for recovery of debt and NCLT proceedings;

JUDGMENT

The Court opined that the proceedings were in a “fluid stage” and for the same course of action, two split

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proceedings i.e. before the DRT as well as the NCLT, should be avoided, if possible. The Court also held went on to stay the proceedings against the guarantors before the DRT. Furthermore, it was held that sufficient safeguards have been provided under the Code; and the liability of the Company has not yet crystallized against either the principal debtor or the guarantors.

NATIONAL COMPANY LAW APPELLATE TRIBUNAL

In certain other cases, questions on maintainability of proceedings against guarantors have arisen when a moratorium has been declared against a Corporate Debtor by the NCLT. An analysis of some earlier judgments in this regard can be found [here](#).

In two recent cases (discussed below) the appellate tribunal (“**NCLAT**”) upheld the view of NCLT that recourse against guarantors could not be taken when a moratorium has been declared against a Corporate Debtor.

(i) *Alpha & Omega Diagnostics (India) Ltd. v Asset Reconstruction Company of India Ltd. & Ors.*³

In this case, the personal properties of the promoters had been given as security to the banks. The question before the NCLT (Mumbai) was whether such properties that are not owned by the Corporate Debtor would come within the meaning of moratoriums under the Code.

The NCLT used principles of statutory interpretation to hold that the term “its” under Section 14(1)(c) of the Code refers to the property of the Corporate Debtor. Accordingly, the property not owned by the Corporate Debtor would not fall within the ambits of the moratorium under the Code.

Upholding the decision of the NCLT, the NCLAT held that the moratorium would not be applicable to any assets, movable or immovable, that do not belong to the Corporate Debtor.

(ii) *Schweitzer Systemtek India Pvt. Ltd. v. Pheonix ARC Pvt. Ltd. & Ors.*⁴

In this case as well, the grievance of the appellant was whether personal property that was given as security to the creditor-banks would fall within the scope of the moratorium under the Code. The NCLAT referred to earlier judgments of the Tribunal and held that the moratorium under the Code is only applicable to the property of the Corporate Debtor.

ANALYSIS

The position taken by the NCLAT and NCLT (“**Tribunals**”) on one hand, and the Court on the other hand, appears contradictory. While the Tribunals have interpreted the Code strictly, the Court seems to have taken into account the purpose of the Code and tried to ensure that the mechanism provided under the Code is practically enforceable. The implications of both positions have been discussed below.

Purpose of Moratorium: The purpose of the moratorium is, amongst other things, to suspend all pending or fresh proceedings against the Corporate Debtor and to bar any encumbrance, sale, or alienation of its assets. Once the application is admitted and a moratorium is declared, the financial position of the Corporate Debtor must be transparent and crystallized. This suspension of proceedings is essential as it stabilizes the assets of the Corporate Debtor thereby giving the creditors clarity regarding the financial health of the Corporate Debtor and providing them with a drawing board to formulate a resolution plan.

Strict Interpretation: The Tribunals have interpreted the aforementioned provisions pertaining to moratorium strictly i.e. that the moratorium is applicable only to the property of the Corporate Debtor and that the moratorium should not extend to any third party, including a guarantor of a Corporate Debtor.

In such a case, take a situation where a creditor decides to continue/ initiate proceedings against a guarantor of a Corporate Debtor during the pendency of the CIRP. In such a situation, a creditor may well be able to satisfy its outstanding debts through the assets of the guarantor. However, this will alter the financial position of the Corporate Debtor after the declaration of the moratorium. This may effectively derail the CIRP and any resolution plan that the Committee of Creditors (“**COC**”) may be formulating, thereby defeating the scope and purpose of the Code. (if this is the argument you are taking, you should support the HC ruling).

Additionally, if such a creditor is a part of the COC, post satisfaction of its outstanding debts, the composition of the COC will also presumably stand changed. This is another situation that has not been envisaged under the Code.

Purposive Interpretation: The Court has interpreted the provisions of the Code purposively to bar simultaneous proceedings against the Corporate Debtor and guarantors under the Code as well as the 1993 Act respectively. The Court’s interpretation appears to keep in mind the letter and spirit of the Code, which is to effectively restructure the outstanding debts of a corporate debtor.

However, this interpretation is not provided for under the provisions of the Code and it would effectively render any guarantees for the Corporate Debtor infructuous for the term of the moratorium. This would prejudice the sanctity of the contract of guarantee, and deter future creditors from relying on guarantees as a safety net for the recovery of their debts.

The Way Forward: The Court has not opined on the applicability of S. 60 of the Code, and has left it open for interpretation- and the Code is otherwise silent on the applicability of moratorium to guarantors. If guarantors are not brought within the ambit of moratoriums, it may lead to incongruities and eventually delays in implementation of the Code. On the other hand, if guarantors are brought within the scope of the moratorium, the guarantees for Corporate Debtors would be rendered redundant, thereby giving a go-by to the sanctity of the contracts already in existence. In light of this predicament, it is pertinent for an appropriate forum to clarify the scope of moratoriums under the Code and close the floodgates for an otherwise overly-litigious community.

The bare text of the provisions analyzed in this hotline can be found [here](#).

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¹ Civil Writ Petition No. 30285 of 2017

² It had been contended that SBI, a financial creditor, was also party to the proceedings before NCLT and was thus, aware of the proceeding before DRT and NCLT.

³ Company Appeal (AT) (Insolvency) No. 116 of 2017

⁴ Company Appeal (AT) (Insolvency) No. 129 of 2017

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