SC Ruling on Creditors invoking Personal Guarantees

Why in news?

The Supreme Court (SC) has ruled that creditors can proceed against promoters of defaulting companies to recover debt, if such promoters have given personal guarantees to secure funds.

What is a personal guarantee?

- A personal guarantee is most likely to be furnished by a promoter or promoter entity.
- It is an assurance that if the lender allows them the fund, they will be able to turn around the loss-making unit and repay the said loan on time.
- A personal guarantee is different from the collateral that firms give to banks to take loans.
- Because, Indian corporate laws say that individuals such as promoters are different from businesses and the two are very separate entities.
- [Banks demand for collateral which equals the risk they are taking by lending to the firm which may not be doing so well.]

What is the rational behind SC ruling?

- Personal guarantees from promoters are a kind of assurance to lenders that the money being borrowed will be returned.
- So, under the contract of guarantee, the liability of the promoter will be over and above the liabilities of the company.
- Thus, mere approval of a resolution plan under the IBC for a debt-laden company does not automatically discharge a promoter from their liability.
- [IBC – Insolvency and Bankruptcy Code]
- Lenders/Banks are, in most cases, forced to compromise on their pending dues when a resolution plan is approved.
- The SC ruling thus allows them to recover substantially more from the resolution of a stressed corporate entity.

- Lenders can proceed against the promoters even when corporate insolvency resolution process itself has not been completed.

What were the earlier government measures?

- Bad loans have been a major problem for banks and financial creditors over the past decade.
- Also, promoters are able to secure funds from banks without the due diligence in most cases because of their past transaction history.
- There was also the practice of securing funds for a particular project but then diverting it to other projects or works.
- To end these and make promoters more liable, the government had in December 2019 introduced a provision.
- It made personal guarantors a separate category of individuals.
- This gave banks the power to move application for initiation of insolvency against personal guarantors to corporate debtors.

What is the promoters' stance?

- Promoters argue that it was always a management board that ran the company.
- So, promoters alone should not be held liable for the default on debt repayment.
- [The Supreme Court transferred all the cases related to personal insolvency to itself in December 2020.
- By that time, as many as 75 promoters and guarantors had challenged the personal insolvency provisions of the government.]

What is the likely impact?

- Several corporate leaders are set to be impacted.
- The promoters of many defaulting corporates facing action under the IBC had furnished guarantees for thousands of crores in loans.
- Entrepreneurs, before signing a personal guarantee, will now have to be very certain that the business they fund will not flounder.

Source: The Indian Express, The Hindu