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Short-Comings and Pitfalls of Registering Corporate Guarantee as Charge

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ABSTRACT

The scholars have argued that the basic purpose of registration of a charge created on assets of the company is to serve as a public notice and any person who deals with a company may verify the charges registered with ROC and take an informed commercial decision whether to deal with the said company or not. Scholars have opined that both existing and contingent, should be known to the general public and a 360 degree panoramic view of the credit history including guarantees executed by a company has to be in the public domain. Therefore, according to them, it is also necessary to register charges in respect of Corporate Guarantees executed by a company. This paper has tried to mention some shortcomings and pitfalls of this approach such as inability to raise low capital and thus less money flow in the economy. The paper tries to roughly suggest some balanced approach and how we need to look this through the political lens.

Keywords*: Charge, Corporate Guarantee, Short Comings.*

I. INTRODUCTION

The paper first elaborates on the claim why scholars have argues that corporate guarantee should be registered as charge. Then it tries to criticize it by mentioning that the money flow in the economy reduces if the corporate guarantee is registered as charge. It mentions the need on why we need a more balanced and flexible system and its relation with politics.

The moot point of the discussion is when a company gives guarantee to any person or body corporate *(Refer Sections 126 128 of Indian Contract Act, Ram Kishun Vs.State of Uttar Pradesh [(2012) 11 SCC 511, Section 186 of Companies Act, 2013],*

whether a charge in respect of such guarantees can be registered (Refer Section 125(4) of 1956 Act and 77 of 2013 Act, ***S.T.Patil Vs.Registrar of Companies, [[1998]91CompCas578(CLB)*** with the Registrar of Companies or not?

The basic purpose of registration of a charge created on assets of the company is to serve as a public notice and any person who deals with a company may verify the charges registered with ROC and take an informed commercial decision whether to deal with the said company or not.

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A guarantee when enforced through court of law, the guarantor would be liable for the entire amount that the principal debtor is liable to pay though he has a right of subrogation. Where a suit is filed against a company for enforcement of guarantee, the assets, moveable or immoveable, can be attached and sold for realization of the debts of the borrower/creditors and/or a company may be referred to NCLT for initiating insolvency proceedings for default in honouring the guarantee executed by them. **(*Suraj Lamps and Industries Pvt. Ltd. Vs.State of Haryana* [AIR 2009 SC 3077])**

A corporate guarantee is no less security for the creditors. Hence, those who deal with a company should also be able to know about the guarantees furnished by it and amount involved therein. Companies do extend guarantees in favour of Banks, especially for the loans availed by their subsidiary companies. [It is the companies which extend guarantees for other companies or their subsidiaries while it is the individuals/persons like Directors of the Companies who extend guarantee for the benefit of Companies. It is rare that companies extend guarantees for the loans to be availed by individuals save and except like loans to their own employees].

The creditors may, if the principal borrowers default, proceed against the guarantors for recovery of their dues. Supreme Court in catena of judgements held that the liability of surety is immediate and a creditor may choose to proceed against the guarantor first before proceeding against the Principal Debtor for recovery of their dues. In the case of ***Ram Kishun Vs.State of Uttar Pradesh*** **[(2012) 11 SCC 511]**

Some scholars opine that claims against a company, both existing and contingent, should be known to the general public and a 360 degree panoramic view of the credit history including guarantees executed by a company has to be in the public domain. Therefore, according to them, it is also necessary to register charges in respect of Corporate Guarantees executed by a company. However, new Companies Act, 2013 also does not have a provision for registration of charge in respect thereof as Section 2(16) of Companies Act, 2013

They also opine that when "Guarantee" is a valuable security for the lenders, the same assumes importance and registration of the same as charge should be allowed. It is interesting to note that charge on intangible assets could be registered but not a "Guarantee". But, sub-section (9) of Section 186 mandated only to keep a register wherein particulars of guarantee given shall have to be mentioned which may not serve the purpose as mentioned in the earlier paragraphs.

Further, Limited Liability Partnership Act, 2008 which is similar to that of the Companies Act, has no provision for registration of any kind of charges created on LLP's assets. When an LLP

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is given corporate and legal status as that of a company, there is no reason why the Charges created by LLP should not be registered with ROC.

Therefore, scholars advocate that there is a need for amendment of Section 2(16) which defines the term "Charge", Section 77 of Companies Act, 2013 and Limited Liability Partnership Act, 2008, to provide for registration of charge in respect of corporate guarantee executed by a company and LLP.

II. SHORT-COMINGS AND PITFALLS OF REGISTRING CORPORATE GUARANTEE AS CHARGE

The definition of charge under section 77 of CPA 2013,[2] includes the registration against intangible and intangible assets which makes it broad enough to allow companies to raise money on its assets if it is able to do so. The understanding of not including corporate guarantee provides an alternative to the company to raise money despite not having enough assets by itself but at the same time providing a security if the debtor fails. The shortcomings and pitfalls of creating charge against the corporate guarantee is that, the ability to raise capital of the company reduces which reduces the money flow in the economy. The paper substantiates the claim below.

In a scenario where corporate guarantee is also considered as charge the ability to raise capital on its assets reduces. For example, when corporate guarantee is not considered as charge it could be raise 10 crore in capacity of guarantor and at the same time create charge on its assets and raise another 10 crores. But when corporate guarantee is considered as charge the same amount of assets can only raise 10 crores from the market, thus the capacity of the company to raise capital with the same amount of assets reduces if corporate guarantee is considered as charge.

The creditor pressurizes to create fixed charge on the assets in order to secure and protect its interests in the best way possible. If corporate guarantee is registered as fixed charge and in a case where company has limited assets and wants to raise capital on the same assets it would need permission from the earlier lending institution/person to create a second charge.[3] This interference on the internal matters of the company from the first lender would not have been there had the charge on the earlier assets not been created for corporate guarantee. If the lens is zoomed out and the picture is focused on macroeconomics, the ability to raise capital by the

[2]Companies Act 2013, s 77

[3]Geeta Saar, 'Charges and Its Registration (Residual provision of Sec77)' (2015) <https://www.icsi.edu/media/portals/86/manorama/Geeta_Saar_18-_Charges___Its_Registration__Residual_provisio.pdf>

company if reduced has a direct consequence of reduced flow in the economy. At large scale if the capacity of companies to raise capital reduces it would reduce the money flow in the economy .As the Keynsian economists proves reduced flow in economy could bring down the aggregate demand and cause stagnation of the economy as a whole.[4] Thus if larger picture is focused it would be safe to say that corporate guarantee should not be registered as charge.

It is important to safeguard the interests of creditor yet at the same point strike a balance of providing enough flexibility to company to raise money and expand their business. It is important to understand that guarantee is a tri-partite contract and should not involve another layer of covering by registering corporate guarantee as charge. Involving the instrument of government by registering it as charge may seem unnecessary specifically in India, as the judiciary has not backed out in protecting the interests of investors. The courts have taken steps to ensure that the guarantee is executed if the debtor fails. Such as guarantor's responsibility is co-extensive and the creditor does not have to exhaust all its possibilities against the debtor to proceed against the guarantor[5]. And another example is seen in the IDBI Trusteeship Services Ltd. V Hubtown Ltd. Despite some irregularities in filing the guarantee under proper guidelines of FEMA by the creditor the guarantee was binding with some penalties.[6]The Supreme Court's approach in the Hubtown case should provide comfort to the investor community and reinforces the favourable foreign investment climate in India.

The creditors many a times extend capital to the companies because of parent company as the guarantor and seeing the subsidiary group not as a single entity but relying on the corporate group as a whole. Despite the availability of proceeding co-extensively against the guarantor, the guarantor may shift its asset to its other subsidiary. The incompetence of Insolvency and Bankruptcy Code, 2016 to address this issue, another great example set out by judiciary by

[4]Mankiw N. G. (2007), Macroeconomics Latest India edition by South-Western, a part of Cengage Learning, Cengage Learning India Private Limited

[5]Ferro Alloys Corporation Limited v Rural Electrification[(IB) No. 251/KB/2017]

- Corporation Limited the court 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.
- 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.

[6]IDBI Trusteeship Services Ltd. vs. Hubtown Ltd. (15.11.2016 - SC) : MANU/SC/1490/2016

applying the doctrine of substantial consolidation in case of State Bank of India v Videocon Telecommunication limited India . In this doctrine to secure the interests of creditor the assets of parent company, its subsidiaries and associated companies were consolidated to remove the partition and hold the separate legal entities as horizontally liable.[7] In case of State Bank of India v Videocon Industries limited,[8] 2019, the Mumbai NCLT, applied the doctrine of substantial consolidation burrowed from the US and the UK courts despite the Report of the Insolvency Law Committee, 26th March 2018 that it is too soon to introduce the doctrine in India.[9] Thus it could be argued that when a parent company gives a guarantee it should not be registered as charge because the doctrine of substantive consolidation protects the interests of investors. The court specified that this doctrine is exception and not a general rule so that the stakeholders of the members in the other subsidiaries is not affected but at the same interest of the creditor is protected. The statutory presence of section 129(3) and 129(4) of Companies Act, 2013 mandates the holding company to provide a consolidated financial statement of all its subsidiaries and associated companies.[10] This removes the partition between subsidiaries and combines the assets of the corporate group and this gives access to the creditors to assess the capacity of the parent company to act as a corporate guarantor. The interest of the creditors is safe guard since the judiciary uses it power to remove the partition and invoke the insolvency process against the corporate group. This provides security to the creditors and enough flexibility to companies to raise money on its assets and act as a corporate guarantor.

A more middle ground than creating charge on corporate guarantee is to deposit an amount that would mature when the moratorium period ends. This amount matured would be same as the amount guaranteed by the guarantor. This deposit would pump money in the economy through the channel of bank at the same time protect the interest of the creditor. The amount required

[7]Schwarcz, Steven L. "Collapsing Corporate Structures: Resolving the Tension Between Form and Substance." *The Business Lawyer* 60, no. 1 (2004): 109-45. http://www.jstor.org/stable/40688263. Accessed on 9 September 2019.

[8]State Bank of India v Videocon Industries Ltd (MA 1306/2018, MA 1416/2018, MA 393/2019, MA 115/2019, MA 1574/2019, MA 774 /2019, MA 778/2019, MA 1583/2018)

The consortium of banks led by the State Bank of India (SBI) moved an application for substantial consolidation for the 15 companies belonging to the 'Videocon Group', where the consortium was the common creditor. A separate CIRP petition was admitted against all the entities, but it failed to obtain any attractive bid because of the lack of collateral assets and their inability to survive individually. In the absence of any prevailing provision in the legislature, using its equity jurisdiction, the tribunal analysed bankruptcy jurisprudence in the US and the UK and decided in favour of the consortium, where 13 out of its 15 companies turned to one entity. The court developed a two-step test in the case for the application of the doctrine. It laid down list of non-exhaustible list such as common control, common creditors etc. as a check list for the application of the doctrine. And secondly the court said "if an entity is self-serving, self-dependent and self-sustainable, a view can be taken for not granting consolidation", thus maintaining the balance between separate legal entities and the consolidation.

[9]Report of the Insolvency Law Committee, 26th March 2018<http://www.mca.gov.in/Ministry/pdf/ReportInsolvencyLawCommittee_12042019.pdf>

[10]Companies Act, 2013 s 129(3), 129(4)

to deposit would be comparatively much less than registering corporate guarantee as charge but simultaneously at the individual level it would increase the pressure on the company to raise some upfront capital compared to what corporate guarantee is at present. This pressure could be distributed on the debtor's shoulder by incorporating a clause of fees on guarantee in the tri-partite agreement. Or another possible way is to just register the corporate guarantee without and assets attached so that the world at the large has notice. This provides complete information to the investors before investing in a company. Thus, we need a more comprehensive approach that addresses the deficiency of registering corporate guarantee as charge.

III. LOOKING THROUGH POLITICAL LENS

To have a comprehensive and more holistic view of why corporate guarantees should be registered as charge it is important to look through the lens of politics and economics. The international politics and market along with the domestic regime of a country influences how countries frame its law or come up with some interim measures to protect the interest of creditor. China is a great example to understand this view. The Chinese government banks had to come forward to protect the companies from running debt risk and insolvency process, specifically in context of the on-going trade dispute between US and china. The political sanctions had suspended productions of the company and these companies that had provided the guarantee were heavily indebted thus the loans given out by banks turned into 'bad loans'. In Guangrao Rural Commercial Bank, 95% of its debts tuned into bad loans because the guarantors were heavily indebted.[11]The private sector of the China contributes 50 percent of taxes, 60 percent of GDP, 80 percent of urban jobs and 90 percent of new hires;[12] given that their contribution is so significant to the economy as a wholethe government has come forward to prevent a potential hazardous front for the economy. Given the growth of global market and is responsive to politics it would not be very far-fetched to say that in order to avoid shocks of large corporations, corporate guarantee could be registered as charge.

It is important to strike a balance of allowing the corporate structures to have enough flexibility to raise capital and at the same time protect the interests of the creditors. The paper has tried to explore options that achieve this balance, but due to the lack of resources the paper does not

[11]Shu Zhang, 'Debt guarantee tangle: China's private firms hit by default contagion' (Reuters, February 12 2019) <https://www.reuters.com/article/china-economy-debt/debt-guarantee-tangle-chinas-private-firms-hit-by-default-contagion-idUSL3N1ZG36F>accessed on 13 September 2019.

[12]Shu Zhang, 'Debt guarantee tangle: China's private firms hit by default contagion' (Reuters, February 12 2019) <https://www.reuters.com/article/china-economy-debt/debt-guarantee-tangle-chinas-private-firms-hit-by-default-contagion-idUSL3N1ZG36F>accessed on 13 September 2019.

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focuses on mathematical calculations that is provided by the scholars such as Richard Squire and E. Houghton, G. Dean and P. Luckett.

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