

## **A guarantor can question the valuation of security being enforced by a secured creditor**

In the matter of *Mr. Shantanu Prakash vs. Mr. Mahendar Singh Khandelwal (resolution professional of Educomp Solutions Limited) and others*<sup>1</sup>, while disposing of an interim application filed under Section 60(5) of the Insolvency and Bankruptcy Code, 2016 (“**IBC**”), the New Delhi bench of the National Company Law Tribunal (“**NCLT New Delhi**”) held that a guarantor can question the valuation at which the security pledged by the borrower with its secured creditor is enforced.

### **Brief Facts**

1. Educomp Asia Pacific Pte Limited (“**Educomp Asia**”) is a wholly owned subsidiary of Educomp Solutions Limited (“**Corporate Debtor**”). The Corporate Debtor was admitted into corporate insolvency resolution process (“**CIRP**”) on September 12, 2017 (“**Insolvency Commencement Date**”). Mr. Mahendar Singh Khandelwal was appointed as the resolution professional of the Corporate Debtor (“**RP**”).
2. Educomp Asia entered into a facility agreement dated May 16, 2008 (“**Facility Agreement**”) to avail a loan facility amounting upto USD 20,000,000 (US Dollars twenty million) (“**Facility**”) from the State Bank of India, Singapore (“**SBI Singapore**”) for acquiring a 51% stake in The Learning Internet Inc. (“**TLI**”), an e-learning solutions company.
3. To secure / guarantee the obligations of Educomp Asia under the Facility Agreement (“**Obligations**”):
  - a) the Corporate Debtor furnished a corporate guarantee in favour of SBI Singapore in terms of a corporate guarantee dated May 22, 2008 (“**Corporate Guarantee**”); and
  - b) Educomp Asia created a pledge on the shares held by it in TLI (“**Pledged Shares**”) in favour of SBI Singapore in terms of a stock pledge agreement dated July 23, 2008.
4. In terms of an order dated June 30, 2017, passed by the High Court of Singapore, Educomp Asia went into liquidation. Subsequently, a CIRP was also initiated against the Corporate Debtor on the Insolvency Commencement Date. By virtue of invoking the Corporate Guarantee, SBI Singapore became a member of the committee of creditors (“**CoC**”).
5. At the 21<sup>st</sup> meeting of the CoC, Mr. Shantanu Prakash (an erstwhile director of the Corporate Debtor) (“**Applicant**”), after becoming aware that SBI Singapore was contemplating to sell the Pledged Shares, raised queries in relation to the process being followed for the sale of the Pledged Shares. He emphasized that the recognized principles of valuation must be followed for the sale to yield maximum value.

<sup>1</sup> IA. No. 187/ND/2022 in Company Petition No. (IB)-101/(PB)/2017.

6. In this regard, an application was made by the Applicant to the NCLT New Delhi inquiring about the details of the sale of the Pledged Shares and if due process was followed. The State Bank of India (“**SBI**”) informed the RP that the Pledged Shares did not fall under the purview of CIRP and had been sold pursuant to an agreement dated September 3, 2021 (“**Sale Agreement**”), entered into, amongst, Educomp Asia (through its liquidator), the purchaser and the SBI Singapore.

### Issues before the NCLT New Delhi

1. Whether the shares held by Educomp Asia in TLI could be treated as an asset of the Corporate Debtor.
2. Whether in the wake of 100% shares of Educomp Asia being held by the Corporate Debtor in the present proceedings, the shares held by Educomp Asia in the TLI could be treated as assets of the Corporate Debtor.
3. Whether the plea of under-valuation raised by the Applicant in terms of the provisions of Section 47 of the IBC is tenable.
4. Whether moratorium could be applied to the Pledged Shares held by Educomp Asia.
5. When the Corporate Guarantor is liable to discharge such debt of a creditor for which it stands as a guarantor, whether it can question the valuation and sale price of the Pledged Shares.

### Key Arguments by the Parties

Contentions of the counsel to the Applicant:

1. It was alleged by the Applicant that the Pledged Shares were sold by SBI Singapore at a scrap value price and that such a sale was significantly undervalued and was ex-facie illegal, and therefore, the CoC and the RP ought to have intervened and not permitted the same. The Applicant further expressed that a genuine and transparent sale of shares could have extinguished the entire debt of the CoC, which could have resulted in the revival of the Corporate Debtor.
2. The counsel appearing for the Applicant contended that the sale of the Pledged Shares by SBI Singapore was an under-valued transaction. Since the RP failed to report the transaction to the NCLT New Delhi under Section 47 of the IBC, the Applicant was obligated to file an application to seek the declaration that the under-valued transaction was void and was liable to be reversed with all its effect.
3. It was argued that the CoC did not question the sale of the Pledged Shares, which secured the facility granted by SBI Singapore, for which the Corporate Debtor stood as a guarantor. Hence, the CoC had failed to exercise its commercial wisdom and CIRP stood vitiated.

### Contentions of the counsel to the RP:

1. The counsel appearing for the RP argued that the application was not maintainable as the transaction for sale of the Pledged Shares didn’t involve the Corporate Debtor. The counsel also argued that the assets of the wholly owned subsidiary company of the Corporate Debtor, which is already under liquidation, cannot be the subject matter of the CIRP.
2. It was further argued that it is a settled position under law that the assets of a subsidiary company must be treated differently than the assets of the corporate debtor undergoing a CIRP. Consequently, the assets of Educomp Asia could not have been subjected to a moratorium which was imposed on the assets of the Corporate Debtor.

## Findings and Analysis of the NCLT New Delhi:

### 1. Issues 1 and 2:

- a) On the first and second issue, the NCLT New Delhi relied on the judgement of the Supreme Court in *Vodafone International Holdings BV vs. Union of India*<sup>2</sup> and observed that the legal relationship between a holding company and a wholly owned subsidiary is that they are two distinct legal persons, and the holding company cannot own the assets of its subsidiary. Thus, the Corporate Debtor is not entitled to have any interest in the assets of Educomp Asia even if it is its wholly owned subsidiary.
- b) Relying on the judgement of the Supreme Court in *Bacha F. Guzdar, Bombay vs. Commissioner of Income Tax*<sup>3</sup>, the NCLT New Delhi opined that the assets of Educomp Asia could not be treated as a part of the assets of the Corporate Debtor since a shareholder only acquires a right to participate in the profits of the company but it does not acquire any interests in the assets of the company by virtue of purchasing its shares.
- c) Having established that the Pledged Shares were not the assets of the Corporate Debtor, the NCLT New Delhi noted that as per provisions of Section 20(1) and Section 25(1) of the IBC, it cannot be viewed that the RP and the CoC failed to discharge their legal obligations in taking relevant steps to prevent SBI Singapore from disposing off the shares.

### 2. Issue 3:

On the third issue, the NCLT New Delhi analysed Section 45(2) of the IBC which lays down the criteria for a transaction to be considered as an 'undervalued transaction' and noted that an undervalued transaction could only be alleged against a 'corporate debtor'. In the transaction pertaining to the sale of the Pledged Shares, SBI Singapore, in whose favour the security was created, sold the Pledged Shares to a third party pursuant to a Sale Agreement. Therefore, such a transaction could not be declared as an undervalued transaction as it didn't involve the Corporate Debtor or the assets owned by such Corporate Debtor.

### 3. Issue 4:

In relation to the fourth issue, after reading Section 89 of the Companies Act, 2013 and the rules thereunder, the NCLT New Delhi observed that the Applicant was unable to show if the Corporate Debtor held any beneficial interest in the Pledged Shares as neither the Corporate Debtor nor Educomp Asia had filed the relevant forms declaring or disclosing the beneficial interest of the Corporate Debtor in the Pledged Shares. Therefore, a moratorium could not be imposed on the shares held by Educomp Asia in TLI.

### 4. Issue 5:

In relation to the fifth issue, the NCLT New Delhi made the following observations:

- a) It will not be improper for a guarantor to be vigilant about the valuation of the collateral pledged by the debtor which is sought to be disposed of by the secured creditor, since it will directly impact the liability of the debtor to discharge the loan.
- b) Under Section 128 of the Indian Contract Act, 1872 ("**Contract Act**"), the liability of the guarantor is co-extensive with that of the principal debtor unless it is otherwise provided by the contract, and the liability of the borrower and the guarantor to discharge the debt is almost a joint liability.
- c) In terms of Section 141 of the Contract Act, a surety is entitled to the benefit of every security which the creditor has against the principal debtor at the time when the contract of guarantee is entered into, irrespective of whether the surety is aware of the existence of each security. If the creditor loses or without the consent of the surety, parts with such security, then the surety is discharged to the extent of the value of such security.

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<sup>2</sup> (2012) 6 SCC 613

<sup>3</sup> AIR 1955 SC 74

In view of the aforesaid observations, NCLT New Delhi held that the guarantor could raise questions about the valuation of the security pledged by the principal debtor / borrower with the secured creditor. It directed the RP to approach the Insolvency and Bankruptcy Board of India for the appointment of 2 (two) registered valuers (“**Valuers**”) for carrying out the valuation of the Pledged Shares. It further held that if the valuation done by the Valuers or third valuer so appointed, as the case may be, is found to be more than the value of USD 7,100,000 (US Dollar seven million one hundred thousand) for which the Pledged Shares were sold, the claim of SBI Singapore against the Corporate Debtor would stand reduced to the equal or to that extent.

## Conclusion

The decision of NCLT New Delhi is protective of the interests of a guarantor as it permits a guarantor to take steps to protect itself to reduce risk while standing as a guarantor.

The judgement may however be a cause for concern for secured lenders whose enforcement actions may be impeded by frivolous or nuisance actions by a guarantor.

While it is possible to see the rationale of the NCLT New Delhi in this case, the order does not necessarily take into consideration the commercial realities that a lender is faced with at the time of enforcement. For instance, it may not be possible to obtain the fair value of an asset when enforcing security on the same. That should not prevent a lender from enforcing the security and recovering whatever is possible.

If security enforcement actions by lenders are questioned by promoters who were responsible to ensure that the borrower services its debt, it has the potential to open a floodgate of litigation. Having said that, until this order is set aside or overruled, lenders need to tread with caution and follow a transparent and fair process at the time of security enforcement.

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