February 2023

A shortfall undertaking has been recognised as a financial debt under IBC

In the case of ***IL&FS Infrastructure Debt Fund v. McLeod Russel India Limited***,[1] the Kolkata bench of the National Company Law Tribunal ("**NCLT**") held that in order to determine whether a shortfall undertaking will qualify as an instrument of guarantee as defined under Section 126 of the Indian Contract Act, 1872 ("**Contract Act**"), one has to look into the intention of the parties as reflected in the terms of such undertaking. Further, the NCLT observed that a guarantee given in respect of a financial debt will qualify to be a financial debt under Section 5(8)(i) of the Insolvency and Bankruptcy Code, 2016 ("**IBC**").

Brief Facts

1. IL&FS Infrastructure Debt Fund ("**Financial Creditor**") subscribed to the non-convertible debentures ("**Debentures**") issued by Babcock Borsig Limited and Williamson Magor & Company Limited ("**Borrowers**") for an amount of INR 1,50,00,00,000 (Indian Rupees one hundred fifty crore) and INR 99,5,00,000 (Indian Rupees ninety nine crore five lakh) respectively (**"Facilities**"). IL&FS Financial Services Limited was appointed as the debenture trustee for the transaction ("**Debenture Trustee**").
2. In consideration of the Facilities, McLeod Russel India Limited ("**Corporate Debtor**") executed a shortfall undertaking ("**Shortfall Undertaking**") in favour of the Financial Creditor which *inter alia* provided as follows:
   a) If the Borrowers fail to maintain the amount required as per their respective debenture trust deeds in the debt service reserve account ("**DSRA**") for the purpose of redeeming the Debentures or paying interest thereon, the Corporate Debtor will have an irrevocable and unconditional obligation to meet any shortfall in the DSRA.
   b) The Corporate Debtor will indemnify the Financial Creditor against any losses, expenses, claims and liabilities incurred or suffered by it in relation to the Shortfall Undertaking.
   c) The Corporate Debtor will provide post-dated cheques ("**PDCs**") to the Financial Creditor for the principal and interest amounts payable by the Borrowers to the Financial Creditor in the next 1 (one) year.
3. Pursuant to the Shortfall Undertaking, the Corporate Debtor issued 24 (twenty four) PDCs to the Financial Creditor. Additionally, the Corporate Debtor provided a letter of comfort ("**Letter of Comfort**") to the Debenture Trustee.
4. On default by the Borrowers in fulfilling their obligations under the debenture trust deeds, the Financial Creditor served 2 (two) default notices to them. The Borrowers failed to respond to the aforesaid default notices. Consequently, the Facilities were recalled by the Financial Creditor.

[1] CP (IB) No. 1986/KB/2019.

5. Thereafter, the Financial Creditor issued a funding notice requiring the Corporate Debtor to fund the shortfall in the DSRA. Since the Corporate Debtor failed to fund the said shortfall, the Financial Creditor filed an application under Section 7 of IBC with the NCLT seeking initiation of the corporate insolvency resolution process against the Corporate Debtor ("**the Section 7 Application**"). It is to be noted that the PDCs were brought on record before the NCLT through a supplementary affidavit after taking leave of the NCLT to file such affidavit.

Issues

The NCLT had to decide 2 (two) primary issues as part of the proceedings:

1. Whether the Section 7 Application can be admitted by the NCLT on the basis of the documents brought on record through a supplementary affidavit.
2. Whether the Letter of Comfort, the indemnity bond and the Shortfall Undertaking given by the Corporate Debtor in respect of the Facilities can be construed as instruments of guarantee.

Key Arguments by the Parties

1. The Financial Creditor contended that by way of the Shortfall Undertaking, the Corporate Debtor had promised to discharge the liability of the Borrowers in case of their default. Therefore, the Shortfall Undertaking falls within the definition of "contract of guarantee" provided under Section 126 of the Contract Act. Further, it observed that the Facilities constituted "financial debt" under Section 5(8)(c) of the IBC. Accordingly, the Financial Creditor submitted that the Shortfall Undertaking, being a guarantee in respect of such financial debt, will also qualify to be a financial debt in terms of Section 5(8)(i) of IBC.
2. The Corporate Debtor, on the other hand, argued that the Shortfall Undertaking was only for infusion of funds by the Corporate Debtor in the DSRA in case of default by the Borrowers and not for repayment of any debt in respect of the Facilities. Hence, the Shortfall Undertaking cannot be construed as guarantee for repayment of the Facilities. Further, it contended that the Letter of Comfort specifically mentions that it is not a contract of guarantee as per Section 126 of the Contract Act. Moreover, it submitted that the PDCs were issued merely for the custody of the Financial Creditor and not for repayment of any debts.

Analysis and Findings of the NCLT

After considering the submissions of the parties, the NCLT made the following observations:

1. The PDCs, which were brought on record by a supplementary affidavit, are of material significance for the instant matter because they tend to give a tangible shape to a security cover which otherwise exists in the maze of documents called by various names. Thus, the supplementary affidavit can be taken on record.
2. Whether or not the Letter of Comfort, the indemnity bond and the Shortfall Undertaking can be considered as guarantees under the Contract Act would depend upon the intention of the parties as reflected in these instruments. The NCLT observed that in the instant case, there was clear intention of the parties that these instruments are provided as security for protecting the interests of the Financial Creditor.
3. The NCLT also observed that the Corporate Debtor failed to deposit the amount in DSRA in terms of the Shortfall Undertaking. Accordingly, a financial debt was owed by the Corporate Debtor to the Financial Creditor and there was a default in payment of such financial debt by the Corporate Debtor.

4. As per the decision of the Supreme Court in the case of ***Innoventive Industries Limited v. ICICI Bank***,[2] an application under Section 7 of IBC must be admitted by the NCLT if it is satisfied that there is a debt and a default in respect of such debt, unless it is incomplete.
5. In light of the foregoing, the NCLT admitted the Section 7 Application and initiated the corporate insolvency resolution process of the Corporate Debtor.

JSA Comment

This decision of the NCLT is a welcome move for the lender community who often provide credit facilities based on shortfall undertakings from promoters or group entities of the borrower, without an explicit corporate guarantee. The NCLT has emphasised the importance of substance over form and has not focused on technicalities when rendering this order. The NCLT did not consider the contention of the Corporate Debtor that the Shortfall Undertaking was not a guarantee under the Contract Act as it was only for infusion of funds in the DSRA in case of default by the Borrowers and not for repayment of any debt in respect of the Facilities. It appears to have adopted a fact-based interpretive approach to make sure that the Corporate Debtor was not wrongfully safeguarded under the garb of technicalities, when the intention (evidenced by the Shortfall Undertaking, Letter of Comfort, indemnity bond and PDCs) was to ensure repayment of the Facilities.

However, it should be noted that this judgement is not binding on other NCLTs, the NCLAT or the Supreme Court. Considering some other prior judgements of the NCLAT and Supreme Court on interpretation of "financial debt" and "financial creditors", it would still be prudent for lenders to obtain guarantees or indemnities for the financial debts that they provide, wherever commercially feasible, to avoid any ambiguities under the IBC.

Insolvency and Debt Restructuring Practice

JSA is recognized as one of the market leaders in India in the field of insolvency and debt restructuring. Our practice comprises legal professionals from the banking & finance, corporate and dispute resolution practices serving clients pan India on insolvency and debt restructuring assignments. We advise both lenders and borrowers in restructuring and refinancing their debt including through an out-of-court restructuring as per the guidelines issued by the Reserve Bank of India, asset reconstruction, one-time settlements as well as other modes of restructuring. We also regularly advise creditors, bidders (resolution applicants), resolution professionals as well as promoters in connection with corporate insolvencies and liquidation under the IBC. We have been involved in some of the largest insolvency and debt restructuring assignments in the country. Our scope of work includes formulating a strategy for debt restructuring, evaluating various options available to different stakeholders, preparing and reviewing restructuring agreements and resolution plans, advising on implementation of resolution plans and representing diverse stakeholders before various courts and tribunals. JSA's immense experience in capital markets & securities, M&A, projects & infrastructure and real estate law, combined with the requisite sectoral expertise, enables the firm to provide seamless service and in-depth legal advice and solutions on complex insolvency and restructuring matters.

[2] (2018) 1 SCC 407

This Prism has been prepared by:

Aashit Shah
Partner

Malika Tiwari
Associate

Chambers TOP RANKED Asia-Pacific 2023 JSA

17 Practices and
24 Ranked Lawyers

The LEGAL 500

16 Practices and
11 Ranked Lawyers

BENCHMARK LITIGATION

7 Practices and
2 Ranked Lawyers

IFLR1000

11 Practices and
39 Ranked Partners
IFLR1000 APAC Rankings 2022

Banking & Finance Team
of the Year

Fintech Team of the Year

Restructuring & Insolvency
Team of the Year

INDIA BUSINESS LAW JOURNAL
BEST OVERALL LAW FIRMS
2022
LAW ASIA

Among Top 7 Best Overall
Law Firms in India and
10 Ranked Practices

---

13 winning Deals in
IBLJ Deals of the Year

---

10 A List Lawyers in
IBLJ Top 100 Lawyer List

ALB
EMPLOYER OF CHOICE 2021
THOMSON REUTERS

Banking & Financial Services
Law Firm of the Year 2022

Dispute Resolution Law
Firm of the Year 2022

Equity Market Deal of the
Year (Premium) 2022

Energy Law Firm of the Year 2021

Ranked #1
The Vahura Best Law Firms to Work Report, 2022

Top 10 Best Law Firms for Women in 2022

For more details, please contact km@jsalaw.com

www.jsalaw.com

advocates & solicitors

Ahmedabad | Bengaluru | Chennai | Gurugram | Hyderabad | Mumbai | New Delhi