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The Wilful Defaulter – A Beginner's Guide & A Ready Reckoner

■ **Jayashree Shukla Dasgupta**

"We need a change in mindset, where the wilful or non-cooperative defaulter is not lionized as a captain of the industry, but justly chastised as a freeloader on the hardworking people of this country" **-Dr. Raghuram Rajan, Governor, The Reserve Bank of India**

With one eye firmly on the RBI Governor's views, this article aims at giving a lowdown on the Master Circular with respect to the regulations governing Willful Defaulters and on the rights of borrowers and guarantors who are at a potential risk of being declared as willful defaulters as well as judgments passed by various Indian courts in this regard.

On 23rd April 1994, the Reserve Bank of India keeping in perspective the economic liberalization ushered in 1991, issued a Scheme of Disclosure of Information on Defaulting Borrowers of Banks and FIs. Thereafter, based on the instructions of the Central Vigilance Commission, a scheme was formulated by RBI with effect from 1st April, 1999 under which all Banks and notified Financial Institutions were required to submit details of willful defaulters to the RBI.

However the Scheme of 1999, was largely ineffective in curbing the persistence of willful defaulters in the financial system. This was reflected in the 2000 report of the then Parliamentary Standing Committee on Finance, resulting in the constitution of a Working Group on Willful Defaulters in 2001.

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Based on the recommendations of the Working Group, RBI revised its Scheme and issued modified Guidelines on 30th May, 2002. Ever since then, the RBI has been amending its guidelines keeping in mind the dynamic financial and economic scenarios, which has led to the present Master Circulars, as they stand now.

On 01st July, 2015, the RBI has also issued a Master Circular on 'Willful Defaulters', compiling all previous Circulars, Schemes, Reports and Recommendations. RBI Master Circulars are a 'One-Point-Reference' of instructions on particular subjects. They are normally issued on the 1st of July of every year and are valid for a period of one year. Various judgments, starting from the Constitution Bench judgment of the Supreme Court titled Central Bank of India vs. Ravindra (2002 (1) SCC 367), have repeatedly held that these guidelines are binding in nature and have statutory force. The Master Circular on 'Willful Defaulters' charts the history of these guidelines and the term 'willful default' has been redefined (Clause 2.1), which would be deemed to have occurred if any of the following events occur:-

a) Default in repayment obligations despite having capacity to honour the said obligations.

b) Default in repayment obligations and diversion of funds for other purposes, including non-utilization of funds for the specific purposes for which finance was availed.

c) Default in repayment obligations and siphoning off the funds and non-utilization of funds for the specific purposes for which finance was availed moreover when the funds are not available with the unit in the form of other assets.

d) Default in repayment obligations to a lender and disposal or removal of assets (movable, fixed or immovable) which have been given as security without the knowledge of the lender.

It is to be noted that a willful default occurs on the occurrence of either of the above contingencies and the common thread across the eventualities is default in repayment. Therefore in case there is no default in repayment, there cannot be any willful default.

Clause 2.1.3 (c) of the Master Circular lays special emphasis on diversion and siphoning of funds (Clause 2.2). Diversion and siphoning of funds includes the following situations: (i) utilization of short-term working capital funds for long-term purposes in contravention of the terms of sanction; (ii) utilization of borrowed funds for creation of assets other than those for which loan was sanctioned; (iii) Transferring of funds to subsidiaries or group companies or other corporates; (iv) routing of funds through any bank other than the lender bank or consortium without prior permission of the lender; (v) investment in other companies by acquiring equities / debt instrument without the approval of lenders; (vi) shortfall in deployment of funds vis-à-vis the amounts disbursed / drawn without the difference being accounted for.

RBI has further qualified the definition of the term 'siphoning of funds' by stating that transfer of funds to subsidiaries as mentioned above, must specifically be for purposes which are un-related to the operations of the borrower and to the detriment of the financial health of the entity or the lender. Apart from the above, RBI has made an attempt to balance equities by cautioning lenders that decisions pertaining to instances of siphoning/diversion of funds must be based on objective facts and circumstances and should be made keeping in view the track record of borrowers and should not be decided on the basis of isolated transactions / incidents. The default to be categorized as willful must be intentional, deliberate and calculated. Borrowers and prospective candidates must bear the above safe-guards in mind to defend the proposed decision of the lenders.

Clause 2.6 of the Master Circular talks about Corporate Guarantees given by group companies to defaulting borrowers. It states that for single borrowing companies, the lenders must only consider the track record of the individual company, however in cases where corporate guarantees or letters of comfort have been provided by group companies, such Group Companies must also be reckoned as willful defaulters. This definition was open to judicial scrutiny and various interpretations. In view of the same, RBI vide its clarification dated 09th September, 2014 has removed the term 'letter of comfort' given by group companies to reduce the ambiguity of this clause. It has also clarified with respect of individual guarantors (not corporate guarantors) by

referring to Section 128 of the Indian Contract Act that the liability of the surety is co-extensive with that of the principal debtor. Therefore, when a default is made in making repayment by the principal debtor, a banker can also proceed against the guarantor/surety without exhausting the remedies against the principal debtor. The criteria for Guarantors has been clarified by stating that in case the guarantor refuses to comply with the demand of a banker, despite having sufficient means to pay the dues, such Guarantor would be liable to be declared as a Willful Defaulter. However, the said clarification has been expressly introduce with prospective effect, being applicable only to cases where Guarantees are being given subsequent to the issuance of the clarification. The Lenders have been made duty bound to inform all prospective Guarantors of this legal position.

After identification of Willful Defaulters under Clause 2.1, the Guidelines mandatorily direct the lenders to adopt certain penal measures under Clause 2.5, which include the following:

a) No additional facilities will be granted by banks and financial institutions.

b) Promoters of companies that have been identified for siphoning of funds, misrepresentation of accounts and fraudulent transactions will be debarred from institutional finance for floating new ventures for a period of five years

c) Legal process will be initiated expeditiously. Lenders may initiate criminal proceedings also as and when required. As per Clause 4 this has been extended to include Dishonest Misappropriation of Property, Breach of Trust and Cheating under Section 403, 405 and 415 of the IPC.

d) Banks will adopt a proactive approach for a change of management of borrower unit. This is one of the most stringent recourses provided under the circular and is one of the major reasons, why potential willful defaulters are trying to shake off the tag.

e) Willful defaulters will not be allowed to take up board positions in any company and those who are on board will be removed expeditiously.

The RBI has clarified that lenders must have a transparent mechanism for the process of declaration of an entity as a Willful Defaulter, so that the penal provisions are not misused and not used in an arbitrary or discretionary manner. It has been reiterated that solitary or isolated instances are not made the basis of imposing penal action.

SEBI has also imposed several restrictions on Willful Defaulters vide its Circular dated 25.05.2016, wherein SEBI has clarified that if the issuer company or its promoters or its directors are in the list of the willful defaulters, no public issue of equity shares / debt securities / non-convertible redeemable preference shares can be made. Further, such Companies or their directors or promoters who are in the list of willful defaulters have been barred from taking control over any other listed entity. However if there is a take-over offer, then, they may be allowed to make a competing offer for the said listed company in accordance with the Takeover Code. Further SEBI has also clarified that fresh registration will not be granted to any Company if that Company or its directors or promoters or

key managerial personnel are in the list of Willful Defaulters.

These are sweeping provisions which are set to bring about a paradigm shift in the financial markets of our country. These regulations therefore call for greater caution from lenders before companies or their directors or promoters are listed as willful defaulters.

The RBI Guidelines aim to provide a transparent process for Redressal of Grievances under Clause 3 of the Master Circular which now provides a three stage process, which is as follows:

(a) Any proposed decision taken on classification must be entrusted to a Committee (First Committee) which is headed by the Executive Director and which must also consist of two GMs / DGMs. The decision taken by this Committee must be well reasoned, well documented and supported by requisite evidence. Further, the decision must clearly spell out the reasons for declaration by giving specific reference to the clauses of the RBI guidelines.

(b) After such decision of proposal to classify a Borrower as Willful Defaulter is taken, the Borrower must be given a Show Cause Notice giving clear 15 days' time for making a representation against such a decision to a Grievance Redressal Committee.

(c) Thereafter, the Borrower has been given a right of hearing before the Grievance Redressal Committee (Second Committee) headed by the Chairman/CEO and MD, in addition to two independent Directors who is empowered to review the opinion of the First Committee. Therefore the decision of the Committee would only become final after it is confirmed / ratified by the Second Committee.

DRAWBACKS OF THE GUIDELINES & ISSUES WHICH NEED TO BE ADDRESSED THE MOST

The purpose of classification of entities or their directors or promoters as Willful Defaulters is to identify and segregate the mala fide borrowers who are misusing the funds from the genuine bona fide borrowers who are sincerely engaged in business and have incurred losses due to reasons beyond their control due to micro and macro factors influencing their business. However, it is being largely seen that the object and purpose of the guidelines is being defeated due to rampant abuse of these guidelines by several creditors. In the current scenario it is being observed that all defaulters are being threatened to be classified as 'Willful' defaulters in order to put pressure on them for recovery of their dues. The Minister of State for Finance has recently informed the Rajya Sabha that as of December 2015, there were 7686 Willful Defaulters who owe Rs. 66,190 Crores to state-owned banks. This statistic is a clear reflection of the abuse of the guidelines by the creditors. This is largely because of the onerous conditions laid down in the Guidelines. The identification and segregation of bona fide and willful defaulters is therefore a critical aspect of these guidelines and which must be exercised with great caution. In this regard, there is also some apprehension because lenders who grant financial assistance themselves cannot be expected to remain unbiased and impartial in proceedings of such nature. In the absence of the same, it is also highly likely that Lenders may try to impart a criminal color to a purely civil dispute under the garb of adhering to the provisions of the Guidelines. A careful balancing of the equities is therefore mandatorily required in order to prevent such abuse. The guidelines are so broad in their sweep, that even transactions conducted in the normal course of business can be called into question in case of default.

SETTING THE PRECEDENCE

The Master Circular issued by the Central Bank is facing a tough scrutiny and litmus test from the multitude of Courts in India.

The vires of the Master Circular on Willful Defaulters (of the year 2012) was challenged before Hon'ble High Court of Gujarat, which passed the judgment titled Ionic Metalliks vs. Union of India, thereby holding that the Master Circular in so far as it is sought to be made applicable to all the directors of the company is arbitrary and unreasonable. Rest of the Master Circular was held to be in conformity with the constitution. In view of the same, certain parts of the Master Circular were modified to abide by the judgment of the Gujarat High Court.

As of now the fort is being held by the judgment of Kingfisher Airlines Ltd. Vs. Union of India & Ors. bearing W.P. (C) No. 5532 of 2014 passed by the Ld. Single Judge of the Hon'ble High Court of Delhi, which specifically states that material that is to be relied upon by the authority

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for arriving at a decision regarding declaration of a party as a willful defaulter, must necessarily be made available to the affected party before arriving at such a decision. This judgment has been upheld in Appeal before the Division Bench of the Hon'ble High Court of Delhi where in Punjab National Bank Vs. Kingfisher Airlines Ltd. & Ors, in LPA bearing No. 589 of 2014 the Hon'ble Division Bench has laid down the law directing that Borrowers, who are proposed to be classified / declared as wilful defaulters must be given an opportunity of hearing before the Grievance Redressal Commission and must be entitled to be represented by Advocates. This view has been consistently upheld by the Delhi High Court in the judgments titled Moser Baer India Ltd. Vs. State Bank of India & Others bearing WP (C) No. 5917 of 2016 dated 13.07.2015, in Ratul Puri Vs. State Bank of Bikaner & Jaipur bearing WP (C) 367/2016 dated 15.01.2016, in Ramesh Kumar Sareen Vs Union of India and Ors bearing W.P. (C) 3306/2014 dated 24.05.2016 and most recently in the judgment titled Ratul Puri Vs. State Bank of India bearing WP (C) 6412/2016 decided as recently as on 28.07.2016.

However the High Courts of Calcutta and Bombay, have taken contrary views with respect to representation of proposed willful defaulters through advocates before the Committee. The Division Bench of the High Court of Calcutta in the judgment dated 28.08.2014 titled Kingfisher Airlines Ltd. vs. Union of India & Ors. bearing AST No. 320 of 2014 & CAN No. 8329 of 2014 has upheld the view of the single judge which held that a borrower has no right to be represented by an advocate at the hearing before the Committee. The Calcutta High Court (Single Bench) has also held in the judgment dated 15.04.2016 Dynametic Overseas Pvt. Ltd. vs. State Bank of India 3989 & 3990 (W) of 2016 that the Borrower has no right to be represented by his Chartered Accountant. The Division Bench of the Bombay High Court relied upon the view taken by the Calcutta High Court in the judgment dated 15.07.2015 titled Kingfisher Airlines Ltd. vs. Union of India & Ors. bearing WP(L) No. 1684 of 2015 and has held that the defaulter does not have a right to be represented by an advocate before the Committee. However, the Bombay High Court has left some window open by opining that there cannot be any straitjacket formula to determine whether or not a party can be represented by an advocate and such a decision would ultimately vary from case to case based on their respective facts. A single bench of the Calcutta High Court has recently held in the judgment dated 15.04.2016 titled Dynametic Overseas Pvt. Ltd. vs. State Bank of India 3989 & 3990 (W) of 2016 that the Borrower has no right to be represented by his Chartered Accountant.

It is therefore evident that the law on this subject is still in its nascent stage and as such all issues and disputes arising out of the Guidelines are yet be conclusively addressed or settled.

The hue and cry around the issue of classification of Borrowers / Guarantors / Directors as wilful defaulters is entirely justified in the current economic scenario of our country, and deserves utmost attention not just from the RBI, but also from the Government and the law makers. With the ever changing economic scenario, we have to be ready to tackle such challenges and protect India Inc. from being unnecessarily being burdened and its growth slowed down.