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Regulations on Wilful Defaulters in India: Hits & Misses

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Wilful default in India captured the attention of RBI for nearly three decades now but the statistics governing wilful default in India are alarming. As of 31st May, 2022, the amount owed by wilful defaulters to Indian Banks stands at INR 2.4 Lakh Crore, accounting for nearly 12000 such defaults.[1] Interestingly, this figure is incomparable with any other country, since India is the only country to have created a distinction between "wilful" defaulters and other defaulters, both in terms of legislative mechanism and in terms of credit reporting. Though the regulatory framework governing "wilful defaulters" has continuously evolved in past three decades, yet, there remains considerable number of unaddressed issues and lacunas. Thus, this Article intends to trace these issues in the current framework by analysing its legislative and jurisprudential evolution.

The evolution of Regulations governing Wilful Defaulters can be categorised into three phases, based upon significant developments in disclosure norms, definition, penal measures and grievance redressal mechanism.

Phase 1 began towards the late 1980s when there was a rapid increase in institutional lending, thereby causing increase in defaults too, either due to genuine business losses or due to malpractices like fraud, siphoning of funds etc. These concerns highlighted the issue of information asymmetry amongst various lenders, wherein the errant borrowers approached different lenders, despite having already defaulted on debt raised from another lender. Though, the 1986 Guidelines fell short of coining the term "wilful default,"[2] the RBI defined the phrase "wilful default" as "defaults other than those caused by genuine factors beyond the control of the borrowers" in its 1990 Guidelines wherein, the disclosure requirements, by the Commercial Banks, were annual in nature initially.[3] However, with raising concerns on increase in quantum of wilful default, the frequency of reporting was changed from annual to half-yearly. Thereafter, the RBI had framed a Scheme of Disclosure of Information on Defaulting Borrowers of Banks and Financial Institutions (FIs) for circulating the names of defaulting borrowers above a threshold limit,[4] in order to alert the banks and financial institutions and put them on guard against the borrowers who had defaulted in their dues or other lending institutions. However,

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significant development took place when the Central Vigilance Commission (CVC), issued directions upon the Reserve Bank to submit the details of wilful defaulters for "Improving vigilance administration in Banks" since it was felt that there was "lack of communication between the Banks".[5] Pursuant to the directions received from the CVC, the RBI introduced a scheme under which Commercial Banks and All India Financial Institutions were required to submit to the RBI the details of wilful defaulters with outstanding of Rs.25 lakhs and above.[6]

Even though Phase I was successful in solving the problem of information asymmetry, to an extent, yet the Regulations did not create any deterring effect on the errant borrowers. Thus, the Second phase marked a shift in the focus from the problem of information asymmetry to introduction of penal measures, as recommended by the Parliament's Standing Committee on Financial Institutions in its 8th Report (2000)[7] and by the Working Group on Wilful Defaulters (WGWD) in its Report (2001). Taking into consideration these recommendations, the Reserve Bank revised its earlier circular in the year 2002, wherein the penal provisions were incorporated and the definition of "wilful defaulters" was further enlarged.[8] However, the move to introduce penal measures saw limited success insofar as the current provisions under IPC (particularly section 405 and 415) proved ineffective to prosecute and hold the errant borrowers guilty as observed by the Joint Parliamentary Committee (JPC) on Stock Market Scam in its report.[9] Though there has been no progress in making legislative efforts to introduce specific penal provisions, the RBI, in its 2004 Circular, advised the Banks to take criminal action in all cases where

the borrowers diverge the funds with mala fide intentions, to closely monitor the end-use of funds and to obtain certificates from the borrowers certifying that the funds have been used for the purpose for which these were obtained, and in cases of wrong certification should attract criminal action against the borrowers.[10]

In order to develop the Regulations governing wilful defaults, the Phase-III began with consolidating the regulations by way of Master Circulars since 2006, and have been routinely revised in the year 2007, 2013, 2014 and 2015.[11]

According to the latest Master Circular dated 01.07.2015,[12] 'wilful default' would be deemed to have occurred if the unit has defaulted in its obligations to the lender, despite having capacity to honor it or utilise it for purposes other than the agreed purpose or the funds have been siphoned off. Additionally, if any encumbered asset is disposed of or removed without the knowledge of the bank / lender, it shall also be covered within the ambit of "wilful default". However, even though the scope of "wilful default" has significantly increased over the period of time, much less attention has been paid to strengthen the mechanism to identify such defaults but concerns relating to abuse of the process are still left unaddressed. This has compelled the Hon'ble Supreme Court and various High

Courts to strengthen the process and to prevent its abuse, especially with respect to violation of principles of natural justice and vicarious liability of the directors of the defaulting companies.

The need to adhere to the principles of natural justice while classifying a borrower as a "wilful defaulter" has been highlighted by the Hon'ble SC in the matter of SBI versus Jah Developers Pvt Ltd (2019) 6 SCC 787. However, in the said judgment it was also clarified that that there is no right to being represented by a Lawyer in the in-house proceedings before the Committee.[13] Furthermore, the Hon'ble SC, in Jah Developers (supra) has also added certain checks and balances to bolster the fairness in the process of identifying such defaulters.

Another issue which has received considerable attention is the liability of directors in case a Company is declared to be a wilful defaulter. In Case of a Company being a "wilful defaulter", there is an automatic presumption that the individuals (Promoters/Whole-time Directors) who are in charge and responsible for managing the affairs of the company shall also be held guilty. This sweeping provision has been a matter of concern in several cases and in the matter of Ramesh Kumar Sareen versus Union of India, 2016 SCC OnLine Del 3374, the Hon'ble Delhi HC has held that it cannot be the intention of the Circular to include every director associated with the Company. Therefore, it was clarified that such presumption is limited to only such promoters/whole-time directors who were/are associated with the company within a period of 90 days prior to the time the company account was classified as non-performing asset.

However, the Circular is cognisant of the fact that a Non-Executive Director shall not be considered a Wilful Defaulter except in cases where it is conclusively established that such a non-whole-time director was aware of the fact of wilful default by the borrower.[14]

The aforesaid safeguards and ensures mandatory adherence to the principles of Natural Justice as sine qua non in light of the fact that being declared a "wilful defaulter" has severe and far-reaching consequences for the Borrower, not only under 2015 Master Circular but also under other statutes. Some of these consequences are discussed below:

CIVIL CONSEQUENCES

a) No additional facilities should be granted by any bank / FI to the listed wilful defaulters.

b) Such companies (including their entrepreneurs / promoters) where banks / FIs have identified siphoning / diversion of funds, misrepresentation, falsification of accounts and fraudulent transactions should be debarred from institutional floating of new ventures for a period of 5 years from the date of removal of their name from the list of wilful defaulters as published/ disseminated by RBI/CICs. However, it is noteworthy that the said clause does not clarify whether such defaulter shall be prohibited from raising foreign funds for business purposes in the Country. It is to be noted that the Circular only prescribes that it shall be applicable on overseas branches of Indian Banks, however, does not specify anything with respect to foreign banks/lenders.

c) Change in management of the wilfully defaulting borrower unit.[15]

d) Any borrowing company should not induct on its board a person whose name appears in the list of Wilful Defaulters

e) a person who has been declared to be a wilful defaulter shall be ineligible to submit a Resolution Plan u/s 29A(1)(b) of the Insolvency and Bankruptcy Code, 2016.

f) Under Regulation 4 of SEBI (Issue of Capital and Disclosure Requirements) (Third Amendment) Regulations, 2016, no issuer shall make a public issue of equity securities, if the issuer or any of its promoters or directors is a wilful defaulter.

PENAL CONSEQUENCES

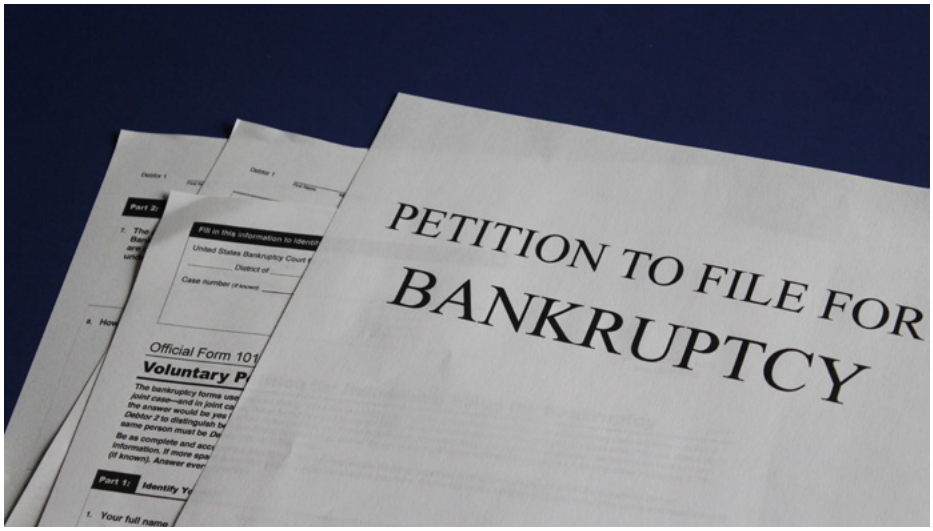
a) Initiating criminal proceedings under Section 405 (criminal breach of trust) and Section 415 (Cheating) of the Indian Penal Code, 1860.

b) Criminal Proceedings u/s 447 and 448 of the Companies Act, 2013.

c) Proceedings under Section 66, 68, 73 of the Insolvency and Bankruptcy Code, 2016

d) Proceedings under Fugitive Economic Offenders/Prevention of Money Laundering Act etc.,

However, despite such far reaching consequences, there are no safeguards or mechanism to challenge the show cause notice or the order passed by the First Committee or the Review Committee and the only remedy available, for an aggrieved borrower, is by invoking the writ jurisdiction of the concerned High Court. However, the High Courts have allowed limited grounds for invoking the said jurisdiction like violation of



principles of natural justice, unreasoned decision in the order, formation of Committee without following due process of law, implication of non-executive directors etc.[16]

INTERPLAY BETWEEN IBC, 2016 AND RBI'S MASTER CIRCULAR ON WILFUL DEFAULTERS.

A recent issue with respect to interplay between IBC and RBI's Master Circular is the applicability of moratorium given u/s 13 and 14 of the Code in case the defaulting company has gone into Corporate Insolvency Resolution Process (CIRP) prior to being declared as a "wilful defaulter". The said issue has been decided by the Hon'ble Calcutta HC in Ayan Mallick versus State Bank of India [WPO No. 23 of 2021] wherein it was noted that, although, the declaration of wilful defaulter dealt with in the RBI guidelines is not an action to foreclose, recover or enforce any security interest created by the corporate debtor, the effect of such a declaration is to interdict and create conflict with the functioning of the resolution professional within the scope of the Code. Hence, a Corporate Debtor cannot be declared to be a wilful defaulter once the Company goes into CIRP under IBC. However, the Hon'ble Calcutta HC in the said matter and also in the matter of Adarsh Jhunjhunwala versus State Bank of India & Anr [WPO 1548 of 2021] has clarified that such immunity does not extend to the Directors/Promoters/Personal Guarantors of Corporate Debtor u/s 96 of the Code.

CONCLUSION

Even though the RBI has worked extensively to address major concerns with respect to staggering value of wilful default, a few creases can be identified in the current regulatory framework.

1) Lack of legislative provisions to deal with foreign lending: The Current framework is silent on the applicability of the RBI's Master Circular on foreign lending and also does not prohibit any further lending by wilful defaulters. The lack of similar laws in other jurisdictions also aid the errant borrowers to seek financial help from other jurisdictions. Furthermore, since the current legal framework is developed by a Regulatory Body (being RBI) and not by the Parliament (Legislature), there is an

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inherent lack of jurisdiction to deal with the said problem. With ever increasing Global Economy and increasing problem of fugitive economic offenders, this might pose a greater threat, wherein the foreign lenders may invest in such entities, thereby hampering the entire Indian Economy.

2) Lack of legislative safeguards: As already noticed, in the absence of grievance redressal mechanism under the Master Circular, 2015, invocation of writ jurisdiction of a High Court is the only option available for an aggrieved person. However, it is a well settled position of law that the Writ Jurisdiction of the Hon'ble High Courts is to be used sparingly. Therefore, there is always a scope of abuse of the process, especially when the consequences of being decaled a "wilful defaulter" are grave and serious.

3) Lack of clarity in its interplay with the IBC: Since the initiation of CIRP/ Personal insolvency, is no bar to stay the criminal/civil proceedings against a Director/Guarantor who has been declared to be a "wilful defaulter," it may lead to an anomaly, where the criminal/civil proceedings against such wilful defaulter may include recovery of the sum which has been siphoned off/defrauded etc. Such recovery proceedings under the Criminal law shall be inconsistent with the provisions of personal insolvency under the IBC.

4) Scattered legal framework to prosecute the errant borrowers: Currently, the banks initiate criminal proceedings against the wilful defaulters under provisions of Indian Penal Code, Companies Act, 2013, IBC and other connected laws. However, none of these Provisions are effective enough with conviction rate being less than 1% and this problem is bound to increase due to complexity in financial frauds and lack of technical expertise in the current judicial system to effectively deal with such cases. Hence, a comprehensive framework to deal with prosecution of wilful defaulters is essential.

[1]*https://www.indiatimes.com/worth/news/indian-willful-loan-defaults-rise-ten-fold-in-a-decade-575338.html*
[2]*Reserve Bank of India (1986) Circular IECD.No.PMS.145/C. 446(PL)-86/87 dated August 20, 1986*
[3]*Reserve Bank of India (1990) Circular IECD.No.PMD.25/ C.446 (PL)-89/90 dated April 5, 1990.*
[4]*Reserve Bank of India (1994) Circular DBOD No. BC.CIS.47/20:16:002/94 dated April 23, 1994.*
[5]*Central Vigilance Commission (1998) Circular No. 8(1)9(h)/98(2) dated November 27, 1998. http://cvc.gov.in/ins2.pdf*
[6]*Reserve Bank of India (1999) Circular DBOD No. BC. DL(W) 12/20.16.002/ 98-99 dated February 20, 1999 and Reserve Bank of India (1999) Circular DBOD No. BC. DL.4/20.16.002/ 99-2000 dated October 21, 1999.*
[7]*The Parliament"s Standing Committee Eighth Report on Financial Institutions – Objectives, Performance and Future Prospects http://164.100.24.208 /ls/committeeR/finance/8.pdf*
[8]*Reserve Bank of India (2002) Circular DBOD No. DL (W).BC.110/20.16.003/ 2001-02 dated May 30, 2002.*
[9]*Report of the Joint Committee on Stock Market Scam and matters relating thereto http://www.prsindia.org/administrator/uploads/general/ 1292845141JPC*
[10]*Reserve Bank of India (2004) Circular DBOD No. DL.BC 94/20.16.003/ 2003-04 dated June 17, 2004, and Reserve Bank of India (2004) Circular DBOD No. DL.BC.16/20.16.003/ 2004-05 dated July 23, 2004.*
[11]*The constitutional validity of the Master Circulars have been upheld by the Hon'ble Delhi High Court in Sudarshan Overseas Ltd versus Reserve Bank of India & Anr (2009 SCC OnLine Del 1656), wherein the Master Circular of 2007 was challenged for violating the principle of Nemo Debet Esse Judex in Propria Sua Causa, i.e., nobody can be a judge in its own cause).*
[12]*Reserve Bank of India (2015) Master Circular RBI/2015-16/100 DBR. No. CID.BC 22/20.16.003/2015-16 dated 01.07.2015.*
[13]*Other judgments which deal with the application of principles of NJ are Frost International Limited v. Punjab National Bank (2021 SCC OnLine Del 3683), Jagdish Prakash vs Union Bank Of India & Ors. W.P.(C) 5309/2021*
[14]*This has also been held in the matters- Kailash Shahra versus IDBI Bank Ltd (WP No. 1630 of 2019), Meena Anand Suryadutt Bhatt v. Union of India, 2022 SCC OnLine Bom 1505 and Om Vir Singh v. Union of India, 2016 SCC OnLine Guj 8404*
[15]*Also provided in Section 164(1) of the Companies Act, 2013.*
[16]*Sandip Kumar Bajaj vs SBI 2020 SCC OnLine Cal 1659; Union Bank of India vs Sudhir Kumar Patodia 2020 SCC OnLine Cal 3259; Union Bank of India vs Sudhir Kumar Patodia 2020 SCC OnLine Cal 3259; Kingfisher Airlines Ltd. Vs UoI 2014 SCC OnLine Del 7731; Frost International ltd vs PNB 2021 SCC OnLine Del 3683; Siemens Ltd vs State of Maharashtra (2006) 12 SCC 33; Ishwari Prasad Tantia vs IDBI Bank 2021 SCC OnLine 3683; Ramesh Kumar Sareen vs UoI 2016 SCC OnLine Del 3374.*

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