

BORROWERS BEWARE - AN ANALYSIS OF THE CREATION AND ENFORCEMENT OF SECURITY INTEREST BY BANKS AND FINANCIAL INSTITUTIONS BILL 2001

Defaults in payment of loans and financial assistance is one issue which seriously affects the economy by increasing the non-performing assets ("NPAs") of banks and financial institutions. The situation gets further aggravated when banks and financial institutions are unable to sell the secured assets for decades. The State Financial Corporations Act, 1951 ("SFCs Act"), which conferred special powers upon state financial corporations, also did not alleviate the situation. The SFCs Act enabled state finance corporations to sell mortgaged properties without court intervention, in cases where the borrower was an industrial concern. However, in many instances this practice did not prove beneficial to the state finance corporations. Is this due to lack of adequate laws to tackle the problem or lack of mechanisms to implement the existing debt recovery laws!

In this backdrop, the Government has now proposed the Creation and Enforcement of Security Interest by Banks and financial institutions Bill, 2001 (the "Bill") to remedy and improve the situation.

The Bill, currently pending in Parliament, seeks to codify and consolidate the law and practice relating to creation and enforcement of security interests by banks and financial institution, without court intervention. Banks include banking companies, corresponding banks, the State Bank of India, subsidiary banks and Regional Rural Banks. Financial institutions ("FIs") include public financial institutions as defined under § 4A of the Companies Act, 1956 (the "Act"), the International Finance Corporation, non-banking finance companies registered with the Reserve Bank of India ("RBI") and other institutions specified by the RBI.

§ 2(q) of the Bill defines security interest as right, title and interest of every kind including any mortgage, charge, hypothecation, assignment, lien, grant, indenture of trust, trust receipt, transfer or conveyance created in favour of a secured creditor as security for financial assistance granted or to be granted to a borrower. Financial assistance means any loan or advance granted, debentures or bonds subscribed, guarantees or letters of credit issued, or any other commitment which gives rise to a pecuniary liability or requires payment of interest, fees, commitment charges, etc. However, the Bill does not apply to the following security interests:

- a.a lien given by or under any other statute or a bankers' lien and right of set-off;
- b.a pledge of movables as provided under section 172 of the Indian Contract Act, 1872;
- c.creation of security interest in any aircraft or vessel as defined under the Merchant Shipping Act, 1959;
- d.any conditional sale, hire purchase or lease or any other contract which is a title retention contract and not a security interest creation;
- e.any unpaid seller governed by the provisions of the Sale of Goods Act, 1930;
- f.creation or transfer of interest in present or future wages, salary, pay or any other compensation for work or services, the assignment or transfer of which is prohibited by any law;
- g.any security interest securing repayment of financial assistance not exceeding Rs. 1,00,000;
- h.a security interest not registered under this Bill; and
- i.a security interest created in agricultural land. (§ 4 of the Bill)

Creation of security interest

§ 3(1) of the Bill provides that a security interest may be created over any property (other than those specified in § 4 of the Bill) by any security agreement or arrangement.

§ 3(3) of the Bill provides that a secured creditor can enforce its security interest over any property notwithstanding anything contained in § 69 of the Transfer of Property Act, 1882 ("TP Act"). § 69(1) of the TP Act, permits sale of mortgaged property without court intervention in cases where an English mortgage has been created and the parties do not belong to a notified class, or where the mortgage deed provides for sale without intervention of the court and the mortgagee is the government, or where the property is situated in notified places and it provides for sale of the mortgaged property without court intervention. Additionally, § 3(2) provides that a security interest created in favour of a secured creditor before the Bill comes into force can also be enforced under the provisions of the Bill.

This provision takes away the existing requirements to satisfy various conditions under the TP Act for enforcement of mortgaged securities by secured creditors. Therefore, irrespective of the class or place of the borrower or the secured assets, the secured creditor can enforce a security interest registered in its favour.

As per § 3(4) of the Bill, an agreement for creation of a security interest can give the borrower a right to sell or otherwise deal with or dispose off secured assets such as consumer goods, stock-in-trade or by-products without approval of the secured creditors, subject to the provisions of the Bill. However, § 10(2) of the Bill provides that after a notice is issued to a defaulting borrower, he cannot sell the secured assets otherwise than in ordinary course of business. Thus, from a combined reading of §§ 3(4) and § 10(2), it can be inferred that § 3(4) permits the borrower to sell secured assets, based on any right to sell created under an agreement, only until issue of a recovery notice.

Registration of security interests

The Bill provides for establishment of a Central Registry for the purpose of recording creation of security interests in favour of secured creditors on payment of the prescribed fees. Under § 6(1) of the Bill, the notice of security interest can be filed with the Central Registry within whose geographical area, the registered head office of the secured creditor or borrower is situated, and in the case of an individual, the geographical area of his residence. § 7(a) of the Bill specifies that it is not mandatory for a secured creditor or a borrower to register the notice of security interest with the Central Registry. However, if a secured creditor does not register a notice of security interest under the provisions of the Bill, it shall not be entitled to avail the rights conferred by the Bill for enforcement of the security interest. § 9 of the Bill specifies that registering a security interest with the Central Registry does not preclude the

secured creditors and borrowers from adhering to the registration requirements prescribed in all other laws, i.e., the Act or the Indian Registration Act, 1908. Therefore, registration under the Bill will not affect the priority or validity of charges registered under any other enactments.

§ 6(2) of the Bill provides that in case a security interest has been created before the commissioning of the Central Registry, the secured creditor may file notice of the security interest within six (6) months of its commissioning or within the period, if any, notified by Central Government. Further, the secured creditor is required to give notice of such registration to the borrower.

Registration of security interest with the Central Registry should be made mandatory. It will introduce a system whereby the security interests of all banks and FIs are registered with one authority. As a result, fraud relating to title deeds of documents in equitable mortgages, etc., will be minimised.

Disputes relating to the registration of notice of security interest can be referred to the Debt Recovery Tribunal ("DRT"). The borrower, secured creditor or any other person interested in the secured property can approach the DRT for suitable orders under § 6(4)(i) of the Bill.

Since there is no time limit prescribed for disposal of disputes by the DRT, it may lead to a time consuming procedure. The Bill should prescribe a time limit of 30-60 days for disposing off such matters.

Enforcement of security interest

§ 10(1) of the Bill provides that if any borrower, who is liable to a secured creditor under an agreement, defaults in repayment of the secured debt, the secured creditor can require the borrower, by a notice in writing, to discharge his entire liability within a period of sixty (60) days from the date of notice. If the borrower fails to do so, the secured creditor is entitled to take possession of the secured assets and sell them or take other steps to recover its dues. This provision overrides the TP Act, all kind of agreements between the borrowers and secured creditors and any other law in force. Therefore, in case of default by the borrower, upon expiry of the notice period, secured creditor can sell the property without reference to any agreements or any other laws. It, thus simplifies the procedure for enforcement of security interest by secured creditors.

The Bill provides for the sale of secured assets only. It does not provide for the sale of unsecured assets. This becomes relevant in a situation where secured and unsecured assets are bundled together. It may be difficult for the secured creditor to sell only the secured assets. Moreover, it may so happen that the sale proceeds of the secured assets alone are not sufficient to satisfy the claims. The Bill should provide for combined sale of both secured as well as unsecured assets.

The Bill defines default as default in payment of principal, interest or any other dues as a consequence of which the borrower's account is categorised as a NPA in accordance with the RBI guidelines, or other guidelines. However, if the secured creditor is of the view that the borrower has availed financial assistance through any fraudulent, illegal or dishonest means, the financial assistance can be treated as in default even before it becomes a NPA.

§ 11 of the Bill provides that in case a borrower makes default in repayment of dues, notwithstanding the security agreement or any other law for the time being in force, the secured creditor may:

- a. take possession or transfer by way of lease, sale or assignment, the whole or part of the secured assets. This right can be exercised by an officer of the secured creditor of the rank specified by Central Government;
- b. appoint a receiver to the secured assets with rights and duties specified by the secured creditor; or
- c. when money is due from a borrower, send him a written notice requiring him to pay the dues forthwith.

If a secured creditor or the receiver transfers the property of the borrower in default, the rights vested in the transferee will be the same as if the property has been transferred by the owner / borrower. Thereafter, the borrower or any other person who has given the property as security on behalf of the borrower, is absolutely denied of the right to redeem the property.

The expenses, properly incurred by a secured creditor, for taking actions against a borrower are recoverable from the borrower. When a secured creditor recovers money, in the absence of any other contract to the contrary, the money should be realised firstly towards expenses incurred as stated above, secondly towards dues of the secured creditor and finally the balance can be paid to the person entitled in accordance with his rights.

In case of joint financing done by secured creditors, the secured assets cannot be transferred unless agreed upon by secured creditors representing not less than three-fourth (3/4th) in value of the total outstanding dues. Further, the proceeds from transfer of secured assets have to be kept in an escrow account and shared among the secured creditors as per their agreement or mutual consent. If sharing is not possible, the matter is to be referred to a sole arbitrator, to be appointed by the secured creditors, for arbitration under the provisions of the Arbitration and Conciliation Act, 1996.

The Bill merely gives first priority to the secured creditors for reimbursement from the sale proceeds. Only if money remains after realisation of the secured creditors' claims, can it be paid to other entitled persons. The Bill is silent about payments of dues such as excise duties, sales and income taxes, workers' dues, etc. which may have priority over the claims of secured creditors.

The decision of the Hon'ble Supreme Court of India in the case Dena Bank v. Bhikhabhai Prabhudas Parekh & Co., (unreported) dated April 25, 2000, becomes relevant in this regard. In Dena Bank's case, the court held that the State Government has preferential right to recover its dues over the rights of banks as secured creditors. This was an appeal filed by the bank against the decree passed by the High Court granting preference to the sales tax dues of the State Government under Karnataka Sales Tax Act, 1957 (the "KST Act") over the dues of the bank as a secured creditor. In this regard, the court analysed two issues. Firstly, whether recovery of sales tax dues has priority over

the dues of the secured creditors. Secondly, whether in case of a partnership firm, property of the partners can be proceeded against for recovery of sales tax dues. § 13 of the KST Act provides that sales tax dues can be recovered as if it were an arrears of land revenue. Additionally, § 158 of the Karnataka Land Revenue Act, 1964 (the "KLR Act") provides that claims of State Government have precedence over all other debts. Further as per § 190 of the KLR Act if any law provides that an amount is recoverable as an arrear of land revenue, it can be recovered under the KLR Act in the same manner as arrear of land revenue. Therefore, taking the aforesaid factors into consideration, and also since both the KST Act and KLR Act specifically provided that recovery of government dues has priority over the dues of the secured creditors, the court held that sales tax dues had priority over the bank's dues. It was also held that property of the partners of a partnership firm is liable to be proceeded against for recovery of the aforesaid sales tax dues.

Several states in India have provisions similar to the KST Act. The Bill, however does not have any provisions to protect the interests of the secured creditors in this kind of situation. Therefore, the secured creditors will not be in a better position even under the Bill, if some other law provides that certain dues will have priority over the dues of the secured creditors.

Borrowers in winding-up

§ 11(13) of the Bill provides that in case of borrowers, who are companies governed by provisions of the Act, notwithstanding anything contained in § 446 of the Act or any other law governing the liquidation of the borrower or secured assets, the secured creditor can sell the secured assets without leave of the court. § 446 of the Act provides that if a company is ordered to be wound up, no suits or legal proceedings are to be initiated or existing ones to be continued against the company, without obtaining leave of the court. Since the Bill overrides § 446 of the Act, recovery procedure against borrowers in winding up will be simplified. However, if the amounts realised from the sale of secured assets are subject to distribution in accordance with section 529A of the Act, the secured creditor can retain the proceeds from sale of secured assets to satisfy its debts and to handover the balance to the official liquidator or the court. § 529A of the Act provides that workmen of a company in liquidation will be treated as secured creditors of the company and they will have a charge over the assets of the company to the extent of their dues. Under § 529A of the Act, the dues of the workmen and debts due to secured creditors are to be treated pari passu and have to be treated as prior to all other dues. (*Aryavarta Plywood v. Rajasthan State I&I Corporation*, (1991) 72 Com. Cases 5 (Del), *Official Liquidator, High Court of Kerala v. Federal Bank* AIR 1997 Ker 352, as cited in II A. Ramaiya, *Guide to the Companies Act* (15th ed.) p. 3682) If the amount is retained by the secured creditor as aforesaid, it is liable to pay interest on the retained amount.

This is a unique provision, as the secured creditor need not apply for leave of the Company Court where the borrower's winding up petition is pending, in order to deal with the secured assets. Even though the SFCs Act has several provisions similar to the Bill, an important difference is that the SFCs have to obtain leave of the court to proceed against an undertaking in winding up. The Bill has two provisions. One says that amounts realised from sale of secured assets are subject to distribution under § 529A of the Act. The second says that out of the amount realised, the secured creditor can retain the amount for satisfying of its debts and hand over the balance for distribution under § 529A. Since § 529A provides that workmen's dues will rank pari passu with the debts due to the secured creditor, there is lack of clarity in the language of § 11(13) of the Bill. Instead of providing that the secured creditor can retain 'the amount sufficient to satisfy its debts', the Bill should have provided that the secured creditor can retain 'the proportionate amount to which they are entitled on the basis of pari passu distribution'.

In cases where dues of the secured creditor are not fully satisfied from the sale proceeds of the secured assets, the balance amount can be recovered from the borrower or the guarantor. For this purpose, the secured creditor can approach the DRT or any other appropriate forum. The Bill also gives the secured creditor the right to proceed against the guarantors or pledgors without first enforcing the secured assets.

Any disputes regarding the dues payable by the borrower to the secured creditor, subsequent to sale, lease or assignment of the secured assets will be considered by the DRT on application by the borrower. The DRT can entertain such an application even if the amount involved is less than its pecuniary jurisdiction, i.e., below Rs. 10,00,000. However, this does not prevent the secured creditor from appropriating the sale proceeds, subject to final determination of the matter by DRT.

Even though the secured creditor can appropriate the sale proceeds subject to final determination by DRT, the Bill does not provide a time frame within which DRT should dispose off the application filed by the borrower. The Bill does not specify the scope and extent of adjudication by the DRT. The Bill should have clarified these aspects.

Taking possession of secured assets

§ 12 of the Bill provides that for taking possession or custody of any secured assets, the secured creditor can apply in writing to the Chief Metropolitan Magistrate or District Magistrate, who has jurisdiction over the secured assets or the related documents. Upon receipt of such an application, the magistrate is required to take possession of such assets and documents and hand them over to the secured creditor. For this purpose, the magistrate can take necessary steps and use force as provided under law. § 12(3) of the Bill specifies that none of the actions taken by the magistrate in this regard shall be questioned in any court or authority.

This is a very important provision as it gives teeth to the Chief Metropolitan Magistrate and District Magistrate. However, the conditions prevalent in our system may render effective usage of the provision nugatory.

Immunity to secured creditors from legal proceedings

As per § 13 of the Bill, a secured creditor or any of its authorised representatives shall not be prosecuted for any acts done or omitted to be done under the provisions of the Bill. Further, no court or authority shall grant any stay or injunction in respect of actions taken or to be taken under the provisions of the Bill.

Rights and obligations of borrower and secured creditor

§ 14(1) of the Bill provides that, notwithstanding any agreements to the contrary, a secured creditor is required to furnish to the borrower a true copy of the security agreement and periodical statements of accounts. Further, the secured creditor is required to protect and preserve the secured assets possessed by the secured creditor, until they are sold, at the cost of the borrower. If possession of perishable goods is taken by the secured creditor, then they are required to be sold within a reasonable time, and in case of other secured assets, the sale should take place within a period of two (2) years from date of possession.

However, notwithstanding the aforesaid, a secured creditor can approach the DRT for extension of time for a period not exceeding one year in the aggregate, to sell the secured assets.

This provision sounds quite attractive. However, the Bill does not provide for any eventualities where the secured creditors are unable to dispose off the secured assets within the maximum period of three (3) years. The experience in our country is that the secured creditors are unable to find purchasers for the secured assets for years together.

The situation only gets aggravated when the value of the secured assets is high.

Similar provisions under existing law

Provisions similar to the Bill are provided under § 29 of the SFCs Act. However, the SFCs Act applies only if the borrower is an industrial concern within the meaning of the SFCs Act. If an industrial concern fails to repay the dues arising out of a liability under an agreement to a financial corporation, the financial corporation has a right to take possession and manage the industrial concern. Further, the financial corporation has the right to transfer or sell any of assets mortgaged, pledged or hypothecated in its favour.

Conclusion

The rights under the provisions of the Bill are available to all the Banks and FIs, even though it is not mandatory for them to register notice of security interest under the Bill. Further, unlike the SFCs Act, under the provisions of the Bill action can be initiated against any borrower irrespective of its status. The salient features of the Bill such as the power given to Banks and FIs for sale of secured assets without intervention of court and without leave of the court if the borrower is in winding up; the provisions for immunity from legal proceedings in respect of actions taken under the provisions of the Bill; the establishment of a Central Registry for registration of notice of security interest; the prescribed time limit for disposing of secured assets, etc. may do away with the delays and laches in the existing debt recovery mechanism.

Even though suits or legal proceedings will not lie against a secured creditor while exercising its powers under the Bill (§ 13 of the Bill), the borrowers can approach the courts by way of writ petitions, as has been the case with SFCs. The recovery proceedings initiated under the SFCs Act get entangled in writ petitions for several years. Further, as against the lengthy litigations before civil courts, under the Bill, disputes are to be decided by the DRT. In the present scenario where the Government is planning to repeal Sick Industrial Companies (Special Provisions) Act, 1985 and to establish more DRTs, the provisions of the Bill may help the Banks and FIs recover their dues, effectively.