

POCKET NOTEBOOK ON CORPORATE CRIMINAL LAWS

PART I

OVERVIEW OF LAW OF FRAUD IN BORROWER-LENDER RELATIONSHIPS

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PROLOGUE

The resilience of a growing economy is tested and determined when its banking system is put to the test. Despite being relatively stable throughout a series of recessions, the Indian banking industry contains a series of vulnerabilities which have been left unaddressed, increasingly becoming gaping black holes and tarnishing the image of the banking sector.

While the recent downgrade to the lowest Investment Grade by Moody's and a negative outlook for India (sovereign) as a whole may be temporary and (partly) cyclic in nature, what cannot be swept under the carpet is the problem of burgeoning Non Performing Assets ("NPAs"). It is revealing, in itself, that India is the global leader in bad loans. As per the statement of Union Minister of State for Finance's statement in Lok Sabha¹, the NPAs of the Public Sector Banks ("PSBs") stood at Rs. 7.27 Lakh Crore as on September 30, 2019. The gross NPAs of PSBs, as per Reserve Bank of India ("RBI") data on global operations, rose from Rs 2,79,016 Crore as on March 31, 2015, to Rs 6,84,732 Crore as on March 31, 2017 and Rs 8,95,601 Crore as on March 31, 2018. RBI, in its Financial Stability Report ("FSR") released on December 27, 2019, has estimated that the gross NPA ratio of banks may increase to 9.9% by September, 2020. The FSR has further estimated that in PSBs, gross NPA ratios may increase to 13.2% by September 2020 from 12.7% in September 2019, whereas for private banks it may climb to 4.2% from 3.9%, under the prevailing stressful scenario and foreign banks' gross bad loans may increase to 3.1% from 2.9% in September 2019. The FSR attributes this carnage to change in macroeconomic scenario, marginal increase in slippages and the effect of declining credit growth. Owing to the COVID – 19 pandemic outbreak, the picture is expected to get murkier. In a country of India's size, private sector participation in the banking and finance sector has been slow and confined to a few large players. While part of this is due to the robust and largely successful prudential regulations issued from time to time by the RBI together with India's commitment to adopt global standards (Basel norms), it has left the NPA curve heavily skewed in favour of the PSBs.

PSBs have long been the repository for public money, and conventional and conservative wisdom has driven the masses (especially the middle class Indian) to leave their money in PSBs in fixed deposits. With rising NPAs, not only are the balance sheets of PSBs under stress, it means increased risk exposure for the public at large as well as reduced income for the Government from PSBs where copious amounts of money has been invested by the Government towards equity capital and recapitalizations. This, obviously, has knock on effects in terms of inflationary and other macro-economic trends as one stream of Government's income has been dwindling over the last decade or so.

While the issue of NPAs is deep rooted, yet, widely reported, what is still spoken about in hushed tones is the dual problem of evergreening by PSBs and private lenders alike and fraud, wilful default and other similar aspersion casting and unscrupulous methods that plague lending-borrowing relationships in the Indian economy. These are cases where the image of PSBs is tarnished the most while also reducing public and investor confidence and eroding general market sentiment. That said, the RBI has been proactive and focused in its approach through some prudent regulatory measures such as:

- ✓ RBI's directions on *Disclosure in the "Notes to Accounts" to the Financial Statements - Divergence in the asset classification and provisioning* bearing reference number RBI/2018-19/157 DBR.BP.BC.No.32/21.04.018/2018-19 dated 01.04.2019;
- ✓ RBI's *Master Directions on Frauds – Classification and Reporting by commercial banks and select FIs* bearing reference number RBI/DBS/2016-17/28 DBS.CO.CFMC.BC.No.1/23.04.001/2016-17 dated 01.07.2016 (updated on 01.07.2017) ("**Fraud Circular**");

¹"NPAs of PSBs stands at Rs 7.27 lakh crore", The Economic Times, February 03, 2020. Available at <https://economictimes.indiatimes.com/markets/stocks/news/npas-of-psbs-stands-at-rs-7-27-lakh-crore/articleshow/73898192.cms?from=mdr>

- ✓ RBI's *Master Circular on Wilful Defaulters* bearing reference number RBI/2015-16/100 DBR.No.CID.BC.22/20.16.003/2015-16 dated 01.07.2015 (“**Wilful Default Circular**”); and
- ✓ RBI's *Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances* bearing reference number RBI/2015-16/101 DBR.No.BP.BC.2/21.04.048/2015-16 dated 01.07.2015.

Timely detection and early reporting of cases of misfeasance are incentivized leading (atleast) to escalation of the deep rooted issue so that suitable remedial measures can be implemented by the RBI/Government while unscrupulous borrowers are brought to book early. In a 5 part series, we cover law and judicial precedents through a series of questions and summaries that compel a deep analysis of lending borrowing relationships where such misfeasance and unethical practices have crept in leading to enactment and evolution of laws and judicial precedents. In this Part (Part I), we cover the law on banking frauds.

BRIEF OVERVIEW OF RBI'S FRAUD CIRCULAR

Issued on July 1, 2016 and last updated on July 3, 2017, the RBI's Fraud Circular is applicable to all Scheduled Commercial banks (except Regional Rural Banks) and All India Financial Institutions (“**AIFI**”), which are (i) Export-Import Bank of India, (ii) National Bank for Agriculture and Rural Development, (iv) National Housing Bank and (v) Small Industries Development Bank of India. The Fraud Circular broadly covers the following:

- ✓ Classification of various kinds of frauds;
- ✓ Quarterly and annual review of frauds and closure of fraud cases;
- ✓ Mechanism of reporting of fraud to the Board of Directors of the respective banks and the RBI; and
- ✓ Guidelines of reporting of fraud to law enforcement agencies;
- ✓ Framework for Loan Frauds – Early detection and reporting by banks (both as sole lenders and under consortium arrangement), staff empowerment, role of auditors, complaints to law enforcement agencies and penal measures for fraudulent borrowers.

In respect of loan frauds, in terms of the Fraud Circular, banks are armed with significantly potent (and, as we will learn later in this Notebook, significantly vulnerable) tools under Chapter VIII. Paragraph 8.3 of the Fraud Circular refers to red flagged account (“**RFA**”) and early warning signals (“**EWS**”) in a loan account, the appearance of which mandate banks to put an account on alert immediately while triggering reporting requirements. Further, paragraph 8.9.4 of the Fraud Circular, whether on mere detection of EWS or otherwise, allows banks to classify any account as RFA or Fraud straightaway, without providing for any opportunity of representation to the borrower, and report the same to RBI and investigation agencies such as Central Bureau of Investigation. It is also an established position of law that RBI circulars carry statutory force and as such are binding on all banks. Following the aforesaid mechanism, RBI has confirmed in its Annual Report of 2018-19 that in the Financial Year (“**FY**”) 2018-19, banking sector reported 6,801 frauds involving a total Rs. 71,542.93 Crores as against 5,916 cases involving Rs. 41,167.04 Crores reported in FY 2017-18. The amount involved in frauds has gone up by 73.8% in a span of one year. The Annual Report also stated that among bank groups, PSBs, who collectively represent the dominant market share in bank lending, have accounted for the bulk of frauds reported in 2018-19.

While the numbers pose a grim picture and make a more robust framework imperative for tackling the menace of fraud, we cannot lose sight of the fact that reporting in such large numbers could also be a consequence of the fact that banks can now straightaway report an account as fraud, in the absence of a specific and binding requirement to conduct any preliminary enquiry to ascertain such fraud.

In its attempt to strengthen the framework and equip banks with powers to proceed swiftly against certain borrowers, RBI appears to have failed in ensuring adherence to the basic tents of the Constitution of India. *Prima facie* it appears that the Fraud Circular is manifestly arbitrary and in violation of the principles of natural justice in view of the fact that there are no provisions in the Fraud

Circular requiring giving of show cause notice, opportunity of personal hearing and representation by banks to the borrowers before banks declare their accounts as fraud and report the same with RBI and other law enforcement agencies. However, it would be incorrect to assume that RBI is oblivious of the significance of the opportunity of hearing/representation to the ones indicted. In the Fraud Circular itself, paragraphs 8.12.3 and 8.12.4 provide for opportunity of hearing/representation to any third party (other than the borrowers) before holding them accountable for any alleged fraudulent transaction, in the following words:

“8.12.4 In addition to above borrower-fraudsters, third parties such as builders, warehouse/cold storage owners, motor vehicle/tractor dealers, travel agents, etc. and professionals such as architects, valuers, chartered accountants, advocates, etc. are also to be held accountable if they have played a vital role in credit sanction/disbursement or facilitated the perpetration of frauds. Banks are advised to report to Indian Banks Association (IBA) the details of such third parties involved in frauds.

8.12.5 Before reporting to IBA, banks have to satisfy themselves of the involvement of third parties concerned and also provide them with an opportunity of being heard. In this regard the banks should follow normal procedures and the processes followed should be suitably recorded. On the basis of such information, IBA would, in turn, prepare caution lists of such third parties for circulation among the banks.”

The RBI directive in the Fraud Circular is distinct and clear that banks are required to satisfy themselves of the involvement of third parties first and are also required to provide them with opportunity of hearing/representation before proceeding against them in respect of any alleged fraudulent transaction. However, the Fraud Circular is arbitrary and discriminatory *qua* borrowers, without so much as a whisper of such rights to them in the entire scheme.

Resultantly, the constitutionality of the Fraud Circular has been assailed in the matter of ***Apple Sponge and Power Limited & Ors., vs. RBI, W.P. (C) No. 306/2019*** before the Hon'ble Delhi High Court and in the matter of ***AGR Steel Strips Pvt. Ltd. vs. RBI & Ors., C.W.P. No. 34297/2019*** which are currently pending before the Hon'ble High Court of Delhi and the Hon'ble High Court of Punjab & Haryana. Both Courts have issued notice in the matters and granted interim protection to the Petitioners (being, *inter alia*, the respective borrowers, who have been at the receiving end of the lenders' actions under the Fraud Circular). The Fraud Circular confers upon the banks unbridled powers to declare any account as fraud and, consequently, step into the shoes of an adjudicator, without so much as providing borrowers an opportunity of hearing or representation.

Time, perhaps, for the RBI to revisit the provisions of the Fraud Circular and introduce appropriate safeguards for the borrowers with a view to ensure their constitutional rights guarantees are not impacted.

Our analysis on the Fraud Circular is split into 2 (two) Parts as follows:

- ✓ **Part A** – Summary Analysis of the Fraud Circular with certain aspects, capable of being challenged, also noted therein; and
- ✓ **Part B** – Analysis of various contentious issues emanating from, or linked to, the Fraud Circular and judicial disposition regarding the same.

PART A – SUMMARY ANALYSIS OF THE FRAUD CIRCULAR

PROVISION OF FRAUD CIRCULAR	PARTICULARS/IMPACT OF THE PROVISION	POTENTIAL GROUNDS FOR MOUNTING CONSTITUTIONAL OR OTHER LEGAL CHALLENGE
<p>Classification of Fraud – Paragraph 2.2 of the Fraud Circular read with Annexure II (enlisting the EWS, which may be used as basis to report Fraud).</p>	<p>The Fraud Circular provides that, in order to have uniformity in reporting by banks and financial institutions governed by the Fraud Circular, the following are classified as instances of fraud, based mainly on the provisions of the Indian Penal Code, 1860 (“IPC”):</p> <ul style="list-style-type: none"> ✓ Misappropriation and criminal breach of trust, ✓ Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property, ✓ Unauthorized credit facilities extended for reward or for illegal gratification, ✓ Cash shortages, including those resulting from negligence and fraudulent forex transactions involving irregularities / violation of regulations have also to be reported as fraud if the intention to cheat/defraud is suspected or proved, ✓ Cheating and forgery, ✓ Fraudulent transactions involving foreign exchange, ✓ Any other type of fraud not coming under the specific heads as above. <p>GL Note</p> <p>There are 42 Early Warning Signals which have been set out indicatively in Annex II to the Fraud Circular. As mentioned previously, these could trigger reporting requirements in terms of the Fraud Circular. The Early Warning Signals range from resignation of key managerial personnel to issues in stock audit report to non-production of original bills for verification.</p>	<ul style="list-style-type: none"> ✓ The Fraud Circular, while classifying Frauds, has referred to, and relied upon, the IPC. However, while IPC goes hand in hand with the Code of Criminal Procedure, 1973 (“CrPC”) and the Indian Evidence Act, 1872 (the “Evidence Act”), the Fraud Circular empowers bank to straightaway trigger penal and punitive consequences against a borrower it considers to have engaged in fraud. ✓ All mechanisms for effective detection, reporting, investigation and trial of a particular offence are conspicuous by their absence from the Fraud Circular. ✓ As per criminal jurisprudence in India, an accused is <i>innocent until proven guilty</i>. The evidence tendered is to be of highest degree and beyond reasonable doubt. ✓ Effectively, the Fraud Circular carries the potential to condemn guilty a person unheard, which is against all principles of natural justice.
<p>Reporting of Frauds to RBI – Paragraph 3.2</p>	<ul style="list-style-type: none"> ✓ Banks required to furnish Fraud Monitoring Return (“FMR”) to RBI electronically using FMR Application in XBRL System within three weeks from the date of detection of fraud to RBI; ✓ Monthly Certificate, mentioning that soft copy of all FMRs have been submitted to RBI, is to be furnished to Central Fraud Monitoring Cell; ✓ Fraud Reports to be submitted even where Investigating Agencies have taken <i>suo moto</i> 	<p>Fraud Circular does not require the banks to provide a copy of FMR or any other incriminating material to the concerned borrower. Analogy can be drawn from the relevant criminal laws which require mandatorily that the accused ought to be provided with the copy of the FIR.</p>

	action.	
Guidelines for Reporting Frauds to Police/Central Bureau of Investigation (“CBI”) – Paragraph 6	<p>Banks can lodge complaint with different law enforcement agencies in respect of fraud cases on the basis of the amount involved. The categorization is as follows:</p> <ul style="list-style-type: none"> ✓ Private Sector/Foreign Banks <ul style="list-style-type: none"> a) Rs. 10000 and above but below Rs. 0.1 million – State Police b) Rs. 0.1 million and above but below Rs. 10 million – State Police c) Rs. 10 million and above – State Police, Serious Fraud Investigation Office (“SFIO”) ✓ Public Sector Bank <ul style="list-style-type: none"> a) Rs. 10000 and above but below Rs. 0.1 million – State Police b) Rs. 0.1 million and above but below Rs. 30 million – State Crime Investigation Department/Economic Offences Wing of the State c) Rs. 30 million and up to Rs. 250 million – Anti-Corruption Branch of CBI (where staff involvement is <i>prima facie</i> evident) and Economic Offences Wing of CBI (where staff involvement is <i>prima facie</i> is not evident). d) Above Rs. 250 million and up to Rs. 500 million – Banking Security and Fraud Cell (BSFC) of CBI (irrespective of the involvement of a public servant) e) Above Rs. 500 million – Joint Director (Policy) CBI, New Delhi. ✓ All Fraud cases of value below ₹10,000/- involving bank officials, are to be referred to the Regional Head of the bank, who would scrutinize each case and direct the bank branch concerned on whether it should be reported to the local police station. 	<p>Under the Fraud Circular, before reporting the suspected cases of fraud to the law enforcement agencies, there is no pre-requisite to conduct any internal inquiry and ascertain the veracity of suspicions or to provide any opportunity of representation/hearing to the borrower as opposed to same being provided to the third party suspects under the Fraud Circular as well as the same being present in the scheme of RBI’s Wilful Default Circular.</p>
Early Detection and Reporting – Paragraph 8.4	<ul style="list-style-type: none"> ✓ For strengthening of monitoring processes, checks and balances during the different stages of the loan-cycle, i.e. Pre-sanction, Disbursement and Annual Review, are to be put in place. ✓ Employees and auditors empowered and expected to report instances that point to the possibility of fraudulent transactions in the account. ✓ The initial decision to classify any account as RFA or Fraud will be at the individual bank level. The bank is free to classify the account as fraud straightaway on detection of EWS (Paragraph 8.9.4). ✓ The bank is then required to report the same to RBI within 21 days of detection and also report the case to Police/CBI. ✓ In consortium lending, majority rule of 60% in consonance with erstwhile JLF norms to be followed for red flagging loan accounts to initiate forensic audit. ✓ The forensic audit needs to be completed within 3 months and within 15 days of its 	<p>GL Note</p> <p><i>The grounds for mounting challenge basis this provision are mentioned in Part B of this Notebook under points (II) and (III) and have not been repeated here for the sake of brevity.</i></p>

	<p>conclusion, decision on the status of account needs to be taken by consensus or majority rule.</p> <ul style="list-style-type: none"> ✓ On fraud classification, complaints need to be registered against the borrower with CBI, Police, Central Economic Intelligence Bureau, SFIO, Financial Intelligence Unit, Directorate of Revenue Intelligence and the Indian Banks' Association. 	
EWS and RFA – Paragraph 8.3	<ul style="list-style-type: none"> ✓ RFA: An account where a suspicion of fraudulent activity is thrown up by the presence of one or more EWS. ✓ EWS: A signal in a loan account that should immediately put the bank on alert regarding a weakness or wrong doing which may ultimately turn out to be fraudulent. ✓ Threshold for Reporting (based on EWS and RFA): Exposure of Rs. 500 million irrespective of the lending arrangement (sole lending or consortium). ✓ CRILC Reporting: All accounts beyond ₹500 million classified as RFA or 'Frauds' to be reported on the Central Repository of Information on Large Credits data platform. ✓ Below ₹500 million: As per discretion of lenders. Nonetheless, requirement to report to Central Fraud Monitoring Cell is applicable as per existing cut-offs specified in the Fraud Circular. ✓ Incentive for Prompt Reporting: In case of accounts classified as 'fraud', banks are required to make provisions to the full extent immediately, irrespective of the value of security. The banks can make provisions over four quarters in case there is no delay in reporting. In case there is delay in reporting fraud, the banks under Multiple Banking Arrangements or member banks in a consortium are required to make provision in one go. 	<ul style="list-style-type: none"> ✓ The usage of word '<i>may</i>', in the first sentence of Annexure-II to the Fraud Circular, is evidence to the fact that the existence of the EWS isn't conclusive proof of fraudulent activity in a borrower's account; ✓ Paragraph 8.9.4 of the Fraud Circular, on mere detection of EWS, allows the banks to classify any account as RFA or Fraud straightaway triggering penal and punitive consequences; and ✓ There is no provision or requirement for the banks to conduct any preliminary inquiry to ascertain existence of fraud.
Penal Measures for Fraud – Paragraph 8.12	<ul style="list-style-type: none"> ✓ Penal provisions applicable to wilful defaulters (including promoter director(s) and other whole-time directors of the company) apply to fraudulent borrowers. ✓ No restructuring or grant of additional facilities may be made in the case of RFA or fraud accounts. ✓ Fraudulent borrowers are debarred from raising funds from the capital markets by companies with which they are associated. ✓ Fraudulent borrowers are debarred from availing bank finance from Scheduled Commercial Banks, Development Financial Institutions, Government owned NBFCs, Investment Institutions, etc., for a period of 5 years from the date of full payment of the defrauded amount. ✓ No compromise settlement involving a fraudulent borrower is allowed unless the conditions stipulate that the criminal complaint will be continued. 	<p>GL Note</p> <p><i>The grounds for mounting challenge basis this provision are mentioned in Part B of this Notebook under points (II) and (III) and have not been repeated here for the sake of brevity.</i></p>

GL Notes

- ✓ Banks also bound by the directions of the Central Vigilance Commission (“CVC”).
- ✓ CVC’s **Office Order No. 14/3/05 dated 05.04.2005** read with **Office Order No. 3/1/08 dated 03.01.2008** and **Circular No. 30/8/10 dated 17.08.2010** sets out procedures to be followed by the PSBs for reporting cases involving financial frauds to various investigative agencies and to pursue further recovery measures.
- ✓ As per **CVC’s Office Order No. 06/08/19 dated 21.08.2019**, Advisory Board for Banking Frauds (“**ABBF**”) functions as the first level of examination of all large fraud cases before recommendations/references are made to any investigative agencies.
- ✓ Large fraud cases above Rs. 500 million are referred to ABBF and on receipt of its recommendation/advice, the concerned public sector bank takes further action in such matters.

PART B – ANALYSIS OF JUDICIAL DISPOSITION ON CONTENTIOUS ASPECTS EMANATING FROM FRAUD CIRCULAR

PROPOSITION OF LAW	LEGAL POSITION BASED ON JUDICIAL PRECEDENTS AND OTHER SUBSTANTIVE LAWS IN FORCE	RELEVANT CASE LAW / SUBSTANTIVE PROVISION OF LAW
Statutory force of RBI Circulars	✓ Circulars / directions issued by RBI under Sections 21 and 35A of the Banking Regulation Act, 1949 (“ BR Act ”) carry statutory force and are bound to be complied with.	<i>Canara Bank vs. P.R.N. Upadhyaya & Ors.</i> , (1998) 6 SCC 526
	✓ Under the BR Act, wide powers are conferred on RBI to enable it to exercise effective control over all banks. Sections 21 and 35A of BR Act enable RBI to issue directives in public interest to regulate the charging of interest on loans or advances made from time to time and as such these circulars/directions would have statutory flavour.	<i>Corporation Bank vs. D. S. Gowda & Ors.</i> , (1994) 5 SCC 213
	✓ The directions issued under Sections 21 and 35A of the BR Act are binding on banking companies unless declared to be illegal and unreasonable.	<i>B.O.I. Finance Ltd. vs. The Custodian & Ors.</i> , 1997 (2) SCP 539; (1997) 10 SCC 488
	✓ Circulars / directions issued by RBI are based on rational policy in the interest of banks and coupled with a duty to act.	<i>Sardar Associates vs. Punjab & Sind Bank</i> , (2009) 8 SCC 257
	✓ RBI is prime banking institution of the country entrusted with a supervisory role over banking and conferred with the authority of issuing binding directions, having statutory force, in the interest of public in general and preventing banking affairs from deterioration and prejudice as also to secure the proper management of any banking company generally. ✓ RBI is one of the watchdogs of finance and economy of the nation. It is, and it ought to be, aware of all	<i>Central Bank of India vs. Ravindra</i> , AIR 2001 SC 3095

	<p>relevant factors, including credit conditions as prevailing, which would invite its policy decisions.</p> <ul style="list-style-type: none"> ✓ RBI has been issuing directions/circulars from time to time which, <i>inter alia</i>, deal with rate of interest which can be charged and the periods at the end of which rests can be struck down, interest calculated thereon and charged and capitalized. It should continue to issue such directives. ✓ RBI circulars shall bind those who fall within the net of such directives. 	
<p>Absence of the provisions of opportunity of representation to the borrowers under Fraud Circular before reporting of an account as 'Fraud'</p>	<p>Unlike provisions of the IPC, CrPC or the Evidence Act (where the burden of proof as regards alleged fraud is on the person alleging the fraud), in terms of the Fraud Circular, lenders can straightaway trigger penal and punitive consequences.</p>	Paragraph 8.9.4 of the Fraud Circular
	<p>There is no provision for furnishing a Show Cause Notice or other mechanism (which is built in to other RBI Circular on a similar subject – Wilful Default) providing for an opportunity for the borrower to represent its case before the Bank or any other authority.</p>	Paragraph 8.12 of the Fraud Circular
	<ul style="list-style-type: none"> ✓ Even under the Companies Act, 2013 (“Companies Act”), offences in the nature of frauds are to be tried by <i>Special Courts</i>. ✓ Everyone is, except under the Fraud Circular, presumed innocent until proven guilty after due enquiry and trial, whether in a civil or a criminal proceeding. 	Section 447 of the Companies Act
	<ul style="list-style-type: none"> ✓ Fraud like any other charge of a criminal offence, whether made in civil or criminal proceedings, must be established beyond reasonable doubt. ✓ However suspicious may be the circumstances, however strange the coincidences, and however grave the doubts, suspicion alone can never take the place of proof.” 	<i>Union of India vs. M/s Chaturbhai M. Patel & Co., AIR 1976 SC 712</i>
	<ul style="list-style-type: none"> ✓ In case of a serious charge of fraud, a higher degree of probability is needed to establish the same. In the absence a reasonably strong evidence, even in a civil proceeding, a person cannot be held guilty and awarded punishment. ✓ Mere surmise, conjuncture or suspicion cannot sustain the finding of fault, except under the Fraud Circular. 	<ul style="list-style-type: none"> ✓ <i>Parsoli Corporation vs. SEBI, [2011] 109 SCL 62, SAT</i> ✓ <i>Sterlite Industries vs. SEBI, Appeal No. 20/2001 order dated 22.10.2001, SAT</i>
	<ul style="list-style-type: none"> ✓ Powers of Serious Fraud Investigation Office (itself under challenge in the matter of <i>SFIO vs. Neeraj Singal & Anr.</i>, SLP (Crl) No. 7241 of 2018 before Hon’ble Supreme Court of India), while extremely potent, are predicated on investigation followed by initiation of prosecution. The Fraud Circular, by contrast, contains no provision for investigation of enquiry. <p>GL Note</p> <p><i>The substantive law in respect of ‘fraud’ does not, straightaway, hold a person guilty or accountable, without trial or opportunity of hearing, at the very least. However, any such mechanism is absent in the Fraud</i></p>	<p><i>The constitutional validity of Sections 212(6)(ii), 212(7) and 212(8) of the Companies Act was assailed before the Hon’ble Delhi High Court in the matter of Neeraj Singal vs. Union of India & Ors., W.P. (Crl.) No. 2453 of 2018.</i></p> <p><i>However, the Hon’ble Supreme</i></p>

	<p><i>Circular, which empowers lenders to declare an account as 'fraud' straightaway, and is therefore liable to constitutional challenge due to absence of this provision. The law is clear that: (i) every person is innocent until proven guilty; and (ii) no one can be condemned unheard.</i></p>	<p><i>Court transferred the matter to itself vide its order dated 04.09.2018 in SFIO vs. Neeraj Singal & Anr., SLP (Crl.) No. 7241 of 2018 with SLP (Crl.) No. 7242 of 2018 and is now being heard before the Hon'ble Supreme Court along with The Directorate of Enforcement vs. Karti P. Chidambaram, Diary No. 9360 of 2018.</i></p>
<p>Constitutional validity of the Fraud Circular</p>	<ul style="list-style-type: none"> ✓ The constitutional validity of the Fraud Circular has been assailed before the Hon'ble Delhi High Court and the Hon'ble Punjab and Haryana High Court on various aspects as mentioned in this Notebook, amongst others. ✓ As stated in the introduction, under the Fraud Circular, which carries statutory force, banks can now straightaway report an account as fraud without conducting any preliminary enquiry to ascertain fraud. ✓ The Fraud Circular is manifestly arbitrary and in violation of the principles of natural justice due to the absence of requirement of giving any show cause notice, opportunity of personal hearing and representation to the borrowers before banks declare their accounts as fraud and report the same with RBI and other law enforcement agencies. ✓ The Fraud Circular provides an arbitrary and cursory procedure to subject a borrower and/or its promoters and directors to drastic and penal consequences as provided under the criminal law, without providing any mandate to adhere to the doctrines of the criminal law. ✓ The Fraud Circular, issued by RBI in pursuance of its powers under Section 35A of the BR Act, is subordinate to the BR Act. Since the BR Act itself does not deal with criminality or authorize banks to declare someone as criminal, the Fraud Circular exceeds the scope of the statute. <ul style="list-style-type: none"> ✓ The Hon'ble Supreme Court has held that when an instrumentality of State acts contrary to public good and public interest, unfairly, unjustly and unreasonably, in its constitutional and statutory obligations, it acts contrary to constitutional guarantees enshrined under Article 14 of the Constitution of India. ✓ RBI, while framing the Fraud Circular, has transgressed into a territory exclusively and exhaustively covered under IPC, the Evidence Act and the CrPC and that too, without adherence to the principles of providing sufficient safeguards to the accused persons. As such RBI, being an instrumentality of the state and under the duty to act fairly, in good faith and public interest, is in gross violation of its constitutional and statutory 	<ul style="list-style-type: none"> ✓ <i>Apple Sponge and Power Limited & Ors., vs. RBI, W.P. (C) No. 306/2019, Delhi High Court</i> ✓ <i>AGR Steel Strips Pvt. Ltd. vs. RBI & Ors., C.W.P. No. 34297/2019, Punjab and Haryana High Court</i> <p>GL Note</p> <p><i>In both the matters, notice has been issued, interim protection has been granted to the borrowers, and matters are pending final adjudication.</i></p> <p><i>Abl International Limited & Anr. Export Credit Guarantee of India Ltd., (2004) 3 SCC 553</i></p>

	<p>obligations.</p> <ul style="list-style-type: none"> ✓ Even under the Wilful Default Circular, a detailed mechanism for issuance of a show cause notice to the concerned borrower, and grant of two opportunities of hearing to the borrower to represent its case before the in-house committees have been provided. ✓ The Hon’ble Supreme Court, realizing the harsh consequences that follow after declaration of a borrower as a ‘wilful defaulter’, has directed the incorporation of 'two opportunities' to the borrower to present its case before being declared a ‘wilful defaulter’ on similar lines as mentioned under the earlier 2013 Master Circular on Wilful Defaulters. <i>This observation of the Supreme Court finds its way into the Wilful Default Circular.</i> ✓ Furthermore, the Hon’ble Court directed that after Identification Committee declares a borrower a ‘wilful defaulter’, it shall serve a copy of such order to the borrower. Thereafter, the borrower is entitled to make its representation within 15 (fifteen) days before the Review Committee, after which the Review Committee is expected to pass a reasoned order with evidence relied upon in the matter, which shall then be served upon the borrower. <i>No such provision/requirement of informing the borrower regarding declaration and reporting of fraud, let alone an opportunity of hearing/representation before such declaration, is present under the Fraud Circular.</i> <p>In view of various judgments of the Hon’ble Supreme Court, the adherence to the principles of natural justice has been treated as fundamental to the system established by the Rule of Law and under the common-law doctrines on criminal offences and justice. Any action taken or order passed without complying with the same is liable to be declared void being against the principles of natural justice, fairness and the guarantees enshrined under the Constitution of India.</p>	<p><i>State Bank of India vs. Jah Developers Pvt. Ltd., (2019) 6 SCC 787</i></p> <p>✓ <i>Canara Bank vs. V.K. Awasthy, AIR 2005 SC 2090</i> ✓ <i>Uma Nath Pandey & Ors vs. State Of U.P. & Anr., AIR 2009 SC 2375</i></p>
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GL Notes

- ✓ Office Memorandum No. 25016/31/2017-Imm. on issuance of Lookout Circular (“**LOC**”) in respect of Indian citizens and foreigners dated 27.10.2010 (“**O.M. dated 27.10.2010**”) has been amended by the confidential (*not in public domain*) Office Memorandum (“**O.M.**”) dated 12.10.2018 and, when read with Press Release dated 24.07.2019 issued by Ministry of Home Affairs (directions issued by the Government to deal with fraud, wilful bank loan defaulters or fugitive economic offenders), empowers Chairmen/Managing Directors/Chief Executive Officers of PSBs to request issuance of the LOC against fugitive economic offenders/wilful defaulters/fraudsters.
- ✓ Under any law in force in India, any bank, which is essentially a commercial institution engaged in private commercial transactions, does not have the authority or power to conduct trial or act as an adjudicator and consequently take coercive measures, like causing issuance of LOC against any person, nor can such power be read inherently vide an office memorandum (such as the O.M).
- ✓ Even by way of amending the substantive laws, i.e. the BR Act, powers equivalent to ‘adjudication’ cannot be conferred upon banks which are merely body corporates engaged in private commercial transactions of lending and borrowing with other body corporates.

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- ✓ As such any LOC issued basis an office memorandum (such as O.M.), which leads to deprivation of the liberty of any individual, without affording such individual fair trial, cannot be held as ‘due process of law’ and is, therefore, liable to be struck down as being violative of Articles 14 and 21 of the Constitution of India.
- ✓ As such, issuance of the 2018 amendment to the O.M. dated 27.10.2010 conferring upon banks the power to request issuance of LOC, is also liable to be struck down. This amendment to the O.M. dated 27.10.2010 is amenable to constitutional challenges on various grounds which have been dealt with in detail in Part-V of this Notebook containing overview of Law on Look-Out Circulars.
