POCKET NOTEBOOK
ON CORPORATE CRIMINAL LAWS

PART II

OVERVIEW OF LAW ON WILFUL DEFAULTERS

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HISTORY AND GERMINATION OF LAW ON WILFUL DEFAULTERS

In the year 1986, Reserve Bank of India ("**RBI**"), *vide* its Circular No. 145 dated 20.08.1986, introduced a reporting mechanism in order to introduce financial discipline amongst credit institutions. In order to curb a rapid upsurge in non-performing assets ("**NPA**") in the 1990s[1] stringent measures against 'wilful defaulters' were brought into place and received the necessary impetus when the Central Vigilance Commission ("**CVC**"), in accordance with the powers and functions vested upon it under Section 8(1)(h) of the CVC Ordinance of 1998, issued instructions on 27.11.1998 on "*Improving vigilance administration in Banks*" which included directions to the financial institutions ("**FIs**") to report cases of 'wilful default'. Pursuant to the instructions of the CVC, RBI introduced guidelines by way of a Scheme dated 01.04.1999 requiring banks and FIs to report all cases of 'wilful default' of Rs. 25.00 Lakhs (Rupees Twenty Five Lakhs Only) and above to the RBI on a quarterly basis ("**Scheme of 1999**"). In the Scheme of 1999, a broad scope was given to the definition of 'wilful default' by expanding the same to cover deliberate non-payment of dues despite adequate cash flow and good net worth, siphoning off of funds to the detriment of the defaulting unit, misrepresentation/falsification of records, disposal/removal of securities without bank's knowledge and fraudulent transactions undertaken by the borrower. RBI had advised credit institutions that *prima-facie* for a default to be categorized as 'wilful' it must be intentional, deliberate and calculated.

However, the Scheme of 1999 was largely ineffective in curbing the menace of wilful defaulters in the financial system. This was reflected in the Eighth Report of the *Parliament's Standing Committee on Financial Institutions - Objectives, Performance and Future Prospects*, submitted to the Parliament on 20.12.2000. As such, the Committee recommended creation of a database of credit information which would be a comprehensive system and would include details of wilful defaulters and information on promoters and group companies who have mis-utilized the borrowed funds. The Committee also recommended stringent penal measures including filing of criminal cases against such companies as well as denial of access to capital markets to such companies, amongst others. In May 2001, RBI, in consultation with the Government of India, constituted a 'Working Group on Wilful Defaulters'. Based on the recommendation of the said Working Group, various directions and guidelines on 'wilful defaulters' were issued by RBI to the lending institutions by way of Circulars. Further, the Credit Information Bureau (India) Limited ("**CIBIL**") was also established in the year 2001. Subsequently, the Government of India also notified the Credit Information Companies (Regulation) Act, 2005 on 23.06.2005.

The evolution of the law relating to wilful defaulters in relation to lenders has been shaped, in no small measure, by Courts and Tribunals in India. In one of the earliest indications and measures, in 1998, RBI had received a suggestion from the Hon'ble Supreme Court of India pursuant to its verdict in the matter of *Common Cause (A registered Society) vs. Union of India & Anr.*, W.P. (C) No. No.291 of 1998 to expand the scope of definition of 'wilful default'. It is rather surprising that after the Scheme of 1999 provided that disposal/removal of securities without bank's knowledge would be one of the transactions triggering 'wilful default', RBI omitted this parameter when it redefined 'wilful default', in supersession of the Scheme of 1999, in its circular no. DBOD. No.DL(W).BC ./110 /20.16.003(1)/2001-02 on *Wilful defaulters and action thereagainst* dated 30.05.2002. Thereafter, in the year 2006, RBI consolidated all instructions and guidelines in respect of 'wilful defaults' at one place in *Master Circular on Wilful Defaulters* dated 01.07.2006 ("**Master Circular, 2006**"). However, this parameter also did not appear in definition of 'wilful default' as provided in the Master Circular, 2006. It was only in the year 2008 that RBI issued a statement *vide* notification number RBI/2007-08/377 UBD.PCB.Cir.No.57/16.74.00/2008-09 dated 24.06.2008 noting that, pursuant to the Hon'ble Supreme Court's order in the *Common Cause (A registered Society) vs. Union of India & Anr. (Supra)*, it had received a suggestion to expand the scope of definition of 'wilful default' to include within its ambit cases where the borrower has also disposed off or removed the movable fixed assets or immovable property given by it for the purpose of securing a term loan without the knowledge of the bank/lender. Subsequently, the definition of 'wilful default' was

[1]Karthik, Lakshmi & Subramanyam, M, 2017, '*Evolution of "Wilful Defaults" Management in India: Compendium of Instructions*', *International Journal of Advanced Research (ISSN: 2320-5407),* Volume 5, Issue 3 (pg. nos. 1734-1747)

amended. Over the years, based on recommendations of Working Group on wilful defaulters and various feedbacks received from different stakeholders, the Master Circular, 2006 has been revised time and again.

RBI CIRCULARS ON WILFUL DEFAULT AND EVOLUTION THEREOF

In the year 2015, with the objective of consolidating the aforesaid recommendations of various committees and stakeholders and for giving directions to banks/FIs on identifying and dealing with 'wilful defaulters', RBI issued the *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, ("**Master Circular**").
RBI has also proposed setting-up of a Public Credit Registry[2] ("**PCR**") for capturing all details of borrowers and wilful defaulters. The PCR is meant to include data from entities like Securities and Exchange Board of India ("**SEBI**"), the Ministry of Corporate Affairs ("**MCA**"), the Goods and Services Tax Network and the Insolvency and Bankruptcy Board of India to enable banks and FIs to get a complete profile of the existing, as well as prospective, borrowers on a real-time basis.

The RBI guidelines dealing with the subject of wilful default are loaded in favour of lending institutions, while at the same time perhaps not being as apparently flawed as, say, the guidelines of declaration of 'Fraud'. In view of the fact the power to declare a borrower as a 'wilful defaulter' lies in the hands of its lender, as such, there is always potential for abuse of powers. Unfortunately, in some cases, with the adverse consequences that emanate from the Master Circular, lenders use the threat of declaration as a 'wilful defaulter' as a tool to hasten recovery. Lenders thereby endeavour to impart a criminal colour to a purely civil dispute under the garb of adhering to the provisions of the Master Circular. The Master Circular is extremely broad in the sense that it does not take into consideration any extraneous circumstances such as reasons beyond the control of the promoters that have led to a default. Such extraneous circumstances which can often lead to default have been recognized by RBI in the *Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances* dated July 01, 2015 ("**IRAC Norms**"). As per paragraph 4.2.4 of the IRAC Norms, RBI has advised banks to not downgrade the asset classification of borrowers to NPA, where their accounts face temporary deficiencies which can be rectified. However, owing to the onerous conditions laid out in the Master Circular, with the object to hasten recovery, a *bona fide* defaulter can also be categorized as 'wilful defaulter' at the behest of creditors. A careful balancing of equities is, therefore, the need of the hour in order to prevent such abuse. In a society like ours where reactive lawmaking is (almost) the norm, considerable time and thought ought to be given before declaring a borrower as a 'wilful defaulter'.

The Hon'ble Supreme Court of India has also been walking on a tight rope, struck between balancing the interests of the creditors as against the principles of natural justice. Taking into account various equities and other relevant factors, in the landmark case of ***State Bank of India vs. Jah Developers Pvt. Ltd.*, (2019) 6 SCC 787**, the Court recognized that harsh consequences, having a direct and immediate impact on rights of the borrowers enshrined under Article 19(1)(g) of the Constitution of India, are attracted the moment a person is sought to be declared a 'wilful defaulter'. So, the Hon'ble Supreme Court, *inter-alia*, directed/declared:

- ✓ Incorporation of a second opportunity of representation/hearing to the borrower (which was also present in the Circular on Wilful Default issued by RBI on 01.07.2013 but was reduced to a single opportunity in the Master Circular). The Court also directed that the orders of the both the committees shall be served upon the borrower (*Paragraph 24 of the judgment)*[3]; and
- ✓ The committees are neither a tribunal, nor are vested with any kind of judicial powers nor can they call for evidence while making a decision. Their powers are only administrative in nature. Their duty is to only gather facts and then arrive at a result. Such committees formed are not legally

[2] Ashwin Manikandan, '*RBI, government working on law to create new database for borrowers*', The Economic Times, September 03, 2019. Available at https://economictimes.indiatimes.com/news/economy/policy/rbi-government-arms-to-build-new-borrower-database/articleshow/70941357.cms?from=mdr

[3] This recommendation of the Hon'ble Supreme Court is yet to be incorporated into the Master Circular. It is expected that as and when the Master Circular is revised next, the same will be reflected in it.

authorized to take evidence under any statute, or subordinate legislation. Hence, no lawyer would have any right to appear before such committees (*Paragraph 11 to 14 of the judgment, now reflected in Paragraph 3(b) & 3(c) of the Master Circular)*; and

- ✓ Oral hearings are not mandatory. A just result can be arrived at after considering the written representations given by parties also (*Paragraph 15 of the judgment, now reflected in Paragraph 3 of the Master Circular)*.

As a (somewhat) related point, it may be noted that if an enquiry is made as to the list of wilful defaulters, RBI may not be able to withhold such information in view of the decision of the Hon'ble Supreme Court in ***Reserve Bank of India vs. Jayantilal N. Mistry*, 2016 (3) SCC 525** wherein the following was held:

- ✓ The provisions of Right to Information Act, 2005 ("**RTI Act**") are applicable to RBI, and RBI is duty-bound to disclose the information sought, but with certain exceptions;
- ✓ There is no fiduciary relationship between RBI and banks/FIs;
- ✓ RBI has a statutory duty to uphold interests of the public-at-large, the depositors, the economy of the nation and the banking sector;
- ✓ Exceptions (*paragraph 77 of the judgment*): RBI is permitted to conceal only such information which could be a threat to the economy of the nation or national security. Otherwise, being the chief regulator of banks and sentinel/custodian of the economy, it is under duty to discharge its obligations with utmost transparency.

In ***Girish Mittal vs. Parvati V. Sundaram & Anr.*, Contempt Petition (C) No. 928 of 2016 in Transfer Case (C) No. 95 of 2015** (decided on 26 April, 2019), the Hon'ble Supreme Court directed that RBI disclose its annual inspection reports on banks, along with the list of wilful defaulters and information related to them under the RTI Act. In response to an application filed under the Act in May 2019, RBI released a list of 30 major wilful defaulters. As per the information received in response to the RTI, total funded advances outstanding to these 30 companies, along with the amount that the banks have written off so far, add up to over Rs 50,000 Crore. Further, as of December 2018, over 11,000 companies had wilfully defaulted on amounts worth over Rs 1.61 lakh Crore as per the data collated by TransUnion Cibil[4].

Despite periodic amendments and interpretations by various courts, many contentious issues remain with the Master Circular, basis which it becomes amenable to challenge. The same have been laid out in the third part of this notebook. Our analysis of the Master Circular, therefore, is split into 3 (three) Parts as follows:

- ✓ Part A – Summary of key provisions of the Master Circular;
- ✓ Part B – Summary of judicial precedents on various aspects of the Master Circular; and
- ✓ Part C – Potential challenges and undecided issues with respect to the Master Circular.

[4] Kabir Agarwal & Anuj Srivas, *'Major wilful defaulters revealed: RBI finally discloses details under RTI'*, The Business Standard, November 21, 2019. Available at https://www.business-standard.com/article/finance/rbi-finally-discloses-details-of-major-wilful-defaulters-under-rti-119112100441_1.html

PART A – SUMMARY OF KEY PROVISIONS OF THE MASTER CIRCULAR

Proposition	Reference in Master Circular & Other Acts/Regulations	Content	Whether previously considered by Court	Cross Reference	GL Observation
Scope and Applicability	Page 2 of the Master Circular	✓ All Scheduled Commercial banks (excluding Regional Rural Banks); and ✓ All India Notified Financial Institutions ("**AIFIs**"): ((i) Export-Import Bank of India ("**EXIM Bank**"), (ii) National Bank for Agriculture and Rural Development ("**NABARD**"), (iii) National Housing Bank ("**NHB**") and (iv) Small Industries Development Bank of India ("**SIDBI**").	Yes	Part B (1) of this Notebook	The Master Circular is amply clear as regards its applicability. However, the Hon'ble Telangana High Court[5], while interpreting Section 45M of the Reserve Bank of India Act, 1934 ("**RBI Act**"), has erroneously made the same applicable to Non-Banking Financial Institutions ("**NBFCs**"). ***Please refer Part B (1) of this Notebook for the same.***
Definition of Wilful Default	Paragraph 2.1.3 of the Master Circular (*Please refer to paragraph 2.2 of the Master Circular for definition of terms 'diversion of funds' and 'siphoning of funds'*.)	Absolute test contained in Master Circular: ✓ Borrower had the ability to repay but defaulted; ✓ Funds have been diverted or siphoned; and ✓ Secured assets removed and dealt without permission of banks.	Yes	Part B (2) of this Notebook	The Master Circular's scope has been expanded to cover in its ambit 'default' in meeting payment obligations under bank guarantees. ***Please refer Part B (2) of this Notebook for the same***.
	Recognition of Wilful defaulters under SEBI guidelines: ✓ The SEBI (Issue of Capital and Disclosure	**Points of Difference between SEBI and RBI norms**: SEBI implications are stricter in nature when compared with those under RBI guidelines: ✓ Issuer companies, whose directors or	No		**Common threads between RBI and SEBI definitions on wilful default**: SEBI has, while incorporating the definition of 'wilful defaulter' under relevant regulations, deferred to RBI

[5] This is covered in greater detail in Part B(1) of this Notebook.

	Requirement) Regulations, 2018 – Regulation 2(lll) ✓ SEBI (Issue of Listing and Debt Securities) Regulations, 2008 – Regulation 2(n) ✓ SEBI (Issue and Listing of Non-Convertible Redeemable Preference Shares) Regulations, 2013 – Regulation 2(t) ✓ SEBI (Intermediaries) Regulations, 2008 – Regulation 2(n) ✓ SEBI (Substantial Acquisition of Shares and Takeover) Regulations, 2011 – Regulation 2(ze)	promoters are classified as 'wilful defaulter', are automatically categorized as 'wilful defaulter; ✓ While RBI restricts borrowing from the banks/FIs for a period of 5 (five) years for borrower/promoters, SEBI regulations impose prohibition on raising funds from capital markets; and ✓ Borrowers declared as 'wilful defaulter' cannot make an open offer. The only exception carved out is in instances where the company makes counter offers to combat hostile takeover.			by making reference to the Master Circular in such regulations.
	Companies Act, 2013 ("**Companies Act**")	✓ A person, who has raised monies other than through banks/FIs, i.e. through issuance of securities, who defaults and diverts/siphons such monies, without the permission of its creditor, can be prosecuted. ✓ While such person may not be categorized as a 'wilful defaulter', prosecution for diversion/siphoning of funds can be carried out against such person under Section 447 of the Companies Act before a Special Court constituted for such purpose. ✓ 'Fraud' under Section 447 of the	Yes	Part B (3) of this Notebook	

		Companies Act includes any act/omission committed with the intent to deceive or to injure the interests of the creditors of a company, irrespective of the actual loss or gain by any company or a person. Any damage to the interest of a company or other person is sufficient.			
Liability of External Agencies	Paragraph 2.7 of the Master Circular	Implications on auditors when found to be negligent or deficient in conducting the audit: ✓ Complaint shall be lodged with the Institute of Chartered Accountants ("**ICAI**"), RBI and Indian Banks' Association ("**IBA**"); and ✓ RBI to circulate such names with MCA and Comptroller and Auditor General of India.	Yes	Part B (4) and Part C (1) of this Notebook	In the absence of any statutory backing, RBI has, in effect, conferred ICAI and IBA with adjudicatory powers to sit, mull over and decide complaints against auditors. A *de-facto* statutory/adjudicatory status has been conferred upon IBA as RBI guidelines can be construed as providing legal force to IBA guidelines by making banks follow them. ***Please refer Part B (4) and Part C (1) of this Notebook.***
Right to Representation	Paragraph 3 of the Master Circular	✓ Committee headed by an Executive Director or equivalent and consisting of two other senior officers of GM/DGM rank of the bank to examine evidence of 'wilful default'. ✓ Show Cause-Notice ("**SCN**") to be issued to the concerned borrower and promoter/whole-time director on adverse conclusion by the committee ✓ A nominee/independent director can be considered a 'wilful defaulter' only in case it is conclusively established that: ☞ He was aware of 'wilful default' by	Yes	Part B (5) of the Notebook	Despite severe implications on Fundamental Rights like denial of additional finance, bar from institutional finance, issuance of Look Out Circulars ("**LOC**") against the promoters/directors of borrowers, etc., the Hon'ble Supreme Court has erroneously gone so far as to propound that no *lis* is being adjudicated upon by these committees. As such, the Court has denied representation of a borrower through a lawyer before these

		the borrower by virtue of any proceedings recorded in the minutes of the meetings of the Board and has not recorded his objection to the same; and ☞ The 'wilful default' has taken place with his consent or connivance. ✓ The above exception does not apply to a promoter director even if not a whole-time director.			committees. Lawyers would obviously be more adept in handling matters wherein (atleast effectively, even if not theoretically) a *lis* is being adjudicated upon. ***Please refer Part B (5) and GL Note 4 of this Notebook***.
Authority of GMs/DGMs	Paragraph 3 of the Master Circular	✓ **Section 7 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970**: The general superintendence, direction and management of the affairs and business of any bank vests in its Board of Directors, which is entitled to exercise all such powers and do all such acts as the bank is authorized to do. ✓ Indian Bank (Officers') Service Regulations, 1979 ("**IBOS Regulations**"): GM/DGM belong to top executive grade; delegation of powers decided by the Board of Directors; powers revised periodically, depending upon Government/RBI guidelines; sanctioning of loan is absolute discretion of the sanctioning authority in a bank; specific to every bank, there are manuals of instructions, classified circulars, scheme of delegation of powers, proceedings of the board etc.	No	Part C (2) of this Notebook	The creditors have been elevated to the position of judges in declaring borrowers as 'wilful defaulters', a declaration which has severe implications on the Fundamental Rights of such borrowers. Not only there is apprehension of bias, the procedure also lacks transparency, which ought to be of utmost significance considering public interest is at stake. ***Please refer Part C (2) of this Notebook***.
Criminal action by	Paragraph 4(ii) of the Master Circular	Criminal action can be initiated against 'wilful defaulters' under Sections 403 and	Yes	Part B (6) of this Notebook	***Please refer Part B (6) of this Notebook.***

banks/FI under Indian Penal Code 1860("IPC")		415 of the IPC.			

GL Note 1

Most of the above provisions have been interpreted by various High Courts and Hon'ble Supreme Court of India in a few cases, on this subject, that have come up before them. The table below summarizes the legal positions that have emerged based on interpretation of the substantive provisions of the Master Circular.

PART B – SUMMARY OF JUDICIAL PRECEDENTS ON VARIOUS ASPECTS OF THE MASTER CIRCULAR

S. No.	Proposition	Legal Position (Based on Interpretation of Substantive Laws in Force through Judicial Precedents)	Relevant Case Law
1)	**Applicability of Master Circular on financial institutions other than banks and AIFIs**	Powers of NBFCs to classify a borrower as 'wilful defaulter' ✓ Master Circular applicable only to all Scheduled Commercial banks and the AIFIs, which are (i) EXIM Bank, (ii) NABARD, (iii) NHB and (iv) SIDBI. ✓ NBFCs do not have the power to declare a borrower as a 'wilful defaulter' under the Master Circular. ✓ Only bearing the Master Circular has on NBFCs, as per its paragraph 2.5(a), is that, as a consequence of a borrower being identified as 'wilful defaulter', 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 availing institutional finance from NBFCs. ✓ '*Master Direction - Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016*' bearing DNBR. PD. 008/03.10.119/2016-17 dated 01.09.2016 (last amended on 17.02.2020) ("**NBFC Circular**") – Even the NBFC Circular does not empower an NBFC to declare a borrower as a 'wilful defaulter'. The only bearing of wilful default on the NBFC Circular is regarding the eligibility criteria of a borrower for restructuring of its account. ***GL Observation*** ✓ In *Mr. Dumpala Madhusudhana Reddy vs. M/S. REC Ltd.*, W.P. (C) Nos. 1420, 1421 & 1428 of 2019, the Hon'ble Telangana High Court has held that under Section 45M of the RBI Act, every NBFC is under duty to comply with the directions issued by RBI under that Chapter III B. ✓ Under Chapter III B on provisions relating to NBFCs receiving deposits, RBI is empowered specifically under Section 45J (Bank to regulate or prohibit issue of prospectus or advertisement soliciting deposits of	*Mr. Dumpala Madhusudhana Reddy vs. M/S. REC Ltd.*, W.P. (C) Nos. 1420, 1421 & 1428 of 2019, Telangana High Court

		money) and 45JA (Power of Bank to determine policy and issue directions) of the RBI Act to issue directions for NBFCs. ✓ The Master Circular (having been issued by RBI in exercise of powers conferred upon it under Section 21 and 35A of the Banking Regulation Act, 1949 ("**BR Act**")) is amply clear in making itself applicable to only Scheduled Commercial Banks and the four AIFIs, which does not include NBFCs. ✓ The Hon'ble Telangana High Court has erroneously made the Master Circular applicable to the NBFCs in the absence of any express statutory backing/RBI directive in that regard.	
2)	**Definition of Wilful Default**	**First judicial interpretation and original test (that is prior to 2015) in relation to law on 'wilful defaulters'**: ✓ The term 'wilful default' has to be construed based on a combined reading of the Master Circular as a whole, provisions of the RBI Act and the BR Act. ✓ Purpose for which the Master Circular was issued and the mischief that the Master Circular intends to remedy. ✓ Definition of 'wilful default' contained in the Master Circular to be interpreted keeping the above in mind.	*Kotak Mahindra Bank Ltd vs. Hindustan National Glass & Industries Limited & Ors.*, (2013) 7 SCC 369
		Wider interpretation of 'wilful default' taken by the Court to hold: ✓ The term 'wilful default' would mean not only default in repayment of loans but would also include 'default' in meeting payment obligations such as under bank guarantees. ✓ The expression 'lender' used in the Master Circular has to be construed to mean a bank/financier guided by the Master Circular.	*Revati Cements Pvt. Ltd. & Anr. vs. State Bank of India & Ors.*, W.P. No.27421/2018, Madhya Pradesh High Court
3)	**Classification of a person as a 'wilful defaulter' outside the purview of RBI/SEBI guidelines**	**Companies Act** ✓ The deceitful intention, which makes the transaction a fraud, need not be present at the time of diversion of funds. This intention can be developed at any time even after the money was transferred or used. ✓ Even if the money was initially transferred or used as per some legal agreement, any subsequent act done or omission or concealment made, *qua* that money or *qua* the transaction made with or regarding that money, which intends to cause any damage to the interest of creditors, can convert the otherwise legal transaction into an act punishable under Section 447 of the Companies Act directly.	*Siddharth Chauhan vs. Serious Fraud Investigation Office*, CRM-M No. 38296 of 2019, order dated 13.11.2019, Punjab and Haryana High Court *(please refer page 86 to 88 of the order as available on website of the Hon'ble High Court)*

4)	**Liability of auditors under the Master Circular**	**ICAI** RBI cannot discontinue the services of a Statutory Central Auditor of a bank without fair and proper enquiry into allegations against such firm.	*Gupta & Gupta Chartered Accountants & Anr. vs. RBI & Ors.*, W.P. (C) No. 10672/2009, Delhi High Court
		✓ Section 22 of the Chartered Accountants Act, 1949 ("**CA Act, 1949**"): Professional Misconduct includes any act/omission described under the First & Second Schedule of the CA Act, 1949. ✓ The expression 'other misconduct' under Part IV of the First Schedule of the CA Act, 1949, includes any conduct, which brings disrepute to the profession or the ICAI, whether or not related to professional work.	*Lalit Agarwal vs. ICAI*, 2019 SCC OnLine 6960, Delhi High Court
		IBA ✓ Private arrangement/voluntary association of banks management in the country to hold only negotiations, membership of IBA is not compulsory. ✓ Not a statutory body; not registered under the Trade Union Act, 1926 or Registration of Societies Act, 1860. ✓ Government renders no financial assistance to IBA; government has no deep and pervasive control over IBA. ✓ No duties and responsibilities fastened on IBA to which they are duty bound to comply with.	*Kishore S. Bhat vs. IBA*, W.P. (C) No. 2796 of 2005, Bombay High Court
5)	**Issuance of SCN to borrowers before declaring them as 'wilful defaulters'**	✓ The subjective satisfaction recorded by the First Level Committee to be based on the evidence brought on record as per paragraph 3(b) of the Master Circular. ✓ The subjective satisfaction cannot be construed as expressing opinion on the merits of the matter. ✓ Issuance of SCN does not brand a borrower as 'wilful defaulter' unless declared so by the First Level Committee in accordance with paragraph 3(b) of the Master Circular ✓ The First Level Committee must serve its order upon the borrower and the borrower can, within 15 (fifteen) days, make a representation to the Review Committee. ✓ The Review Committee must then pass a reasoned order and serve the same upon the borrower.	*Mr. Dumpala Madhusudhana Reddy vs. M/S. REC Ltd.*, W.P. (C) Nos. 1420, 1421 & 1428 of 2019, Telangana High Court
6)	**Criminal action by banks/financial institutions under IPC**	✓ SCN against a borrower cannot be quashed because of the pendency of proceedings against such borrower before National Company Law Tribunal and the Economic Offences Wing despite the fact that the subject matter before all the forums is the same. ✓ Even though subject matter in the proceedings is same, the ambit and scope of two remedies is essentially different.	*Mr. Dumpala Madhusudhana Reddy vs. M/S. REC Ltd.*, W.P. (C) Nos. 1420, 1421 & 1428 of 2019, Telangana High Court

7)	**Constitutional validity of the Master Circular**	**Challenges Raised** ✓ The provisions of the 2011 & 2012 Circular on Wilful Default ("**Erstwhile Master Circulars**") are substantive provisions affecting the rights of the citizens. Such substantive provisions can only be introduced by way of a legislative enactment and not by exercise of powers to issue directions. ✓ Erstwhile Master Circulars prescribed a particular conduct by a borrower as a 'wilful default' and imposed penalty for the same and to prescribe a procedure for adjudication of the *lis* regarding the "wilful default" are beyond the scope and ambit of Section 35(A) of the BR Act. ✓ Provisions are violative of Article 14 and 19(1)(g) of the Constitution of India as it has the effect of almost borrowers from obtaining finance from any other bank or financial institution. ✓ None of the provisions of the RBI Act and BR Act confer any power upon the RBI to impose any penalty relating to a particular conduct of a borrower. ✓ The Erstwhile Master Circulars confer uncanalized, unbridled and untrammeled power upon the banks to decide the future of any borrower and make the bank *a judge in its own cause* in deciding whether the other banks should lend money to the borrower declared as a wilful defaulter or not. ✓ The provisions presuppose 'default' which is otherwise required to be proved in accordance with law before the Debts Recovery Tribunal or any other competent forum. The question whether there exists any debt or not is a question the bank is obliged to prove and satisfy before the Debts Recovery Tribunal under the RDBI Act, 1993, against the borrower. **Findings and Observation of Court***:* <u>Constitutional validity of Erstwhile Master Circulars upheld</u>. ✓ *On power of RBI to issue such circulars*: Full discretion with RBI making it open for it to decide, depending upon the contingencies, the various alternatives or combination of them as provided by law to ensure protection of the interest of the depositors, the public interest and the interest of banking policy. ✓ *On bank being a judge in its own cause*: Duty to act fairly is the theme of the principles of natural justice; rule applied only to conduct leading directly to a final act of the decision, and not to the making of a preliminary decision or to an investigation designed to obtain information for the purposes of a report or a recommendation on which a subsequent decision may be founded; Mere possibility or likelihood of abuse of power does not make the provision ultra vires or bad in law. ✓ *As regards violation of Article 19(1)(g)*: Having regard to the object with which the RBI issued the Erstwhile Master Circulars and the policy decision to declare borrowers as wilful defaulters, implications are not unreasonable restrictions violating Article 19(1)(g) of the Constitution of India.	*Ionic Metalliks and others vs. UOI,* 2015(2) GLH 156, Gujarat High Court
		✓ The Master Circular is issued by RBI on recommendations of CVC and the instructions are revised periodically for taking strict measures against the 'wilful defaulter'. ✓ There is no breach of any legal right, much less fundamental rights, of the borrowers.	*Giriraj Industries Through Partner & Ors. vs. RBI & Ors.,* Special

		✓ Relying on *Ionic Metalliks and others (Supra)*, the Hon'ble Supreme Court held that the issue had attained finality. ***GL Note 2*** The judgment of Hon'ble Supreme Court in ***State Bank of India vs. Jah Developers Pvt. Ltd., (Supra)***, is evidence to the fact that, with respect to the law of 'wilful default', many issues still linger on and are yet to attain finality. Some of those have been laid out in the next part (Part C) of this Notebook.	Civil Application No. 8701/ 2017, Gujarat High Court

GL Note 3

Although various issues have seemingly been settled with respect to the Master Circular, there are a host of potential grounds for challenging the Master Circular. A judgment is authority only for what it holds and not for something that may be logically deduced. The law of precedent is based upon what the common law describes as the ratio decidendi of a judgment. This reason alone has to be followed. The law on this issue has been laid down in the case of ***Union of India vs. Dhanwanti Devi*, (1996) 6 SCC 44** in the following words:

"It is not everything said by a Judge who giving judgment that constitutes a precedent. The only thing in a Judge's decision binding a party is the principle upon which the case is decided and for this reason it is important to analyse a decision and isolate from it the ratio decidendi…. A decision is only an authority for what it actually decides. What is of the essence in decision is its ratio and not every observation found therein not what logically follows from the various observations made in the judgment. Every judgment must be read as applicable to the particular facts proved, since the generality of the expressions which may be found there is not intended to be exposition of the whole law, but governed and qualified by the particular facts of the case in which such expressions are to be found. It would, therefore, be not profitable to extract a sentence here and there from the judgment and to build upon it because the essence of the decision is its ratio and not every observation found therein…

Therefore, in order to understand and appreciate the binding force of a decision, it is always necessary to see what the facts were in the case in which the decision was given and what was the point which had to be decided. No judgment can be read as if it is a statute. A word or a clause or a sentence in the judgment cannot be regarded as a full exposition of law. Law cannot afford to be static and therefore, Judges are to employ an intelligent in the use of precedents."

MANY QUESTIONS LEFT UNANSWERED

Despite the aforesaid issues having been agitated before many high courts, there are still many fundamental issues within the Master Circular. For instance:

- ✓ **Excessive Delegation of powers to institutions such as ICAI and IBA**: There is no bar upon banks to arrive at a consensus (either through resolutions passed at IBA or of their own accord) against availing services of auditors against whom complaint with ICAI has been filed. Without fair and proper inquiry or providing any hearing to the auditors before a court of law (empowered by law to conduct such trial/inquiry), mere filing of complaint with ICAI can lead to impairment of their right to practice of such auditors

- ✓ ***De-facto* statutory status to IBA**: RBI circulars (carrying statutory force) often take cognizance of IBA and have directed banks to follow IBA guidelines, thereby providing legal force/legislative backing to the IBA circulars, without any statutory backing to IBA circulars; without express provision for continuation in service of auditors (against whom complaint before ICAI is pending) until the allegation against them is adjudicated upon by ICAI internally, mere filing of complaint can lead to impairment of the right to practice of such auditors, impacting their right to livelihood.
- ✓ **Adjudicatory powers to banks**: Despite providing opportunities of hearing to the borrowers, it is still a fundamental flaw within the Master Circular that a borrower is pronounced a 'wilful defaulter' and suffers from reputational and penal consequences at the determination of the banks that are 'interested parties'. As such, banks are empowered by the Master Circular to exercise powers of a criminal court and effectively sit over and decide constitutional rights of borrowers.

As already stated above, a judgment is authority for what it holds and nothing more, therefore, room for challenging the Master Circular is still available. It is pertinent to mention here that the constitutional validity of the Master Circular was agitated before the Hon'ble High Court of Gujarat. In the absence of the Hon'ble Supreme Court's decision on such contentious issues impairing the fundamental rights of borrowers, room to challenge the Master Circular before any other High Court of India and escalate the same before the Hon'ble Supreme Court still remains for the fact that the judgment of one High Court is not a binding precedent for another High Court and at best carries a persuasive value (***State of Gujarat vs. Gordhandas Keshavji Gandhi and Ors.*, AIR 1962 Guj 128,** Gujarat High Court; ***M/S. Ambica Industries vs. Commissioner Of Central Excise*, (Civil Appeal No. 2749 of 2007)** Supreme Court). Thus, these issues agitated before the Hon'ble Gujarat High Court are yet to attain finality in the strict sense. The table below contains a brief description of such issues.

PART C – POTENTIAL CHALLENGES AND UNDECIDED ISSUES IN THE MASTER CIRCULAR

S. No.	Proposition of Law/Current Legal Position	Potential Grounds For Mounting Challenge	GL Observation
1)	**ICAI and IBA: Excessive Delegation by RBI to the two institutions**	**Discrimination** The case of ***Gupta & Gupta Chartered Accountants & Anr. vs. RBI & Ors., (Supra)*** affords protection only to Statutory Central Auditors. As far as other auditors are concerned, there is no bar upon banks to arrive at a consensus (either through resolutions passed at IBA or of their own accord) against availing services of auditors against whom complaint with ICAI has been filed. **Violation of Principles of Natural Justice** Without fair and proper inquiry or providing any hearing to the auditors, mere filing of complaint can lead to impairment of their right to practice of such auditors.	✓ Without any provision within the RBI Act or the BR Act, RBI does not have authority to confer ICAI with adjudicatory powers impacting Fundamental Rights. ✓ In the absence of any substantive law to the

		Excessive Delegation ✓ Despite IBA being a private arrangement/voluntary association of banks management in the country to hold only negotiations and not being statutory body or registered under any statute, IBA is being given the authority to frame guidelines on various aspects impacting Fundamental Rights. ✓ Since IBA follows a consultative approach and arrives at decisions through consensus, IBA could arrive at a consensus against using such auditors in future, against whom a complaint is filed with IBA, impairing their constitutional guarantees even prior to the establishment of their guilt. At the very least this should be a unanimous decision.	effect, IBA cannot be conferred with a *de-facto* statutory status.
2)	**Authority of GMs/DGMs : A colourable exercise of power**	**Violation of the second principle of natural justice nemo judex in causa sua (no man shall be judge in his own cause or a deciding authority must be impartial and neutral while deciding any case)** ✓ The test to be applied is not whether in fact bias has affected the judgment, but whether a litigant could reasonably apprehend that a bias attributable might have operated against him in the final decision (***Jiwan K. Lohia vs. Durga Dutt Lohia***, **(1992) 1 SCC 56**). ✓ In the instant case, lenders are elevated to being judges in their own cause while spearheading the committees examining wilful default. There is a strong reasonable apprehension that these creditors cannot be expected to remain unbiased and impartial in these proceedings while presiding over these committees. **Apprehension of Bias** ✓ Reasonable apprehension that officers can misuse powers under the Master Circular in order to benefit themselves to the detriment of public interest; ✓ Where implications of a decision on a borrower are severe, it is imperative that the deciding authority be absolutely free from bias, which isn't the case when such committees are presided over by the GMs/DGMs of the creditors of borrowers; and ✓ Highly likely that lenders try to impart a criminal colour to a purely civil dispute under the garb of adhering to the provisions of the Master Circular. **Lack of Transparency** ✓ This process lacks transparency, which is of utmost significance in matters involving public interest.	✓ The creditors have been elevated to the position of judges in declaring borrowers as 'wilful defaulters', a declaration which has severe implications on the Fundamental Rights of such borrowers (***State Bank of India vs. Jah Developers Pvt. Ltd. (Supra)***). ✓ Adjudication of Fundamental Rights – happen only before the court of law especially empowered for the same. ✓ Banks/FIs – body corporates engaged in private commercial transactions with other body corporates; cannot be bestowed with

		✓ The Master Circular is extremely broad in the sense that it does not take into consideration any extraneous circumstances such as reasons beyond the control of the promoters that have led to a default. ✓ Such extraneous circumstances which lead to default have been recognized by RBI in the IRAC Norms (Paragraph 4.2.4) whereby RBI has advised banks to not downgrade the asset classification of borrowers to NPA where such accounts face temporary deficiencies which can be rectified. ✓ In the absence of such express provisions under the Master Circular, in order to hasten recovery, a bonafide default can also be categorized as 'wilful default' at the behest of creditors, which then sit as judges to ascertain this 'default' and are very likely to overlook these considerations while passing orders.	judicial/quasi-judicial powers.

GL Note 4

In addition to the points of challenge referred to above, there are many other arguments which may not directly impact or pose challenge to the Master Circular. For instance, in ***Dynametic Overseas Private Limited & Anr. vs. State Bank of India & Ors.*, AIR 2016 Cal 303**, the Hon'ble Calcutta High Court held that proceedings under the Master Circular do not involve any *lis* being decided. Subsequently, in ***State Bank of India vs. Jah Developers Pvt. Ltd., (Supra)***, the Hon'ble Supreme Court of India held that the in-house committees are neither a tribunal, nor are vested with any kind of judicial powers and also cannot call for evidence while making a decision. Their powers are only administrative in nature. The duty of such in house-committee is to only gather facts and then arrive at a result. Such committees formed are also not legally authorized to take evidence under any statute, or subordinate legislation. Hence, considering the above, no lawyer would have any right to appear before such committees. What is even more ironic is the fact that the Hon'ble Supreme itself, in paragraph 9 of the judgment of ***State Bank of India vs. Jah Developers Pvt. Ltd. (Supra)*** has categorically recognized that declaration of any borrower as a 'wilful defaulter' has a direct bearing upon the fundamental rights of such borrower. Moreover, as per section 29A of the Insolvency and Bankruptcy Code, 2016, a wilful defaulter cannot be a resolution applicant.

In addition to the above, Office Memorandum ("**O.M.**") No. 25016/31/2017-Imm. on issuance of LOC in respect of Indian citizens and foreigners dated 27.10.2010 issued by the Ministry of Home Affairs ("**MHA**"), as amended by O.M. dated 12.10.2018 when read with Press Release dated 24.07.2019 (directions issued by the Government to deal with fraud, wilful bank loan defaulters or fugitive economic offenders ("**FEO**")), issued by MHA, empowers Chairmen/Managing Directors/Chief Executive Officers of public sector banks to request issuance of the LOC against FEO/wilful defaulters/fraudsters. In cases of 'wilful default', there is no pre-requisite of a pending criminal investigation or enquiry or complaint or FIR and public sector banks can request for issuance of LOC against any person accused of 'wilful default', casting serious aspersions upon the Fundamental Rights of borrowers. The law on LOC has been dealt in detail in the next Part of our Pocket Notebook. The Hon'ble Courts, to the contrary, however, observed that the decision of the committees do not involve any *lis* being decided and that these committees do not possess any judicial or quasi-judicial powers. Such observation is erroneous in light of the aforesaid severe implications on rights under Article 19(1)(g) and 21 of the borrowers accused of 'wilful default'.

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