CHAPTER – II

LEGAL ASPECTS OF WILFUL DEFAULT

2. LEGAL ASPECTS OF WILFUL DEFAULT

2.1. Introduction

In April 2019, the Supreme court of India raised serious objections to the RBI's policy related to non-disclosure of details linked to Wilful Defaults in India. The court stated that RBI was 'duty bound to disclose the information related Wilful Default. The decision came in response to the RTI applications filed by Girish Mittal and Subhash Chandra Agrawal in 2015 seeking copies of loan inspection reports of leading banks like ICICI, SBI and HDFC among others along with the file noting's citing serious irregularities from April 2011 till December 2015. Finally, in November, 2019 RBI released the list of 30 Wilful Default companies, indicating an outstanding of over Rs. 50,000 crores (Agarwal & Srivas, 2019). Though RBI was averse to disclose the details, several banks had already made the default public by filing legal suits for recovery. TransUnion Cibil, an American MNC subsidiary in India is a leading credit information company, has also collected and released important data related to Wilful Default during the last few years. As per the report published in Indian Express in May 2019, the Wilful Defaults by over 11000 borrowers who had the capacity but not paid back the loans accounted to Rs. 1,61,213 crores as on December, 2019 (Mathew, 2019).

On the other hand, the Wilful Default data released by RBI is computed from CRILC – Central Repository of Information on Large Credits, a large centralized banking system database. The system has been very useful in regard to expose the identity of errant borrowers and ensure that they do not repeat the offence with other banks. Since 2019 the banks in India have an option to classify the borrower with exposure of over 5 crores as a Wilful Defaulter.

In April 1999, RBI first notified the Wilful Defaulter dissemination scheme which was later amended in May 2002. RBI defines Wilful Default only if it is proved that the 'borrower or the company has not met repayment obligations despite having the capacity to do so. (RBI, 2002). The Wilful Default tag is also attached to loan fraud cases, if it is proved that the borrower has diverted the loan for purposes other than which it was initially stated.

However, it is interesting to note that in context of classifying NPA the term Wilful Default is used only in India. Most of the other countries including USA, identify this as voluntary or involuntary bankruptcy depending upon who initiates the process of bankruptcy. Voluntary bankruptcy is initiated by the debtor himself. The insolvent debtor files the petition to declare

bankruptcy because either as an individual or a company, they are unable to pay off the debts. While the involuntary insolvency is the process initiated by the creditors who presume that the borrower is not in a capacity to meet the debt obligation (Chapter 11 - Bankruptcy Basics).

The chapter focuses on various aspects related to the Wilful Default in terms of constitutional legality in India. Discussion on the legal aspect of Wilful Default will help us to understand the concept in reference to identification, causes, treatment, penalty and control measures as mentioned in the law. Further, what banks can do thereafter to get money from such cases through various recovery mechanisms.

There has been several opposition to regarding the nomenclature to the concept of insolvency used as 'Wilful Default'. One of the perspectives on usage of the term 'wilful' has been vehemently criticized in context to rule of law. The default is the violation of contract while wilful is the intent in the mind or something premeditated whose intention is to violate the contract. This is argued as not possible to implement and is irrelevant in term of breach of contract (Shah A. , 2014). Right of creditors and debtors were not placed appropriately and scattered under various legislations. Various adjudicatory forums are involved in different categories of creditors and there is no uniform concept of 'insolvency' (Saxena & Sachthey, 2016). Use of SARFAESI Act, 2002 has been fair for non-core assets and for core assets security enforcement cannot be given a free hand (Pandya, 2018). The study identifies the need to explore the nuances of Wilful Default entities in India, Companies Act, 2013, SARFAESI Act, 2002, The Recovery of Debts Due To Banks and Financial Institutions Act, 1993 and other regulations.

Further discussion is on various laws, notifications and regulations issued by the government, and government agencies like SEBI, IBBI and RBI for dealing with Wilful Default. Discussion is focused on the nuances of under which circumstances an individual or an entity is declared Wilful Default over the time. It gives clear idea about what is covered for Wilful Default under various legal umbrella of legislations. For better understanding of the trajectory regarding what and how of Wilful Default further discussion is on the process of Wilful Default.

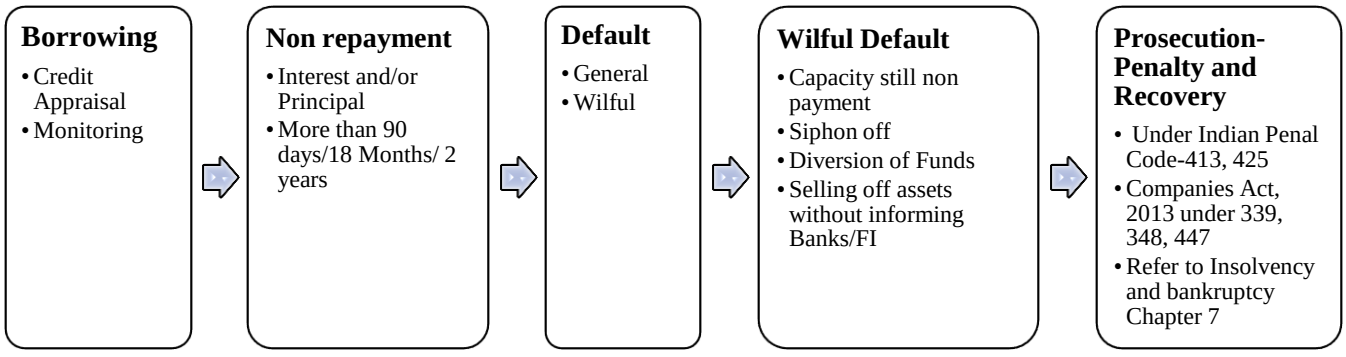
2.2. Process flow of Wilful Default

Before understanding about the Wilful Default it is imperative to review the process of lending. The process of lending by a bank is initiated with the loan application form, where bank credit appraisal officer studies, verifies and approves the credibility of the borrower. Finance is then

disbursed as approved by the bank; in instalments or in lump sum. Further, the credit officer keeps himself updated with the performance of the borrower on regular basis. When entities default to make the payment of principal and/or interest it is called as Non-Performing Assets as defined by RBI declaring after various stages of Special Mention Account (SMA) and Quality of Assets. As defined by RBI, the asset with regular flow of interest and principal is observed to be categorized as Standard Assets, in case of dues outstanding for 18 months is categorized as Sub-Standard Asset and Doubtful asset with outstanding due for more than 2 years. Lastly, written off in case of loss asset.

When the asset is declared as loss, the internal committee of bank inspects for the reasons of default. If the reason/s coincides as defined by RBI, the committee declares the entity as Wilful Default. As guided by the RBI, the persons related to the entity shall be prosecuted under Indian Penal Code (sections 413 and 425) and few penalties is imposed thereupon. The case is then referred to National Company Law Tribunal (NCLT) under the provisions of Insolvency and Bankruptcy Code 2016 for the recovery, since the case is related to fraud the charges under IPC, Companies Act and IBC are levied. Other than debtor the banks are the most affected entities, as its liquidity cycle gets affected since the outstanding dues are blocked for 2 years. Thereafter some more time is lost during the prosecution and recovery of dues. Till 2017, recovery for bankrupt firms use to take an average of more than 4 years which hampers the capital and liquidity for the banks for total 6 years (WorldBank, 2019).

Figure 2-1 Process Flow of Wilful Default



2.3. Definition of Wilful Default

Definition of Wilful Default has evolved over the years, first Notification- Collection and Dissemination of Information on cases of Wilful Default of Rs.25 lakhs and above by RBI was issued in 1999. It included the following points covered:

a. Deliberate non-payment of the dues despite adequate cash flow and good net-worth.
b. Siphoning off of funds to the detriment of the defaulting unit.
c. Assets financed have either not been purchased or have been sold and proceeds have been mis-utilised.
d. Misrepresentation/falsification of records.
e. Disposal/removal of securities without bank's knowledge.
f. Fraudulent transactions by the borrower.

Amendment was brought by RBI in the year 2002 where the activities added under the definition of siphoning off and diversion of funds were categorically presented. (RBI, 2002)

1) utilization of short-term working capital funds for long-term purposes not in conformity with the terms of sanction;
2) deploying borrowed funds for purposes / activities or creation of assets other than those for which the loan was sanctioned;
3) transferring funds to the subsidiaries / Group companies or other corporates by whatever modalities;
4) routing of funds through any bank other than the lender bank or members of consortium without prior permission of the lender;
5) investment in other companies by way of acquiring equities / debt instruments without approval of lenders;
6) Shortfall in deployment of funds vis-à-vis the amounts disbursed / drawn and the difference not being accounted for.
7) Siphoning of funds; borrowed from banks or Financial Institutions are utilized for purposes un-related to the operations of the borrower. The financial health is damaged of the entity or the lender. The decision as to whether a particular instance amounts to siphoning of funds would have to be a judgment of the lenders based on objective facts and circumstances of the case.

Subsequent amendment was in year 2008, according to the Master circular after the Hon'ble Supreme Court's Order relating to writ petition Civil No.291 of 1998 titled Common Cause (A registered Society) Vs. Union of India & Anr. had received a suggestion to expand the scope of definition of "Wilful Default". (RBI, 2008)

"3(d) the unit has defaulted in meeting its payment / repayment obligation to the lender and has also disposed of 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."

Forth update was in year 2014 where definition was made compact, crisp and clear covering four major reasons defining Wilful Defaulter:

a. Capacity to repay but still defaulted in meeting its repayment.
b. Diverted the funds for other purposes other than specified in the loan terms.
c. Siphoned off the funds, the funds are neither used in buying assets specified in the loan terms nor other assets.
d. Disposed or removed the movable fixed assets or immovable property given by him or it for the purpose of securing a term loan without the knowledge of the bank/lender.

The scope of research emphasis on public limited companies in India and hence SEBI's view on Wilful Default is important. Further the regulations covering Wilful Default under SEBI's regulation is discussed.

2.4. Implications to Wilful Default under Security and Exchange Board of India (SEBI)

SEBI has incorporated the issue of Wilful Default entities; and these are to be considered as guiding principles as well as regulations to be followed once anybody is declared as Wilful Default. The SEBI has been prompt in updating the law regarding the Wilful Defaulter, according to the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) (Third Amendment) Regulations, 2016, Regulation 4, no issuer is allowed to make any public issue of equity securities, if the issuer or any of its promoters or directors is a Wilful Defaulter. If the issuer or any of its promoters or directors is a Wilful Defaulter then they have to make disclosures like name of the bank, the year of default, outstanding amount,

name of the party, steps taken, if any, for the removal from the list of Wilful Defaulters, other disclosures, as deemed fit by the issuer in order to enable investors to take informed decisions or any other disclosure as specified by the Board of the Wilful Default entity.

The issuer or any of its promoters or directors is a Wilful Defaulter then it has to be disclosed prominently on the cover page with cross-reference in the document. Disclosures specified are made in a separate chapter or section distinctly identifiable in the Index / Table of Contents. The same were observed in the IPO Titagarh Wagon Ltd in 2008 for its TSL promoter's group of companies. (TitagarhWagon, 2008).

A Wilful Default is not allowed to participate in the listing process on the Institutional Trading Platform in a SME Exchange, In the cases related to registration as intermediaries, Securities and Exchange Board of India (Intermediaries) Regulations, 2008 criteria for determining a 'fit and proper person' categorically excludes Wilful Default entities. Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 amended the clause of voluntary Offer. It covered the aspect on Wilful Default as person who is a Wilful Defaulter shall not make any kind of public announcement of an open offer for acquiring shares or enter into any transaction that would attract the obligation to make a public announcement of an open offer for acquiring shares under these regulations. It also allows to make competing offer as permitted under Regulation 20.The evolution of definition by RBI and the implication of Wilful Default after being declared for listed companies are discussed so far. The next section deals with the extent of penalty and/or sentence for the Wilful Default under various laws. RBI has been prominently working on this topic since 1999.

2.5. Penalty for Wilful Default under various law

The penalty clause for the offenders has been distinctly mentioned directly under the Regulation of RBI, Companies Act, 2013, SARFAESI Act, 2002, and Insolvency and Bankruptcy Code, 2016. RBI has made the offence stringent over the period of time (RBI, 2008).

2.5.1. Reserve Bank of India

RBI amended penalty or the measures in case of Wilful Default time and again. In the year 1999, after defining the Wilful Default penalty measures were notified in 2002 and

subsequently additions were made in the year 2003 and few minor changes in the definition but not in the penal action in the year 2008. In the year 2002, the following measures were notified are presented further (RBI, 2002).

1. Any additional facilities not to be granted by any bank / FI to Wilful Default and be debarred from institutional finance from the scheduled commercial banks, Development Financial Institutions, Government owned NBFCs, investment institutions etc. also not allowed to float new ventures for 5 years from the date the person is declared Wilful Default.
2. The legal process should be done expeditiously where there is any scope of recovery. The lenders can also initiate criminal proceedings against Wilful Defaulters, wherever necessary.
3. Wherever possible, the banks and FIs to adopt proactive approach to change the management of the unit involved in Wilful Default.
4. It must be clearly mentioned in the terms of agreement of loan where the borrowing company should not induct any person who is a Director on the Board and Wilful Default. This also applies to Banks and Financial Institutions.

Thereafter, in the year 2003, based on the recommendation by the Joint Parliament Committee (Standing Technical Advisory Committee) on Financial Regulation the case of Wilful Defaulter should be prosecuted and need to initiate criminal action and the recommendations were accepted (RBI, 2003). Following measures were taken by the RBI:

a. The breach of trust or cheating construed is clearly defined under the existing statutes governing the banks and to be treated as a criminal offence on those with malafide intentions.
b. Banks are directed to monitor the funds lent closely through fund usage certificates from the borrower. It is an attempt to surety on usage of funds and prosecution in case of any breach.
c. Under the existing legislations, criminal action against Wilful Defaulters depending upon the facts and circumstances of the case under the provisions of Sections 403 and 415 of the Indian Penal Code (IPC) 1860. Banks / FIs are, therefore, advised to seriously and promptly consider initiating criminal action against Wilful Defaulters or wrong certification by borrowers, wherever considered necessary, based on the facts and circumstances of each case under the above provisions of the IPC to comply with instructions of RBI and the recommendations of JPC.

It is to be ensured that the penal provisions are used effectively and determinedly after careful consideration and due caution. Banks/FIs are advised to put in place a transparent mechanism, with the approval of their Board, for initiating criminal proceedings based on the facts of individual case.

2.5.2. Companies Act, 2013

The relevance of the Wilful Default case under the Companies Act, 2013 lies in the Section 339 and 348. According to the section regarding Information as to pending liquidations, *If a Company Liquidator makes Wilful Default in causing the statement referred to in sub-section (1) audited by a person who is not qualified to act as an auditor of the company, the Company Liquidator shall be punishable with imprisonment for a term which may extend to six months or with fine which may extend to one lakh rupees, or with both.*

Under Section 339 related to liability for fraudulent conduct of business, Clause 1, during winding up process of a company, intent to defraud creditors of the company or any other persons or for any fraudulent purpose if Tribunal thinks it may declare any person can be responsible without any limitation of liability for the debts or other liabilities of the company as proved.

Under Section 447, Punishment for fraud, without prejudice to any liability including repayment of any debt. Any person who is found to be guilty of fraud to be punished with imprisonment for at least six months to ten years and also to be penalized for the amount as much as fraud which can be extended to three times of the fraud amount.

2.5.3. Insolvency and Bankruptcy Code, 2016

Under chapter 7 on offences and penalties, punishment for concealment of property in case of any officer of the corporate debtor wilfully concealing, tempering, destroying, omitting, violating either of the section 7, 9, 14, 31, 75, 76 by providing false information, mutilating, mal-practicing, gifting, transferring or falsifying any property before twelve months of declaring as bankrupt shall be punishable with imprisonment for a term of at least three years till five years, or with fine of not less than one lakh rupees, but may extend to one crore rupees, or with both.

During the process of bankruptcy, if the officer of the corporate debtor does not disclose the Insolvency professional all the details of the property, does not co-operate in the resolution process by not passing important information, producing facts and accounts shall be punishable

as stated above. However, over and above that imprisonment may extend upto six month and fine up to five lakh rupees.

And for the Offences and Penalties for Partnership firms, individual debtor or creditor providing false information, concealing material information to the insolvency professional, creditor promising the debtor to vote in his favor dishonestly by accepting money or kind, wilfully concealing, tempering, destroying, omitting, mutilating, mal-practicing, gifting, transferring or falsifying any property or material information shall be punishable to with imprisonment for a term which may extend to one year, or with fine which may extend to five lakh rupees, or with both.

2.5.4. SARFAESI Act, 2002

There has not be specific mention of Wilful Default, however, based on the relevance of RBI the section 27, penalties for non-compliance of direction of Reserve Bank of India shall be punishable with fine which may extend to five lakh rupees and in the case of a continuing offence, with an additional fine which may extend to ten thousand rupees for every day during which the default continues.

In context of Companies Act, penalty has been defined for the cases of fraud. The definition of the Wilful Default activities by RBI and fraud defined under Companies Act matches to a good extent. However, RBI has defined the Wilful Default explicitly and exhaustively, the quest of banks doesn't end mere by declaring Wilful Default, it has to strive to get the capital back. It can be concluded that RBI has been vigilant about the Wilful Default cases. In June 2017, the list of top 12 default entities was released by the RBI to be referred to National Company Law Tribunal (NCLT) under IBC where NCLT resolved two of the cases by the end of June 2018. Despite of such mechanism developed there have been issues cropping up every now and then, but the intentions and efforts put in by the government, NCLT and RBI has been worth appreciating. (RBI, Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, 2015).

2.6. Conclusion

From the content analysis of law for Wilful Defaulter, it can be concluded that RBI has worked extensively as the regulatory body. It has tried to address a major concern for the industry and the economy at large. RBI has been vigilant about the practices of Wilful Default and has been

updating the regulations as and when required. After analyzing various laws and the current scenario of Wilful Default, most severe punishment is under Companies Act, 2013 followed by IBC, 2016. This means before 2013 the fraud cases did not face severe consequences and hence such pre-meditated behavior amongst firms and individuals is found to be rampant. It is indicative of systemic loophole exploited by many people at the cost of Banks' fund and Tax payers' money at large.