Strengthing of Laws Against Wilful Defaulters

written by Akshay Ramesh | July 17, 2019

WHO ARE WILFUL DEFAULTERS?

The general meaning of the word ‘default’ is a failure to repay loans availed by a borrower from a bank and/or financial institution(s). Wilful defaulters are entities (legal/natural) which have not repaid the loan amount despite its financial ability to repay it.

The Reserve Bank of India (“RBI”) has defined the 'wilful default' as a 'unit' (individual/company) which has defaulted in meeting its payment obligations or not utilized the finance from the lender for the specific purposes for which finance was availed or has siphoned off the funds.

In case of business enterprises (other than companies), banks / financial institutions may also report (in the Director column) the names of those persons who are in charge and responsible for the management of the affairs of the business enterprise.

HISTORY OF THE CONCEPT OF ‘WILFUL DEFAULT’

The beginning of measures against wilful defaulter began in the year of 1999 when the Central Vigilance Commission and the RBI gave instructions to the bank/financial institution(s), for collection of information on wilful defaulters of INR 25,00,000 and above.

Several modifications were made by the RBI in the identification of the wilful defaulters and the procedures that should be initiated against them. The regulation against ‘wilful defaulters’ have gained attention again due to the striking rise in the number of non-performing assets with the banks and/or financial institution(s) (especially Public Sector Banks) in the recent past.

In view of the above, the RBI on July 01, 2015 issued a master circular providing directions to the banks/financial institutions on identifying and dealing with ‘wilful defaulters’.

SCENARIOS TO IDENTIFY WILFUL DEFAULTERS

The RBI identified the following scenarios on occurrence of which a unit shall be identified as a ‘wilful defaulter’ under its Master circular dated July 01, 2015:

(a) When the unit has defaults in meeting payment / repayment obligations to the lender, even after having the financial capacity to honour the said obligations.

(b) When the unit has defaulted in meeting its payment / repayment obligations to the lender and has not utilised the credit facilities received from the lender for the specific purposes for which

finance
was availed of but has diverted the funds for other purposes.
(c) When the unit has defaulted in meeting
its payment / repayment obligations to the lender as it has siphoned off the funds and the funds are untraceable in the unit.
(d) When the unit has defaulted in meeting its
payment / repayment obligations to the lender and it has also disposed off or removed the movable fixed assets or immovable property given for the purpose of
securing the loan without the knowledge of the lender.
The
RBI has further specified that the identification of the wilful defaulter should be made keeping in view the track record of the borrower and should not
be decided on the basis of isolated transactions / incidents. The default shall
be categorised as wilful default only when its ‘intentional’, ‘deliberate’ and
‘calculated’.
WHAT IS CONSIDERED TO BE ‘SIPHONING OF FUNDS’?
Siphoning
of Funds means (mis)utilization of funds for a purpose for which the loan was not sanctioned. It further means draining off of money from business without having legitimate authority. Conversely, if the transfer of funds is duly recorded in the books of accounts with legitimate narration and that narration
is a rightful explanation which is not found to be fabricated or untruthful then no court of law shall hold such legitimate transfer of money as illicit siphoning of funds.
The
Supreme Court in the recent case of Bikram Chatterji v. UOI has dealt with ‘siphoning of funds’ and has
termed it as a ‘serious fraud’. The Apex Court has further listed the following
circumstances which shall construe as ‘siphoning of funds’:
(i) Utilisation of short-term working capital
funds for long-term purposes, which is not in conformity with the terms of sanction of the loan availed;
(ii) deploying borrowed funds for purposes /
activities or creation of assets other than those for which the loan was sanctioned;
(iii) transferring borrowed funds to the
subsidiaries / group companies or other corporates by whatever modalities;
(iv) routing of funds through any
bank/financial institution, other than the lender or members of consortium without prior permission of the lender;
(v) investment in other companies by way of
acquiring equities / debt instruments without prior approval of the lender(s);
(vi) shortfall in deployment of funds vis-à-vis
the amounts disbursed / drawn and the difference not being accounted for.

In the case of Indranil Mukherjee v. Jayeeta Mukherjee & Ors. , the Calcutta High Court demonstrated that the court has power to pass an injunction order and thereby restraining the defendants from withdrawing and/or siphoning any amount of money lying in the various deposits of different descriptions either in the joint name of the plaintiff and his wife (defendant) or from withdrawing any money lying in the fixed deposit or savings bank account in the name of the defendant alone.

The RBI further clarified that the term 'siphoning of funds', should be construed to occur if any funds borrowed from banks / financial institutions are utilised for purposes unrelated to the operations of the borrower, to the detriment of the financial health of the entity or of 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.

STEPS TO BE TAKEN WHILE DEALING WITH A WILFUL DEFAULT

The RBI listed the following steps to be taken while dealing with a 'wilful default':

(a) In the event an evidence arises of a wilful default on the part of the borrower (in case of a company) and its promoter / whole-time director at the relevant time should be examined by a Committee ("Identification Committee") headed by an Executive Director or equivalent and consisting of two other senior officers of the rank of General Manager/Deputy General Manager.

(b) If the Identification Committee concludes that an event of wilful default has occurred, it shall issue a Show Cause Notice to the concerned borrower and the promoter / whole-time director and call for their submissions and after considering their submissions issue an order recording the fact of wilful default and the reasons for the same. An opportunity should be given to the borrower and the promoter / whole-time director for a personal hearing if the Identification Committee feels such an opportunity is necessary.

(c) The Order of the Committee shall be thereafter reviewed by another Committee ("Review Committee") headed by the Chairman / Managing Director/ Chief Executive Officer and shall consist of two independent directors / non-executive directors of the bank. The Order of the first Committee shall become final only after it is confirmed by the said Review Committee. However, if the Identification Committee does not pass an Order declaring the borrower as a wilful defaulter, then the Review Committee need not be set up to review such decisions.

Further, except in very rare cases, a non-whole-time director should not be considered

as a wilful defaulter unless it is conclusively established that:
(a) he was aware of the fact of wilful default by the borrower by virtue of any proceedings recorded in the minutes of meeting of the Board or a Committee of the Board and has not recorded his objection to the same in the Minutes; or,
(b) the wilful default had taken place with his consent or connivance.
In case a non-whole-time director is identified as a ‘wilful defaulter’, a similar process as is for the promoter / whole-time director, has been laid down
The above exception will however not apply to a promoter director even if he is not a whole-time director.
CONSEQUENCES OF BEING DECLARED AS A WILFUL DEFAULTER
The consequences to be faced by a company/an individual who has been identified as a ‘wilful defaulter’ are as follows:
- No bank/financial institution shall provide any additional facilities to the wilful defaulters.
- The entrepreneurs /promoters of the companies where banks/financial institutions have identified siphoning of funds, misrepresentation, falsification of accounts and fraudulent transactions would be debarred from institutional finance and floating new ventures for a period of five years from the date the name of the wilful defaulter is published in the list of wilful defaulters by the RBI.
- The lenders may initiate criminal proceedings against wilful defaulters, wherever necessary. The banks and financial institutions may adopt a pro-active approach for a change of management of the wilfully defaulting borrower unit.
- Further under section 29A of the Insolvency and Bankruptcy Code, 2016, a wilful defaulter shall not be allowed to be a resolution applicant.

The Apex Court in the case State Bank of India (SBI) v. Jah Developers Pvt Ltd, qua circular dated July 2015 had a chance to deal with the much-debated issue as to whether a person/company who is about to be identified as a ‘wilful defaulter’ by the in-house committee (Identification Committee/Review Committee) is entitled to be represented by a lawyer of his choice before such a committee?
It was held that in-house committees are neither a tribunal nor are vested with any kind of judicial powers. Their powers are only administrative in nature. The duty of such in house-committees is to only gather facts and then arrive at a result. Such Committees formed are also not persons legally authorised to take evidence under any statute or subordinate legislation. Hence, considering the above, no lawyer would have any right to appear before such committees.
The

RBI in its 2013 circular gave the borrower two opportunities to present his case before the internal committees, which are as follows:

(i) When the Identification Committee informs the borrower/its director the proposal to classify him as a wilful defaulter, the concerned entity shall be given 15 days to make his defence. This reply would then be submitted before the Identification Committee.

(ii) When the Identification Committee begins with its proceeding of identification, before declaring a wilful defaulter.

The 2015 Circular issued by the RBI though diverged from the 2013 Circular and only entitled the borrower to one opportunity to present his case before the Identification Committee which would issue him a show-cause notice if they proposed to declare him a wilful defaulter. The borrower may then make his submissions upon such notice being served and had no further right thereafter to appear and/or make submissions before any internal committee.

In the case of Jah Developers, the Supreme Court felt that, since harsh consequences follow after declaration of a borrower as a wilful defaulter, and the fact that Article 19(1)(g) is attracted in facts of the case, the moment a person is sought to be declared as a wilful defaulter, the fundamental right to carry on business is direct and immediate, the Court held that 2015 Circular must be construed reasonably and directed the incorporation of 'two opportunities' mentioned under 2013 Circular, so that the borrower can defend himself/itself before he/it is being declared a wilful defaulter. It was further held that once the Identification Committee, declares a borrower a wilful defaulter, it shall serve a copy of such an order to the borrower. Thereafter, the borrower must be given an opportunity to make his representation within 15 days before the Review Committee, after which the Committee is expected to pass a reasoned order with evidence relied upon in the matter. This reasoned order of the Review Committee must also be then served on the borrower.

CONCLUSION

The Courts of India have held that involvement of a lawyer in the initial stage of identifying a 'wilful defaulter' shall unnecessarily complicate the process and will tend to make it slow. It is further believed by the Courts that if the 'wilful defaulter' represents himself/itself before the committees, the true facts of the matter will be revealed much easily. Moreover, the Supreme Court recently held that the RBI is duty-bound to disclose the list of wilful defaulters when such information is sought under Right to Information Act, 2005.

On analysis of the above, we opine that this process of differentiating a simple defaulter from a willful defaulter by RBI is progressive in nature, considering how India has become a start-up hub in the recent times. Unlike earlier, all defaulters won't be treated harshly by the various financial institutions just on the first instance of default. This also assures the entrepreneurs that if they follow the law of the land, the law shall not treat them severely for the situation beyond the control of any entity. This concept of 'wilful default' clearly distinct between 'defaulter' and 'wilful defaulter'!

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