

THE TUG-OF-WAR: EXAMINING THE CLASH BETWEEN BORROWER'S FUNDAMENTAL RIGHTS AND RBI'S MASTER CIRCULAR ON FRAUD ACCOUNTS

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ABSTRACT

The constitutional validity of the Master Directions on Frauds – Classification and Reporting by commercial banks and select Financial Institutions has been challenged on the grounds that these directions do not provide any opportunity to be heard by the authorities. Once a bank declares a company's accounts as Red Flagged Accounts, the accounts are frozen, and for the next five years, the company is barred from seeking capital from any bank or financial institution. After the completion of five years, it is at the discretion of the financial institutions and banks to decide whether to lend to fraudulent companies or not. These Master Directions are issued in accordance with Section 35A of the Banking Regulation Act, 1949.

The Early Warning Signs (EWS) play a crucial role in this process as they indicate potential wrongdoing in the company that could later lead to fraud. If multiple EWS are issued, the bank declares the account as a Red Flagged Account, and an investigation commences. During the investigation and conclusion of the decision, the only opportunity given to the borrowers is their participation in the forensic audit report. However, this falls short of providing a genuine opportunity to be heard. Borrowers do not have the right to object to the final decision. Once they come under the purview of fraudulent companies, they are unable to seek capital from banks or any financial institution. Even after the completion of the designated duration, it ultimately depends on the individual financial institutions whether they trust the fraudulent company or not. In most cases, financial assistance is denied due to the stigma and loss of goodwill in the market. This not only results in the loss of the right to reputation but also severely impacts the right to livelihood.

The RBI Master Circular is not entirely void, but several amendments are required to ensure compliance with the due process of law. It is necessary to incorporate these amendments to strike a balance between preventing fraud and safeguarding the rights of borrowers.

Keywords: Red Flagged Accounts, Early Warning Sign, Joint Lender's Forum, Audi alteram partem, Natural Justice, Right to Reputation, Master Circular on Fraud Accounts

OVERVIEW OF RBI'S MASTER CIRCULAR ON FRAUD

In the recent case of *S S Hemani v. The Reserve Bank of India & Ors*ⁱ, the Supreme Court of India addressed the issue of the validity of the Reserve Bank of India's (RBI) Master Circular concerning the rights of borrowers. The court's decision provided important observations, drawing upon the landmark case of *State Bank of India & Ors v. Rajesh Agarwal & Ors*ⁱⁱ. Let's delve into the details in the subsequent paragraphs.

According to the Reserve Bank of India (RBI) and its Master Circular on Fraud 2016, the declaration of a company as a fraudulent borrower can occur. The ongoing dispute between RBI and borrowers primarily revolves around the lack of opportunity for the borrowers to present their case. To gain a comprehensive understanding, it is crucial to familiarize oneself with the key aspects of the procedure. Within **Clause 8.9**ⁱⁱⁱ of the circular, there is a specific provision addressing lending in the context of consortium or multiple banking arrangements. Under **Clause 8.9.2**^{iv}, all banks involved in financing a borrower under such arrangements are required to collaborate and take coordinated actions based on a mutually agreed strategy for subsequent legal proceedings, follow-ups, and consistent exchange of details and information. The process for classifying a borrower's account as fraudulent is outlined in **Clauses 8.9.4**^v and **8.9.5**^{vi}.

The primary responsibility for determining whether to classify a standard account or Non-Performing Asset (NPA) account as a Red Flagged Account (RFA) or fraud rests with the concerned bank. This bank is also accountable for reporting the account's RFA or fraud status on the Central Repository of Information on Large Credits (CRILC) platform to notify other banks. If a bank chooses to immediately categorize the account as fraud during this stage, it is required to report the fraud to the RBI within 21 days of detection and notify the CBI/Police, following existing procedures.

Upon identifying an account as RFA/fraud, the financial institution responsible will promptly request a meeting of the Joint Lender's Forum (JLF) to address the issue, contacting either the consortium leader or the largest lender within the multiple banking arrangement (MBA). The JLF meeting is expected to be arranged within 15 days of the request. If a widespread agreement is reached, the account will be officially classified as fraudulent. Alternatively, if a consensus is attained among banks that collectively hold at least 60% of the total lending share, the account will be flagged as red, triggering the consortium leader or the largest lender in the MBA to initiate a forensic audit.

Early Warning Signals (EWS) and Red Flagged Accounts (RFA) are the initial part of the procedures through which a suspicious fraudulent activity is detected in the presence of more than one EWS. **Clause 8.3^{vii}** lists out some of the EWSs. For instance, dishonour of high value cheques and delay in payment of outstanding dues.

THE TUSSLE BETWEEN THE MASTER DIRECTIONS AND PRINCIPLES OF NATURAL JUSTICE

Clause 8.12.2^{viii} specifies that accounts labeled as **Red Flagged Accounts (RFA)** or involved in fraud **are not eligible for restructuring or receiving additional facilities**. However, in cases of fraud or misconduct where new owners take over and the borrower company becomes completely independent from the previous management, banks and the Joint Lender's Forum (JLF) may consider restructuring these accounts if they are financially viable. It is important to note that this restructuring will not interfere with the ongoing legal actions against the previous management, and the assessment of the account will be conducted separately.

With the prohibition on restructuring or obtaining additional facilities, the borrowers are deprived of potential avenues to improve their financial position. They may require restructuring to address their financial difficulties or access additional funds to sustain their operations or undertake necessary business initiatives. The lack of these options can severely limit their ability to recover or overcome the challenges they face.

The provision states that in exceptional cases where new promoters replace the existing ones and the borrower company becomes independent, banks and the Joint Lender's Forum (JLF) may consider restructuring based on viability. This implies that the borrowers' access to

restructuring is contingent upon the evaluation and judgment of the banks and JLF. Such assessments might subject borrowers to additional scrutiny, delays, and uncertainties in obtaining financial relief.

Overall, this provision can be perceived as harsh on borrowers, particularly those facing financial distress but are not directly involved in fraudulent activities. It restricts their opportunities for financial assistance and places them at the mercy of the banks and JLF's viability assessment. However, it is important to consider that the provision aims to prevent the misuse of restructuring facilities and protect the interests of the banking system, lenders, and overall financial stability.

THE UNSUCCESSFUL CLAIM OF FORENSIC AUDIT PARTICIPATION AS MEETING THE REQUIREMENTS OF NATURAL JUSTICE PRINCIPLES

RBI and other lenders contended, albeit unsuccessfully, that the borrower's participation during the preparation of the forensic audit report fulfilled the requirements of natural justice. In contrast, borrowers argued that merely seeking their input during the report's preparation did not satisfy the principles of natural justice, as they should also have the opportunity to be heard before being classified as fraud^{ix}. The court ruled that the principles of natural justice necessitate serving the borrowers with a notice, granting them a chance to explain the findings in the forensic audit report, and allowing them to present their case before classifying the account as fraud under the Master Directions on Frauds. Upon examination of the facts, it is evident that the lending banks did not afford the borrowers the opportunity to be heard before categorizing their accounts as fraudulent^x.

In *S S Hemani*^{xi}, the court clarified that the order does not interfere with ongoing criminal proceedings, emphasized the independence of CBI proceedings based on FIRs, and assures that private parties' legal remedies are unaffected by the order.

THE CIVIL CONSEQUENCES AFFECTING THE FUNDAMENTAL RIGHTS OF THE BORROWER

Classifying a borrower's account as fraud based on the procedure outlined in the Master Directions on Frauds carries substantial civil consequences for the borrower. As the Master Directions on Frauds do not explicitly grant the borrower an opportunity to be heard before such classification, the principle of audi alteram partem must be inferred into these provisions to prevent arbitrariness. This situation directly affects the fundamental rights of the individual.

In the case of *Mohinder Singh Gill v. Chief Election Commissioner, New Delhi*^{xii}, a Constitution Bench of the Court determined that the term 'civil consequences' encompasses more than just violations of property or personal rights, extending to infringements on civil liberties, material deprivations, and non-pecuniary damages. The Court specifically held that the denial of a democratic right to vote results in civil consequences. In the instance of *D K Yadav v. J M A Industries*^{xiii}, a panel of three judges in the Court made an observation that any issue affecting an individual's civil life carries implications of a civil nature.

The RBI and lender banks argue that the civil consequences outlined in Clause 8.12.1 of the Master Directions on Frauds are reasonable. This clause prohibits the borrower, including company promoters and directors, from accessing credit in financial and credit markets for a period of five years, and potentially even longer. The RBI and lender banks assert that such restrictions should be viewed in the context of public interest. While recognizing that the procedure established in the Master Directions on Frauds is intended to safeguard the banking system in the public's interest, one cannot overlook the significant civil ramifications that borrowers face as a result.

HOW YASHDEEP SHARMA CASE WAS DIFFERENT?

In the case of *Yashdeep Sharma v. Reserve Bank of India*,^{xiv} the Promoter and Director of a private company challenged the constitutional validity of the circular, arguing that it violates **Article 14**^{xv} and **21**^{xvi} of the Constitution since it does not provide for a show cause notice or an opportunity for a hearing. The purpose outlined in the Master Circular makes it evident that the classification of an account as 'fraud' is purely an administrative process. However, the

decision in this particular case differed, as the court upheld RBI's determination that the company was involved in fraudulent activities.

The court arrived at this conclusion based on several observations. *Firstly*, it noted that the borrower had participated in the forensic audit report, indicating a form of opportunity to present their case. Nonetheless, the question remained whether such participation and compliance with the investigative process could be considered equivalent to the borrower presenting their case. *Additionally*, the court observed that the forensic audit report revealed that the company had issued Letter of Credits (LC) without having any financial arrangements to repay them. The court also distinguished the case of *UMC Technologies Private Limited v. Food Corporation of India*^{xvii}, stating that it was not applicable as it pertained to the blacklisting of individuals rather than the declaration of a company as fraudulent. The court further relied on the cases of *Union of India v. W. N. Chadha*^{xviii} and *Ajit Kumar Nag v. General Manager (PJ), Indian Oil Corporation Limited*^{xix} established that there are exceptional circumstances, such as dire urgency, where the principles of natural justice can be exempted for individuals. This principle applies particularly to companies holding fraudulent accounts, where providing an opportunity for a hearing may not be necessary. RBI and lender banks argued that invoking the principles of natural justice is not applicable during the initial reporting of a criminal offense. Similarly, the right to a hearing is typically not granted before the registration of an FIR.^{xx}

THE RIGHT TO REPUTATION IS JEOPARDIZED

The classification of an account as fraud has a profound impact not only on the borrower's business and reputation but also on their right to maintain a favorable reputation. This right to reputation influences an individual's goodwill and exposes them to civil consequences. In the case of *State of Maharashtra v. Public Concern for Governance Trust*,^{xxi} the court made the following observation:

“In case any authority in discharge of its duties fastened upon it under the law, travels into the realm of personal reputation adversely affecting him, it must provide a chance to him to have his say in the matter.”

IMPLICATIONS FOR THE RIGHT TO CARRY ON BUSINESS

Once these clauses become applicable to the borrowers, their credits will be frozen, rendering them helpless even in their attempts to raise the necessary capital for their sustenance. The court has discussed the right to carry on business, but it is important to note that the right to livelihood is equally lost in this process, especially if the lenders continue to withhold financial assistance in the future.

The borrowers relied on the *Jah Developers*^{xxii} case to argue that the prohibition on accessing institutional finance under **Clause 8.12.1**^{xxiii} of the Master Directions violates their fundamental right to carry on business as guaranteed by **Article 19(1)(g)**.^{xxiv} The *Jah Developers case* dealt with the question of whether a person declared a wilful defaulter under the procedure outlined in the Master Circular on Wilful Defaulters has the right to be represented by a lawyer of their choice before such a declaration is made. The Court answered in the negative, ruling that a borrower does not have the right to legal representation during the in-house proceedings described in Paragraph 3 of the Master Circular on Wilful Defaulters.

Once a company is declared fraudulent, banks and financial institutions are unlikely to provide financing to the promoters/entrepreneurs. Consequently, the promoter/entrepreneur is disqualified from becoming a promoter or director of any other company. Additionally, under **Section 29-A of the Insolvency and Bankruptcy Code (IBC)**^{xxv}, a wilful defaulter is barred from applying as a resolution applicant. Considering these severe consequences, it is evident that the Revised Circular, driven by public interest, must be interpreted reasonably.

The Apex Court, in the *Jah Developers case*, formulated certain guidelines for the lenders to incorporate principles of natural justice, thereby superseding their argument that they function as administrative authorities and perform quasi-judicial functions. The court made the following observation:-

The first committee is required to promptly issue its directive to the borrower. Subsequently, the borrower has the option to submit a written appeal to the review committee regarding the decision of the initial committee. Finally, the review committee is obligated to issue a well-founded order and provide it to the borrower.

In the case of *Erusian Equipment case*^{xxvi}, the court established the principle of fair play, which necessitates providing notice to the individual who is blacklisted so that they can

effectively present their case. The court further ruled that the concern is not that the RBI is unable to formulate economic measures in the public interest. Rather, such measures should be in accordance with the due process of law.

CONCLUSION & RECOMMENDATIONS

The constitutional validity of the Master Directions on Frauds issued by the Reserve Bank of India (RBI) has been challenged due to the lack of an adequate opportunity for borrowers to be heard. The classification of accounts as Red Flagged Accounts (RFA) or fraudulent carries significant civil consequences for borrowers, impacting their right to reputation and the right to carry on their business. The current procedure outlined in the Master Directions does not explicitly grant borrowers the opportunity to present their case before being categorized as fraud. While the RBI and lender banks argue that borrower participation in the forensic audit report fulfills the principles of natural justice, it falls short of providing a genuine opportunity to be heard.

To strike a balance between preventing fraud and safeguarding the rights of borrowers, it is necessary to incorporate amendments to the Master Directions on Frauds. These amendments should ensure compliance with the principles of natural justice by providing borrowers with a fair opportunity to present their case before their accounts are classified as fraudulent. Such a procedure would align with the fundamental rights of individuals and prevent arbitrary classification.

Furthermore, it is important to consider the broader implications of the Master Directions on borrowers. The denial of access to financial assistance for a prolonged period severely impacts their ability to recover and overcome financial difficulties. While the aim is to safeguard the banking system and financial stability, borrowers who are not directly involved in fraudulent activities may face undue hardships and limitations in their pursuit of livelihood.

Overall, a balanced approach that upholds the principles of natural justice while addressing the concerns of preventing fraud is essential. By incorporating amendments to the Master Directions on Frauds, the RBI can ensure a fair and transparent process that respects the rights

of borrowers, maintains the integrity of the banking system, and promotes overall financial stability.

RECOMMENDATIONS

Based on the issues highlighted, here are some recommendations for amendments to the Master Directions on Frauds:

- i. ***Provision for Notice and Hearing***: Introduce a clear provision that mandates the RBI and lender banks to provide borrowers with a formal notice of potential fraudulent classification and an opportunity to present their case before any final determination is made. This ensures compliance with the principles of natural justice and affords borrowers the right to be heard.
- ii. ***Timeframe for Response***: Specify a reasonable timeframe within which borrowers must respond to the notice of potential fraudulent classification. This will prevent undue delays in the process and allow for a timely resolution.
- iii. ***Independent Adjudicatory Body***: Establish an independent adjudicatory body or mechanism, separate from the RBI and lender banks, to objectively review and decide on the classification of accounts as fraudulent. This body should have the power to evaluate the evidence presented by both the RBI and the borrowers, ensuring a fair and impartial assessment.
- iv. ***Transparency and Clarity***: Enhance transparency by clearly outlining the criteria and factors considered for classifying accounts as fraudulent. This will enable borrowers to understand the basis of such classification and prepare a robust defense, if necessary.
- v. ***Legal Representation***: Allow borrowers the right to be represented by legal counsel or experts during the hearing process. This will help level the playing field and ensure that borrowers can effectively present their case.

By incorporating these recommendations, the Master Directions on Frauds can be strengthened to strike a balance between preventing fraud and safeguarding the rights of borrowers, fostering a fair and transparent process that upholds the principles of natural justice.

ENDNOTES

- ⁱ S S Hemani v. The Reserve Bank of India, Writ Petition (L) No. 15240 of 2023, Bombay High Court.
- ⁱⁱ Rajesh Agarwal v. Reserve Bank of India & Ors, 2020 SCC OnLine TS 2021.
- ⁱⁱⁱ RBI, Master Directions on Frauds, 2016, Cl. 8.9.
- ^{iv} RBI, Master Directions on Frauds, 2016, Cl. 8.9.2.
- ^v RBI, Master Directions on Frauds, 2016, Cl. 8.9.4.
- ^{vi} RBI, Master Directions on Frauds, 2016, Cl. 8.9.5.
- ^{vii} RBI, Master Directions on Frauds, 2016, Cl. 8.3.
- ^{viii} RBI, Master Directions on Frauds, 2016, Cl. 8.12.2.
- ^{ix} *Supra* note 2.
- ^x *Supra* note 2.
- ^{xi} *Supra* note 1.
- ^{xii} Mohinder Singh Gill v. Chief Election Commissioner, New Delhi, (1978) 1 SCC 405.
- ^{xiii} D K Yadav v. J M A Industries, (1993) 3 SCC 259.
- ^{xiv} Yashdeep Sharma v. Reserve Bank of India, WRIT PETITION No.23229 OF 2021, Telangana High Court.
- ^{xv} The Constitution of India, 1950, Ar. 14.
- ^{xvi} The Constitution of India, 1950, Ar. 15.
- ^{xvii} UMC Technologies Private Limited v. Food Corporation of India (Civil Appeal No. 2687 of 2020, dated 16.11.2020).
- ^{xviii} Union of India v. W. N. Chadha, 1993 Supp (4) SCC 260.
- ^{xix} Ajit Kumar Nag v. General Manager (PJ), Indian Oil Corporation Limited, (2013) 6 SCC 384.
- ^{xx} Anju Chaudhary v. State of UP, (2013) 6 SCC 384.
- ^{xxi} State of Maharashtra v. Public Concern for Governance Trust, 2007) 3 SCC 587.
- ^{xxii} State Bank of India v. Jah Developers, (2019) 6 SCC 787.
- ^{xxiii} RBI, Master Directions on Frauds, 2016, Cl. 8.12.1.
- ^{xxiv} The Constitution of India, 1950, Ar. 19(1)(g).
- ^{xxv} The Insolvency and Bankruptcy Code (IBC), 2016, s.29-A.
- ^{xxvi} Erusian Equipment & Chemicals Ltd v. State of West Bengal, (1975) 1 SCC 70.