

# THE INHERENT FUTILITY OF ‘EXCEPTIONAL’ DEBT RECOVERY MECHANISMS ALTERNATIVE TO THE SARFAESI, 2002: SUCH AS THE ‘OTS’ SCHEME DUE TO CREDITOR RIGHTS PRIMACY

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DOI: 10.55662/ALPPR.2023.809

The primary modus of debt recovery by ‘Secured-Creditors’, in the jurisdiction of India, is subject to the legislative impetus of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (**SARFAESI Act, 2002**), with the alternative/resultant: **initially direct (for secured-creditors) /appellate (for borrowers)**, recourse of Debt Recovery Tribunals and Debt Recovery Appellate Tribunals-prescribed by **Sections 17<sup>i</sup> and 18<sup>ii</sup> of the SARFAESI Act** [originally stipulated by the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (**RDBFI Act, 1993**) and the Recovery of Debts and Bankruptcy Act, 1993 (**RDB Act, 1993**)], and the ultimate recourse of the Insolvency and Bankruptcy Code-(**IBC, 2016**).

**Banks and Financial Institutions**, are compelled to rely on the SARFAESI Act 2002, for the recovery of loans extended to Non-Performing Assets (**NPA’s**)- exceeding 100,000 INR, and due amounts in excess of 20% of the extended principal and interest of the loan- in accordance to **Section 31 (j)<sup>iii</sup>**; if there is an **intention to: Mitigate Balance Sheet exposure to NPA induced loss-**

- (i.) via the Securitization of debt extended to NPA’s, upon selling aggregates of collateralized distressed debt to Asset Reconstruction Companies (**ARC’s**), which pursue subsequent financial asset creation, in exchange for cash- encapsulated by **Sections 3-12b<sup>iv</sup>**, and

- (ii.) either directly/vicariously through ARC's; enforcing the claim of Security-Interest (collateral security provided by the NPA borrower, in exchange for the original loan, with exclusions stipulated in **Section 31<sup>v</sup>**)- **via Sections 13-19<sup>vi</sup>** devoid of reliance upon civil court adjudication- according to **Section 13 (1)<sup>vii</sup>**.

Additionally, the SARFAESI Act, 2002: empowers the assumption of control in NPA borrowers, by the Secured-Creditors (Banks and Financial Institutions) and the ARC's, for the exercise of managerial discretion, in the liquidation of the NPA's assets/advancement of profitability, in the recovery of debt- according to **Section 13 (4) (b)<sup>viii</sup>**. The Act, prescribes the modus of fundraising by ARC's, as the issue of 'Security Receipts' to Qualified Institutional Buyers, in exchange for capital-investment<sup>ix</sup>.

The debt-recovery mechanism, by the SARFAESI Act, thereby empowers the unilateral derivation of **punitive pecuniary restitution (upon the possession and sale of Security-Interest), by Secured-Creditors, against borrowers, devoid of pre-requisite judicial review**. The constitutionality of such privatized debt-recovery enforcement, mandating the primacy of creditor rights to capital reclamation, over the borrowers right to pre-empt arbitrariness, was upheld in the case of **Mardia Chemicals v. Union of India**.<sup>x</sup>

In exceptional circumstances of debt recovery, such as consideration awarded to specific forms of enterprises (i.e., MSME's) or the requisite of expedience- inhibiting pre-sale asset value depreciation and preserving the potency of recovery; Banks and Financial Institutions have been empowered by the Reserve Bank of India (**RBI**), in its **June 8, 2023<sup>xi</sup> and September 3rd, 2005<sup>xii</sup>** circulars to pursue an alternative modus of Debt Recovery, such as '**Compromise Settlements**' potentially assuming the form of '**One Time Settlements/ OTS**'.<sup>xiii</sup>

Compromise Settlements, empower NPA borrowers to pay a discounted settlement to Banks and Financial Institutions, resulting in the complete resolution of outstanding dues, and the elimination of NPA status, with the presence of any debt.<sup>xiv</sup> Such arrangements, potentially being OTS have been validated by the RBI, as valid mechanisms for NPA resolution, in the **Prudential Framework for Resolution of Stressed Assets<sup>xv</sup>**.

**Such Exceptional Mechanisms of Debt-Recovery by Secured-Creditors (with emphasis upon OTS-and Compromise Settlements), however, have emerged futile, from the lens of**

**borrower protection (derived from Secured-Creditor obligations, subject to the statutory primacy of Secured-Creditor Rights).**

The complete statutory and jurisprudential subsistence of authority with Banks to:

- i. Classify Borrowers as NPA's, devoid of Judicial Review/Pre-emptive challenge;
- ii. Classify the NPA's as Wilful/Non-Wilful defaulters and unilaterally initiate proceedings under the SARFAESI Act, 2002;
- iii. Rely upon their 'commercial wisdom' in considering whether a borrower is deserving of OTS or not and unilaterally reject OTS/Compromise Settlement Applications (irrespective of the satisfaction of RBI Requirements), devoid of judicial review;

Has resulted in the **absence of implementational-utility (i.e., borrower consideration), with such exceptional recovery mechanisms**; additionally preceded by the ability of banks to enter into compromise settlements, through contractual terms and allowances.

The aforementioned 3 rights of Secured-Creditors, awarded by the SARFAESI Act and related RBI regulation, in addition to jurisprudential-interpretation has the following implication upon impairing the functional-justification of separate OTS regulation.

The vested authority of Secured-Creditors to unilaterally characterize borrowers as NPA's, devoid of requisite judicial-ratification/scope for initial scrutiny, is specified in **Section 13 (2)**<sup>xvi</sup> of the SARFAESI Act; with the allowance of banks to initiate proceedings—enforcement of Security-Interest (post the 60 day demand notice period) under **Section 13 (4)**<sup>xvii</sup>, against borrowers classified as NPA's. Debenture Trustees were exempt from the NPA classification requisite for SARFAESI Act proceedings, in the enforcement of Security-Interest, via the proviso.

NPA's have been defined in **Section 2 (O) of the SARFAESI Act**<sup>xviii</sup>, as **borrowers classified as sub-standard/vulnerable to loss, by banks or financial institutions**, in alignment with **regulatory guidelines and the RBI Mandate**.

The **RBI Asset-Classification Master Circular**<sup>xix</sup>, defines NPA's through the application of the standardized '90 Days Overdue' norm, as opposed to the preceding 'Past-Due' characterization; prescribing an overdue period of 90 days for Term Loan Repayment (Interest

and/or principal instalment), Overdraft/Cash Credit in ‘Out of Order Status’, Bills Purchased and Discounted, Direct Agricultural Advances-subject to specification in Annex 1 Para 2.1.5 of the Master Circular: and Other Accounts, for the fulfilment of NPA metrics, warranting consideration and classification by Secured Creditors.

The characterization of borrowers, as NPA’s based on the aforementioned metrics stipulated by the RBI, is however entirely left to the ‘discretion of the bank’, on the basis of justified commercial wisdom, as observed in **Sri Srinivasa Rice & Floor Mill v. SBI<sup>xx</sup>**.

The result of such empowerment of Secured-Creditors, is the **elimination of scope by borrowers to pre-emptively challenge unscrupulous practices, potentially adopted in the very classification of borrowers as NPA’s, by Secured-Creditors; due to the only scope for appellate recourse, being prescribed via the DRT/DRAT, post institution of proceedings.**

Additionally, the invocation of Writ Jurisdiction by borrowers, against unscrupulous Secured-Creditor Practices during/preceding the SARFAESI proceedings, has been denied, in the case of **Phoenix ARC Pvt. Ltd. Vs. Vishwa Bharati Vidya Mandir & Ors<sup>xxi</sup>**. The potential adjudicatory role of the Chief-Metropolitan-Magistrate or the District-Magistrate, over disputes between borrowers and Secured-Creditors, has also been denied by the Supreme Court (upholding the prescription of auxiliary involvement in debt recovery) in **Balkrishna Rama Tarle Dead thr LRS & Anr Vs. Phoenix ARC Pvt. Ltd. & Ors<sup>xxii</sup>**.

Post the characterization of borrowers as NPA’s, Secured Creditors have additionally been empowered to unilaterally ascribe ‘Wilful/Non-Wilful Defaulter’ status, to the NPA’s (upon inference of loan characteristics, specified by the RBI: i.e., capacity to pay yet wilful default, diversion of funds/ultra-vires leverage-use, siphoning-off of the funds, unlawful disposal of collateral) , **according to the RBI Master Circular on Wilful Defaulters, 2015**, devoid of precursory judicial ratification/scope for initial-challenge under the SARFAESI Act (placing reliance upon the appellate impetus of **Sections 17 and 18**).

While ‘Non-Wilful Defaulters’, may be awarded consideration for OTS Schemes, in the mandated ‘Non-Discriminatory’ and ‘Non-Discretionary’, manner of treatment (i.e., specifically, SME borrowers), upon fulfillment of prescribed requisites by the RBI, i.e., stipulated in the **Guidelines on OTS Settlement Scheme for SME Accounts;**

Any ‘Compromise Settlements’, entered into with ‘Wilful-Defaulters’, although authorized, are subject to the statutory requisite of discretionary authority exercise- by Secured Creditors, embodied via ‘**vetting by Management Committees/Boards of Banks**’- according to the May 10<sup>th</sup>, 2007 **RBI Advisory letter to the Indian Banks Association<sup>xxiii</sup>**; reinforced in the **June 8, 2023, Circular.<sup>xxiv</sup>**

Upon classifying NPA’s as Wilful Defaulters, devoid of Judicial Scrutiny, Secured-Creditors, may directly deny any scope for entry into an ‘OTS/Compromise Settlement’, irrespective of borrower protections, due to the supremacy of discretionary authority, exercisable by Secured-Creditors.

Even in the context of ‘Non-Wilful’ defaulters, the primacy of Secured-Creditor discretion, over the acceptance/rejection of OTS Schemes, was upheld in the case of **Bijnor Urban Cooperative Bank Limited v. Meenal Agarwal<sup>xxv</sup> (Bijnor Urban)**, which additionally upheld the absence of any right of the borrower to seek ‘OTS/Compromise Settlements’. With the reduction of liability from NPA borrowers in the spirit of expediency, being left entirely at the ‘Commercial Wisdom’ based, exercise of discretionary authority by Secured-Creditors, the **RBI’s proclaimed objective<sup>xxvi</sup>** of facilitating ‘early recoveries’ from borrowers where appropriate, through regulatory codification, is reduced to an unlikely possibility as opposed to an assured outcome. While, the ratio of the **Bijnor Urban** case, is justified in upholding the absence of any obligation upon Secured-Creditors to incur loss, via the provision of mandated OTS options to borrowers; the RBI’s proclaimed attribution of ‘non-discriminatory’ and ‘non-discretionary’ decision making to the award of OTS Schemes, in the specific context of SME borrowers, is adversely performative.

The debt recovery mechanism in India thereby, provides appellate (treatment-centric) relief to borrowers from arbitrariness by Secured Creditors and vicariously, the State, in the violation of their Constitutional Right to Property<sup>xxvii</sup>; as opposed to pre-emptive protection (prophylaxis).

There is accordingly a requisite for expedited precursory and sustained (multi-phase) Judicial/Arbitral Review, throughout the process of Debt Recovery, ranging from borrower: NPA classification to sale of Security-Interest.

## ENDNOTES

- <sup>i</sup> The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002, s 17
- <sup>ii</sup> The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002, s 18
- <sup>iii</sup> The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002, s 31 (j)
- <sup>iv</sup> The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002, s 3-12 (b)
- <sup>v</sup> The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002, s 31
- <sup>vi</sup> The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002, s 13 -19
- <sup>vii</sup> The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002, s 13 (1)
- <sup>viii</sup> The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002, s 13 (4) (b)
- <sup>ix</sup> The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002, s 2 (z) (g)
- <sup>x</sup> *Mardia Chemicals v. Union of India* (2004) 4 SCC 311, [81]
- <sup>xi</sup> Reserve Bank of India, 'Framework for Compromise Settlements and Technical Write-offs' (RBI 2023) <https://www.rbi.org.in/commonperson/English/Scripts/FAQs.aspx?Id=3459> accessed 15 September 2023
- <sup>xii</sup> Reserve Bank of India, 'Guidelines on One-Time Settlement Scheme for SME Accounts' (RBI 2005) <https://www.rbi.org.in/commonman/English/Scripts/Notification.aspx?Id=64> accessed 15 September 2023
- <sup>xiii</sup> Vinod Kothari, 'A Comprehensive Framework for Compromise Settlement and Technical Write-offs' (Vinod Kothari 2023) <https://vinodkothari.com/2023/06/a-comprehensive-framework-for-compromise-settlement-and-technical-write-offs/> accessed 15 September 2023
- <sup>xiv</sup> *Ibid.*
- <sup>xv</sup> Reserve Bank of India - Notifications' (Reserve Bank of India, 7 June 2019) <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11580&Mode=0> accessed 15 September 2023 [1]
- <sup>xvi</sup> The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002, s 13 (2)
- <sup>xvii</sup> The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002, s 13 (4)
- <sup>xviii</sup> The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002, s 2 (o)
- <sup>xix</sup> Reserve Bank of India - Master Circular- Income Recognition, Asset Classification, Provisioning and Other Related Matters - UCBs' (Reserve Bank of India, 1 July 2011) <https://www.rbi.org.in/CommonPerson/english/Scripts/Notification.aspx?Id=889> accessed 15 September 2023 [2]
- <sup>xx</sup> *Sri Srinivasa Rice & Floor Mill v. SBI* 2007 AIR (AP) 252, [21]
- <sup>xxi</sup> *Phoenix ARC Pvt. Ltd. Vs. Vishwa Bharati Vidya Mandir & Ors* 2022 Latest Caselaw 42 SC, [10]
- <sup>xxii</sup> *Balkrishna Rama Tarle Dead thr LRS & Anr Vs. Phoenix ARC Pvt. Ltd. & Ors* 2022 Latest Caselaw 767 SC, [9]
- <sup>xxiii</sup> Reserve Bank of India, 'Letter to IBA' (RBI 2007) <https://rbidocs.rbi.org.in/rdocs/content/pdfs/LettertoIBAdt10507.pdf> accessed 15 September 2023
- <sup>xxiv</sup> Reserve Bank of India, 'Framework for Compromise Settlements and Technical Write-offs' (RBI 2023) <https://www.rbi.org.in/commonperson/English/Scripts/FAQs.aspx?Id=3459> accessed 15 September 2023
- <sup>xxv</sup> *Bijnor Urban Cooperative Bank Limited v. Meenal Agarwal LL* 2021 SC 742, [11]
- <sup>xxvi</sup> Reserve Bank of India, 'Framework for Compromise Settlements and Technical Write-offs' (RBI 2023) <https://www.rbi.org.in/commonperson/English/Scripts/FAQs.aspx?Id=3459> accessed 15 September 2023
- <sup>xxvii</sup> *State of Haryana v. Mukesh Kumar* AIR 2012 SC 559, [36]