

Dispute Resolution Hotline

January 28, 2009

COURT DISALLOWS TRADING IN NPAS BY BANKS

The Hon'ble High Court of Gujarat (“**Court**”) in a recent decision in an appeal filed by Kotak Mahindra Bank Limited (“**Appellant**”) v. Official Liquidators of M/s. APS Star Industries Limited & Others decided on January 12, 2009 that banks cannot trade, transfer or purchase a pool of Non Performing Assets¹ (“**NPA's**”), or more commonly called “bad debts”.

BACKGROUND AND SUBMISSIONS

ICICI Bank Limited (“**Assignor Bank**”) executed a Deed of Assignment (“**Deed**”) in favour of the Kotak Mahindra Bank Limited (“**Appellant**” or “**Assignee Bank**”) by which a basket of NPAs of the Assignor Bank along with underlying security interest, if any, were assigned/transferred on “as is where is” basis to the Assignee Bank at a defined purchase price.

The single judge of the Company Court in an application made by the Assignee Bank held with respect to the Company - APS Star (in liquidation) that the Deed was not a valid document and rejected the request for substitution of the Assignee Bank in place of Assignor Bank. The present decision is passed in an appeal filed by the Assignee Bank against the said order. The Official Liquidator on behalf of the Company alongwith the Company's workmen union raised a preliminary objection resisting the application for substitution made by the Assignee Bank.

JUDGEMENT

The Court after hearing the submissions held that the Deed, executed between the Assignor Bank and the Assignee Bank, was not valid on several grounds. The Court reasoned that the Deed essentially has been executed for the purpose of transferring NPAs from the Assignor Bank to the Assignee Bank, which is nothing but trading in debts. It further said that the concept of trading in debts is, by its very nature, abhorrent to the concept of banking in any form, either the form of primary business of banking or the additional activities envisaged under Section 6² of the Banking Regulation Act, 1949 (the “**Act**”). The court further noted that the act of securitization itself is ‘*necessary concomitant to the activity of lending. Such an activity cannot also be part of any policy of sound economic growth because it only means, if one may use the expression, clearing the debris from one balance-sheet and dumping the same in another balance-sheet*’. The Court further noted that under the provision SARFESI Act, a banking company cannot function as a securitization or a reconstruction company which have separate powers for enforcing their security interest.

The Court observed that the activities envisaged under Section 6(1) (a) of the Act make it clear that concept of buying and selling is available as part of additional business only for certain specified categories of activities and that trading in debts in no measure falls with the ambit of these activities. The Court further said that recovery of a loan can only be from the borrower while in the instant case there is a transfer of NPAs and thus the consideration received for transfer of assets cannot be termed to be towards recovery of outstanding loan. Further the court observed that since customer is an essential element of negotiation of any public or private loan, and therefore, the Deed would be invalid since the creditor is not made party to the Deed. In this context, Court rejected the contention of the Appellant that buying and selling of debt was permitted under the Transfer of Property Act, 1882 as not applicable in this case, as such activities were not permitted under the Act which is a special enactment and therefore Appellants are not allowed to take recourse to a general law when a special law is in place.

The Court has raised a strong objection against such substitution of a creditor by way of assignment, since this exercise adversely affects the right of the debtor. The Court has relied on the findings of Hon'ble Supreme Court in the case C.B. Gautam v/s Union of India & Ors [1993] 199 ITR 530 and said that ‘*notice granting an opportunity of hearing is a must, even in absence of a provision*’ and therefore debt must not be assigned without giving meaningful and reasonable opportunity to the borrower to be heard.

The Court also held that the execution of Deed involves not only assignment but also the concept of novation and further as the law stands, transfer of obligations are not permitted and the terms of the original contract as the terms of the Deed have been varied to that extent and therefore unless and until the creditor is a party with the Assignee Bank, it would have no liability.

The Court has further observed that the benefit of a *pari passu* charge created on assets of the company as per Section 529A³ of Companies Act is available only to the first charge holder and the second charge holder and as such the Assignee Bank does not fit the category of either of the two and therefore cannot be substituted for the Assignor Bank in the instant case.

Since the Court held the very execution of the Deed to be invalid, the Court did not adjudicate the other various issues related to the Bombay Stamp Act, 1958 and the Registration Act, 1908.

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ANALYSIS

The very purpose of the SARFAESI Act was to enable securitization and reconstruction of financial assets and enforcement of security interest which would help banks recover NPAs and enforce security interest in an expeditious manner. We believe that the instant case has raised an important and contentious issue where the Court has questioned the means through which banks could deal with NPAs, which in the present case was done by transferring them to another bank for a consideration.

This judgment would have a ramification and implication on the banking industry and the manner in which the securitization of debts, more particularly the NPAs, are dealt with.

- Litigation & Dispute Resolution Team

1 Section 2 (1) (o), Securitisation and Reconstruction of Financial Assets And Enforcement Of Security Interest Act, 2002 ("SARFAESI Act") defines a "non-performing asset" as an asset or account of a borrower, which has been classified by a bank or financial institution as sub-standard, doubtful or loss asset, -(a) in case such bank or financial institution is administered or regulated by an authority or body established, constituted or appointed by any law for the time being in force, in accordance with the directions or guidelines relating to assets classifications issued by such authority or body;(b) in any other case, in accordance with the directions or guidelines relating to assets classifications issued by the Reserve Bank.

2 Section 6 - Forms of business in which banking companies may engage (1) In addition to the business of banking, a banking company may engage in any one or more of the following forms of business, namely:

(a) the borrowing, raising, or taking up of money; the lending or advancing of money either upon or without security; the drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, hoondees, promissory notes, coupons, drafts, bills of lading, railway receipts, warrants, debentures, certificates, scrips and other instruments and securities whether transferable or negotiable or not; the granting and issuing of letters of credit, traveller's cheques and circular notes; the buying, selling and dealing in bullion and specie; the buying and selling of foreign exchange including foreign bank notes; the acquiring, holding, issuing on commission, underwriting and dealing in stock, funds, shares, debentures, debenture stock, bonds, obligations, securities and investments of all kinds; the purchasing and selling of bonds, scrips or other forms of securities on behalf of constituents or others, the negotiating of loans and advances; the receiving of all kinds of bonds, scrips or valuables on deposit or for safe custody or otherwise; the providing of safe deposit vaults; the collecting and transmitting of money and securities.

3 [529A. Overriding preferential payment

(1) Notwithstanding anything contained in any other provision of this Act or any other law for the time being in force, in the winding up of a company-

(a) workmen's dues; and

(b) debts due to secured creditors to the extent such debts rank under clause (c) of the proviso to sub-section (1) of section 529 pari passu with such dues, shall be paid in priority to all other debts.

(2) The debts payable under clause (a) and clause (b) of sub-section (1) shall be paid in full, unless the assets are insufficient to meet them, in which case they shall abate in equal proportions.]

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