SARFESI ACT – A Big Step Falling Short

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I. BACKGROUND OF SARFESI ACT

The enactment of the SARFESI Act marks a new chapter in the empowerment of banks to effectively deal with defaulting borrowers. Historically, banks in India have not always been in a position of strength vis-a vis their debtors. The banks had not been granted the authority to liquidate the security of a defaulter. This made their position vulnerable owing to the lengthy procedure involved in realizing a security. The banks were required to file a civil suit to recover the debt whereupon they were forced to wait for the court's decree before being able to sell the assets of the defaulter and recover their loans. With the courts already over-burdened with docket explosion, the cases could drag on for years to complete the stages of trial and execution. This was especially problematic on two counts:

a) It provided an escape door for defaulters to get away without answering their liability and translated into losses for the banks.
b) It increased the hurdles for the poor to obtain loans as the banks became more hesitant and the conditions more stringent.

The government sought to resolve this problem by constituting the Tiwari Committee in 1981. The committee did a thorough study of the problems prevalent in the banking sector, the attributes of those problems and the optimum curative measures. The committee recommended setting up of special debt recovery tribunals to streamline the process of debt recovery. The committee made an important suggestion about the form of functioning of these tribunals by proposing that they should not be made to operate in accordance with the civil procedure code. They should have a simple procedure guided only by the principles of natural justice. The proposal of this committee did not find favour with the government of the day and was put on the backburner. Eventually, the idea came to the forefront again in 1991 after the Narasimham committee advocated the creation of special tribunals with powers to adjudicate on the recovery of debt.

The government implemented these recommendations by enacting the Recovery of Debts due to Banks and Financial Institutions Act (DRT Act) in 1993. The major objective of the Act was to expedite the recovery of debt due to banks and financial institutions by establishing Debt Recovery Tribunals (DRTs)1. The processing of debt recovery cases was to be accelerated by making simpler the legal procedure to be followed in court. As recommended by the committees, the Act provided for application of "summary procedure" and not the code of civil procedure to cases filed before DRTs. This procedure involved a fixed 30 days within which the DRT was to issue summons to a defendant once an application against him or her was received, a guideline to dispose of

[1] In its Statement of Objects and Reasons it was noted that as of September 30, 1990 there were pending in various courts above 1.5 million cases filed by public sector banks involving more than Rupees 56.22 billion and 304 cases filed by financial institutions involving Rupees 3.91 billion.

cases within 6 months of the application, and a deadline of 45 days within which to make an appeal to a DRAT against a DRT's decision. The Act further empowered the DRTs by giving them the authority to execute the judgment. The presiding officer of the DRT could issue a recovery certificate to the recovery officer, who could then sell or attach the assets of the judgment-debtor in order to recover the money.

Althought the DRT Act was a step in the right direction; it failed to arrest the incidence of defaulting. The non-performing assets (NPAs) kept mounting and the corporate sector alone accounted for Rs. 50, 000 crore worth NPAs in banks and financial institutions[2]. Over the past few years, the government has been proactive in initiating new major publicly funded programs for generating employment and creating infrastructure. The need of the hour was to identify new resources that could be utilized for these programmes. It became evident that the NPAs were acting as a major hindrance to these efforts and steps needed to be taken to remedy the situation. In 2002, Parliament enacted the Securitisation of Assets and Reconstruction of Financial Assets and Enforcement of Security Act, 2002 (generally referred to as the SARFESI Act). This legislation appears to have made it easier for banks and financial institutions to act against defaulters.

II. ANALYSIS OF THE ACT

The Sarfesi Act appears to be an amalgamation of two legislations. The first part of the legislation deals with regulation of securitisation and reconstruction of financial assets of banks and financial institutions. The second part relates to the provisions dealing with enforcement of security interest.

Securitisation And Reconstruction Of Financial Assets Of Banks And Financial Institutions

(A) Registration of Securitisation companies

The legislation regulates the manner in which securitisation and reconstruction of financial assets of banks and financial institutions is to take place. There is a prescription of guidelines to be followed before registration of securitisation or reconstruction companies. It is essential for a company to complete all formalities of registration prescribed by the Reserve Bank, otherwise it will not be able to carry on any business related to securitisation. The company must have an owned fund of not less than Rs. Crore or such other amount as the reserve bank may specify, subject to the limitation that such amount should not exceed fifteen percent of the financial assets acquired or to be acquired by the company. It is not incumbent upon the reserve bank to register companies by following a mechanical process, but it is empowered to scrutinize the companies to gauge its eligibility for registration. The legislature has provided a number of indicators for the reserve bank to consider before deciding whether or not to grant registration certificate. The most important condition is that the securitisation company should not have incurred any losses in the preceding three years. Also, it should be ascertained that the securitisation company has taken proper steps for realizing the financial assets acquired for the purpose of securitisation or reconstruction, so that it would be able to pay periodical returns on the investments made by qualified institutional or other investors.

There is a common thread running through these pre-requisites that are meant to guide the discretion of the reserve bank while granting registration, which is the protection of investor's interests. This is why the company must comply with conditions like directors of the company should have adequate professional experience and should not have been convicted of any offence involving moral turpitude. Another important aspect that must be

[2] Jairam Ramesh, The Hindu, Thursday, October 20, 2005.

taken care of is that the composition of board of directors of the company should not be done in a manner where more than half its members are nominees of or associated in any manner with the sponsor or subsidiaries of such company. Also, it must be ensured that a sponsor is not a holding company of the securitisation company.

Even if all the aforementioned conditions are satisfied, the reserve bank is still not obligated to register the company. It can insist upon compliance of certain additional conditions before consenting to register the company. However, if the reserve bank wishes to reject the application of registration, the same cannot be done unless a hearing has been provided to the company so that the principle of natural justice is not subverted. The hold or control of the reserve bank upon a company does not cease after granting certificate of registration. The company must intimate and take prior approval of the reserve bank before making substantial changes to its management. The determination of whether or not a particular change in management constitutes a substantial change or not is the exclusive province of the reserve bank and its decision on the matter shall be binding and final.

(B) Cancellation of Registration Certificate—

The authority to cancel a certificate o registration lies with the reserve bank. This can be done if, in the reserve bank's opinion, any of the scenarios enlisted by the legislation has occurred. The most straightforward scenario is that the company ceases to operate as a securitisation or reconstruction company. The certificate can also be cancelled if it is discovered that the company is not complying with the conditions upon which the certificate was granted. The refusal by the company to maintain its account books in accordance with reserve bank's directions or disobeying orders for submitting account books for inspection would act as an immediate ground for canceling registration. The certificate of registration can also be revoked if the company ceases to hold any investment from a qualified institutional investor.

Akin to procedure adopted for rejection of application for registration, the reserve bank should not normally cancel the certificate of registration without first providing the company with an opportunity to set right its course and comply with the conditions that it has been found to be violating. But this requirement can e waived by the reserve bank if it is of the opinion that to do otherwise would be prejudicial to the general interests of the public or the specific interests of the company's investors. The company can appeal from a decision of the reserve bank to the central government within a period of thirty days. The company shall be allowed an opportunity of being heard by the central government during such appeal. It has been ensured that this cancellation of registration does not adversely affects the rights of the investors by including a provision that the company would be considered as a securitisation or reconstruction company unless it repays the entire investments held by it.

(C) Acquisition of Interest in Financial Asset—

This legislation contains a provision that clears the way for securitisation and asset reconstruction companies to acquire assets of banks or financial institutions. The legislation envisages two mechanisms for accomplishing this. Firstly, assets can be acquired by issuing a debenture or bond or any other security in the nature of the Debenture for a mutually agreed upon consideration. The second way is to acquire the assets by entering into an agreement with such bank or financial institution for the transfer of such financial assets to such company on such terms and conditions as may be agreed upon between them.

The legislation takes absolute care to spell out that the securitisation company would stand in absolutely the same position with all the related rights as were being exercised by the bank or financial institution in their position as a lender. The company shall be empowered to enforce any contracts, deeds, bonds, agreements, powers-of-attorney, grants of legal representation, permissions, approvals, consents or no-objections executable by the bank vis-à-vis the assets acquired by the company. The company would also be competent to continue any suit that is pending before any court in respect of these assets.

(D) Issue of Security by Raising of Funds—

This stage follows the acquisition of assets by the company for securitisation or reconstruction. After an asset has been acquired, the company may offer security receipts to qualified institutional buyers, other than by offer to public, for subscription in accordance with the provisions of Companies Act, 1956, Securities Contracts (Regulation) Act, 1956 and the Securities and Exchange Board of India Act, 1992. A securitisation company or reconstruction company may raise funds from the qualified institutional buyers by formulating schemes for acquiring financial assets and shall keep and maintain separate and distinct accounts in respect of each such scheme for every financial asset acquired out of investments made by a qualified institutional buyer and ensure that realisation of such financial asset is held and applied towards redemption of investments and payment of returns assured on such investments under the relevant scheme.

The legislation provides that the assets acquired by the company or funds raised by the company for acquiring such assets will be held by the company for the benefit of qualified institutional buyers holding the security receipts or from whom the funds are raised. The nature of this trust would be determined by referring to the provisions of Indian Trusts Act, 1882. If the securitisation or reconstruction company, as the case maybe, fails in its endeavour to realize the security assets acquired by it, then the qualified institutional buyers holding security receipts of at least 75% of the total value of the security receipts issued by the company, would be empowered to call a meeting of the qualified institutional buyers and every decision taken during such meeting shall be binding upon the company.

(E) Measures for Assets Reconstruction—

This Act has put in place special mechanisms to empower an asset reconstruction company in realizing the assets acquired by it. It incorporates a number of means for reconstructing an asset and an asset reconstruction company has the following measures available to it:

a) The proper management of the business of the borrower, by change in, or take over of, the management of the business of the borrower;
b) The sale or lease of a part or whole of the business of the borrower;
c) Rescheduling of payment of debts payable by the borrower;
d) Enforcement of security interest in accordance with the provisions of this Act;
e) Settlement of dues payable by the borrower;
f) Taking possession of secured assets in accordance with the provisions of this Act.

The company must defer to the guidelines framed by the reserve bank while exercising any of the aforementioned options available to it.

(F) Notice to Obligor—

The bank or financial institution may, if it chooses so, send a notice to the obligor that the relevant asset has been acquired by the securitisation or asset Reconstruction Company. A similar notice could be sent to the registrar of companies of the area where interest created upon the security has been registered. The obligor, on receipt of such notice, should pay the dues to the company and not the bank and payment made in satisfaction of any interest held upon the asset by such company, would be sufficient to relieve the obligor of his liability. But, if such a notice has not been sent to the obligor by the bank, and the obligor makes any payment to the bank post-acquisition, then such payment, in whatever form, would be held by the bank or financial institution in the form of a trust for the benefit of the securitisation or asset reconstruction company that had acquired the asset from the bank in the first place.

Enforcement of Security Interest

(A) Enforcement of Security Interest—

The first thing that needs to be considered is the definition of security interest as incorporated in definitions section of the legislation. Security Interest has been defined as a right, title and interest of any kind whatsoever upon property, created in favour of any secured creditor and includes any mortgage, charge, hypothecation or assignment except for those specified in section 31 of the Act. The Act has substantially modified the previous mechanism wherein the creditor had to wait until obtaining a court decree to act in respect of a security interest. The fresh scheme proposed by the legislation in this regard is that a secured creditor in accordance with the provisions of this Act may enforce any security interest created in favour of any such creditor, without the intervention of court or tribunal.

According to the section, there are four pre-requisites that must be satisfied before the creditor can exercise the remedies provided under this Act. These pre-conditions are:

a) The debt must be secured.
b) The borrower, who is under a liability to a secured creditor under a security agreement, defaults in repayment of the secured debt or any installment thereof.
c) The account in respect of such debt must have been classified by the creditor as a non-performing asset.
d) The creditor has served a notice of sixty days on the debtor requiring him to discharge his liabilities in full. This notice should include details of amount payable by the debtor and the complete list of secured assets intended to be enforced by the creditor in the event of non-payment of dues.

Once the notice has been served, there is very little the debtor can do to stall the progress of recovery, other than repayment of the debt. This is because although the debtor has been allowed to raise objections to the notice and address them to the creditor, the acceptance of such objections is solely dependent upon the whim and fancy of the creditor. The only thing that the creditor is bound to do is to reply to the objections raised within a week along with reasons for rejecting the same. If the creditor decides that the objections raised are untenable, then the process of recovery cannot be stopped by filing an application before the debts recovery tribunal. Therefore,

the creditor is the sole judge of whether to proceed or not, and the only alternative before the debtor to secure the release of the security interest is to repay the debt in full.

If after the expiry of the notice period, the debtor still fails to discharge his liability in full, the secured creditor has been empowered to proceed against the security interest in any of the following ways:

a) Take possession of the secured assets of the borrower including the right to transfer by way of lease, assignment or sale for realizing the secured asset.
b) Take over the management of the business of the borrower including the right to transfer by way of lease, assignment or sale for realizing the secured asset.
c) Appoint any person (hereafter referred to as the manager), to manage the secured assets the possession of which has been taken over by the secured creditor
d) Require at any time by notice in writing, any person who has acquired any of the secured assets from the borrower and from whom any money is due or may become due to the borrower, to pay the secured creditor, so much of the money as is sufficient to pay the secured debt.

The legislature has incorporated certain other provisions in addition to the aforementioned rights, so as to leave no doubt regarding the efficacy of these rights. A borrower cannot transfer any property by way of sale, lease or otherwise, any of the assets that have been listed by the secured creditor in the notice served upon the debtor. If a secured creditor transfers any secured asset after taking possession, in accordance with the Reserve bank guidelines, then the transferee shall enjoy all rights vis-à-vis that property in the same way as if the owner of the property had made the transfer. The creditor has also been granted additional rights to liquidate the assets pledged by the guarantors. It has been specified that the secured creditor does not need to proceed against any of the creditors before taking any action against the guarantor under this provision. This is in keeping with the general principles of contract whereby the onus is upon the guarantor to recover the debt from the borrower after paying the creditor by "stepping into the shoes" of the creditor.

Although the legislature is clearly on the side of the creditors, there is one silver lining for the borrower. The remedy of being able to takeover the borrower's business is subject to a limitation that the right to transfer by way of lease, assignment or sale shall be exercised only where the substantial part of the business of the borrower is held as security for the debt. It has also been specified that where the management of whole of the business or part of the business is severable, the secured creditor shall take over the management of such business of the borrower that is relatable to the security for the debt.

(B) Manner and Consequences of Takeover of Management—

Before taking over the management of the company, it is essential to issue a circular in a newspaper of a national language circulated in the area of borrower's company's principal office is located. This notice should contain the details regarding the new appointments made as the directors of the company if borrower is a company, or as administrator of the business of a borrower. The consequence of the publication of notice is the immediate termination of all the persons previously holding office as the directors of company or administrators

of business. The newly appointed directors have been empowered to take into custody all the property, actionable claims and effects to which the business of the borrower is entitled and the same shall be deemed to be in their custody from the date of publication of the notice.

The position of the new directors appointed by the secured creditor has been further strengthened by providing an exception to some of the provisions of the Companies Act, 1956. If the management of a company has been taken over by the secured creditor, then the shareholders of the company or any other person would not be entitled to nominate or appoint any person as the director of the company, regardless of anything contained in the memorandum or articles of association of the company. Also, any resolution passed by the shareholders shall not be effectuated unless the secured creditor approves it. Additionally, there cannot be a suit filed in the court for winding up the company except with the previous consent of the secured creditor. After the debt has been completely recovered, then it is incumbent upon the secured creditor to restore the management of the business to the borrower.

(C) Right to Appeal—

If a person is aggrieved by any of measures taken by the secured creditor to enforce the security interest, he/she can prefer an appeal to debt recovery tribunal. The important thing to be noted is that the tribunal can only be approached once the secured creditor has enforced the security interest and not while the process is underway. The obvious intention of the legislature in prescribing this is to make sure that possession of the secured asset passes to the creditor and the borrower does not stall the process of taking of possession. There is a limitation period of 45 days from the date when such measure was taken by the secured creditor within which the aggrieved person must bring the matter before the tribunal.

If the tribunal is convinced that measures taken by the secured creditor are not in consonance with the provisions of the Act, or guidelines framed by the Reserve Bank, then the Court can declare such measure to be invalid and restore possession of the secured assets or the management of the business to the borrower. In such a scenario, while invalidating a particular measure, the court can also specify any other measure including the remedies available to the secured creditor. The court can also order the secured creditor to pay compensation to the borrower for taking possession illegally. However, if the court comes to the conclusion that the measure adopted by the secured creditor is in keeping with the provisions of the Act, then it should not disturb the secured creditor's possession, notwithstanding any provision to the contrary in any other Act.

There seems to be an obvious intent on part of the legislature to streamline and expedite the judicial process. The Act provides that matters related to the Act should be disposed of within sixty days and the reasons for delay must be recorded in writing. If a matter is not disposed of within four months, then any of the parties can approach the Appellate Tribunal to obtain a direction to the Debt Recovery Tribunal for speedy disposal of the matter.

There has also been made a provision for appeal from the decision of the Debt Recovery Tribunal to the Appellate Tribunal. This appeal must be preferred within a period of 30 days after receiving the previous order. This appeal can only be made if fifty percent of the amount due from the borrower as determined by the Debt Recovery Tribunal is deposited with the Court. This amount can be reduced to 25 percent of the amount due from the borrower, if directed by the tribunal. Earlier, a similar pre-requisite was there for filing an application before DRT but it was amended following a decision by the Supreme Court in the Mardia case[3] holding that such a provision is unconstitutional as it is violative of Article 14 of the Constitution.

III. CONCLUSION AND SUGGESTIONS

The Sarfesi Act is a strong legislation that is enacted with the clear aim of driving a governmental policy of minimizing NPAs. The provisions of the Act have been drafted with the sole purpose of achieving this objective. The legislature has made no bones about the fact that the legislation is heavily one-sided towards the banking community, and in fact this obvious favour has been justified as being in the best economic interests of the country. In conclusion, there are two points regarding the Act that need to be focused upon. Firstly, it needs to be ascertained if the underlying policy that forms the base of the Act is a sound one. Thereafter, the merit of the legislature itself and its impact thus far needs to be evaluated.

The infirmities of the legislation have been corrected by incorporating the measures required by the Supreme Court. Beyond that, the merit of the legislation can only be evaluated after considering its impact and success. There are two important considerations that need to be factored in while making these assessments – a) the level of NPAs has drastically fallen across the board and the performance of all nineteen public sector banks has seen a marked improvement, and b) there have been instances where rough tactics have been adopted by some banks to recover loans. The latter should not serve as a criticism of the Act as existence of rough tactics is not something new that has come into being only after the existence of Sarfesi Act. It had been adopted by banks throughout the 90's and therefore, it cannot be a measure of the Act's failure unless there has been a drastic increase in such occurrences. Furthermore, victims of such rough treatment always have the option of applying for judicial relief because the actions of the Ban in this scenario are not just illegal but border on criminal conduct. In fact, relief has been granted to a customer of the ICICI bank who proved to have been harassed by the bank and was rewarded a hefty compensation. Therefore, there exist remedies to counter these rough tactics.

Finally, there is a suggestion that could better the efficiency of the Act by furthering the policy aim guiding the Act. While the SARFESI Act provides banks to auction the assets pledged for loans in case of default, there was no such provisions for non-collateralized assets like auto loans. The Indian legislature can take a cue from its U.S. counterpart and include a provision empowering the banks to repossess the vehicle in case of default from anywhere except for the customer's garage. This should help in making the Act more comprehensive and more adept at achieving its objectives.

[3] Mardia Chemicals Ltd. and Ors. v. Union of India and Ors.