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WILFUL DEFAULTERS: AN ERA OF REACTIVE LAWMAKING

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In general, the meaning of word "default" is failure to repay loans availed by a borrower from a financial institutions or banks. A "Wilful Defaulter"[2] can be termed as a natural or legal entity who, despite of its financial ability to repay it, has not repaid the loan amount. The financial institutions or banks may also report the names in the director column, in case of business enterprises other than companies, of those persons who are responsible and in charge for management of the affairs of business enterprise.

The subsequent directors of a company shall be named as wilful defaulters[2] in case when a company is termed as wilful defaulters-

(a) Whole-time director
(b) In case of no key managerial personnel, director or directors as specified by board and such person has given his consent to the board of such specification in writing or all the directors in case of no specifications.
(c) Every director who is a part of any contravention by virtue of receipt of any proceedings of the board by him or participation in such proceedings and not objected to the same or and such contravention has done with his connivance or consent or knowledge, in respect of a contravention of any provisions of Companies Act

In case of non-whole-time directors3, they will only be considered as wilful defaulters if following conditions are satisfied –

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2Reserve Bank of India, Master Circular on "Wilful Defaulters", (Issued on January 2015)
3*Id*

1. That director was aware of wilful default by the borrower by means of any proceedings recorded in board meetings or committee of the board and has not recorded his objection in the meantime.
2. Wilful default has taken place with his connivance or consent.

But in case when such non whole-time directors are also a promoter of the company then none of these conditions are needed to be satisfied before naming a non-whole-time director as a wilful defaulter.

Concept of "Wilful Default"

The concept of "wilful default" first emerged in the year 1999. The RBI and Central Vigilance Commission gave instructions to financial institutions or bank for collection of information on wilful defaulters of INR 25,00,000 and above.

The parameter against "Wilful defaulters" have gained attention and highlighted again due to the striking upsurge in the number of non-performing assets[4] in financial institutions/ banks especially, of late in public sector banks. Various modification has been made by the RBI in the identification of wilful defaulters and subsequent procedure that should be started against them.

RBI[5] has issued a master circular on July 01, 2015 that provides guidelines to financial institutions or banks on identifying and then dealing with "wilful defaulters".

This concept of "wilful default" is considered as an abuse to "the economics of financial transactions" by the Indian regulators. Time after time, the regulators have discovered many new ways of tackling these instances. Wilful defaulters are straightaway dealt in accordance with guidelines laid down by the RBI. Prima facie, the guidelines[6] given by the RBI is more inclined towards the treatment of wilful default rather than the classification of wilful defaulters.

Mechanism of Dealing with Wilful Default-

Following steps have been listed by the RBI while dealing with "wilful default"-

4Non-Performing Assets, https://economictimes.indiatimes.com (last visited Oct. 1, 2020)
5Reserve Bank of India*supra note* 3.
6*Id*

1. In case of any event of wilful default on the part of borrower (in case of company) and its whole time director or its promoter should be examined at the relevant time by an identification committee that is headed by an executive director and consisting of two more senior officers whose rank is deputy general manager/ general manager.
2. A show cause notice shall be issued to the concerned borrower and a whole-time director or promoter by the identification committee in case of wilful default and call for their submission in the same matter. Furthermore, after the considering the submission, issue an order for recording the fact of wilful default and reason for such conduct. If identification committee feels that it is necessary to give an opportunity of personal hearing to the concerned borrower and the whole-time director or promoter then the same should be availed.
3. Thereafter, the order of the identification committee shall be reviewed by another committee named "ReviewCommittee" whereas the review committee is headed by managing director or chief executive officer or chairman and shall consist of two non-executive directors/ independent directors of the bank. The order of the identification committee shall become final after confirmation of the review committee. In case when identification committee itself doesn't declare the borrower as wilful defaulter then there is no need to set up a review committee.

Classification of Wilful Defaulter-

- Identification of Wilful Defaulters:

Under the master circular by the RBI dated July 01, 2015, a unit shall be considered as "wilful defaulter"when the occurrence of the following scenarios has been identified-

(a) In case when the unit has defaulted in repayment obligations or meeting payment to the lender, despite having ability to repay or to honor the obligations.

(b) In case when the unit has defaulted in repayment obligations or meeting payment to the lender, funds provided by lender has diverted and not been utilized for specific purpose for which it was availed of.

(c) In case when the unit has defaulted in repayment obligations or meeting payment to the lender, the funds have been siphoned off and are also untraceable in the unit.

(d) In case when the unit has defaulted in repayment obligations or meeting payment to the lender, an immovable property has been given for securing the loan without the knowledge of lender or it has disposed of or movable fixed assets has been removed.

To declare the default as "wilful" it must be deliberate, intentional, and calculated. Therefore, the identification of such default should be made considering the track record of the borrowers and the sole basis of decision should not be any isolated incidents or transactions.

The Hon'bleHigh Court of Bombay in the case of ***Kailash Shahra vs IDBI Bank***[7], held that mere default is not sufficient to declare a director a wilful defaulter, only an intentional and deliberate act will come under the definition of wilful default, and finally the borrower company, its whole time director or its promoter can be subjected to sucha declaration provided that there should be evidence.

Succinctly, a default will be treated as "wilful default" when borrower refrains from repayment of loan or meeting its obligations despite having the ability to do so. A committee of lender which is headed by an executive director along with two senior officers of the rank DGM/GM is constituted to decide whether default is genuine or deliberate. Moreover, a review committee is also constituted which comes into action when the above committee affirms in positive. The review committee has a final say on whether a borrower will be treated as "wilful defaulter" or not.

- Siphoning of Funds:

  The phenomenon of "Siphoning of Funds" is fundamentally a misutilization of funds for which loan was not sanctioned. The act of draining off money from the business without having any legitimate authority. On the other hand, no court of law shall hold such legitimate transaction of money as illegal siphoning of funds when the transfer of funds is

7kailash shahra vs Idbi bank, writ petition (l) no. 1630 of 2019

legitimate and duly recorded in books of account whereas such transaction is rightfully explained and neither fabricated or untruthful.

In 2018, the Supreme Court has dealt with "Siphoning of funds" in case of ***Bikram Chatterji V. Uoi***[8] and considered it as a "serious fraud". The Apex Court has enlisted some circumstances that will be construed as "Siphoning of funds"

(a) Sending of funds through any financial institution or bank other than the members or lender of consortium without their prior permission.
(b) Case of utilization of working capital for long-term purposes rather than short term purposes, that is not in accordance with terms of sanction of loan.
(c) Investment in other companies by way of debt instruments or acquiring equities without any prior approval of the lenders.
(d) In case of deficit in deployment of funds with regards to amounts drawn or disbursed and the difference is not accounted for
(e) Utilization of funds for any other purpose such as deploying borrowed funds for creation of assets.
(f) Transfer of borrowed funds to other corporates or group companies or subsidiaries by whatever modalities.

The Calcutta high court, in the case of ***Indranil Mukherjee V. Jayeeta Mukherjee & Ors.***[9] established that the court has power to grant an injunction and therefore, restrained the defendants from withdrawing any amount of money or siphoning fund in her various deposits either in the joint account of plaintiff and defendant or withdrawing any money lying in savings bank or fixed deposits in defendant's name alone.

Further RBI has clarified that "Siphoning of funds" should be declared to occur only if funds borrowed from financial institutions or banks are utilized for any unrelated purposes i.e. not in consonance with the operations of borrower. Moreover, such act is detrimental to the financial health of the lender or other lending entity. Therefore, the decision of whether a particular

8Bikram Chatterji V. Uoi,Writ Petition (C) No. 940 of 2017
9Indranil Mukherjee V. Jayeeta Mukherjee & Ors, 2016 SCC OnLine Cal 6495

instance amounts to "siphoning of funds" or not depends on the judgement of lender. The judgement of lender is based on circumstances of case to case and objective facts.

Precisely, it can be said that the lender has an ultimate authority to label a borrower as wilful defaulter.

Provisions of "wilful default" and "wilful defaulter" are against the scope of natural justice.

It is evident from the process of classification of "Wilful default" and "Wilful defaulter" that it is against the principle of natural justice and such principle is severely jeopardized in this kind of situation. The essence of jurisprudence lies in giving accused a fair opportunity of being heard, to put forth his case. A personal hearing cannot be substituted by a show cause notice. Fundamentally, the principles of natural justice are two-folds –

1) Audi alteram partem i.e. every person or party has a right of being heard.
2) Nemo judex in causa sua i.e. no person should be judge in his own cause.

"The tag of wilful defaulter is almost like reading the mind of the defaulter, which is getting into mea culpa of the defaulter."[10]Till now this power was reserved with the criminal courts in the country but if the guidelines given by the RBI will prevail then the ultimate powers will be conferred upon a bunch of bankers who will decide the matter in which they are themselves parties and come up with a decision to call someone a "Wilful-Defaulters" without even giving the defendant a mandatory opportunity of being heard.

As per the Revised Guidelines of the RBI[11], firstly, it makes the bank a judge of its own cause and secondly do not provide the defaulter with a necessary hearing opportunity. subsequently, a defaulter will be declared as a "wilful defaulter" for life.Moreover, this approach involves a bank which is neither judicial nor quasi- judicial authority. Which thereon determine whether a default is wilful or not. After declaring the same, all banks are forced to proceed with penal measures by the subordinate legislations. But this process cannot be said to be formal

10Vinod Kothari & Abhirup Ghosh, The defaulter's will: leaving harsh implications to administrative discretion, Vinod Kothari Consultants (Oct.3, 2020, 10:45 PM), http://vinodkothari.com/wp-content/uploads/2017/02/Article_on_Wilful_defaulter-1.pdf

11Reserve Bank of India, *supra note* 3

adjudication and judicial review. Unfortunately, revised guidelines of the RBI confer such power of adjudication and judicial review on the banks that lacks in judicial skills of adjudication. RBI through his regulation gives bank the ability to exercise their coercive power of judiciary without sufficient checks and balances. The lifetime punishment without adjudication like this depicts the arbitrariness as well as it is against moral principles.

This issue was discussed in length in the case of Kotak Mahindra Bank Ltd. v. Hindustan National Glass & Ind. Ltd.[12]. In this case the Bombay High Court held that the master circular of the RBI covered default by a party in obeying the obligations under derivative transactions. The high court has observed that it will be up to grievance redressal committee to further pass fresh orders in accordance with law after complying the principles of natural justice.

Implication of Being Labelled as Wilful Defaulter-

There are numerous implications on a person who is named as a wilful defaulter as published by CIC or RBI in the list of wilful defaulters. In addition to the implications laid down by the RBI, the SEBI has also come up with a recommendation to restrict the access of wilful defaulters in the capital markets.

Penal Measures Prescribed by the RBI-

Accused attracts numerous implications on being characterized as a "wilful defaulter" namely-

1) Name of accused in a list published by the RBI and Credit information companies that will be further put up on the public domain.
2) The accused shall not avail any further funding by financial institution or bank i.e. debarring the accused from institutional finance. A ban of next 5 years from the date of removal of name from the list of wilful defaulters shall be imposed on the companies in case of misrepresentations, diversion of fund, fraudulent transactions, falsification of accounts have been identified within the accused companies with respect to fund raising from institutions like NBFCs for setting up new ventures, financial institutions, scheduled commercial banks.
3) Right to initiate criminal proceedings by the lenders against the wilful defaulters.

12Kotak Mahindra Bank Ltd. v. Hindustan National Glass & Ind. Ltd.,(2013) 7 SCC 369.

4) The financial institutions or the banks have right to insert clauses in the agreement to effect that borrowing entity does not induct anyone on its board from the list of wilful defaulters or in case when such person is already on the board then necessary steps should be taken to debar such directors from the board.

Penal Measures By the SEBI-

The SEBI had also come up with some measures as if measures prescribed by the RBI are not sufficient to make the lives of wilful defaulter worse. Following are the recommendations from the board meetings of the SEBI-

1) If the issuer company or its director or its promoter is in the list of wilful defaulters, then a company shall not be allowed to make issue of non-convertible redeemable preference shares or debt securities or equity securities.
2) Any company or its directors or its promoters may not be allowed to take control over other listed entity if categorized as wilful defaulter. however the company or its directors or its promoters are allowed to make competing offer for the said listed company, in case of a takeover offer in respect of the listed company, in accordance with the SEBI (SAST) Regulations, 2011[13].
3) No fresh registration shall be granted to any entity if its directors or its promoters or key managerial personnel or any entity itself as defined under SEBI(ICDR) Regulations, 2009[14], for the purpose of determining a "fit and proper person" in SEBI regulation[15], are included in the list of wilful defaulter.
4) The categorized wilful defaulters would be disqualified from acting as intermediaries in the capital markets and no registration would be granted by the SEBI.

Such movewould have a deterrent effect on borrowers who borrow monies from financial institutions and banks. At the same time, it may also be considered as an overkillbecause the new regime restricts wilful defaulters from

13Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, Reg. 62(2)
14 Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009
15 Securities and Exchange Board of India, SEBI Board Meeting, 2016

accessing the capital markets although that may be essential for a revival or restructuring of the business.

In that sense, SEBI has adopted a uniform methodology by restricting all entities rather than allowing some on a case-to-case basis. This may have the impact of unfavorably affecting shareholder or moneylenders of a wilful defaulter who will most likely be unable to improve their situation in the company by getting an access to the capital market. In its zeal to target the promoter or director who are categorized as wilful defaulterfocus on the advertiser or chiefs who are marked wilful defaulters, this advancement may bring about adverseoutcomes on different stakeholders who possibly be innocent.

Provision of Wilful Defaulter as A Spanner of Work In M&A Transaction

The Securities and Exchange Board of India (SEBI), The Indian securities regulator notified an amendment in takeover regulations i.e. in the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 which prohibits a entity or person who is declared as "Wilful Defaulter" from making a public announcement to acquire shares of an Indian listed company or enter into any transaction that would attract the obligation to make a public announcement to acquire the shares of listed company under the prohibition of the Takeover Regulations.[16]

Some of the observations of with reference to Merger &Acquisitions and SEBI's well-intended prohibitions are-

1) **Indirect Open Offers**: The prohibition inserted by the SEBI uses the language "any transaction that would attract the obligation to make a public announcement "17 which covers indirect open offers along with direct open offers as well. An open offer obligation is triggered due to change in control of a listed company by virtue of an underlying transaction.

16Securities and Exchange Board of India (Substantial acquisition Of Shares and Takeovers) Regulations, 2011, Reg. 6A.

17Securities and Exchange Board of India (Substantial acquisition Of Shares and Takeovers) Regulations, 2011, Reg. 4.

Precisely, the acquirer or person acting in concert cannot agree to enter or enter into any underlying transaction if the acquirer or person acting in concert with the acquirer has been declared as wilful defaulter either in the capacity of borrower or guarantor under the circular, then such acquirer or person in concert cannot make an open offer.

Hence, the prohibition does not extend its ambit to transaction directly involving listed company only. This prohibition would require to be given thought inter alia structuring the global transactions affecting a listed company as overseas transaction is a case of intriguing conundrum that triggers an indirect open offer in India in which the acquirer or persons acting in concert have been declared wilful defaulters.

2) **Creeping Acquisitions:** Since an open offer obligation triggers only when an acquisition is made for more than 5% stake in a financial year. Hence, a wilful defaulter who is already holding 25% stake in a listed company can undertake stake-building by acquiring up to 5% in any financial year. It can be concluded that prohibitions do not prohibit wilful defaulters from making creeping acquisitions. It renders the point questionable i.e. whether this intentional or unintentional leeway afforded by the SEBI resonates with the objective reflected at clause 17[18]of a discussion paper floated by the SEBI in January 2016.
3) **Competing Offers:** One of the provisos among prohibition allows wilful defaulters to make a competing open offer. The intent of SEBI can be determined from the clause 19.4 of its discussion paper published in January 2016. According to clause 19.4 “If a hostile bid is made on a listed company which is controlledby a person categorized as a wilful defaulter, restricting such willful defaulter from making a counteroffer may not be legally tenable.” Since, the above proviso allows /any/ wilful defaulter to make a competing offer, to align the literal construction of the proviso, the SEBI could consider breaking the proviso and state that “this regulation shall not prohibit a person in control of the target company who is a wilful defaulter from making a competing offer ”.

18Securities and Exchange Board of India, Discussion Paper on Proposed Amendments to Regulations framed under SEBI Act, 1992 for Imposing Restrictions on Wilful Defaulters, (Issued on January2016)

All in all, though insertion of prohibition by the SEBI is well intended but there is no explicit provision that spells out the implications in case of a wilful defaulter violates such prohibitions. Therefore, consequences under the general provisions of the SEBI Act, 1992 or Takeover Regulations will not only attack on wilful defaulter and the persons acting in concert, but also on the merchant banker who are appointed to manage the open offer.

Conclusion:

There have been numerous instances in the past which indicates that the country is steadily moving towards the reactive law making from the proactive law making. The classic example of reactive law-making is killing of optionally convertible debentures under the Companies Act, 2013. According to experts, its an aftermath of issue of the Sahara. Similarly, with reference to the context of wilful defaulters, reaction of the SEBI is understandably due to increasing news and reports on big time wilful defaulters. Succinctly, basis of law making cannot be contemporaneous waves of public sentiment. If judges start acting on the conscience of nation and lawmakers found to be playing the galleries then society will be at severe threat, this kind of behavior is similar to the reaction of mob that reacts with an outburst of temporal emotions. With reference to the wilful defaulters, most of the provisions are of implication on wilful defaulter rather than focusing on preventive measures for wilful default. But sadly, provisions made by lawmakers and activities of regulators gives clear indication that we are heading towards an era of reactive law making.

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