CHAPTER - VII

SECURITISATION AND RECONSTRUCTION OF ASSETS
AND ENFORCEMENT OF SECURITY INTEREST
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Background of Legislates:

The reforms in the Banking and Financial Sector assume high priority in the liberalizing economy, as the globalization requires adherence by the Banks and the Financial Institutions to standards and yardsticks universally applicable. The rapid growth in the volume of business of the banks on account of liberalization and the introduction of prudential norms of income recognition and asset classification have; however, led to strains in the operational efficiency of Banks and in the accumulation of uncomfortably high level of Non Performing Assts (NPAs); which has been a major cause for worry in the post liberalization era and it has become necessary to bring them down to the internationally acceptable levels for creating a vibrant and competitive financial system. The concept of “quality of assets” and ‘effective recovery measures’ have also gained momentum in the financial sector.

Though financial sector reforms have always been a major agenda for our political economy ever since independence, the far reaching and vibrant reforms in this sector keeping tune with the international standards began in the year 1991; with the recommendation of the Committee on Financial System (CFS), popularly known as the Narasimham Committee.

The Committee felt that there is an urgent need to work out a suitable mechanism through which dues to the credit institutions could be realized without delay. The Committee also recommended the establishment of an Asset Reconstruction Fund (ARF) which would take over from the Banks & Financial Institutions, a portion of the bad and doubtful assets at a discount\(^{31}\).

The Committee emphasized the need for long term strategies for the reduction in Non Performing Assets and considered that speeding up the process for recovery as one of the most important areas which calls for reforms. The observation of the Committee on this point is as under:

“Banks and Financial Institution at present face considerable difficulties in recovery of dues from the clients and enforcement of security charged

to them due to the delays in the legal processes. A significant portion of the funds of banks and financial institutions is thus blocked in unproductive assets, the values of which keep deteriorating with the passage of time. Banks also incur substantial amounts of expenditure by way of legal charges, which add to their overheads. The question of speeding up the process of recovery was examined in great detail by a Committee set up by the Government under the Chairmanship of the late Shri. Tiwari. The Tiwari Committee recommended, inter-alia, the setting up of Special Tribunals, which could expedite the recovery process. This Committee is in full agreement with the recommendations made by the Tiwari Committee and strongly recommends to the Government that special legislation on the line recommended by Tiwari Committee be introduced forthwith. The Committee is of the view that unless a proper judicial framework is established which could help banks and institutions in enforcing the claims against their clients speedily; the functioning of the financial system would continue to be beset with problems.\(^{32}\)

While stressing the need to take off at least a part of existing bad and doubtful debts of the banks and financial institutions from their balance sheets, the CTS further recommended as under:

"While the reform of accounting practices and the creation of Special Tribunals are essential, the Committee believes that an arrangement has to be worked out under which part at least of the bad and doubtful debts of the banks and financial institutions are taken off the balance sheet so that the banks could recycle the funds realized through this process into more productive assets. For this purpose, the Committee proposes the establishment, if necessary by special legislation, of an Assets Reconstruction Fund (ARF) which could take over from the banks and financial institutions a portion of the bad and doubtful debts at a discount, the level stipulated guidelines. The ARF should be provided with special powers for recovery somewhat broader than those contained in sections 29-32 of the State Financial Corporations Act, 1951. The capital of the ARF should be subscribed by the public sector banks and financial institutions.\(^{33}\)

The Government and the Reserve Bank of India accepted most of the recommendations of the CFS and implemented provisioning income recognition and other prudent norms for the banks and financial institutions. By passing the Recovery of Debts Due to Banks and

\(^{32}\) Narasimham Committee Report

\(^{33}\) Ibid
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Financial Institutions Act, 1993 and special Debt Recovery Tribunals were set up for speedy recovery.

As far as the recommendation to set up Asset Reconstruction Fund (ARF) for take over of bad and doubtful debts of banks and financial institutions, the same was not accepted and hence no ARF was set up. But at the same time Government recapitalized some of the weak banks and total recapitalization was to the tune of Rs.20, 000 crores.

In December 1997 Government decided that it was necessary to review the implementation of financial system reforms recommended by the Narasimham Committee (CFS) and to look ahead and chart the reforms necessary in the years ahead so that India's Banking System could become stronger and better equipped to compete effectively in a fast changing international economic environment. The Government therefore set up a high level committee under the Chairmanship of Shri. M Narasimham. This second committee on Banking Sector Reforms (Narasimham Committee-II) reviewed the implementation of the Narasimham Committee-I recommendation and in regard to Asset Reconstruction Fund made following observations:

"Banks and financial institutions should avoid the practice of 'evergreening' by making fresh advance to their trouble constituents only with a view to settling interest dues and avoiding classification of the loans in questions as NPAs. The Committee notes that the regulatory and supervisory authorities are paying particular attention to such breaches in the adherence to the spirit of the NPA definitions and are taking appropriate corrective action. At the same time, it is necessary to resist the suggestions made from time to time for a relaxation of the definitions of NPAs and the norms in this regard."

So far, a sum of Rs.20, 000 crores has been expended for recapitalization and to the extent to which recapitalization has enabled banks to write off losses, this is the cost which the Exchequer has had to bear for the bad debts of the banks. Recapitalization is a costly and, in the long run, not a sustainable option. Recapitalization involves budgetary commitments and could lead to large measure of monetization. The Committee urges that no further recapitalization of banks be undertaken from the Government budget.

The Committee believed that the objective should be to reduce the average level of net NPAs for all banks to below 5% by the year 2000 and 3% by 2002. For those banks with an international presence the minimum objective should be to reduce gross NPA to 5% and 3% by the

34 Narasimhan Committee-II Report Chapter-II para 3.22
year 2000 and 2002 respectively and net NPAs to 3% and 05 by these dates. These targets cannot be achieved in the absence of measures to tackle the problem of backlog of NPAs on a one time basis and the implementation of strict prudential norms and management efficiency to prevent the recurrence of this problem.

The Committee is of the firm view that in any effort at financial restructuring in the form of taking off the NPA portfolio from the books of the banks on measures to mitigate the impact of a high level of NPAs must go hand in hand with operational restructuring. Cleaning up the balance sheets of banks would thus make sense only if simultaneously steps were taken to prevent or limit the re-emergence of new NPAs, which could only come about through a strict application of prudential norms and managerial improvement.

For banks with a high NPA portfolio, the Committee suggests consideration of two alternative approaches to the problem as an alternative to the ARF proposal made by the earlier CFS. In the first approach, all loan assets in the doubtful and loss categories – should be identified and their realizable value determined. These assets could be transferred to an Asset Reconstruction Company (ARC) which would issue to the banks NPA Swap Bonds representing the realizable value of the assets transferred, provided the stamp duties are not excessive. The ARC could be set up by one bank or a set of banks or even in the private sector.

In regard to legal framework for recovery the Narasimhan Committee made further recommendations as under:

"Given the unsatisfactory state of the law of mortgage, the response has been to vest through special statute the power of sale in certain institutions like Land Development Banks and State Finance Corporation. This approach could be extended to other financial institutions and, if possible, to banks. The other approach is to set up special tribunals for recovery of dues to banks and financial institutions. These Tribunals need to have powers of attachment before judgment, for appointment of receivers and for ordering preservation of property. For this purpose, an amendment to the concerned legislation may be necessary. The Committee would like to emphasize the importance of having in place dedicated and effective machinery for debt recovery for banks and financial institutions. (Chapter VIII, paras 8.2-8.4).

Securitization of mortgages is also critically dependent on the ease of enforcement and the costs associated with transfer of mortgages. The power of sale without judicial intervention is not available to any class of...
mortgages except where the mortgagee is the Government or the mortgage agreement so provides and the mortgaged property is situated in Mumbai, Chennai and Calcutta and other towns so notified. Even if the power of the sale without judicial intervention were available there would need to be measures to put the buyer in possession. (Chapter VIII, paras 8.5-8.6).

The question of stamp duties and registration fees also requires review. There is a case for reducing stamp duties and registration fees substantially. (Chapter VIII, para 8.7)"

In addition to the above changes in the legal framework, the Committee also suggested amendments to other laws and in view of the wide ranging changes Narasimhan Committee-II recommended that an expert committee may be set up to look into suggested changes to the legal framework.

Accepting the above recommendations the Ministry of Finance set up an Expert Committee under the Chairmanship of Shri. T.R. Andhyarujina, former Solicitor General. The Expert Committee recommended enactment of new laws for following purposes:

i) Enforcement of securities for loans created over both movable and immovable properties by banks and financial institutions.

ii) Securitization of financial assets.

As a result, the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Ordinance, 2002 (2 of 2002) was promulgated by the President on 21st June, 2002. Since Parliament could not pass the Bill for converting the Ordinance into an Act, in the Monsoon Session, the Ordinance had to be re-promulgated by the President on 21st August, 2002 an Second Ordinance (3 of 2002). The Bill for conversion of Second Ordinance into an Act was passed by both the Houses of Parliament in the Winter Session of 2002 and the Bill as passed by the Parliament received President’s assent on 17th December, 2002.

**Enactment of SARFAESI Act 2002 :**

The Enactment of the Securitization, Reconstruction of the Financial Assets and Enforcement of Security Interest Act, 2002; popularly known as the SRAFAESI Act; is the crystallization a concept that has been in vogue in India for almost one decade. The concept of ‘Securitization’ was limited to Securitization of good loan assets. Now the new Act has provided a platform for Securities of debt as an activity, which was
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already in vogue. Thus, the Act is a dream comes true for the Banks and Financial Institutions as lenders.\(^{35}\)

The Securitization Act 2002 is available to banks and financial institutions who can utilize this Act for recovery of their dues.

The expression ‘Bank’ has been defined in section 2(c) of the Securitization Act 2002, which includes a banking company, a corresponding new bank, State Bank of India, subsidiary bank or such other bank as Central Government may, by notification, specify for the purpose of this Act. The expressions banking company, corresponding new bank, subsidiary new bank, and State Bank of India have also been defined in the Securitization Act 2002.

A Financial Institution means a public financial institutions within the meaning of section 4(a) of the Companies Act 1956, any institution specified by the Central Government under the Recovery of Debts Due to Banks and Financial Institutions Act 1993, the International Finance Corporation established under the International Finance Corporation Act, or any other institution or non-banking financial company as defined in section 45-I of Reserve Bank of India Act, 1934 which may be notified specifically as financial institution for the purpose of this Act.\(^{36}\)

\[ \text{Registration of Securitization or Reconstruction Companies} \]

The Act is a unique enactment as it has combined three heterogeneous concepts of ‘Securitization’, ‘Asset Reconstruction’ and ‘Enforcement of Security Interest’ into it. The only thing common in these three concepts, which are otherwise independent of one another, is that they are related to banking. Therefore it would be wise to discuss the salient features of the Act under the three heads separately.

\text{(A) Securitization:}

1. The provisions of securitization have been clubbed with provisions of enforcement of security interest and asset reconstruction. In fact, usually only a perfectly normal and performing asset, which has good credit rating, is securitized. Of course, non performing asset can also be securitized.

2. A securitization company can also act as asset Reconstruction Company, and \textit{vice versa}.

\(^{36}\) Reserve Bank of India Legal news & views, Vol-9, October-December 2004
3. The basic data is to form an independent ‘Securitization company’ (In securitization terminology, it is termed as “Special Purpose Vehicle” (SPV). However, this term is nowhere used in the Securitization Act). Such company will have to be registered with RBI. (Section 3(1)). Such company will be Public Financial Institution u/s 4(a) of Companies Act.

4. The ‘Securitization Company’ can acquire any ‘financial asset’ (which is in nature of debt or receivable from bank/FI. The ‘asset’ as such is not taken over.

5. In factoring also, receivable is acquired. However, the difference is that in factoring, only existing receivables (which are accrued but not due for payment) can be acquired, while in securitization, even future receivables can be acquired.

6. Purpose of securitization is to avoid mismatch between assets and liabilities of banks/FI. The lending company really ‘sells’ its loans to the investors through SPV.

7. The securitization company can acquire ‘financial asset’ from banks and financial institutions, by issuing debentures, bonds or by entering into any arrangement with Bank/FI. [Section 5(1)]. Once the securitization company takes over ‘financial asset’, that company will be treated as lender and ‘secured creditor’ for all the purposes. [Section 5(3)].

8. The securitization company will devise a separate scheme for each of the financial asset taken over. QIB (Qualified Institutional Buyers) will invest in such ‘scheme’. The ‘Securitization Company’ or ‘Reconstruction Company’ will issue ‘security receipt’ to QIB. The security receipt will represent undivided interest in such financial assets. [Section 2(1) (zg)]. The securitization company will realize the financial asset and redeem the investment and payment of returns to QIB under each scheme. (Section 7).

9. Any dispute between Bank/FI, securitization or Reconstruction Company and QIB shall be compulsorily referred to conciliation or arbitration under Arbitration and Conciliation Act, 1996. [Section 11].
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(B) Asset Reconstruction:

1. The provisions of ‘asset reconstruction’ combine the features of securitization and enforcement of security interest. Like securitization, in ‘Asset Reconstruction’ also, ‘financial asset’ (debt or receivable) is acquired from bank/FI, and not the asset as such. However, in asset reconstruction, the right or interest of any bank/FI is acquired for the purpose of realization of such financial assistance. Thus, non performing asset can alone be acquired for asset reconstruction.

2. The basic idea is to form a ‘Reconstruction Company’. The Asset Reconstruction Company will have to be registered with RBI [section 3(1)]. Such company will be a Public Financial Institution u/s 4A of Companies Act.

3. A securitization company can also act as asset Reconstruction Company, and vice versa.

4. The ‘Reconstruction Company’ can acquire financial asset of Bank/FI for purpose of realization of the financial assistance.

5. Idea seems to be to hand over non performing assets in the banking sector to asset Reconstruction Company, so that Bank/FI can concentrate on their core business of lending.

6. The asset reconstruction company can acquire NPAs from banks and financial institutions, by issuing debentures, bonds or by entering into any arrangement with Bank/FI, [section 5(1)]. Once the asset reconstruction company takes over assets, that company will be treated as lender and ‘secured creditor’ for all the purposes [section 5(3)]. Since purpose is for realization of the financial assistance, only those assets which are classified by the secured creditor as ‘Non Performing Assets’ can be taken over.

7. The asset reconstruction company will devise a separate scheme for each of the financial asset taken over. QIB (Qualified Institutional Buyers) will invest in such ‘scheme’. The ‘Reconstruction Company’ will issue ‘security receipts’ to QIB. The security receipt will represent undivided interest in such financial assets [section 2(1) (zg)]. The reconstruction company will realize the financial assets and redeem the investment and payment of returns to QIB under each scheme [section 7].

8. Any dispute between Bank/FI, securitization or reconstruction company and QIB shall be compulsorily referred to conciliation or
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(C) Enforcement of Security Interest:

1. One very important aspect of the Act is that a secured creditor (Bank/FI) can enforce the security directly, without intervention of Court or Tribunal, after giving 60 days notice [section 13(1)]. If borrower does not pay the principal and interest as specified in the notice within 60 days, the secured creditor can take possession of assets, take over management of assets, appoint any person to manage the assets etc. [section 13(4)].

2. This power can be exercised only if the asset is 'Non Performing Asset' as per guidelines prescribed by RBI. Broadly, NPA means that the interest or installment is overdue for a period exceeding 180 days.

3. Presently, these powers are only to Public Financial Institutions and banking companies. However, Central Government can extend these powers to other banks like cooperative banks, NBFC or any other Institution.

4. The secured creditor can sell the assets. If dues are not fully recovered, he can file application with Debt Recovery Tribunal for balance amount. He can also proceed against guarantors or sale the pledged assets directly [section 13(11)].

5. Instead of Bank/FI itself taking possession and selling the asset, the Bank/FI can hand over the asset to securitization or Reconstruction Company. That securitization or reconstruction company will then enter the shoes of Bank/FI and can act as if it is a 'secured creditor'. However, handing over asset to securitization or Reconstruction Company is at the option of Bank/FI.

6. Application can be filed by borrower with Debt Recovery Tribunal (DRT) only after the asset or management is taken over and not at the stage of receiving notice from secured creditor [section 17(2)]. Jurisdiction of Civil Court has been completely barred [section 34]. [Of course, writ petition can be filed with High Court at any time].

7. Appeal from order of DRT lies with Debt Recovery Appellate Tribunal. (DRAT) [Section 18(1)].
8. If borrower succeeds in appeal (at DRT or DRAT), he is entitled to get back possession of asset plus compensation and costs as may be fixed by DRT or Appellate Tribunal [section 19]. Thus, he is entitled to only ‘compensation’ and not ‘damages’.

9. Protection of SICA will not be available once secured creditor takes steps for realization of assets. If any reference is pending with BIFR, it will abate. [Amendment to section 15(1) of SICA made by the Act]. [Drafting of the provision is not correct, as there can be dispute about interpretation of reference is pending with BIFR].

In nutshell the Act achieve the following two objectives:

1. It provides ‘private remedy’ to a mortgagee by allowing him to foreclose the mortgage and invoke the securities without reference to the court and in this regard it is a substantial improvement on the laws; prior to this Act.

2. It makes it possible to for an Asset Reconstruction Company (ARC) to acquire or purchase the loan assets of the Banks and Financial Institutions together with underlying securities and allows such ARCs to enter into the shoes of the Banks and Financial Institutions with respect to their rights as secured creditors.

Apart from these, another significant features are that the Act, for the first time, defines ‘hypothesation’ 37 and also it extends the meaning of the term ‘property’ 38 by defining it in a manner as seen by a banker.

**Acquisition Of Rights or Interest in Financial Assets:**

Great powers have been given to the banks and financial institutions in recovering their dues from the defaulters. However before we discuss the powers available to the banks and financial institutions, it is necessary that we appreciate the ingredients that are necessary to bring a debt within the four corners of the Securitization Act 2002.

In order to avail the powers enshrined in the Securitization Act 2002, the following conditions must be fulfilled:

(i) existence of security interest;
(ii) in favor of secured creditors;

37 Sec: 2(a)
38 Sec: 2(f)
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(iii) borrower must be under a liability to the secured creditor;
(iv) default in repayment of security debt or installment thereof;
(v) debt must be classified as a non-performing asset;
(vi) issuance of notice by the secured creditor to the borrowers.

We shall here in below deal with each of the abovementioned necessary
ingredients to attract the provisions of the Securitization Act 2002.

➤ Existence of Security Interest

The first and foremost ingredient to attract the Securitization Act 2002 is
the existence of security interest in favor of the secured creditor.

The expression ‘security interest’ has been defined in section 2(zf) of the
Securitization Act 2002 as right, title and interest of any kind upon
property. The right, title and interest has to be created in favor of the
secured creditor and includes within its ambit, mortgage, charge,
hypothecation and assignment.

The expression, ‘mortgage’, ‘charge’ and ‘hypothecation’ have been
explained in detail in Chapter III of this thesis. Briefly stating, mortgage
and charge are governed by sections 58 and 100 of the Transfer of
Property Act, 1882 respectively. Mortgage and charge can be created
over an immovable property.

The expression ‘hypothecation’ is defined section 2(n) of the
Securitization Act 2002 as a charge in or upon movable property created
by borrower in favor of secured creditor, without delivery of possession of
the movable property.

The expression ‘assignment’ means and includes a situation wherein a
person who has a right over the property, assigns or transfer to another
person the authority to use the right over the property. The property
may include within its ambit movable and immovable property.

➤ Exception to Securitization Act 2002

The securities as mentioned hereinabove admit certain exceptions, which
shall not attract the provisions of the Securitization Act 2002. The
exceptions are provided in section 31 of the Securitization Act 2002, and
include the following:
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(a) a lien on any goods, money or security given by or under the
Indian Contract Act, 1872 or the Sale of Goods Act, 1930 or an
other law for the time being in force;
(b) a pledge of movables within the meaning of section 172 of the
Indian Contract Act, 1872;
(c) creation of any security in any aircraft as defined in clause (1) of
section 2 of the Aircraft Act, 1934;
(d) creation of security interest in any vessel as defined in clause (55)
of section 3 of the Merchant Shipping Act, 1958;
(e) any conditional sale, hire-purchase or lease or any other contract in
which no security interest has been created;
(f) any rights of unpaid seller under section 47 of the Sale of Goods
Act, 1930;
(g) any properties not liable to attachment or sale under the first
proviso to sub-section (1) of section 60 of the Civil Procedure
Court;
(h) any security interest for securing repayment of any financial asset
not exceeding one lacs rupees;
(i) any security interest created in agricultural land;
(j) any case in which the amount due is less than 20 per cent of the
principal amount and interest thereon.

Thus, it means that banks and financial institutions cannot exercise the
powers conferred upon them under section 13(4) of the Securitization
Act, 2002, in respect of any assets, which are either owned by the
borrower or in the custody and possession of the borrower, where there
is a prior interest of an independent party by way of a lien, pledge,
conditional sale, hire-purchase, lease or as unpaid seller.

Further, where the security interest is in an aircraft or shipping vessel,
agricultural land or property exempted from attachment under section
60, Civil Procedure Court, the Act shall not have any force. Besides, the
Securitization Act 2002 shall not have any application where the value of
security interest is less than Rs. one lacs or where 80 per cent of
consolidated amount of principal and interest has been paid.

➢ In Favour of Secured Creditor

The second requirement to attract the provisions of the Securitization Act
2002 is that the security interest mentioned hereinabove be created in
favour of the secured creditor.

This Act shall not have application where security interest is not created
in favour of banks and financial institutions.
The expression ‘secured creditor’ has also been defined in section 2(zd) of the Securitization Act 2002. Broadly speaking, this Act defines secured creditors as those banks and financial institutions, in whose favour security interest is created for due repayment by any borrower of any financial assistance.

The expression ‘banks and financial institutions’ also includes the following:

(a) debenture trustee appointed by any banks and financial institutions;
(b) securitization company or reconstruction company;
(c) any other trustee holding securities on behalf of a banks and financial institutions.

a. **Borrower must be Under a Liability to Secured Creditor**

Further requirement of law is that the borrower must be under a liability to the secured creditor under a security agreement. The expression ‘borrower’ means and includes any person:

(a) who has been granted financial assistance by any bank or financial institution;
(b) who has given any guarantee;
(c) who has created any mortgage or pledge on security for financial assistance; and
(d) includes any person who has become borrower of any securitization company or reconstruction company.\(^{10}\)

**Default in Payment of Debt**

Further requirement of the law to succeed in an action under this Act is that the borrower should have defaulted in payment of debt or any installment thereof.

If the borrower is paying debts in accordance with the payment schedule, the secured creditor cannot take benefits of this Act for early liquidation of its debt. Where, however, the debt is less than Rs one lacs or where more than 80 per cent of debt has been paid, default in payment of the same shall not attract the Securitization Act 2002.\(^{11}\)
Non Performing Assets

A debt, which has been defaulted in payment, must be classified as NPA. An account becomes NPA if it does not earn interest for a period of six months, or for a period specified by R.B.I. for classifying an account as N.P.A. from time to time.

This Act defines the expression 'non performing asset' in section 2(o) of the Act. In order to classify a debt as NPA, it must be classified by the banks and financial institutions as sub-standard, doubtful or loss in accordance with the guidelines lay down by the Reserve Bank of India. The concept and classification of NPAs have been discussed under Chapter IV of this thesis.

Notice of Demand

Lastly, before initiating any action under the Securitization Act 2002, it is necessary that a mandatory notice be sent to the defaulter.

Section 13(4) of the Act contemplates a notice before resorting to the remedies provided under section 13 of the Act. It is required that the notice should be issued by the secured creditor in writing, wherein the secured creditor may require the borrower to discharge in full his liability to the secured creditor under section 13(4) with 60 days from the date of notice. If the borrower fails to pay up within the stipulated time, the secured creditor shall be free to proceed against the borrower under the provisions contemplated under section 13(4) of the Securitization Act 2002.12

The notice of demand should state the amount payable by the borrower to the secured creditor and the details of the secured assets intended to be enforced by the secured creditor in the event of non payment of secured debt.

It is incumbent upon the borrowers not to transfer by way of sale, lease or otherwise any of the secured assets after the receipt of notice. The transfer may take place with prior written consent of the secured creditor.

The Supreme Court in Mardia Chemicals case has held that the borrower shall have a right to reply to the notice and the banks and financial institutions shall consider the reply of the borrower before taking an action under section 13(4) of the Act. The borrower should be informed about the decision of the banks and financial institutions.
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judgment has given a breather to the borrowers against an action under section 13(4) of the Act.

➤ Issue of Security by Raising Receipt or Funds

As stated above, banks and financial institutions have been given wide powers to collect their dues. The powers are so exhaustive that initially this Act was addressed by some segments of society and industry as a draconian law. It needs to be seen how successful the banks and financial institutions are in taking the benefit of this Act.

The powers of the secured creditor under this Act have been stated in the Act. The powers, inter-alia, include the following:
(a) take possession of the secured assets of the borrower;
(b) take over the management of the secured asset;
(c) transfer the secured asset by way of lease, assignment or sale;
(d) appoint any person to manage the secured asset; and
(e) require the payment of the debt from the persons who acquire the same from the borrower.

Each of the above stated powers has been dealt with independently herein below.

Methods for Enforcement of Security

The action under section 13(4) of the Act may be broadly classified into two categories, which include:

(a) With the intervention of the court;
(b) Without the intervention of the court.

With the Intervention of the Court

Section 14(1) of the Act states that the secured creditor may seek the assistance of the court for the purpose of taking possession or control of secured asset. The secured creditor shall request, in writing, to the Chief Metropolitan Magistrate or the District Magistrate, as the case may, to:

(1) take possession of such asset and documents relating thereto; and
(2) forward such asset and documents to the secured creditor.

The application to the Chief Metropolitan Magistrate or the District Magistrate should contain in the case of mortgage:
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(1) a copy of title deed,
(2) copy of memorandum of entry/memorandum of deposits of title deeds,
(3) copy of loan agreement / security agreement,
(4) a copy of notice of demand along with proof of dispatch thereof, and
(5) the statement of account subsequent to the expiry of the mandatory period prescribed under the Act.

If the Chief Metropolitan Magistrate or the District Magistrate if satisfied with the claim of the secured creditor, may without notice to the borrower take steps to take possession of such assets and documents from the borrower.

The said Chief Metropolitan Magistrate or the District Magistrate, on the receipt of the application may take the help of the force, as may in his opinion, be necessary to do to ensure smooth functioning of his duties.

Without the Intervention of the Court

As stated earlier, it not necessary that the secured creditor will have to take assistance of the courts in all cases. Wherever the secured creditor feels that he may take possession of the assets without the help of the court; he may not involve the court, in taking possession.¹²

**Manner and Effect of Management Take Over**

Section 15 of the Act contemplates manner and effect of taking over the management of the borrower by the secured creditor. When the secured creditor takes over the management of business of a borrower, it may appoint directors in the company, if the borrower is a company defined in the Company Act, 1956, to be directors of the borrower. If the borrower is not a company the secured creditor may appoint an administrator of the business of the borrower.

The appointment of directors or administrator may be notified by the secured creditor to the benefit of the general public by way of publishing a notice in two newspapers, one of which shall be in English and the other shall be in an Indian vernacular language of the place where the principal office of the borrower is situated. However it is not clear whether the notice shall be published in vernacular language itself. Taking the legislative intention, the overall scheme of the Act and the purpose it seeks to serve, it is advisable always to publish notice in vernacular newspaper in vernacular language itself. Now many of the
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secured creditors resort to the practice of publishing notice in English in vernacular newspapers. But it is submitted as opposed to the spirit of legislative intention.13

The effect of publication in the newspapers in the case of a company is that all persons holding office as directors of the company, in case of a company; and persons holding powers of superintendence, direction and control of the business of the borrower in any other case, shall be deemed to have vacated their offices.

Further, any contract of management between the borrower and director or any other person shall be deemed to be terminated. The directors or administrator alone shall have the power to manage the affairs of the business after the publication of the notice in the newspaper.

Where the management of the secured creditor is taken over in the case of a company, it shall not be lawful for the shareholders or any other person to nominate or appoint any director of such a company. The resolution passed at the meeting of the shareholders, if any, shall not be given effect to unless approved by the secured creditor. Further, the company shall not be wound up or a receiver appointed except with the consent of secured creditor.

The directors or administrator so appointed shall immediately take steps to take into their custody or under their control all the properties of the company, effects and actionable claims, which are of the business or appear to be of the business. The management of the business shall be handed back to the borrower by the secured creditor on realization of its debts in full.

Appoint any Person to Manage Secured Assets

The Act contemplates appointing a person as manager of the properties, the possession of which was taken over.

The appointed manager shall have the right to perform all the functions, which a secured creditor could have done, including transfer by way of a lease, assignment or sale for realizing the secured assets.

The transfer made by the manager shall vest in the transferee all rights in the property as if the owner of the secured asset himself made the transfer. The manager so appointed may also take-over the business of the borrower and may run the business after being appointed as the director or the administrator of the business.
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Transferee Required Paying the Debts

The law earlier suffered from the limitation of not being able to recover the more if the property, which was secured, was transferred to another person. Creating a third party interest in the property secured by the banks and financial institutions may not be a valid transfer in the eyes of law. However, the lender always felt the difficulty in recovering the money from the third party.¹⁴

The Securitization Act, 2002 has given the powers to the banks and financial institutions to recover the money from such transferees, which was due or may become due to the borrower by requiring them by way of a notice in writing to pay the amount to such secured creditor. This demand of money is subject to the maximum of such money as is sufficient to pay the secured debt.

Sub-section (5) of section 13 of the Securitization Act, 2002 provides that if a third party makes the payment due to the borrower to the secured creditor in obedience of the notice mentioned above, such payment shall discharge such third party to the extent of the payment made on behalf of the borrower.

➤ Costs, Charges and Expenses

All cost, charges and expenses which have been incurred by the secured creditor in taking any action under sub-section (4) of the section 13 shall be recovered from the borrower. The money received by the secured creditor subsequent to an action under sub-section (4) of section 13 shall, subjects to contract to the contrary, shall first be applied in payment of such cost, charges and expenses incurred in taking action under sub-section (4) of section 13 of the Act. Thereafter it shall be applied in discharge of debt dues of the secured creditor. The balance funds, if available, shall thereafter be payable to the person entitled thereto in accordance with his rights and liabilities.

If the costs, charges and expenses along with the debt of the secured creditor are tendered by the borrower to the secured creditor at any time before the date fixed for sale or transfer, such secured assets shall not be sold or transferred by the secured creditor and no further steps shall be taken by him for transfer or sale of the secured assets.¹⁵

➤ Joint Financing
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Sub-section (9) of section 13 of the Act states that in the event of joint
finance by more than one secured creditors in respect of a single secured
assets, no secured creditor shall alone be entitled to exercise the powers
contemplated in sub-section (4) of section 13 of the Act. The powers so
given shall be exercised by the secured creditor only in situations where
secured creditor representing at least three fourth in value of the amount
outstanding on a record date agree to exercise the rights.

The action taken by a secured creditor with the consent of other secured
creditors shall be binding on all the secured assets.

➢ Guarantors

The secured creditor is at liberty to proceed against the guarantor or sell
the pledged assets without first taking any measures specified in clause
(a) to (d) of sub-section 4 of section 13.

➢ Balance recovery

Where the amount recovered by the secured creditor from the sale
proceeds of secured assets is less than the amount due, the secured
creditor may approach the concerned DRT for the recovery of balance
amount from the borrower. Subject to the Pecuniary Jurisdiction.

➢ Limitation

The proceedings under sub-section 4 of section 13 can be invoked only if
the claim is within the period of limitation prescribed under the

➢ Appeal Provisions

Section 17 of the Securitization Act, 2002 as it was originally enacted
provided for an appeal against the action of the secured creditor under
section 13(4) of the Act.

The appeal had to be made to the DRT within 45 days from the date on
which such measures had been taken. Earlier, there was a provision,
which provided that an appeal against the measure of section 13(4) of the
Act shall be entertained only on the deposit of 75 per cent of amount
claimed in the notice. The Supreme Court in Mardia Chemicals has
declared this provision ultra virus of the Constitution, and the stipulation regarding deposit of 75 percent of amount was struck down. It was also observed that the terms `prefer an appeal' is a misnomer and now the position is that an application shall be filed to DRT v/s. 17 and if aggrieved by the order of DRT an appeal can be filed before the Debt Recovery Appealicate Tribunal (DRAT). The applicant or appellant filing such application or appeal is required to pay such court fees applicant in the case of Original Application or Appeal as the case may be.

Benefits of Securitization:

1. Lower Cost

Cost reduction is one of the most important motivations in securitization. Securitization seeks to break an originating company's portfolio into echelons of risks, trying to align them to different investor's risk appetite. This alchemy supposedly works-the weighted overall cost of a company that has securitized its assets seems to be lower than a company that depends on generic funding.

Securitization enables the originator to achieve a rating arbitrage-obtain a rating that a generic funding could not have. Such a rating is possible due to the structural enhancements in securitization. The direct impact of lower borrowing costs is on lower lending costs. Mortgage rates in many countries fell after securitization was introduced or became popular. Many banks also claim to be running on lesser lending costs due to securitization.

2. Alternative investor base

Without disturbing the existing lenders, securitization extends the pool of available funding sources to an entity by bringing in a new class of investors. For many entities, typical securitization investors such as insurance companies, asset mangers, pension funds and the like may not be available for access, other than for investment in a securitization program.

3. Perfect matching of assets and liabilities

Asset liability mismatch is a serious issue for financial intermediaries such as banks and finance companies. It refers to the maturity mismatch between assets and liabilities. Mismatch spells either higher risk or higher costs, and therefore, intermediaries try to strike a near perfect match between maturities of assets and liabilities.
4. Makes the issuer rating irrelevant

Being an asset based financing; securitization may make it possible even for a low rated borrower to seek cheap finance, purely on the strength of the asset quality. Hence, the issuer makes him irrelevant in a properly structured securitization exercise.

5. Multiplies asset creation ability

Securitization makes it possible for the issuer to create any amount of asset with given equity. The securities create assets and then parts with the same. In essence, therefore, the issuer acts as a manufacturer and inventories of assets. The extent of assets he can created is therefore solely dependent on his "conversion cycle", that is, the period that lapses between the date an underlying receivable is created and is marketed.

6. Allows higher funding

A traditional financier looks at the assets on the balance sheet and lends a fraction thereof. For example, a typical bank funding capital will look at the working capital gap and fund a certain percentage. Securitization investor look at the cash flows in further. Which are not necessarily on the balance sheet so the issue might end up getting a higher amount of funding through securitization than by conventional funding methods?

7. Off balance sheet financing

Financial intermediaries look at securitization essentially as an off balance sheet funding method. Off balance sheet feature could be looked at either from accounting standards viewpoint, or from regulatory viewpoint. The latter is relevant for computation of regulatory capital or capital adequacy requirements.

The tendency of financial institutions is to prefer off balance sheet funding over on-balance sheet funding is because the former allows higher returns on assets, and higher returns on equity, without affecting the debt equity ratio. As tools of managerial performance, these have a definite relevance.

Securitization allows a firm to create assets, make income thereon, and yet put the assets off the balance sheet the moment they are transferred through securitization device. Thus, the income from the asset is accelerated and the asset disappears from the balance, leading to an improvement in both income related ratios as also asset-related ratios.
8. Helps in capital adequacy requirements

One of the very strong motivations for securitization is that it allows the financial entity to sell off some of its on balance sheet assets and thus remove them from the balance sheet and hence reduce the amount of capital required for regulatory purposes. Alternatively, if the amount raised by selling on balance sheet assets is used for creating new assets, the entity is able to increase asset. Creation without a haircut for its capital.

9. Improves capital structure

By being able to market an asset outright securitization avoids the need to raise a liability and hence, it improves the capital structure. The improvement of capital structure as a result of lower debt equity ratio may not be mere accounting gimmick-if securitization results into either transfer of risks inherent in assets or capping of such risks, there is a real re-distribution of risk taking place, leaving the firm with a healthier balance sheet and reduced risk.

10. Better opportunity of trading on equity with no increased risk

The ability to create assets, as a result of off balance sheet treatment and regulatory freedom results into more profits and hence a stronger firm.

11. Extends credit pool

Securitization keeps the other traditional lines of credit undisturbed. Hence, it increases the total financial resources available to the firm. Securitization has been tried by many firms in addition to regular borrowings, not in place of.

12. Not regulated as a loan

Corporate laws in some countries have laws regulating borrowing abilities of financial companies, since financial companies are taken as Para banking companies. Securitization does not suffer borrowing related fetters, as it is not taken by regulation to be debt. For example, a regulation relating to borrowings from public will not be attracted, since a securitization is not a case of borrowing.

In India, for example securitization will escape regulation pertaining to rising of deposits by financial companies; as such regulation is a part of the law, not prudential regulation.
13. Reduces credit concentration

Securitization has also been used by many entities for reducing credit concentration. Concentration, either sector or geographical implies risk. Securitization by transferring on a non recourse basis exposure by an entity has the effect of transferring risk to the investor.

14. Avoids interest rate risk

One of the primary motives in securitization of mortgage receivables was to transfer interest rate risk to the investors. The lenders were subject to the risk since the mortgages carried a fixed rate of return while the loans taken by the lenders had a variable rate. When the mortgages were securitized, the lender made an instant spread on the basis of a fixed rate, and therefore, completely avoided the price risk.

15. Arbitraging by repackaging

Securitization has been used by number of banks and fiancé professionals for arbitraging purposes: that is bought up assets from the market at higher spreads, accumulate them, provide or organize enhancements and securities them. These transactions are sometimes called repackaging transactions-giving a net arbitrage profit to the repackage.

16. Arbitraging on liquidity and term structure

A significant aspect of securitization structures, particularly relating to long term receivables, is that the originator makes profits by arbitraging on the yield differences in term structure of interest rates. In CMO trenches, for example long term mortgages were de-composed into shorter-term securities each paying successively. In the process, the securities were able to lower down his cost, and the arbitrageur was able to make profits.

17. improves accounting profits

Securitization allows upfront recognition of profits. The profit is the difference between the average spread inherent in the financial asset and weighted average return provided to the investors. Accounting standards permit the up fronting of this profit if the securitization transaction satisfies certain requisites.
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Advantages to the Inventors:

All over the World, investors, particularly, institutional investors have shown active interest in investing in securitized products. Rating agencies have helped in promoting these interest levels since most securitized products have obtained good ratings. Securitization offers three features that investors will love to have in any investment option: good rating, rating resilience and good spreads.

1. Better security

Securitized instruments are devices of asset-backed finance. The investors have a direct claim over a portfolio of assets, often diversified and reasonably credit enhanced. Investors are not affected by any of the risks that beset the originator. Thus, securitization investments are far safer than investing directly in debt or equity of the originator.

2. Good ratings

Many-structured finance has obtained good ratings. With increasing institutionalization of investment function, investments are being managed by professional managers who would prefer a formally rated instrument to an unrated one. Rated investments are now preferred all the more because of a regulatory advantage conferred by a new capital adequacy framework proposed by the bank for international settlements.

3. Rating resilience

Rating resilience stands for the stability of a rating after issuance. For securitization issuance, both Moody’s and Standard and Poor’s recently published rating resilience studies, which indicate that securitization investments are considerably safer than investments in corporate debt.

4. Better matching with investment objectives

Securitized instruments have a great flexibility to match with the investment objectives of the investors. Similarly, investors can look at investing over a short term, medium term or long term. It is even possible for investors to go for a fixed rate investment, floating rate investment or inverse floating rate investment.

5. Good spreads

Securitized offerings have good yields with adequate security. Empirical data about securitization offerings reveal that an investor who
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maintained a good balance of emerging market and developed market offerings has been able to come out with good rates of return.

6. Few instances of default

History provides far lesser incidents of default and loss in securitization than in corporate debt. In Europe, for example there is no instance of default at all so far in almost a decade of securitization issuance.

Economic and Social Impact of the Act:

1. Facilitates creation of markets in financial claims

By creating tradable securities out of financial claims, securitization helps to create markets in claims, which would, in its absence, have remained bilateral deals. In the process, securitization makes financial markets more efficient, by reducing agency costs.

Since financial assets are tradable, it also reduces the liquidity risks in the financial system. Liquidity related problems have been responsible for a number of economic crises: recently Japanese crises and South East Asian crises. Securitization can help financial intermediaries better manage asset liability mismatches and therefore avert liquidity problems. Result, the need for risk capital that is needed, among other things, for supporting liquidity also comes down.

2. Disperses holding of financial assets

The basic intent of securitization is to spread financial assets amidst as many savers as possible. With this end in view, the security is designed in minimum size marketable lots as necessary. Hence, it results into dispersion of financial assets. Recent securitization applications, viz., mortgages, receivables, etc. are therefore yet to become acceptable to lay investors.

3. Promotes Savings

The availability of financial claims in a marketable form with proper assurance as to quality in form of credit ratings, and with double safety nets in form of trustees, etc., securitization makes it possible for the lay inventors to invest in direct financial claims at attractive rates. This has salubrious effect on savings.

4. Reduces costs
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Securitization tends to eliminate fund based intermediaries, and it leads to specialization in intermediation functions. This saves the end-user company from intermediation costs, since the specialized intermediary costs are service related and generally lower.

5. Diversified risks

Financial intermediation is a case of diffusion of risk because of accumulation by the intermediary of a portfolio of individual risks. Securitization further diffuses such diversified risk to a wide base of investors, with the result that the risk inherent in financial transactions gets very widely diffused.

6. Focuses on use of resources and not their ownership

Once an entity securitizes its financial claims, it ceases to be the owner of such resources and becomes merely a trustee or custodian for the several investors who thereafter acquire such claim. In this sense, securitisation carries Gandhi’s idea of capitalist being a trustee of resources and not the owner.

7. Smoothens impact of recession

In 1991, when the US economy was passing through recession, securitisation was booming. A December 1991 article in the Institutional Investor said “The asset backed securities market is roaring its way through the recession with record issuance and reliable performance that prove it has come of age.” In the year 2001-2002 the global economy passed through multifarious problems-large bankruptcies, terrorism, etc. However, securitisation markets have continued to grow through all this, and the growth has been wide spread across different sectors. Evidently, more money is being raised by credit card securitisation than in the past-which means consumer spending is being spending propped by capital markets. More auto loans have been securitised in 2002 than in the past. All this tends to ease out the impact of economic recession.

The constitutional validity of the SARFAESI Act was examined by the Hon. Supreme Court is Mardia Chemicals Ltd Vs Union of India. The main challenge to the Act was that the banks and financial institutions had been vested one sided and unguided arbitrary powers on the banks to recover the dues. Besides that the Act did not provided any appropriate and adequate mechanism to decided dispute relating to the correctness of he demand, its validity and actual amount due to the banks etc.
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Taking into consideration the submission made by the parties, the Supreme Court inter alia framed the following issues for adjudication.

(i) Whether it is open to challenge the statute on the ground that it was not necessary to enact it in the prevailing background particularly when another statute was already in operation?

(ii) Whether provisions as contained under Section 13 and 17 of the Act provide adequate and efficacious mechanism to consider and decide the objections/disputes raised by a borrower against the recovery, particularly in view of the bar to approach the civil court under Section 34 of the Act?

(iii) Whether the remedy available under Section 17 of the Act is illusory for the reason it is available only after the action is taken under Section 13(4) of the Act and the appeal would be entertainable only on deposit of 75% of the claim raised in the notice of demand?

(iv) Whether the terms or existing rights under the contract entered into by two private parties could be amended by the provisions of law providing certain powers in one-sided manner in favour of one of the parties to the contract?

(v) Whether provision for sale of the properties without intervention of the court under Section 13 of the Act is akin to the English mortgage and its effect on the scope of the bar of the jurisdiction of the civil court?

(vi) Whether the provisions under Sections 13 and 17(2) of the Act are unconstitutional on the basis of the parameters laid down in different decisions of this Court?

(vii) Whether the principle of lender's liability has been absolutely ignored while enacting the Act and its effect?

Considering the points put forward by the parties, the recommendations of Narasimhim Committee, and the changes in the global economy, Supreme Court upheld the constitutional validity of the Act, stating that in view of the changing global economy, it may difficult to stick to old and conventional method of financing and recovery of dues. Further it was held that the condition of pre deposit of 75% of the dues or filing appeal (Section 17 (2)) was bad rendering the remedy. At this juncture, it would be interesting to quote the following from the judgment.

"The effect of some of the provisions may be a bit harsh for some of the borrowers but on that ground the impugned provisions of the Act cannot be said to be unconstitutional in view of the fact that the object of the Act is to achieve speedier recovery of the dues declared as NPAs and better
availability of capital liquidity and resources to help in growth of economy of the country and welfare of the people in general which would sub serve the public interest.”

Drawbacks and Limitation:

This researcher came across the following limitations in the operational Scheme of the act. (i) Sec: 13 (4) (1) permits a secured creditor “to take possession of the secured assets” of the borrower including the right to dispose it off for realizing the secured assets.

The Act also permits a secured creditor “to take over the management of the secured assets” of the borrower including the right to dispose of the assets. The intention seems to be that section 13(4) (1) would get attracted if the unit is closed and section 13(4) (b) would get attracted if the unit is still in operation. However, a bare reading of the provisions does not necessarily reflect this view and at the stage of implementation, these two phrases may create confusion, especially, in cases where a unit when taken over u/s 13(4(a) was closed but is likely to fetch much higher price if brought into operation and then disposed of as a running unit.16

(ii) Section 9 uses the phrase “management of the business of the borrower” and section 15 deals with the situation where the management of the business of the borrower” is taken over by the secured creditor. As against this, section 13 (4) (b) refers to “take over of the management of the secured assets”. Since these phrases have nowhere been defined, it is not clear as to how ‘taking over the management of the secured assets’ is different from “taking over the management of the business of the borrower”. It is, therefore, desirable that intention of the legislature is clearly explained in using different terminologies in different sections, more so, in section 9, 13 and 15. This section tends to bring in a series of litigation involving the constitutional validity of the section itself.

(iii) Whether the intention of the legislatures in framing section-9 and 13 is that a securitisation/reconstruction company can take over the “management of the business of the Borrower” and “bring in change in the management, if considered necessary, but a secured creditor can only take over “the management of the assets”. Does it mean that a secured creditor can take over only closed units and see whether the unit could be operated upon and if unit is running then only an ARC can take over possession of such units? Or does it mean that taking over of the management of assets of the borrower necessarily imply the right to change the management? These issues need to be clarified by suitable guidelines/regulations to be issued by RBI.
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(IV) Section 13(4) empowers the secured creditors to take possession of the assets after giving the borrower sixty days notice. This is a sufficiently long time for unscrupulous borrowers, to rob the company of, all good assets. There is no mechanism provided in the Act to ensure that within the period of sixty days, the secured creditors remain assured that the assets would not be tampered with.

(v) In the event of a claim application or suit pending before any court or Tribunal; against a borrower whose assets have been acquired under section 13(4) of the Act, the claim application would remain pending and in the meantime the secured assets would be acquired and disposed of. Hence, there is need for a specific provision to say that “on an application to be filed by secured creditors, wherever necessary, the claim application or suit shall be kept in abeyance with liberty to continue the proceedings for balance dues after action under section 13(4) is complete.”

(vi) Section 17 of the Act permits any person (including borrower) aggrieved by any of the measures referred to in Section 13(4) taken by secured creditors, to prefer an appeal to the Debt Recovery Tribunal within 45 days from the date on which such measures have been taken. The scope of the section is too wide and it allows not only the borrower but also any other person, which may include the shareholders, workers, sundry creditors, etc. to file an appeal against the action of the secured creditor taken in terms of section 13(4) and create hurdles in invocation of the right of the secured creditor to invoke the security without reference to Court granted under the Act. It is therefore desirable that the right is restricted to the borrowers and the actual owners of the assets which have been taken over or purported to be taken under the Act.

(vii) Section 15 lays down the manner and effect of taking over of the management. Section 15(4) says, where the management of the business of the borrower had been taken over, the secured creditor shall, on realization of his debt, restore the management of the business of the borrower. This obviously means that taking over the management or bringing in any change in the management has to be temporary phenomena and after realization of the debt, the management has to be restored back to the original promoters. Thus, the Act seems to provide that Asset Securitisation/Reconstruction Company has the power of taking over of the management of the business of the borrower for the limited purpose of restructuring/ rehabilitating the company. Assuming it decides to dispose of all the assets of the Company, then in such a situation whether it has to pass on the shell company to the original promoters and if so, it is not clear as to what would be the modalities of
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such transfer? In this circumstance it is suggested that suitable rules may be framed or guidelines issued in this regard.

(viii) In terms of section 17 of the Act, any person aggrieved by any of the measures taken by the secured creditor, may approach DRT. Thus the present scope of the powers of the DRT has been enlarged. Consequently, Darts are to be bestowed with powers to hear such applications/appeal. However, the statute is silent on this count. There is need to carry out consequential amendment in the Recovery of Debts Due to Banks and Financial Institutions Act, 1993.

(ix) There is need for a forum to break the cartelization by the bidders and to function as a market maker for second hand plant/machines and other assets. This role can be played very effectively by ARCs. If ARC has to carry on this function, it would need permission from RBI in terms of Section 10(2) of the Act. IFCI alone has got 148 Rocs/sale orders issued by DRTs/Company courts for an amount of Rs.1407 cores. It would greatly help the cause of assets resolution and its monetization if RBI grants general permission in favour of ARCs to participate in bids as on independent business activity. Under the present norms, our ARC is not expected to carry on this activity.

**The Doctrine of Sovereign Debt and enforcement of security interest:**

The common law doctrines that crown debt has priority over other debts acknowledge the pre-eminence that the sovereign enjoys over all other persons. It has been contended before the courts that recovery of the amount due to Government from a citizen must take precedence and priority over dues from the said citizen to his other creditors. The question about applicability of crown prerogative in India was considered by Bombay High Court as early as in 1868. In Secretary of State and Council of India vs. the Bombay Lending & Shipping Company Ltd. (1868-69) 5 Bombay SCR Page-23, We strop J held that a judgment debt due to crown was in Bombay entitled to the same precedence in execution as in England. The learned Judge also observed that the common law doctrine was “no novelty in India” and he referred to the Rule enunciated by Yajnavalkya, who said “a debtor shall be forced to pay to the creditor in the order in which the debts were contracted after first discharging those of a priest and the king.” He also added that “Muhammadan sovereigns were not prone to waive or abandon such royal prerogative as they found in India.

In Builder Supply Corporation vs. Union of India represented by the Commissioner of Income Tax, West Bengal & others. (1965) 2 SCR 289/AIR 1965 Supreme Court 1061, the Humble Court was called upon to consider whether the decrinal dues of the appellant, at whose instance
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certain property of respondent No.2 had been attached, will have precedence over the tax dues of respondent no.1, the Govt. of India, due and payable by respondent no.2? The Income Tax Act provided for certificate procedure for recovery of income-tax dues as arrears of land revenue. Referring to the decision of the Bombay High Court in Bank of India vs. John Bowman & others.\textsuperscript{19} AIR 1955 Bombay 305, where it was held that “the priority given to the crown is not on the basis of its debt being a judgmental or debt arising out of a statute, but the principle is that if the debts are of equal degree, and the Crown and the subjects are equal, the Crown’s right will prevail over that of the subject. A debt owed to a decree holder was held to be “unsecured debt”. Referring to the various decisions of the High Courts on the issue, the Court observed that recovery of amount of tax due from a citizen must take precedence and priority over the “unsecured debts” from the said citizen to his other private creditors.

A reference is made to the decision of the Supreme Court in case of Bank of Bihar vs. State of Bihar & others.\textsuperscript{20} (Air 1971 SC 1210). The question to be examined by the Supreme Court was whether the rights of the Pawnee, who had parted with money in favour of the pawnor on the security of the goods, could defeated by the goods being lawfully sixed by the Government and whether the money could be made available to other creditors of the pawnor, without the claim of the Pawnee being fully satisfied. The Court observed that a Pawnee had a special property and a lien, which is not of ordinary nature and so long as his claim is not satisfied, no other creditor of the pawnor has nay right to take away the goods or its price. In this case, the District Magistrate, Patna, under the Public Demand Recovery Act, seized certain bags of sugars pursuant to lawful orders made by him and the sale proceeds of 5000 mds. Of sugars were deposited with the Treasury and were, subsequently, attached under the orders of certificate officers, Patna under the Public Demand Recovery Act on account of the arrears of “sugar cess” amount to Rs.2.00 lakhs. Deciding the case, the Hon’ble Supreme Court observed the right of Bank of Bihar “as a Pawnee could not be extinguished by the seizure of the goods in its possession, inasmuch as the pledge of the goods was not meant to replace the liability under the cess credit agreement. It was intended to give the plaintiff a primary right to sell the goods in satisfaction of the liability of the pawnor. The Cane Commission, who was an “unsecured creditor”, could not have any higher right than the pawnor and was entitled only to the surplus money after satisfaction of the claim of Bank of Bihar. “This case, thus, established that the crown debt will have priority only against the claim of “unsecured creditors” and not against the claim of the “secured creditors”. The judgment, as given in the case of Bank of Bihar vs. State of Bihar, has been referred and relied upon in various subsequent judgments. Thus in State vs. Andhra Bank and others.\textsuperscript{21}AIR 1988 AP
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18) when the tehsildar attached the stocks of sugar hypothecated to the plaintiff bank for recovery of a sum of Rs.5.2 lakhs due towards sugarcane ‘purchase tax’ to the State under the provision of “AP Sugarcane (Regulation of Supply & Purchase) Act”, it was held that the “hypothecate, viz., the Bank has a lien on the goods which are held by way of security and the bank as a ‘preferential claim as a secured creditor” even against the Government’s demand of taxes”.

Again, in the case of Indian Bank v. State of Andhra Pradesh and others,22 (1993 STC page 548), it was held that “while land revenue and public revenue are secured debts for recovery of which there lies a charge on the land and buildings upon it, other amount recoverable as arrears of land revenue, are not secured debts. Sales tax arrears of a defaulting dealer are not a secured debt. Therefore, the Sales Tax Department does not have a prior claim on the proceeds of the sale of property hypothecated to the Bank, a secured creditor, which are brought to sale in a suit instituted by the secured creditor.” Similarly in Satyam v. Krishna Murthy & others,23 (AIR 1969 AP 237), it was held that “Having regard to the strong line of authority, I hold that the sale in the instant case for recovery of arrears of Income-tax subsequent to the mortgage, did not have the effect of superseding the rights of the mortgagee nor giving him any priority over the rights of the mortgagee”. In SITANI TEXTILE & FABRICS (P) LTD. V. ASSTT. C. OF CUS & C.E., HYDERBAD,24 (1999-(106) – ELT – 0296 – AP) one M/s. Dakshin Fabrics Ltd., had taken a loan from AP Industrial Development Corporation, a financial institution. Since there was default in payment of loan, the unit of Dakshin Fabrics Ltd, was brought to sale under Section-29 of the State Financial Corporation Act, 1951 on 4/2/92. The Supdt of Central Excise had detained the plant and machinery of M/s. Dakshin Fabrics Ltd. On the ground that it had to pay a sum of Rs.8, 27,792.19 ps. In terms of adjudication order nos. 4/90 dated 9/3/90 and 79/90 dated 11/11/90. Aggrieved by the orders of adjudication and also the order of demand dated 21/2/94 and 13/6/94, a writ petition was filed. It was held that –

(a) “In the case of pledge, Pawnee has special property and lien which is not of an ordinary nature on the goods and so long as his claim is not satisfied, no other creditor of the pawnor has any right to take away goods or its price. The right of a Pawnee could not be extinguished by the subsequent attachment/seizure of the goods under any other law. It gives the Pawnee a primary right to sell the goods in satisfaction of the liability of the pawnor. An unsecured creditor could not have any higher right than the pawnor and was entitled only to the surplus money after satisfaction of the secured creditors’ due. The above principle applied to hypothecation as well as the mortgage. A mortgage is a transfer of an interest in
immoveable property. Hence, mortgagee has a preferential right over other unsecured creditors. On this basis, the Court held that "AP Industrial Development Corporation, being secured creditors, has a preferential claim even against demand of Central Excise duty of the Government".

Reference is also made to DENA BANK v. Bhikabhai Parachutes Parikh & Company. And others, Respondents – 2000 (SUP) – AIR – 3654 – SC. Having reviewed the available judicial pronouncement regarding priority of Government debts, the Court observed that (i) there is a consensus of judicial opinion that the arrears of tax dues to the State can claim priority over private debt; (ii) the Common Law Doctrine about priority of crown debt recognized by India courts, prior to 1950, constitutes law in force within the meaning of Article 372 (1) of the Constitution and continue to be in force. The basis justification is the necessity and wisdom of conceding to the State the right to claim priority in respect in respect of its tax dues. The doctrine may not apply to the debts due to the State if they are contracted in relation to the commercial activities, which may be undertaken by the State. However, the crown’s preferential right to recovery of debts over other creditors is confide to the claims of ordinary or unsecured creditors. The Common Law of England or the principal of equality and good conscience (as applicable in India) do not accord the crown a preferential right for recovery of its debts over a mortgage or a pledge of goods. It is only in cases where the crown’s rights and that of the subject meet at one and the same time, that the crown is, in general, preferred. The Court also referred to Rasbehary Ghose's observations “it seems that a Government debt in India is out entitled to precedence over a prior secured debt”25 And yet .referring to Section-151 of the Karnataka Land Revenue Act, 1964, the Supreme Court finally held that the State usually have a preferential right to recover its dues over the secured creditors. It is respectfully submitted that the land revenue has a first charge over the landed property and merely because the sales tax is recoverable “as arrears of land revenue” that does not provide the sales tax dues, the same priority as is enjoyed by “land revenue”. It needs to be appreciated that the provisions of Public Demand Recovery Act for recovery of land revenue lay down the procedure and they have nothing to do with the priority of the debt. This has been made clear in a number of decisions of the Hon’ble Supreme Court itself, including in the case of Builder Supply Corporation vs. Union Bank of India where the Court had held that the Public Debt Recovery Act is not directly concerned with the right to recover the arrears, or, with priority, of tax dues. Arrears of tax fall

25. Ghose; Rasbehary :-Law of Mortage VII Edn: P.186
recover the arrears, or, with priority, of tax dues. Arrears of tax fall within the scope of the proceedings contemplated by it.

In other words, the Public Debt Recovery Act deals only with the procedure for recovery of loan and is, in no way, concerned with the priority of crown debt. If a particular tax dues is recoverable “as arrears of land revenue”, it does not mean that such recovery will have precedence over the debt of a “secured creditor” whole confusion about “Doctrine of Crown Debt” can be avoided and Banks and Files can be saved from frequent litigations on this issue initiated by various departments of the central/State Governments like Income Tax, Excise, Customs, Sales-tax etc., by inserting suitable provision, to say that the priority of crown debt, as stipulated under different Statute, is with reference to “unsecured debts” and has not application as against “secured debts”.

Impact of Relief Undertaking Act on the enforcement of securities:

The Sick Industrial Companies Act, 1985 was promulgated, more or less, on the lines of United States, to encourage rehabilitations of viable units and early liquidation of units which required winding up. We have seen how the SICA provided a large field to defaulting borrowers to play the game of hide and seek with the lenders.

The Eradi Committee, therefore, recommended abolition of BIFR. It suggested that the possibility of rehabilitation, as also the need for liquidation of a company, should be decided by a single forum and suggested establishment of National Company Law Tribunals, before making these recommendations, the Committee had occasion to study the Company Laws of various jurisdictions and had observed that in a large number of countries, there is a single forum to consider rehabilitation and, if necessary, carry out liquidation. The “days of debtors playing hide and seek with the creditors” on account of the provisions of the SICA is, however, not over. This is because different State Legislatures have passed what is known as “Relief Undertaking Act”, which empowers the State Government to declare a unit as a “relief undertaking”, if the State Government is satisfied that it is “expedient so to do in public interest, with a view to enabling the continue running or restarting of an undertaking as a measure of preventing or providing relief against unemployment.”21 Once an undertaking is declared as a Relief Undertaking, the operation of all contracts, assignment of properties, agreements, settlements, awards, standing orders or other instruments in force, is suspended and all or any of the rights or privileges, obligations and liabilities accruing or arising there under also remains suspended or is enforceable with such modifications and in such manner as may be specified in the Notification. The Act further
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provides that no suit or legal proceedings shall be instituted or commenced or if pending, shall be proceeded with against the industrial undertaking during the period in which it remains a Relief Undertaking, notwithstanding any law, usage, customs, contract, instrument, decree, order, awards settlement or other provisions whatsoever. The State Government has power to declare any undertaking as a “Relief Undertaking” for a period of one year and the period can be extended to five years. It can thus be seen that the implications of the Relief Undertaking Act, as promulgated in the States of Maharashtra, Karnataka, Gujarat, Rajasthan, Madhya Pradesh, Andhra Pradesh and a couple of other States, is that it gives statutory protections on the lines of Section-22 of SICA and there have been many examples where, in spite of decree being available in their favour, the Banks and FIS have not been able to touch the secured assets. These Acts were promulgated when the “economy was in development mode” and the Sick Industrial Companies Act, 1985, had not come into existence. Now that SICA has been repealed, there is need also to persuade the State Governments to repeal the Relief Undertaking Acts in their respective State.

Impact of Mardia chemicals case:

The Legislative Impact – an Appraisal

The major impact of this piece of legislation over the economy is summed up by the researcher as under.

1. **Facilitates creation of markets in financial claims**

By creating tradable securities out of financial claims, securitization helps to create market in claims, which would, in its absence, have remained bilateral deals. In the process, securitization makes financial markets more efficient, by reducing agency costs.

Since financial assets are tradable, it also reduces the liquidity risks in the financial system. Liquidity related problems have been responsible for a number of economic crises: recently Japanese crisis and South East Asian crisis. Securitization can help financial intermediaries better manage asset liability mismatches and therefore avert liquidity problems. Result, the need for risk capital that is needed, among other things, for supporting liquidity also comes down.

2. **Disperses holding of financial assets**

The basic intent of securitization is to spread financial assets amidst as many savers as possible. With this end in view, the security is designed in minimum size marketable lots as necessary. Hence, it
results into dispersion of financial assets. Recent securitization application, viz., mortgage, receivable, etc. are therefore yet to become acceptable to lay investors.

3. **Promotes Savings**

The availability of financial claims in a marketable form with proper assurance as to quality in form of credit ratings, and with double safety nets in form of trustees, etc., securitization makes it possible for the lay investors to invest in direct financial claims at attractive rates. This has salubrious effect on Savings.

4. **Reduces costs**

Securitization tends to eliminate fund based intermediaries, and it leads to specialization in intermediation function. This saves the end-user company from intermediation costs, since the specialized intermediary costs are service related and generally lower.

5. **Diversified risks**

Financial intermediation is a case of diffusion of risk because of accumulation by the intermediary of portfolio of in risks. Securitization further diffuses such diversified risk to a wide base of investors, with the result that the risk inherent in financial transactions gets very widely diffused.

6. **Focuses on use of resources and not their ownership**

Once an entity securitizes its financial claims, it ceases to be the owner of such resources and becomes merely a trustee or custodian for the several investors who thereafter acquire such claim. In this sense, securitization carries Gandhi's idea of capitalist being a trustee of resources and not the owner.

7. **Smoothens impact of recession**

In 1991, when the US economy was passing through recession, securitization was booming. In the year 2001-2002 the global economy passed through multifarious problems-large bankruptcies, terrorism, etc. However, securitization markets have continued to grow through all this; and the growth has been wide spread across different sectors. Evidently, more money is being raised by credit card securitization than in the past-which means consumer spending is being spending propped by capital markets. More auto loans have
been securitized in 2002 than in the past. All this tends to ease out the impact of economic recession.

The illegalities in the Act:-

The constitutional Validity of the SARFAESI Act was examined by the Hon. Supreme Court is Mardia Chemicals Ltd Vs Union of India. The main challenge to the Act was that the banks and Financial Institutions had been vested one sided and unguided arbitrary powers on the bank to the recover the dues. Besides that that the Act did not provide any appropriate and adequate mechanism to decided dispute relating to the correctness of he demanded, its validity and actual amount due to the banks etc.

Taking into consideration the submission made by the parties, the Supreme Court inter alia framed the following issues for adjudication:

(ii) Whether it is open to challenge the statute on the ground that it was not necessary to enact it in the prevailing background particularly when another statute was already in operation?

(iii) Whether Provisions as contained under Section 10 and 17 of the Act provide adequate and efficacious mechanism to consider and decide the objections/disputes raised by a borrower against the recovery, particularly in view of the bar to approach the civil court Under Section 34 OF THE Act?

(iv) Whether we remedy available Under Section 17 of the Act is illusory for the reason it is available only after the action is taken Under Section 13(4) of the Act and the appeal would be entertainable only on deposit of 75% of the claim raised in the notice of demand?

(v) Whether the term or existing rights under the contract entered into by two private parties could be amended by the provisions of the law providing certain power in one-sided manner in favor of one of the parties to the contract?

(vi) Whether provision for sale on properties without intervention of the court under Section 13 of the Act is akin to the English mortgage and its effect on the Scope of the bar of the jurisdiction of the civil court?

(vii) Whether the provision under Section 13 and 17(2) of the Act are unconstitutional on the basis of the parameters laid down in different decisions of this Court?
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(viii) Whether the principle of lender's liability has been absolutely ignored while enacting the Act and its effect?

Considering the points put forward by the parties, the recommendation of Narasimhim Committee, and the changes in the global economy, Supreme Court upheld the Constitutional validity of the Act, stating that in view of the changing Global economy, it may difficult to stick to old and conventional method of Financing and recovery of dues. Further it was held that the condition of pre deposit of 75% of the dues or filing appeal Under (Section17 (2)) was bad rendering the remedy. At this juncture, it would be interesting to quote the following from the judgment.

"The effect of the some of the provisions may be a bit harsh for some of the borrowers but on that ground the impugned provisions of the Act cannot be said to be unconstitutional in view of the fact that the object of the Act is to achieve speedier recovery of the dues declared as NPAs and better availability of capital liquidity and resources to help in growth of economy of the country and welfare of the people in general which would sub serve the public interest".

Role of IBA & Enforcement of Security Interest

IBA is an association of Banks and, therefore, is expected to function as a watch-dog to protect the interests of Banks as lenders. So far as the interests of debtors are concerned, there are umpteen number of Forums, Association of Merchants and Chambers of Commerce to act as agency to persuade the government and legislatures to carry out suitable amendments in the existing laws, by organizing workshops and seminars and based on it, sending their recommendations to various governmental agencies. There is no such forum to take care and highlight the cause of Banks and Fls. At times, the decisions, affecting adversely to the interests of the Banks, have come and as a result, the whole financial system has faced difficulties. IBA can easily keep a track of these decisions and become intervener in appropriate cases to further the interests of its members.

In this regard, a reference is made to a decision of the Supreme Court in the case of Union Bank of India vs. Manu Narayana,27 where the Supreme Court held that since a portion of the decrrial amount was covered by the mortgage, the decree-holder Bank had to proceed against the mortgage property first and then against the guarantors. This decision of the Supreme Court had upset the well-accepted concept of the "liability of the surety" being joint and several, together with the
principal debtor. Since this decision of the Supreme Court, the Institutions labored had to overcome the situation created by this judgment and it was after a long wait of 5 years that the Hon'ble Supreme Court in the case State Bank of India vs. India Export.\textsuperscript{28} held that a composite decree comprising of money decree against the judgment debtors is passed jointly and severally against all the defendants, including the guarantors. Hence, decree holder can execute a decree first against the guarantors without proceeding against the mortgaged property. The Court further held that the observations of the Court (Supreme Court) in Manu Narayana case that “even if the two portion of the decree are severable and merely because a portion of the decial amount is covered by mortgage decree, the decree holder per force has to proceed against the mortgaged property first, are not based on any principle of law.” Thus, the hardship caused by the judgment of the Hon'ble Supreme Court in Manku Narayana case could be rectified only after five years.

Similarly, in Mukesh Chand vs. Regional Branch Manager, UP State Financial Corporation & others.\textsuperscript{29} the Supreme Court observed that Section-29 does not exclude the application of the principle of natural justice. Referring to Section-24 of the UP State Financial Corporation Act, they observed that the “Corporation must pay due regard to the interest of the industry, commerce and general public,” more so, because the Financial Corporations under the Act, were visualized not as a profit-seeking concerns, but “an extended arm of a welfare State” to harness business potential of the country to benefit the common man. It further held that a “helping attitude, on the part of the Corporation, to constantly monitor the working of the industrial concerns would further the object of the Act and the constitutional objective of economic justice to the needy” and on this basis, held that by disposing of the secured assets, the Corporation “acted indifferently and not in public interest”. After this judgment, the Financial Corporations felt themselves obliged to confine to the standard that met the test of justness, fairness, reasonableness and relevance and hesitated in taking action under Section-29 of the SFC Act. It was only after the Supreme Court in Haryana State Financial Corporation & another vs. Jagdamba Oil Mill & another.\textsuperscript{30} (2002) 3 SCC 496 that the balance which had tilted in favour of debtor and against the creditor got corrected. The Supreme Court in the above case made the following observations:

“The relationship between the Corporation and the Borrower is that of a creditor and a debtor. Corporation is not supposed to give loan and then write it off and, ultimately, go out of business..... Promoting industrialization does not serve public interest, if it is at the cost of public funds. Grant of loans as also the steps taken towards recovery are administrative action. The extent of judicial scrutiny/judicial review
in the case of administrative action cannot be larger than in the case of quasi-judicial action”.

Quite often, the Institutions are not able to defend themselves properly. As a result, the decisions affect the whole system. It is therefore, desirable that forums like Indian Banks; Associations, which are supposed to be working as self-regulatory organization (SROs), should become intervener and further the interest of their own members, so that the pleading in favour of Banks &FIS are properly presented before the Courts and the system is saved from adverse observations of the Courts having systemic implications. Such a step by IBA like Institutions would go a long a way to help the cause of Banks and of the whole financial system.

**Suggestions for Improvement:**

Effective “Enforcement of security interest” does not depend only on the rights and liabilities as dealt in the TP Act or the Contract Act or SRFA ESI Act. It get adversely affected by various other factors like the concept of Crown debt, Relief Undertaking, conflicts between the provisions of different statutes, etc.

There is need to be equitable, both to the creditors and debtors, but at the same time, path of recovery must be kept clear of obstructions and it is, in this content, that the RBI and its Legal Department can play a very useful role. The Legal Department of RBI is capable of understanding and appreciating the implications of any new statute or amendments or of case laws on the functioning of Banks and Files and can be made to work as a nodal agency for ensuring that road to healthy and efficient financial system is kept clear of all obstructions. On the lines of Chamber of Commerce, there is need for a forum for Banks and Files to act as a watchdog of their interest. In this connection, the IBA can play a very useful role. With the liberalization and globalization of the economy, the protective cover provided by the Municipal Laws and Rules and Regulations framed there under are falling apart. It has now, become incumbent on the part of each of the countries to make its law compatible with similar provisions existing world over. As part of this process, the Reserve Bank of India, as Central Bank of the country and the regulator of its financial system, needs to ensure that the statutes or modifications carried out and law as laid down by Courts, do not impeded generally the functioning of Banks and Financial Institutions and especially the enforcement of security interests. It goes without saying that health of the financial system depends on the money coming back to the system; hence the road to recovery needs to be kept clear of all impediments, all the time.