



THE CHANGING PARADIGM OF BANKRUPTCY CODE

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ABSTRACT:

The paper aims to address the need for Bankruptcy Code and how it works to address a serious issue of wilful defaulter a menace affecting Indian Banking System adversely. The paper also aims at making suggestions to tackle this chronic issue. The fact of the matter is RBI is issuing circulars to curb this menace but somehow fails to take the matter to its conclusive end. The reason is mainly because people with Political clout feature in this list, making it more difficult for banks to recover the dues. This is a descriptive paper aiming at make related information at one place.

INTRODUCTION:

Banks lent money to businesses and individuals at a charge called Interest. The whole purpose is to help the economic development of the economy. But more often than not, companies and individuals fail to repay back the loan taken, making it impossible for banks to function effectively. The fact of the matter is RBI is issuing circulars to curb this menace but somehow fails to take the matter to its conclusive end. The reason is mainly because people with Political clout feature in this list, making it more difficult for banks to recover the dues. The very belief that they (the borrowers) are above law adds fuel to the fire, affecting the very financial health of the banks. Today the situation in India has its jar full of defaults and many banks are in a bad shape.

Who is a Willful Defaulter?

A "wilful default" is deemed to have occurred if any of the following events is noted¹:-

- a) One who has defaulted in repayment obligations of the unit to the lender/s who has lent money and the critical issue here is the Borrower has the capacity to honour the said obligations.
- b) Anyone who has defaulted in repayment obligations to the lender and has not utilized the finance from the lender for the purposes for which finance was availed of but has diverted the funds for other purposes.
- c) One who has defaulted in repayment obligations by the unit to the lender and has siphoned off the funds, so that the funds have not been utilized for the specific purpose for which finance was availed of, nor are the funds available with the unit in the form of other assets.
- d) Indian banks are reeling under this menace. It is something that RBI is viewing very seriously but still struggles to resolve the issue. In fact the amount stuck under this category is growing every day. The fact of the matter is the list of willful defaulter has names that surprise one and all. The main cause for this menace is lack of political will. RBI is unable to



use its powers of bringing the defaulter on record and creating a mechanism whereby their assets are seized and further loans are refused.

To throw more light on the matter we clarify the matter further the categories this is divided includes²:

DIVERSION OF FUNDS:

Diversion of funds, include any one of the under noted occurrences:

- a. Utilization of short-term working capital funds**
- b. deploying borrowed funds for purposes / activities**
- c. Transferring funds:**
- d. Routing of funds:**
- e. Investment in other companies**
- f. Shortfall in deployment of funds:**

SIPHONING OF FUNDS:

Siphoning of funds is said to have occurred if any funds borrowed from banks / FIs are utilized for purposes un-related to the operations of the borrower and is to the detriment of the financial health of the entity or of the lender. The decision as to whether a particular instance amounts to siphoning of funds would be a judgment of the lenders based on objective facts and circumstances of the case.

The identification of the wilful default should be made keeping in view the track record of the borrowers and should not be decided on the basis of isolated transactions or incidents. The default should be e categorized as willful must be intentional, deliberate and calculated.

END-USE OF FUNDS:

In cases of project financing, the banks / FIs seek to ensure end use of funds by, *inter alia*, obtaining certification from the Chartered Accountants. The banks and FIs should not depend entirely on the certificates issued by the Chartered Accountants but strengthen their internal controls and the credit risk management system to enhance the quality of their loan portfolio.

Some of the illustrative measures that could be taken by the lenders for monitoring and ensuring end-use of funds:

- (a)** Meaningful scrutiny of quarterly progress reports / operating statements / balance sheets of the borrowers;
- (b)** Regular inspection of borrowers' assets charged to the lenders as security;
- (c)** Periodical scrutiny of borrowers' books of accounts and the no-lien accounts maintained with other banks;
- (d)** Periodical visits to the assisted units;
- (e)** System of periodical stock audit, in case of working capital finance;
- (f)** Periodical comprehensive management audit of the 'Credit' function of the lenders, so as to identify the systemic-weaknesses in the credit-administration.



Wilful Default is an offence under the RBI regulations. But the fact is all these people enjoy clout and never get penalized. For Example, Dr. Vijay Malaya. But the RBI act prescribes the following penal measures.

PENAL MEASURES:

The following penal measures have been suggested:

- The penal measures are applicable to any wilful defaulter with an outstanding balance of Rs. 25 lakh or more. This limit of Rs. 25 lakh may also be applied for the purpose of taking cognizance of the instances of 'siphoning' / 'diversion' of funds.
- List of wilful defaulters (non-suit filed accounts) and list of wilful defaulters (suit filed accounts) are forwarded to SEBI by RBI and Credit Information Bureau (India) Ltd. (CIBIL) respectively so as to prevent the access to the capital markets by the wilful defaulters.
- Banks and FIs are required to initiate penal measures against the identified wilful defaulters as under:-
- No additional facilities should be granted by any bank / FI to the listed wilful defaulters.
- The entrepreneurs / promoters of companies where banks / FIs have identified siphoning / diversion of funds, misrepresentation, falsification of accounts and fraudulent transactions should be debarred from institutional finance from the scheduled commercial banks, Development Financial Institutions, Government owned NBFCs, investment institutions etc. for floating new ventures for a period of 5 years from the date the name of the wilful defaulter is published in the list of wilful defaulters by the RBI.
- Initiation of legal process including criminal proceedings, wherever necessary, against the borrowers / guarantors and foreclosure of recovery of dues expeditiously.
- Banks and FIs should adopt a proactive approach for a change of management of the willfully defaulting borrower unit, etc.

Banks and FIs should put in place a transparent mechanism for the entire process so that the penal provisions are not misused and the scope of such discretionary powers is kept to the barest minimum. It should also be ensured that a solitary or isolated instance is not made the basis for imposing the penal action.

Guarantees furnished by group companies. In cases where a letter of comfort and / or the guarantees furnished by the companies within the Group on behalf of the wilfully defaulting units are not honoured when invoked by the banks / FIs, such Group companies should also be reckoned as wilful defaulters.

Role of Auditors In case it is noticed that there exists falsification of accounts on the part of the borrowers and the auditors were negligent or deficient in conducting the audit, they should lodge a formal complaint against the auditors of the borrowers with the Institute of Chartered Accountants of India (ICAI) to enable the ICAI to examine and fix accountability of the auditors.

Role of Internal Audit / Inspection

The aspect of diversion of funds by the borrowers should be adequately looked into while conducting internal audit / inspection of their offices / branches and periodical reviews on



cases of wilful defaults should be submitted to the Audit Committee of the bank. The audit committee should mention these in his annual report to the Bank.

Reporting to Credit Information Companies:

The Reserve Bank of India has, in exercise of the powers conferred by Section 5 of the Credit Information Companies (Regulations) Act, 2005 and the Rules and Regulations framed there under, granted Certificate of Registration to (i) Experian Credit Information Company of India Private Limited, (ii) Equifax Credit Information Services Private Limited, (iii) CRIF High Mark Credit Information Services Private Limited and (iv) Credit Information Bureau (India) Limited (CIBIL) to commence / carry on the business of credit information.

(b) Banks / FIs should submit the list of suit-filed accounts and non suit filed accounts of wilful defaulters of Rs.25 lakh and above on a monthly or more frequent basis to all the four Credit Information Companies. This would enable such information to be available to the banks / FIs on a near real time basis.

Mechanism for identification of Wilful Defaulters

The mechanism referred to in paragraph 2.5 above should generally include the following:

(a) The evidence of wilful default on the part of the borrowing company and its promoter/ Whole-time director at the relevant time should be examined by a Committee headed by an Executive Director or equivalent and consisting of two other senior officers of the rank of GM / DGM.

(b) If the Committee concludes that an event of wilful default has occurred, it shall issue a Show Cause Notice to the concerned borrower and the promoter / whole-time director and call for their submissions and after considering their submissions issue an order recording the fact of wilful default and the reasons for the same. An opportunity should be given to the borrower and the promoter / whole-time director for a personal hearing if the Committee feels such an opportunity is necessary.

(c) The Order of the Committee should be reviewed by another Committee headed by the Chairman / Chairman & Managing Director or the Managing Director & Chief Executive Officer / CEOs and consisting, in addition, to two independent directors / non-executive Directors of the bank and the Order shall become final only after it is confirmed by the said Review Committee. However, if the Identification Committee does not pass an Order declaring a borrower as a wilful defaulter, then the Review Committee need not be set up to review such decisions.

(d) As regard a non-promoter / non-whole time director, it should be kept in mind that Section 2(60) of the Companies Act, 2013 defines an officer who is in default to mean only the following categories of directors:

(i) whole-time director

(ii) where there is no key managerial personnel, such director or directors as specified by the Board in this behalf and who has or have given his or their consent in writing to the Board to such specification, or all the directors, if no director is so specified;

(iii) every director, in respect of a contravention of any of the provisions of Companies Act, who is aware of such contravention by virtue of the receipt by him of any proceedings of the



Board or participation in such proceedings and who has not objected to the same, or where such contravention had taken place with his consent or connivance.

Therefore, except in very rare cases, a non-whole time director should not be considered as a wilful defaulter unless it is conclusively established that:

I. he was aware of the fact of wilful default by the borrower by virtue of any proceedings recorded in the minutes of meeting of the Board or a Committee of the Board and has not recorded his objection to the same in the Minutes; or, II. the wilful default had taken place with his consent or connivance.

The above exception will however not apply to a promoter director even if not a whole time director.

(iv) As a one-time measure, Banks / FIs, while reporting details of wilful defaulters to the Credit Information Companies may thus remove the names of non-whole time directors (nominee directors / independent directors) in respect of whom they already do not have information about their complicity in the default / wilful default of the borrowing company.

However, the names of promoter directors, even if not whole time directors, on the board of the wilful defaulting companies cannot be removed from the existing list of wilful defaulters.

(e) A similar process as detailed in sub-paragraphs (a) to (c) above should be followed when identifying a non-promoter / non-whole time director as a wilful defaulter For monitoring the end use of funds, in case the lender desires a specific certification from the borrower's auditors regarding diversion /siphoning of funds by the borrower, the lender should award a separate mandate to the auditors for the purpose. Appropriate covenants may be incorporated in the loan agreements to enable award of such certification by auditors. Reporting to RBI / Credit Information Companies Banks/FIs are required to submit to Credit Information Bureau (India) Ltd. (CIBIL) the list of suit-filed accounts of willful defaulters of Rs.25 lakhs and above as at end-March, June, September and December every year and a quarterly list of willful defaulters where suits have not been filed to RBI.

Banks and FIs need not report cases where outstanding amount falls below Rs.25 lakhs and cases where banks have agreed for a compromise settlement and the borrower has fully paid the compromised amount. Banks and FIs take suitable steps to report the names of current directors as also the directors who were associated with the company at the time the account was classified as defaulter to put other banks and FIs on guard.

The names of independent and nominee directors are also be included with suitable distinguishing remarks as applicable. Grievances Redressal Mechanism Decisions to classify the borrower as willful defaulter should be entrusted to a Committee of higher functionaries headed by the Executive Director and consisting of two GMs/DGMs as decided by the Board of the concerned bank/FI with a view to have more objectivity in identifying cases of willful default.

The borrower should be suitably advised about the proposal to classify him as a willful defaulter along with reasons therefore. He should be provided reasonable time (say 15 days) for making representation against such decision to a Grievance Redressal Committee headed by the CMD and consisting of two other senior officials. 4 He should also be given a hearing in case he represents that he has been wrongly classified as willful defaulter and a final



declaration as 'willful defaulter' should be made after a view is taken by the Committee on the representation and the borrower should be suitably advised.

CONCLUSION:

It is in the interest of Indian Financial Institutions that this bill is passed. It will help them to recover bad loans & reduce their NPA's, which are growing at an alarming pace and causing a lot of pain to the economy.

REFERENCES:

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