

Topic: RBI Circular on Wilful Defaulter

Need for the concept of Wilful Default

- Since 1999, RBI has introduced the concept of wilful and non-wilful as classification of defaulters.
- The concept of wilful default was introduced due to increasing bad loans in Indian economy.
- Also, the motive was to catch hold of such borrowers who deliberately default the loans and differentiate them from such borrowers whose business had genuinely fallen and were not able to repay the loans.

What is the definition of Wilful Default?

- RBI has issued various circular for Wilful Default and the most recent one being **“DBR.No.CID.BC.22/20.16.003/2015-16” - Master Circular on ‘Wilful Defaulters’**” As per the circular, definition of wilful defaulter is as follows;

A ‘wilful default’ would be deemed to have occurred if any of the following events is noted:

- a. The **unit*** has defaulted in meeting its payment / repayment obligations to the lender even when it has the capacity to honour the said obligations.
- b. The **unit*** has defaulted in meeting its payment / repayment obligations to the lender and has not utilised the finance from the lender for the specific purposes for which finance was availed of but has diverted the funds for other purposes.
- c. The **unit*** has defaulted in meeting its payment / repayment obligations to the lender and has siphoned off the funds so that the funds have not been utilised 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. The **unit*** has defaulted in meeting its payment / repayment obligations to the lender and has also disposed of or removed the movable fixed assets or immovable property given for the purpose of securing a term loan without the knowledge of the bank / lender.

****Unit is defined as – “The term ‘unit’ includes individuals, juristic persons and all other forms of business enterprises, whether incorporated or not. In case of business enterprises***

(other than companies), banks / FIs may also report the names of those persons who are in charge and responsible for the management of the affairs of the business enterprise.”

***Lender is defined as** –*“The term ‘lender’ covers all banks / FIs to which any amount is due, provided it is arising on account of any banking transaction, including off balance sheet transactions such as derivatives, guarantees and letters of credit.”*

Analysis of the definition:

- The general meaning of the word 'default' is failure to repay loans availed by a borrower from a bank and/or financial institution(s).
- **A wilful defaulter is the one who has not repaid the loan amount despite its financial ability to repay it.**
- As per the definition above, wilful default needs to fulfil the conditions of **any one of the following:**

1. Unit has defaulted **AND** has the ability to pay.

OR

2. Unit has defaulted **AND** has not used the loan for its sanctioned purpose

OR

3. Unit has defaulted **AND** has siphoned off or diverted the loan amount so that it is not used for its sanctioned purpose

OR

4. Unit has defaulted **AND** has sold off or removed all fixed assets (land, property, jet planes etc.) that were used to back the loan without the bank’s knowledge.

**The meaning of diversion of fund and syphoning has already been covered by CA Drashti in her write up. Hence the same is not covered here.”*

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- It is to be noted that a wilful default occurs on the occurrence of either of the above contingencies and the common thread across the eventualities is default in repayment. **Therefore in case there is no default in repayment, there cannot be any wilful default.**

On what default can the unit be classified as Wilful Defaulter?

- It is important to understand that the default can be of a loan, overdraft account, cash credit account.
- The default can also be of an off balance sheet transaction like derivatives, guarantees and letter of credits.

Who can be a wilful defaulter?

- It is important to note that not only the companies who has defaulted the loans can be classified as wilful defaulter, however even the persons managing the affairs of such company may be classified as wilful defaulter.
- Further, not only companies, however even individuals, juristic persons and all other forms of business enterprises (partnership firms, proprietorship concerns, Limited Liability Partnerships, Association of Persons, Body of Individuals, Municipal Authorities and so on) whether incorporated or not can be classified as a wilful defaulter.

Intent to Default & Evidence

- As per the circular “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 / incidents. The default to be categorised as wilful must be intentional, deliberate and calculated”
- **Thus mere breach of law will not amount to wilful default; there must be an intention too.**
- **Firstly and importantly, a mere default is not enough.**
- **Secondly, only an intentional, deliberate act brings in the declaration. Lastly, other than the borrower company, its promoter/ whole-time**

director can be subjected to such a declaration, but for that, there should be evidence.”

- **Intent of a wilful defaulter will differ from case to case and there is no definition for the same. Hence we, the forensic auditors has to apply our judgement skills and experience in order to classify the borrower as a “wilful defaulter’**
- **It is also to be noted that, the onus to prove a borrower as a wilful defaulter lies with the lender.**
- Wilful default broadly covers the following:
 - a) Deliberate non-payment of the dues despite adequate cash flow and good net worth;
 - b) Siphoning off of funds to the detriment of the defaulting unit;
 - c) Assets financed either not been purchased or been sold and proceeds have been misutilized;
 - d) Misrepresentation / falsification of records;
 - e) Disposal / removal of securities without bank's knowledge;
 - f) Fraudulent transactions by the borrower.

Guarantees furnished by individuals, group companies & non-group companies:

- While dealing with wilful default of a single borrowing company in a Group, the banks / FIs should consider the track record of the individual company, with reference to its repayment performance to its lenders. **However, in cases where 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.**
- In connection with the guarantors, in terms of Section 128 of the Indian Contract Act, 1872, the liability of the surety is co-extensive with that of the principal debtor unless it is otherwise provided by the contract. Therefore, when a default

is made in making repayment by the principal debtor, the banker will be able to proceed against the guarantor / surety even without exhausting the remedies against the principal debtor.

- As such, where a banker has made a claim on the guarantor on account of the default made by the principal debtor, the liability of the guarantor is immediate. In case the said guarantor refuses to comply with the demand made by the creditor / banker, despite having sufficient means to make payment of the dues, such guarantor would also be treated as a wilful defaulter. This treatment of non-group corporate and individual guarantors was made applicable with effect from September 9, 2014 and not to cases where guarantees were taken prior to this date. Banks/FIs may ensure that this position is made known to all guarantors at the time of accepting guarantees.

Does End Use Certificate suffice the need?

- As per the circular, In cases of project financing, the banks / FIs seek to ensure end use of funds by, *inter alia*, obtaining certification from the Chartered Accountants for the purpose.
- In case of short-term corporate / clean loans, such an approach ought to be supplemented by 'due diligence' on the part of lenders themselves, and to the extent possible, such loans should be limited to only those borrowers whose integrity and reliability are above board.
- The banks and FIs, therefore, 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.
- It is important to note that in many a time such end use certificates from Chartered Accountant are made up and submitted to bank.
- In such scenario's, the forensic auditors/banks should not entirely depend on the end use certificates provided by the borrower.
- In such cases, it is important to go through the evidences and find a proper trail for the disbursements.
- If the borrower submits such false end use certificates, it further indicates the intent of the borrower which will indeed help in classifying the borrower as a wilful defaulter.

Consequences/Penal Measures of being declared as a wilful default

- As per the circular, the following measures should be initiated by the banks and FIs against the wilful defaulters:
 - a. No additional facilities should be granted by any bank / FI to the **listed wilful defaulters**.
 - b. In addition, such companies (including their entrepreneurs / promoters) 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, Financial Institutions, NBFCs, for floating new ventures for a period of 5 years from the date of removal of their name from the list of wilful defaulters as published/disseminated by RBI/CICs.***
 - c. The legal process, wherever warranted, against the borrowers / guarantors and foreclosure for recovery of dues should be initiated expeditiously. The lenders may initiate criminal proceedings against wilful defaulters, wherever necessary.
 - d. Wherever possible, the banks and FIs should adopt a proactive approach for a change of management of the wilfully defaulting borrower unit.**
 - e. A covenant in the loan agreements, with the companies to which the banks / FIs have given funded / non-funded credit facility, should be incorporated by the banks / FIs to the effect that the borrowing company should not induct on its board a person whose name appears in the list of Wilful Defaulters and that in case, such a person is found to be on its board, it would take expeditious and effective steps for removal of the person from its board.
 - f. Further, as per the notification issued by RBI for “Prudential Framework for Resolution of Stressed Assets” stated that “Borrowers who have committed frauds/ malfeasance/ **wilful default** will remain ineligible for restructuring. However, in cases where the existing promoters are replaced by new promoters, and the borrower company is totally delinked from such erstwhile promoters/management, lenders may take a view on restructuring such accounts based on their viability, without prejudice to the continuance of criminal action against the erstwhile promoters/management.
 - g. Further, as per press release issued by Ministry of Finance, *vide* Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) (Second Amendment) Regulations, 2016, wilful defaulters and companies with wilful defaulters as promoters/directors have been debarred from accessing capital markets to raise funds. In addition, the Insolvency and Bankruptcy Code (IBC) has debarred wilful defaulters from participating in the insolvency resolution process.

*An application was filed by “The Wire” under the Right to Information Act to release the list of wilful defaulters.

The RBI's response to an RTI application came four years after the Supreme Court had first directed the central bank to disclose a list of India's wilful defaulters.

In response to a Right to Information (RTI) application filed by a private digital media outlet, RBI released the list of 30 major wilful defaulters.

For many years, RBI had declined to give this information arguing that it would be against the economic interests of the country and that its regulatory powers over banks disallowed it from doing so.

The wilful defaulter data released by the RBI came from a large centralised banking system database called Central Repository of Information on Large Credits. It is a pool of data on the credit information of all borrowers who have an exposure of Rs. 5 crore and above.

The list includes Gitanjali Gems with a default amount of Rs. 5,044 crore, REI Agro (Rs. 4,197 crore), Winsome Diamonds (Rs. 3,386 crore), Ruchi Soya (Rs 3,225 crore), Rotomac Global (Rs 2,844 crore), Kingfisher Airlines (Rs 2,488 crore), Kudos Chemie (Rs 2,326 crore), Zoom Developers (Rs 2,024 crore), Deccan Chronicle (Rs 1,951 crore), ABG Shpyard (Rs 1,875 crore), Forever Precious Jewellery (Rs 1,718 crore), Surya Vinayak Industries (Rs 1,628 crore), S Kumars Nationwide (Rs 1,581 crore), Gili India (Rs 1,447 crore), Siddhi Vinayak Logistics (Rs 1,349 crore), VMC Systems (Rs 1,314 crore), Gupta Coal India (Rs 1,235 crore), Nakshatra Brands (Rs 1,148 crore), Indian Technomac (Rs 1,091 crore), Shree Ganesh Jewellery House (Rs 1,085 crore), Jain Infraprojects (Rs 1,076 crore), Surya Pharmaceutical (Rs 1,065 crore), Nakoda Limited (Rs 1,028 crore), KS Oils (Rs 1,026 crore), Coastal Projects (Rs 984 crore), Hanung Toys (Rs 949 crore), First Leasing (Rs 929 crore), Concast Steel (Rs 828 crore), Action Ispat (Rs 888 crore) and Diamond Power (Rs 869 crore).

Actions taken by SEBI on Wilful Defaulters

- **SEBI has conducted a meeting on restrictions to be imposed on wilful defaulter and following decisions were taken as per the Press Release of SEBI with PR No. 56/2016 dated 12th March 2016.**
 1. No issuer shall make a public issue of equity securities / debt securities / non-convertible redeemable preference shares, if the issuer company or its promoter or its director is in the list of the wilful defaulters.
 2. Any company or its promoter or its director categorized as wilful defaulter may not be allowed to take control over other listed entity. However, if a listed company or its promoter or its director is categorized as wilful defaulter, and there is a take-over offer in respect of the listed company, they may be allowed to make competing offer for the said listed company in accordance with SEBI (SAST) Regulations, 2011.
 3. The criteria for determining a 'fit and proper person' in SEBI Regulations will be amended to include that no fresh registration shall be granted to any entity if the entity or its promoters or its directors or key managerial personnel, as defined under SEBI (ICDR) Regulations, 2009, are included in the list of wilful defaulters.

Mechanism for identification of wilful default and who can be declared as wilful defaulter

- A borrower/unit can be declared as a wilful default only when the amount of default exceeds INR 25 lakhs.
- As per the circular, the mechanism 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 by the bank.
 - (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.

At present there is no specific law for legal action against wilful defaulters. Reserve Bank of India has framed rules defining wilful default, process to be followed by banks for declaring borrower as “wilful defaulter”. Banks initiate action against such accounts under laws like SARFAESI Act.

Principles of Natural Justice

- It is important to keep in mind that, before declaring a borrower as a wilful defaulter, the bank is obliged to provide an opportunity of being heard.
- Further, their responses and submissions should be duly considered before any further course of action.
- Thus, in practical, it is the duty of the forensic auditor, to provide an opportunity to the management of the defaulting borrower to provide a clarification on the observations captured in the forensic audit report.
- Such responses should be considered and in case the replies are genuine and properly backed with evidence, it is the duty of the forensic auditor to modify or change the conclusions/observations.

Whether criminal action can be initiated by Banks / FIs against wilful defaulter?

- RBI has advised Banks / FIs to seriously and promptly consider initiating criminal action against wilful defaulters or wrong certification by borrowers, wherever considered necessary, based on the facts and circumstances of each case under Sections 403 and 415 of the Indian Penal Code, 1860.
- It should also be ensured that the penal provisions are used effectively and determinedly but after careful consideration and due caution. Towards this end, banks / FIs are advised to put in place a transparent mechanism, with the approval of their Board, for initiating criminal proceedings based on the facts of the individual case.

Reporting of Wilful Defaulter by Bank

Credit Information Companies disseminate information on non-suit filed and suit filed accounts respectively of Wilful Defaulters, as reported to them by the banks / FIs and therefore, the responsibility for reporting correct information and also accuracy of facts and figures rests with the concerned banks and financial institutions. Banks / FIs may also ensure the facts about directors, wherever possible, by cross-checking with Registrar of Companies.

Recent Hearings

1. In case of *Ionic Metalliks v. Union of India*, the Gujarat High Court held that the Master Circular issued by RBI on Wilful Default is ultra virus to the Article 19 of the Constitution so far as made applicable to all directors of company. All directors cannot be held liable for the default in repayment of the loan which might be for reasons beyond the control of such directors. This provision in the circular shatters the concept of a company being a separate legal identity distinct from its directors. The circular paints all directors with the same brush. An element of arbitrariness is found in such policy decision. To this limited extent the court held that the Master Circular violates Article 19(1) (g) of the Constitution of India.
2. The Calcutta High Court observed that the banks identification committee on wilful defaulters was comprised of four members, which was one more than prescribed in regulation 3(i) of the master circular on wilful defaulters.

Points of Concerns:

- In case of default, the bank/lender ceases the mortgage assets of the borrower and tries to recover its debt.
- However, whether the default is intentional or unintentional, does not changes the enforcement of the assets mortgaged.
- However, it is to be noted that, once a borrower is termed as a wilful default, he has to face many consequences.

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- At the same time, the decision to declare a borrower as a wilful default entirely lies with the bank committee with a show cause notice to be served to the defaulter.
- It is to be noted that, there is no judiciary process to determine a borrower as a wilful defaulter. Thus, the borrowers are entirely left on the mercy of bankers.