

## Comparative Analysis of Wilful Default and Fraud: In terms of RBI Circulars and Judicial Pronouncement

Mr. V V S N Raju

**Founder and Managing Partner of Juris Prime Law Services**

The Regulating bodies come up with different mechanism to protect the Indian economy from financial abuses and alert the stakeholders in respect of defaulters and fraudsters. The mechanism involves various steps for identifying the defaulters and fraudsters and also defines what actions falls under those categories by issuing circulars from time to time. The circulars guide the stakeholders particularly the banks and financial institutions as to how the declaration of Wilful Defaulter and Fraud Accounts are to be made and the steps to be followed while doing such declaration.

However, the affected parties challenge these declarations of Wilful Defaulter and Fraud Accounts before the Hon'ble High court under the Writ jurisdiction and the Hon'ble Court ensures that, while making such declarations, the required steps were followed, no violation of fundamental rights were done and principal of natural justice were dully served. With this background let us examine the various circulars issued by the RBI in respect of Wilful Defaulters and Fraudsters and the Judicial pronouncements made in this regard.

RBI issued **Master Circular No. RBI/2014-15/73 dated 01.07.2015** [**"Circular on Wilful Defaulter"**] with respect to Wilful Defaulters, consolidating instructions on how all scheduled commercial banks and notified financial institutions are to deal with Wilful Defaulters. The purpose of the said master circular is to put in place a system to disseminate credit information pertaining to Wilful Defaulters for cautioning banks and financial institutions so as to ensure that further bank finance is not made available to them.

The RBI issued a **Master Directions on Frauds No. RBI/DBS/2016-17/28 dated July 01, 2016** (**"Circular on Fraud"**) which was further updated on 3.07.2017. The directions are provided with an intent to give a clear framework to Banks and Financial Institutions to take timely actions by disseminating the information to banks regarding such fraud.

It is easier to get confused between the terms such as Fraud and Wilful Defaulter. Thus, to understand the difference we must look at its definition, scope and guiding principle for this.

**WILFUL DEFAULT**

**FRAUD**

**Scope**

As per the Circular, a Wilful Default would occur if any of the following events occur:

**Capacity to pay:** The unit evaded its financial obligations despite having the capacity to honor the obligation.

**Diversion of funds:** The unit evaded its financial obligations & has diverted the funds for purposes other than what was sanctioned for.

**Siphoning of funds:** The unit evaded its financial obligations & has siphoned off the funds for any illegal purpose and the availability of the funds with the unit is uncertain.

**Security:** The unit evaded its financial obligations & has sold the security granted for procuring a loan devoid of the knowledge of the bank.

**Covers**

The whole-time directors, such director or directors as specified by the Board every director, in respect of a contravention of any of the provisions of Companies Act, who is aware of such contravention can be termed as Wilful Defaulter

**Procedure**

1. The evidence of Wilful Default on the part of the borrowing company should be examined by a Committee headed by an Executive Director and consisting of two other senior officers of the rank of GM/DGM.
2. If the findings of the committee are in positive, a Show Cause Notice is issued to the concerned borrower and call for submission in this regard.
3. The Order of the Committee shall be reviewed by another Committee headed by the Chairman / CEO and MD and consisting independent directors of the Bank and their findings shall be final.

**Penal Provisions**

1. Name shall be published in the list which is published by RBI and Credit Information Companies, which shall be in public domain
2. The accused shall not be eligible to avail any further funding by any bank/ financial institution.
3. The lenders shall have the right to initiate criminal proceedings against the accused Wilful Defaulters.
4. The Bank should adopt a proactive approach for a change of management of the wilfully defaulting borrower unit
5. A covenant in the loan agreements with the companies in which the banks/FIs have significant stake and ensure that the borrowing company does not induct on its board a person whose name appears in the list of Wilful Defaulters.

**Scope**

The Circular for Fraud in order to maintain the uniformity in reporting, relied on the provisions of Indian Penal Code and considered the following to be fraud:

1. Misappropriation and criminal breach of trust.
2. Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.
3. Unauthorised credit facilities extended for reward or for illegal gratification.
4. Cash shortages.
5. Cheating and forgery.
6. Fraudulent transactions involving foreign exchange
7. Any other type of fraud not coming under the specific heads as above

As regards to the cases where the cash shortages are due to negligence and fraudulent transactions involving foreign exchange having any irregularities or violation of law shall also be reported as Fraud, if the intention was to cheat/defraud.

Cash shortage more than 10,000/-, (including at ATMs) and cases of cash shortage more than 5,000/- if detected by management / auditor/ inspecting officer and not reported on the day of occurrence by the persons handling cash.

**Covers**

The penal provisions are also applicable to the promoters, directors, and other whole-time directors.

**Procedure**

1. As per the detailed guidelines for reporting fraud, the cases based on the amount of fraud shall be invariably be referred to the State Police or to the CBI. Further the fraud cases of value below ₹10,000/- involving bank officials, should be referred to the Regional Head of the bank.

2. Banks file complaints before law enforcement agencies, who conduct an investigation. The ultimate decision on fraud is rendered by a competent court of law.

**Penal provisions**

1. debarred from availing bank finance for a period of five years from the date of full payment of the defrauded amount.
2. No restructuring or grant of additional facilities may be made in the case of RFA or fraud accounts.
3. No compromise settlement involving a fraudulent borrower is allowed unless the conditions stipulate that the criminal complaint will be continued.
4. Third parties shall also be held accountable if they have played vital role in credit sanction/disbursement or facilitated the 29 perpetrations of frauds.

Further it is pertinent to note that both the guidelines intent to give fair chance to the borrowers to present their submission in case of allegations of Fraud or be Wilful Defaulter. The principle of ***Audi alteram partem*** i.e. a right of being heard is considered to be very important part of the entire mechanism of declaring a unit a Wilful Defaulter. It is in the landmark judgement of ***State Bank of India vs. M/S. Jah Developers Pvt. Ltd. & Ors. (2019) ibclaw.in 136 SC*** wherein the Hon'ble Supreme Court of India observed that the moment a person is declared as Willful Defaulter the impact on his fundamental right of carrying out a business is direct and immediate. There are no additional facilities granted by any banks and financial institutions to the person concerned for carrying out business, right of being a promoter or director is taken away and also the person cannot apply as Resolution Applicant as per section 29A of Insolvency and Bankruptcy Code 2016.

Considering the impact and its direct consequences on the affected party, the Hon'ble Supreme Court of India in the above discussed matter held that, there is no right to be represented by a lawyer in the in-house proceedings however, the first committee shall give its order to the borrower and the borrower can then represent against such order within a period of 15 days to the Review Committee. Such written representation can be a full representation on facts and law (if any). The Review Committee must then pass a reasoned order on such representation which must then be served on the borrower.

Thus, it has been clear that while declaring a person as Wilful Defaulter as per the RBI guidelines, the principle of ***Audi alteram partem*** is truly served.

Also it is observant that, there are no procedural steps explicitly mandating ***Audi alteram partem*** in the circular of Fraud but the same has been dealt in detail in the case of ***State Bank of India vs Rajesh Agarwal (2023) ibclaw.in 36 SC*** wherein the Hon'ble Supreme Court of India held that, the principles of natural justice demand that the borrowers must be served a notice, given an opportunity to explain the conclusions of the forensic audit report, and be allowed to represent by the banks/ JLF before their account is classified as fraud under the Master Directions on Frauds.

The Hon'ble Apex Court in the instant case also held that, since the Master Directions on Frauds do not expressly provide an opportunity of hearing to the borrowers before classifying their account as fraud, ***audi alteram partem*** has to be read into the provisions of the directions to save them from the vice of arbitrariness.

Thus, we observe that though there are reasonable differences between both the guidelines in terms of procedure and application but the guidelines have ensured of the principle of ***Audi alteram partem*** is given significant importance. But whether the principle of ***Audi alteram partem*** is truly served where the ultimate decision is in the hands of the lender is an issue where the Judiciary and the Legislature must delve in to truly serve the justice to the parties involved in such dispute.

**Disclaimer:** While every effort is made to avoid any mistake or omission, this document including case-summary/brief

about the decision/ add. info/headnote/ judgment/order/ act/ rule/ regulation/ circular/ notification is being circulated on the condition and understanding that the publisher would not be liable in any manner by reason of any mistake or omission or for any action taken or omitted to be taken or advice rendered or accepted on the basis of this document. The authenticity of this text must be verified from the original source.