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SUPREME COURT CLARIFIES THAT A BORROWER MUST BE GIVEN A HEARING BEFORE CLASSIFICATION OF ITS ACCOUNTS AS FRAUDULENT AND THE BANKS/ JLF SHOULD PASS A REASONED ORDER INDICATING WHY AN ACCOUNT HAS BEEN DECLARED AS FRAUDULENT

30 March 2023 On 27 March 2023, a two Judge bench of the Supreme Court of India (SC) in a group of matters titled *State Bank of India & Ors. v. Rajesh Agarwal & Ors inter alia* upheld the decision of the Telangana High Court (HC) in *Rajesh Agarwal v. Reserve Bank of India & Ors, 2020 SCC OnLine TS 2021*. The HC held that the principles of *audi alteram partem* must be read into the provisions of Clauses 8.9.4 and 8.9.5 of the Master Directions on Fraud dated 01 July 2016 (updated on 03 July 2017) (Master Directions) issued by the Reserve Bank of India in order to grant a borrower a right of hearing before its accounts are classified as fraudulent by banks and financial institutions.

BACKGROUND

The decision of the Telangana HC arose out of a Writ Petition filed by the Petitioner, the former managing director of a company by the name of B S Limited (Company) challenging the decision of a Joint Lenders Forum (JLF) and the Fraud Identification Committee (FRIC) constituted as per the Master Directions to classify the account of the Company as "fraudulent" in terms of Clauses 8.9.4 and 8.9.5 of the Master Directions.

The JLF and the FRIC had classified the account of the Company as fraudulent on 15 February 2019 and 31 July 2019 respectively. It was the Petitioner's case that the same was done without granting the Company a hearing. It was contended that the said classification attracted both civil and criminal consequences upon the Company as well as its Promoters/Directors such as declaring them as ineligible to avail financial loans and assistance from financial institutions and rendered them liable for criminal prosecution by law enforcement agencies. Hence, the position that there was no requirement of hearing a borrower prior to classifying its account as fraudulent under the Master Directions amounted to a denial of the principles of natural justice as well as a violation of the borrower's fundamental rights under Article 19(1)(g) of the Constitution of India. It was further contended by the Petitioner that the same was also a violation of Article 14 of the Constitution inasmuch as the lack of natural justice in the Master Directions provided the JLF and the FRIC to take a decision with unbridled powers without giving an opportunity of hearing to a borrower. The Petitioner relied upon *SBI v Jah Developers (P) Ltd (2019) 6 SCC 787* where the SC held that a prior hearing was required to be given to a borrower prior to classifying a borrower's account as a wilful defaulter under the relevant RBI Master Circular.

Acceding to the above contentions, the Telangana HC relied upon *SBI v. Jah Developers (supra)* and a catena of other judgments relating to the principles of natural justice and held that considering the drastic consequences faced by a borrower as well as its directors/promoters etc upon its accounts being classified as fraudulent, it was imperative that the principles of *audi alteram partem* be read into the Master Directions so as to ensure the passing of reasoned orders, which will ensure that the same are not arbitrary and do not violate the fundamental rights of a borrower. Accordingly, a borrower whose accounts are

classified as fraudulent under the Master Directions must be given an opportunity to be heard before its accounts are classified as fraudulent. On this basis, the decisions of the JLF and the FRIC were set aside by the Telangana HC as being arbitrary and in violation of the principles of natural justice.

DECISION OF THE SUPREME COURT

The State Bank of India, the lead bank forming part of the JLF consortium, filed an appeal before the SC from the judgment of the Telangana HC (Civil Appeal no. 7300 of 2022), which was dismissed by way of the present judgment. The crux of the reasoning adopted by the SC is that the action taken by the Banks have criminal ramifications as well as grave civil ramifications as the borrower or its directors cannot avail credit facilities which amounted to blacklisting. Further, since the said action is an administrative action, the principles of natural justice (specifically *audi alteram partem*) must be incorporated into the Master Directions. Thus, the Hon'ble Supreme Court held that the principles of natural justice be read into the Master Directions and further held that a reasoned order be passed by the banks/ JLF, after granting an opportunity to a borrower to present its case as to why its accounts should not be declared fraudulent.

The Court further held that reading the principles of natural justice as a part and parcel of the Master Directions will ensure that the same are staved off from the challenge of arbitrariness. Ensuring that a reasoned order is passed prior to such classification will provide a borrower with an opportunity to contest the classification and also place a check on the arbitrary exercise of power by banks and financial institutions under the terms of the Master Directions. The Court held that the principles set forth in *SBI v. Jah Developers* with respect to wilful defaulters are directly applicable to classification of an account as fraudulent under the Master Directions as the categorisation of fraud entails not only criminal consequences but grave civil ramifications as well. Hence, a borrower must be served a notice, given an opportunity to explain the conclusions of the forensic audit report, and be allowed to represent itself before its accounts are classified as fraud under the Master Directions.

Comments

This judgment will be of solace to companies undergoing debt restructuring as the process of classification of loan accounts as fraudulent will not take place in a mechanical manner and a borrower will have a right to be heard. Even if banks/financial institutions were to classify a company's accounts as fraudulent, the same will only be after the concerned borrower has an opportunity of presenting its case, and explaining any circumstances in its favour which will bring a modicum of fairness to the entire procedure. In the absence of this, there is tremendous potential for arbitrary blacklisting of companies or their directors from accessing institutional finance while also simultaneously facing criminal proceedings without even being given an opportunity of being heard, which entails significant reputational, legal and financial risks and consequences. The emphasis by the SC on a borrower's fundamental rights and reiteration of the incorporation of the principles of natural justice in the Master Directions is a welcome development in the jurisprudence surrounding this area of law.

- *Thriyambak J. Kannan (Partner), Aseem Chaturvedi (Partner), Milind Jain (Senior Associate) & Aditya Mukerjee (Associate)*

For any queries please contact: editors@khaitanco.com

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