

Course Name – B.A.LL.B 6th Sem
Subject – Competition Law
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Concept Covered - SARFAESI ACT, 2002

SARFAESI ACT, 2002

The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI Act), 2002 is an Indian law. It allows banks and other financial institution to auction residential or commercial properties to recover loans. The first **asset reconstruction company (ARC)** of India, ARCIL, was set up under this act.

Under this act secured creditors (banks or financial institutions) have many right for enforcement of security interest under **section 13 of SARFAESI Act, 2002**. If borrower of financial assistance makes any default in repayment of loan or any installment and his account is classified as Non- performing Asset by secured creditor, then secured creditor may require before expiry of period of limitation by written notice to the borrower for repayment of due in full within 60 days by clearly stating amount due and intention for enforcement. Where he does not discharge dues in full within 60 days, THEN WITHOUT INTERVENTION OF ANY COURT OR TRIBUNAL Secured creditor may take possession (including sale, lease, assignment) of secured asset, or take over management of business of borrower or appoint manager for secured asset or without taking any of these action may also proceed against guarantor or sell the pledged asset, if any.

Banks utilize this act as an effective tool for bad loans (NPA) recovery. It is possible where non- performing assets are backed by securities charged to the Bank by way of hypothecation or mortgage or assignment.

Upon loan default, banks can seize the securities **(except agricultural land)** without intervention of the court.

SARFAESI is effective only for secured loans where bank can enforce the underlying security e.g. hypothecation, pledge and mortgages. . In such

cases, court intervention is not necessary, unless the security is invalid or fraudulent. However, if the asset in question is an unsecured asset, the bank would have to move the court to file civil case against the defaulters.

Background of the act

The previous legislation enacted for recovery of the default loans was Recovery of Debts due to Banks and Financial institutions Act ,1993. This act was passed after the recommendations of the **Narsimhan Committee – I** were submitted to the government. This act had created the forums such as Debt Recovery Tribunals and Debt Recovery Appellate Tribunals for expeditious adjudication of disputes with regard to ever increasing non-recovered dues. However, there were several loopholes in the act and these loopholes were misused by the borrowers as well as the lawyers. This led to the government introspect the act and this another committee under Mr. Andhyarujina was appointed to examine banking sector reforms and consideration to changes in the legal system.

This committee recommended to enact a new legislation for the establishment of securitisation and reconstruction companies and to empower the banks and financial institutions to take possession of the Non performing assets.

Thus, via the Sarfaesi act, for the first time, the secured creditors were empowered to recover their dues without the intervention of the court.

However, as soon as the act was passed, its implementation was challenged in the court and this delayed its coming into force for 2 years. In the **Mardia Chemicals v. Union of India**, the Supreme Court upheld the validity of the SARFAESI act was upheld.

Rights of Borrowers

- The above observations make it clear that the SARFAESI act was able to provide the effective measures to the secured creditors to recover their long standing dues from the Non performing assets, yet the rights of the borrowers could not be ignored, and have been duly incorporated in the law.

- The borrowers can at any time before the sale is concluded, remit the dues and avoid losing the security.
- In case any unhealthy/illegal act is done by the Authorized Officer, he will be liable for penal consequences.
- The borrowers will be entitled to get compensation for such acts.
- For redressing the grievances, the borrowers can approach firstly the DRT and thereafter the DRAT in appeal. The limitation period is 45 days and 30 days respectively

Pre-conditions

The Act stipulates four conditions for enforcing the rights by a creditor.

- The debt is secured
- The debt has been classified as an NPA by the banks
- The outstanding dues are one lakh and above and more than 20% of the principal loan amount and interest there on.
- The security to be enforced is not an Agricultural land.

Methods of Recovery

According to this act, the registration and regulation of securitization companies or reconstruction companies is done by RBI. These companies are authorized to raise funds by issuing security receipts to **qualified institutional buyers (QIBs)**, empowering banks and FIs to take possession of securities given for financial assistance and sell or lease the same to take over management in the event of default.

How it works?

The SARFAESI Act, 2002 gives powers of "seize and desist" to banks. Banks can give a notice in writing to the defaulting borrower requiring it to discharge its liabilities within 60 days.

If the borrower fails to comply with the notice, the Bank may take recourse to one or more of the following measures:

- Take possession of the security for the loan
- Sale or lease or assign the right over the security
- Manage the same or appoint any person to manage the same

The SARFAESI Act also provides for the establishment of **Asset Reconstruction Companies (ARCs)** regulated by RBI to acquire assets from banks and financial institutions. The Act provides for sale of financial assets by banks and financial institutions to asset reconstruction companies (ARCs). RBI

has issued guidelines to banks on the process to be followed for sales of financial assets to ARCs.

Enforcement of Security Interest

- Notwithstanding anything contained in section 69 and 69 A of Transfer of Property act, 1882, any security interest created in favour of any secured creditor may be enforced even without the intervention of the court or the tribunal.
- A notice under section 13(2) of the SARFEASI ACT, 2002 has to be served upon the borrower as soon as his account turns to be NPA (Non- performing asset) known as Demand Notice.
- After serving a notice in writing under section 13(2), then the borrower shall discharge in full his liabilities to the secured creditor within 60 days from the date of notice in case he has made default in payment to the secured creditor.
- In case, the borrower does not dispense of wit his liability then the secured creditor has right to take necessary measures as mentioned in section 13(4).
- Where a demand notice has been served, and any objection is raised by the borrower, then the secured creditor should reply to the objection within 15 days else he cannot proceed further in reference to this notice.
- In case the borrower fails to discharge his liability within sixty days of serving of notice, then the secured creditor can move on with any of the following measures as laid down in section 13(4) of the Act-
 1. Take possession of the secured assets
 2. Take management of the business of the borrower.
 3. Appoint any person, to manage the secured assets, the possession of which has been taken over by the secured creditor.

- The Chief Metropolitan Magistrate or District Magistrate's assistance can be taken by the secured creditor in taking possession of secured debt. [Section 14].
- On takeover of management of the business of a borrower by a securitization company by a secured creditor under section 13(4) (b) the secured creditor shall publish a notice in any two leading newspapers, one to be in the vernacular [section 15].
- On being aggrieved by any of the measures of the secured creditor under section 13(4), the aggrieved party can move to the Debts Recovery Tribunal within 45 days from the date on which such measures had been taken

Procedure after Issue of Notice

Rule 4 of the Security Interest (Enforcement) Rules, 2002 states-

When the borrower fails to acknowledge the amount even after the serving of notice, then the bank or any other financial institution shall move to take any steps under section 13(4), for taking possession of the movable property, namely-

Where the secured asset is in possession of the borrower [movable property], the possession shall be taken in the presence of two witnesses after a Panchnama is drawn and signed by the witnesses as nearly as possible. After taking the possession, the Authorized Officer shall make or cause to be made an inventory of the property as nearly as possible, and a copy of such inventory shall be given to the borrower.

The authorized person shall keep the property whose possession has been taken either in his own custody or in the custody of any person authorized and who shall take care of the property as diligently as a man of ordinary prudence would under the similar circumstances.

In case the secured asset is-

1. Debt, then the authorized officer shall direct the borrower not to recover that Instead he shall ask the debtor to pay the debt to the secured creditor.
2. A share in a body corporate, then in such case the authorized officer shall direct the borrower to transfer the same to the secured creditor and shall also direct the body corporate from not transferring the share in favour of any other person.
3. Other movable property not in possession of the borrower, then the authorized officer shall direct such other person to transfer the property to secured creditor by serving demand notice

In **Transcore v. Union of India**(2007) 135 Company Case, the issues were-

- Whether the banks or financial institutions having elected to seek their remedy in terms of DRT Act, 1993 can still invoke the SARFEASI Act for realizing the secured assets without withdrawing or abandoning the OA filed before the DRT under the DRT Act.
- Whether recourse to take possession of the secured assets of the borrower in terms of section 13(4) of the SARFEASI Act comprehends the power to take actual possession of the immovable property.

The Supreme Court held that withdrawal of application pending before DRT is not a pre- condition for taking action under SARFEASI Act. It is for the bank or Financial Institution to exercise its discretion as to cases in which it may apply for leave and in cases where they may not apply for leave to withdraw.

The authorized officer is like a court receiver under Order XL Rule 1 CPC, 1908. He can take either symbolic possession and in appropriate cases, he can take actual possession also. There is no dichotomy between symbolic possession and physical possession.

Conclusion

Thus, SARFEASI Act was enacted with a view to recovering bad debts easily and to an extent, it has solved the purpose also. The recovery actions under SARFEASI Act need to be dealt with utmost carefulness and sincerity by the banks, and the rules and procedures are to be strictly followed else a small mistake in regard to the manner of issuance of notice, etc can be a strong defense for the other party.

This act makes provisions for two main methods of recovery of the NPAs as follows:

Securitisation: Securitisation is the process of issuing marketable securities backed by a pool of existing assets such as auto or home loans. After an asset is converted into a marketable security, it is sold. A securitization company or reconstruction company may raise funds from only the QIB (Qualified Institutional Buyers) by forming schemes for acquiring financial assets.

Asset Reconstruction: Enacting SARFAESI Act has given birth to the Asset Reconstruction Companies in India. It can be done by either proper management of the business of the borrower, or by taking over it or by selling a part or whole of the business or by rescheduling of payment of debts payable by the borrower enforcement of security interest in accordance with the provisions of this Act.

Further, the act provides Exemption from the registration of security receipt. This means that when the securitization company or reconstruction company issues receipts, the holder of the receipts is entitled to undivided interests in the financial assets and there is not need of registration unless and otherwise it is compulsory under the **Registration Act 1908**.

However, the registration of the security receipt is required in the following cases:

There is a transfer of receipt

The security receipt is creating, declaring, assigning, limiting, extinguishing any right title or interest in a immovable property.

Is Mortgaged House exempted?

The Sarfaesi act covers any asset, movable or immovable, given as security whether by way of mortgage, hypothecation or creation of a security interest. There are some exceptions in the act such as personal belongings. However, only that property given as security can be proceeded under the provisions of SARFAESI Act. If the property of the borrower is his own mortgaged residential house, it is also NOT exempted from the Sarfaesi act.

Powers of Debt Recovery Tribunal

The debt Recovery Tribunals have been empowered to entertain appeals against the misuse of powers given to banks. Any person aggrieved, by any order made by the Debts Recovery Tribunal may go to the Appellate Tribunal within thirty days from the date of receipt of the order of Debts Recovery Tribunal.

Role of Chief Metropolitan Magistrate or District Magistrate

The Chief Metropolitan Magistrate or District Magistrate has been mandated to assist secured creditor in taking possession of secured asset. These officers will make sure that once the creditor has given him in writing that all other formalities of the act have been done, the CMM or DM will take possession of such asset and documents relating thereto; and forward such assets and documents to the secured creditor. Now, here, you have to note that such an act of the CMM or DM cannot be called in question in any court or before any authority.

Role of High Court:

The act allows taking the matter to high courts only in some matters related to the implementation of the act in Jammu & Kashmir. However, High Courts have been entertaining writ petitions under article 226 (Power to issue writs) of the constitution of India.

Proposed amendments to the Sarfaesi Act

The government had approved bill to amend the act. The Enforcement of Security Interest and Recovery of Debts Laws (Amendment) Bill, 2011, amends two Acts — Sarfaesi Act 2002, and Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (DRT Act). Via these amendments:

Banks and asset reconstruction companies (ARCs) will be allowed to convert any part of the debt of the defaulting company into equity. Such a conversion would imply that lenders or ARCs would tend to become an equity holder rather

than being a creditor of the company.

The amendments also allows banks to bid for any immovable property they have put out for auction themselves, if they do not receive any bids during the auction. In such a scenario, banks will be able to adjust the debt with the amount paid for this property. This enables the bank to secure the asset in part fulfillment of the defaulted loan.

Banks can then sell this property to a new bidder at a later date to clear off the debt completely. However lenders will be able to carry this property on their books only for seven years, as per the Banking Regulation Act, 1949.

Aamendment to SARFAESI Act (in 2016)

It allows District Magistrate (DM) to take possession over collateral within 30 days for securing the creditors. It empowers District Magistrate (DM) to assist banks to take over the management of a company, in case the company is to integrate records of property registered under various registration systems with central registry meant for maintaining records of transactions related to secured assets.

What is an Asset Reconstruction Company?

An asset reconstruction company is a special type of financial institution that buys the debtors of the bank at a mutually agreed value and attempts to recover the debts or associated securities by itself. The asset reconstruction companies or ARCs are registered under the RBI and regulated under the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002 (SARFAESI Act, 2002). The ARCs take over a portion of the debts of the bank that qualify to be recognised as Non-Performing Assets.

Thus ARCs are engaged in the business of asset reconstruction or securitisation or both. All the rights that were held by the lender (the bank) in respect of the debt would be transferred to the ARC. The required funds to purchase such such debts can be raised from Qualified Buyers.

What is asset reconstruction?

It is the acquisition of any right or interest of any bank or financial institution in loans, advances granted, debentures, bonds, guarantees or any other credit facility extended by banks for the purpose of its realisation. Such

loans, advances, bonds, guarantees and other credit facilities are together known by a term – 'financial assistance'.

Sec 3. Registration of [asset reconstruction companies].—

(1) No [asset reconstruction company] shall commence or carry on the business of securitisation or asset reconstruction without—

(a) obtaining a certificate of registration granted under this section; and

[(b) having net owned fund of not less than two crore rupees or such other higher amount as the Reserve Bank, may, by notification, specify;

Provided that the Reserve Bank may, by notification, specify different amounts of owned fund for different class or classes of [asset reconstruction companies]:

Provided further that a [asset reconstruction company], existing on the commencement of this Act, shall make an application for registration to the Reserve Bank before the expiry of six months from such commencement and notwithstanding anything contained in this sub-section may continue to carry on the business of securitisation or asset reconstruction until a certificate of registration is granted to it or, as the case may be, rejection of application for registration is communicated to it.

(2) Every [asset reconstruction company] shall make an application for registration to the Reserve Bank in such form and manner as it may specify.

(3) The Reserve Bank may, for the purpose of considering the application for registration of a [asset reconstruction company] to commence or carry on the business of securitisation or asset reconstruction, as the case may be, require to be satisfied, by an inspection of records or books of such [asset reconstruction company], or otherwise, that the following conditions are fulfilled, namely:—

(a) that the [asset reconstruction company] has not incurred losses in any of the three preceding

financial years;

(b) that such [asset reconstruction company] has made adequate arrangements for realisation of the financial assets acquired for the purpose of securitisation or asset reconstruction and shall be able to pay periodical returns and redeem on respective due dates on the investments made in the company by the [qualified buyers] or other persons;

(c) that the directors of 1 [asset reconstruction company] have adequate professional experience in matters related to finance, securitisation and reconstruction;

(d) *****

(e) that any of its directors has not been convicted of any offence involving moral turpitude; (f) that a sponsor of an asset reconstruction company is a fit and proper person in accordance with the criteria as may be specified in the guidelines issued by the Reserve Bank for such persons;

(g) that [asset reconstruction company] has complied with or is in a position to comply with prudential norms specified by the Reserve Bank;

(h) that [asset reconstruction company] has complied with one or more conditions specified in the guidelines issued by the Reserve Bank for the said purpose.

(4) The Reserve Bank may, after being satisfied that the conditions specified in sub-section (3) are fulfilled, grant a certificate of registration to the [asset reconstruction company] to commence or carry on business of securitisation or asset reconstruction, subject to such conditions, which it may consider, fit to impose.

(5) The Reserve Bank may reject the application made under sub-section (2) if it is satisfied that the conditions specified in sub-section (3) are not fulfilled: Provided that before rejecting the application, the applicant shall be given a reasonable opportunity of being heard.

(6) Every [asset reconstruction company] shall obtain prior approval of the Reserve Bank for any substantial change in its management [including appointment of any director on the board of directors of the asset reconstruction company or managing director or chief executive officer thereof] or change of location of its registered office or change in its name:

Provided that the decision of the Reserve Bank, whether the change in management of a [asset reconstruction company] is a substantial change in its management or not, shall be final.

Explanation.—For the purposes of this section, the expression “substantial change in management” means the change in the management by way of transfer of shares or [change affecting the sponsorship in the company by way of transfer of shares or] amalgamation or transfer of the business of the company.

What is securitisation?

It is the acquisition of financial assets either by way of issuing security receipts to Qualified Buyers or any other means. Such security receipts would represent an undivided interest in the financial assets.

Who are Qualified Buyers?

Qualified Buyers include Financial Institutions, Insurance companies, Banks, State Financial Corporations, State Industrial Development Corporations, trustee or ARCs registered under SARFAESI and Asset Management Companies registered under SEBI that invest on behalf of mutual funds, pension funds, FIIs, etc. The Qualified Buyers (QBs) are the only persons from whom the ARC can raise funds.

How will the ARC carry out the process of asset reconstruction?

The main intention of acquiring debts / NPAs is to ultimately realise the debts owed by them. However the process is not a simple one. The ARCs have the following options in this regard:

- Change or takeover of the management of the business of the borrower
- Sale or lease of such business
- Rescheduling the payment of debts – offering alternative schemes, arrangements for the payment of the same.
- Enforcing the security interest offered in accordance with the law
- Taking possession of the assets offered as security
- Converting a portion of the debt into shares

What type of debts can the ARC take over?

The ARC can take over only secured debts which have been classified as a non-performing asset (NPA). In case debentures / bonds remain unpaid, the beneficiary of the securities is required to give a notice of 90 days before it qualifies to be taken over.

What are Non-performing assets?

Banks and other financial institutions are required to classify the debts owned by them into the following four categories:

- Standard
- Sub-standard
- Doubtful
- Loss

The criteria for the classification into such categories depends upon the type of financial institution and the regulatory authority governing such bank or financial institution. Out of the above 4 categories, a non-performing asset would be either a sub-standard, doubtful or a loss asset.