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Loans from NBFCs have no recourse under the SARFAESI Act says the Bombay High Court.

In a recent decision in *Kotak Mahindra Ltd. vs. Trupti Sanjay Mehta of Bombay*¹, a division bench of the Bombay High Court (V.M. Kanade & A.R. Joshi, JJ.) has held that loans granted by a Non-Banking Financial Company (**NBFC**) cannot be recovered by instituting proceedings under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (**SARFAESI Act**), even if the loan is assigned by the NBFC to a bank or securitisation company.

Although the decision of the Bombay High Court does not deal with the earlier and similar decision of the Andhra Pradesh High Court in *M/s Deccan Chronicles Holdings Ltd. vs. Union of India*², it nevertheless reaches the same conclusion.

The loan transaction and the decision of the DRT:

The borrower (Respondent No. 4) originally availed a loan from Citi Financial Consumer Finance (**Citi Financial**), an NBFC, and mortgaged a flat with Citi Financial in order to secure repayment of the loan. The borrower defaulted in repaying the loan and Citi Financial instituted arbitration against the borrower, eventually resulting in an award in favour of Citi Financial on July 21, 2010. Thereafter, by way of a Deed of Assignment dated July 18, 2012, Citi Financial transferred, assigned and released the entire amount payable by the borrower to Citi Financial in favour of the Petitioner – Kotak Mahindra Bank Ltd. (**Kotak**).

In view of the assignment, Kotak proceeded to take steps for realising the outstanding amounts owed by the borrower and under Section 13 (2) of the SARFAESI Act, issued a notice dated July 3, 2013 to the borrower. As there was no reply from the borrower, Kotak filed an application under Section 14 of the SARFAESI Act before the Court of the Chief Metropolitan Magistrate, Esplanade, Mumbai for taking possession of the mortgaged flat. At the time of taking possession, Respondent Nos. 1 and 2 were residing in the mortgaged flat, and challenged the application of Kotak by filing a securitization application before the Debts Recovery Tribunal (**DRT**).

The Presiding Officer of the DRT, Mumbai held that in spite of being a bank, Kotak was not entitled to exercise the provisions and powers under the SARFAESI Act as Citi Financial was not a financial institution for the purposes of the SARFAESI Act. On Appeal, the Debt Recovery Appellate Tribunal too, upheld the view of the Presiding Officer and rejected the appeal. It is from these orders that the Petitioners appealed to the Bombay High Court by way of a writ petition.

¹ Judgment dated July 16, 2015 in W.P. (C) No. 722 of 2015

² AIR 2014 Andhra Pradesh 78



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The Bank's case:

The case for Kotak was based on identical nature of the definitions of crucial and material terms such as "debt", "secured creditor", "secured asset" and "security interest" between the SARFAESI Act and the Recovery of Debts due to Banks and Financial Institutions (**RDDBFI Act**). Kotak submitted that as Citi Financial has assigned the debt to Kotak, a security interest was created in favour of Kotak as understood by and defined under the RDDBFI Act and the SARFAESI Act. Therefore, third parties such as the Respondent Nos. 1 and 2, who were merely residing at the mortgaged flat could not question such an assignment or the exercise of SARFAESI Act provisions by Kotak.

In support of this argument, Kotak also argued that the assignment by Citi Financial, being an NBFC, to Kotak was permitted by law and hence legal, valid and binding on all, including the Respondent Nos. 1 and 2. It was argued that the definition of "security interest" under the SARFAESI Act does not contemplate that only a secured creditor within the meaning of the SARFAESI Act could be the assignor.

The borrower's case:

The borrower too, based his case on the interpretation of the definition of various key terms under the SARFAESI Act such as "financial assistance", "financial asset", "secured creditor", "bank", "financial institution", "securitization company", "reconstruction company", "secured assets", "secured interest", "originator" and "secured debt", in addition to Section 13 of the SARFAESI Act which is the cornerstone provision allowing recovery of dues by disposal of the secured assets without the intervention of a court.

The borrower interpreted these provisions to argue that the measures under the SARFAESI Act can be enforced by a secured creditor only against the borrower as defined under the SARFAESI Act. A person would qualify as a borrower under the SARFAESI Act only if he or she had been granted the financial assistance by any person that was a bank or financial institution for the purposes of the SARFAESI Act, and not by an NBFC. On this line, it was further argued that Citi Financial's assignment of the debt to Kotak would not vest any power in Kotak, being the assignee, to apply for recovery of the secured debt under the provisions of the SARFAESI Act. In support, the judgment of the Andhra Pradesh High Court in *M/s Deccan Chronicles Holdings Ltd. vs. Union of India* was relied upon.

The decision and the Court's rationale:

In an erudite judgment penned by V.M. Kanade, J. the court went into the scheme, purpose and the investment climate in India at the time when the RDDBFI Act and the SARFAESI Act were enacted. To this end, the decision discusses extensively the judgment of the Supreme Court of India in *Mardia Chemicals Ltd. vs. Union of India*³ and *Transcore vs. Union of India*⁴.

³ AIR 2004 SC 2371

⁴ AIR 2007 SC 712



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The court observed that Section 13 of the SARFAESI Act has to be read alongwith the scheme of the SARFAESI Act, and the terminologies as defined under the SARFAESI Act. If the SARFAESI Act is read in this manner, it becomes evidently clear that the provisions under it can only be enforced by a secured creditor against the borrower as defined under Section 2 (f) of the SARFAESI Act. This definition states in no uncertain terms that only if the financial assistance which is given to the borrower is assigned by a reconstruction company or securitisation company to a bank or vice-versa, can the assignment be covered under the SARFAESI Act. Therefore, as a natural corollary, it can be seen that measures under section 13(4) of the SARFAESI Act against the borrower can only be initiated by a bank or financial institution that has given the borrower financial assistance, or by a reconstruction company or securitisation company which has acquired the financial assistance from any bank or financial institution. The court also observed that the understanding and definition of a borrower is identical under the RDDBFI Act.

By this rationale, the court held a person could be termed as a borrower for the purposes of the SARFAESI Act only if the monies have been borrowed from a bank or a financial institution. The court also clarified that the definition of a borrower under the SARFAESI Act specifically excludes any other type of institution, including an NBFC. Consequently, a secured creditor can proceed for recovery under the provisions of the SARFAESI Act only against a borrower who has borrowed monies from a bank or a financial institution. In these terms, the writ petition came to be dismissed.

NBFCs notified as PFIs:

The decision of the Bombay High Court is however not binding on NBFCs which have been notified as Public Financial Institutions (**PFI**) by the Ministry of Corporate Affairs. By virtue of being notified as a PFI, an NBFC acquires the status of a financial institution for the purposes of the SARFAESI Act, and can therefore enjoy the benefits of the recovery mechanism provided by the SARFAESI Act.