

**Bank finance and regulation**

**Multi-jurisdictional survey**

**India**

**Enforcement of security interests in banking transactions**

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**Part I - types of security**

1. *What are the most common types of security in banking transactions in your jurisdiction (standard security package)? Provide a brief characteristic of each type of security.*

In India, all kinds of assets, whether tangible or intangible can be used as security, right from immovable property to intellectual property rights. However, the most common types of security in banking transactions include a mortgage over immovable property, pledge of shares, hypothecation of or a floating charge over movable assets and/or book debts, personal guarantees by individual promoters or corporate guarantees from parent promoter companies or group entities.

It is pertinent to note, however, that in most cases, due to foreign exchange management laws of India, creation of security interest by a person resident in India in favour of a person resident outside India requires the prior approval of the Reserve Bank of India.

(a) **Mortgage**

Mortgages are the most common form of security interest created over immovable property. A mortgage is defined as a transfer of an interest in specific immovable property as security for the repayment of money advanced or to be advanced by way of a loan, an existing or a future debt, or the performance of an engagement which may give rise to a pecuniary liability. Six types of mortgages are recognised in India namely:

(i) **Simple mortgage**

Under this form of mortgage, the mortgagor does not deliver possession of the mortgaged property and binds itself to pay the amounts secured by the mortgage, failing which the mortgagee shall have the right to cause the mortgaged property to be sold and apply the proceeds towards payment of the debt owed.

(ii) **Mortgage by conditional sale**

Under this form of mortgage, the mortgagor ostensibly sells the mortgaged property to the mortgagee with a condition that the mortgaged property shall be returned to the mortgagor and the sale will cease to have effect on payment by the mortgagor of the amounts secured by the mortgage. In the event that the mortgagor defaults in paying the amounts secured by the mortgage, the sale of the mortgaged property will become absolute.

(iii) **Usufructuary mortgage**

Under this form of mortgage, the mortgagor delivers possession of the mortgaged property to the mortgagee authorising the mortgagee to retain such possession until payment of the amounts secured by the mortgage and to receive the rents and profits accruing from the mortgaged property or any part of such rents and/or profits and to appropriate the same in lieu of interest and/or in payment of the amounts secured by the mortgage.

(iv) **English mortgage**

Under this form of mortgage, the mortgagor binds himself to repay the amounts secured by the mortgage on a certain date and transfers the mortgaged property absolutely (though with an intent to create mortgage) to the mortgagee subject to a proviso that the mortgagee will re-transfer it to the mortgagor upon payment of the amounts secured by the mortgage.

(v) **Mortgage by deposit of title-deeds (also known as equitable mortgage)**

Under this form of mortgage, a mortgagor deposits documents of title to immovable property with the mortgagee, with the intent to create a security thereon. A mortgage by deposit of title deeds can be created only in the towns of Kolkata (Calcutta), Chennai (Madras) or Mumbai (Bombay) or any other town or city which has been so notified by the government.

(vi) **Anomalous mortgage**

Anomalous mortgage is a mortgage that does not fall within any of the five classes enumerated above. Anomalous mortgages take innumerable forms moulded either by custom or the caprice of the creditor – some are combinations of the simple form, others are customary mortgages prevalent in a particular district.

(b) **Pledge**

A pledge, as understood in the Indian context, is a type of possessory security. It is a special kind of bailment, where goods are delivered to the pledgee for the purpose of creating security for payment of a debt or performance of a promise and is based on the premise that upon payment of the debt and performance of the promise, the goods will be returned to the pledgor, or disposed of as per the instructions of the pledgor. As between the pledgor and the pledgee, the delivery of goods is an essential requirement for the pledge to be effective. The delivery can be actual, constructive or notional. It is pertinent to note however that though the pledgee is in possession of the goods, the legal title to the goods continues to remain with the pledgor.

A pledge can be created only on goods, and as per Indian law 'goods' has been defined to mean movable property other than money and includes documents of title such as share certificates, fixed deposit receipts etc. As delivery is a pre-condition to valid creation of pledge, a pledge can be created only on goods in existence and not on future property.

(c) **Hypothecation**

Although hypothecation is regularly used as a form of security in India, the term has not been defined in any statute and is accepted in mercantile law by long usage and practice. While a pledge requires actual or constructive delivery of the underlying goods to the pledgee, there is no actual transfer of interest or property in the goods by the hypothecator to the hypothecatee. It only creates a notional and equitable charge in favour of the hypothecatee and the right of the hypothecatee is only to sue on debt and proceed in execution against the hypothecated goods, if they are available.

(d) **Charge**

Charge is used as a form of security over immovable as well as movable assets. As in most common law jurisdictions, the two kinds of charge that can be created over assets are (i) fixed charge, and (ii) floating charge.

A fixed charge can be created only over an asset that is ascertainable, whether present or in future. A floating charge is usually created on all the assets of the debtor, whether in existence or in the future, ascertainable or not, and crystallises (i.e. becomes fixed) on such assets as are in existence at the time of occurrence of an event of crystallisation. The document creating the charge would typically set out the events of crystallisation but a failure to repay the debt or the debtor ceasing to carry on its business would invariably constitute a crystallisation event. From the time of creation of charge until crystallisation, the debtor has the right to use the assets and deal with them in the ordinary course of business as if such assets are unencumbered, to the extent that it may also have a right to dispose of the assets, if it so agreed between the parties.

(e) **Guarantees**

Personal guarantees by individuals or corporate guarantees by group entities generally form part of the additional collateral given by a borrower. There are no restrictions on guaranteeing the obligations of the borrower, provided that the borrower and guarantor are situated in India. However, a person resident in India is prohibited, without obtaining the prior permission of the Reserve Bank of India, from giving a guarantee or surety in respect of, or undertaking a transaction, which has the effect of guaranteeing, a debt, obligation or other liability (i) owed by a person resident in India to a person resident outside India; or (ii) incurred by a person resident outside India.

Security interest in the form of a guarantee can be enforced by invoking the guarantee in the form stipulated by the guarantee. If the guarantor does not make payment on invocation of the guarantee, the same may be enforced through a court in the manner prescribed.

2. *In relation to the following assets, provide the types of security that can be created or granted in your jurisdiction and give details of registration required?*

At the outset, it is relevant to note that apart from the registration requirements set out with respect to the security interests created on each of the assets set out below, the following formalities need to be complied:

(i) **Stamp laws**

Every instrument or document executed between two parties in India needs to be adequately stamped prior to or on execution of such instrument or document as per the stamp laws applicable to the state where the document is executed, which varies from state to state in India. However, if the document or its copy (including facsimile, photocopy, electronic or conformed copy) on which stamp duty is paid as per the provisions of the stamp act applicable to that state, is brought into or retained by any person in another state where either (i) anything under the document is to be done or performed; or (ii) the property to which the document related is situated, then the difference in the stamp duty between the two states would be required to be paid within three months of receipt of such document within that state. If a document is executed outside India, then stamp duty would be required to be payable if such instrument is brought into any state in India as

aforsaid within three months from the date of receipt of the document within that state.

Failure to pay stamp duty or payment of inadequate stamp duty renders the document inadmissible in evidence for any purpose in any court or arbitration proceedings in India, in effect restricting enforcement proceedings on the basis of such document. In addition it has the following consequences, (i) imposition of a penalty by the stamp authority as per applicable stamp laws; (ii) impoundment of the document; and/or (iii) imposition of criminal liability on the person required to pay the stamp duty, if it proved that there was an intent to evade stamp duty.

- (ii) **Registration under Companies Act, 1956 (the 'Companies Act')**  
If the security provider is a company, the requisite form for creation of security (except in the case of pledge) is required to be filed electronically with the Registrar of Companies within 30 days of creation of the security or within such period as may be allowed. Even a charge created by a foreign company (a company incorporated abroad having a presence in India) on properties in India are required to be registered with the Registrar of Companies. A non-compliance with same though does not affect the underlying obligation, results in the security being void against the liquidator and the other creditors of the company.
- (a) **Real estate**  
Real estate includes land, buildings, flats, offices, other developments on land and other immovable property. The term 'immovable property' is defined in several statutes in India, the relevant ones being as follows:
  - (i) The Transfer of Property Act, 1882 uses a non-exhaustive definition and defines 'Immovable Property' as property other than standing timber, growing crops or grass.
  - (ii) The Registration Act, 1908 uses an inclusive definition and defines 'Immovable Property' to include land, building, hereditary allowances, rights to ways, lights, ferries, fisheries or any other benefit to arise out of land, and things attached to the earth or permanently fastened to any thing which is attached to the earth but not standing timber, growing crops nor grass.

#### Security interest

- (i) **Mortgage**  
Where the principal money secured is Indian Rupees 100 or more, a mortgage other than a mortgage by deposit of title deeds can be effected only by a registered instrument signed by the mortgagor and attested by at least two witnesses. Of the six forms of mortgages explained above, the most frequently used types of mortgages are English mortgage and mortgage by deposit of title deeds. In an English mortgage, an indenture of mortgage is executed between the parties setting out the rights and obligations of each party whereas a mortgage by deposit of title deeds, as the name suggests, requires only the act of depositing the title deeds and a memorandum of entry recording the deposit being executed.

It is pertinent to note, however, that for all practical purposes, creation of security interest over land classified as agricultural land in India is highly restricted other than for the purpose of agricultural loans.

All mortgages, other than a mortgage by deposit of title-deeds, are to be compulsorily registered with the Sub Registrar of Assurances in whose sub-district the whole or some portion of the mortgaged property is situated, within

a period of 4 months from the date of execution of the document creating the mortgage. Nonconformity with the registration requirements results in the document not affecting any immovable property comprised therein and being inadmissible in evidence.

As set out in the beginning, stamp duty is payable as per the provisions of the stamp act applicable to the state where the document is executed. Hence, if several properties situated in multiple states are mortgaged by way of one instrument, then the document is recommended to be executed and according stamp duty be paid in the state wherein the courts to which jurisdiction has been granted under the document are situated or where highest stamp duty is payable.

(ii) Charge

Under Indian law, where immovable property of one person is by act of parties or operation of law made security for the payment of money to another and the transaction does not amount to a mortgage, the latter person is said to have a charge on the property.

No particular form of words is required to create a charge. There must however be a clear intention to give property as security for payment of money. A charge is effected in a manner similar to that of a simple mortgage, as given above.

In order to be enforceable, a charge document is also required to be appropriately stamped and registered with the Sub Registrar of Assurances as explained above.

(b) Charging assets (inventory, stocks, etc)  
Please see our comments on: Movables

(c) Movables

(i) Pledge

Owing to the nature of a pledge, the law does not mandate the execution of a formal document for creation of security by way of pledge. A pledge can be effected simply by delivering the pledged goods, however in practice an agreement of pledge is executed between the parties setting out their rights and obligations. The rights and obligations between the pledgor and the pledgee at common law apply together with any other rights contractually agreed between them. At present there are no registration requirements to give effect to a pledge. Registration of pledge under the Companies Act though not mandatory is permissible.

(ii) Hypothecation

A hypothecation movable property has to be made in writing. In the event the hypothecatee is a company, the requisite form together with the prescribed fees needs to be filed with the Registrar of Companies within 30 days from creation of security.

(iii) Charge

A fixed or floating charge can also be created on movable property. A charge document would have to be executed between parties.

An agreement of charge creating a floating charge over the assets of the chargor would in order to protect the interests of the chargee usually includes

clauses such as 'automatic crystallisation' and 'negative pledge'. An automatic crystallisation charge is incorporated to ensure that the floating charge crystallises immediately upon occurrence of a crystallisation event without requiring the chargee to specifically notify the chargor of the same. A negative pledge is to restrict the chargor from creating any subsequent charge over its assets without the prior approval of the chargee.

It is relevant to note, however, that a holder of a fixed charge has higher rights in comparison to a holder of a floating charge. Further, the Companies Act provides that a floating charge created 12 months immediately preceding the commencement of the winding up the charge shall be void and have no effect.

(d) Shares

Pledge is the most common form of creating security over the shares of a company. The shares of a company may be in physical form or dematerialised (electronic) form. In case of shares held in physical form, common law rules together with contractual agreement are applicable and the pledge can be given effect to by depositing the physical share certificates, representing the shares, accompanied with a duly executed deed(s) of transfer, with the pledgee (or its agent).

A special set of regulations govern the procedure for pledge of shares held in dematerialised form. Shares held in dematerialised form indicate beneficial interest in the shares which are legally and actually held by the depository. There are only two recognised depositories in India and the shares have to be held through either of them. A beneficial owner may on making an application to the depository through his depository participant create a pledge in respect of a security owned by him. The depository after receiving confirmation from the pledgee within 15 days from the date of application creates and records the pledge and intimation to that effect is sent to the depository participants.

Banks in India are restricted from holding, as pledgee or mortgagee, more than (i) 30 per cent of the paid-up share capital of any company, or (ii) 30 per cent of its own paid-up share capital and reserves, whichever is less.

Separately, in case the shares of a company listed on any of the stock exchanges in India are pledged by the promoter of such company or any of its group entities, disclosures are required to be made pursuant to a recent amendment of the provisions of the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations (the '**Takeover Regulations**'). The Takeover Regulations mandate the promoter or a group company to disclose to such company details of shares pledged by them within 7 days of creation of such pledge. The company is then required to disclose the details of such pledge to the stock exchanges where the shares of such company are listed if the aggregate number of shares pledged in that quarter exceeds 25,000 or 1 per cent of the total shareholding held by such promoter or group company. Further, while creation of pledge, in general, requires disclosures under the Takeover Regulations, the same is exempted if pledge has been created in favour of banks. Banks in this context are restricted only to Indian banks or Indian branches of foreign banks.

(e) Rights under contracts (receivables)

Receivables can be broadly classified into the following main categories:

- (i) Trade related receivables: Trade related receivables are in the nature of book debts, claims, outstanding bills, credit notes, etc. and accruing in the ordinary course of business and are usually reflected in the trading/accounting books, though not necessarily.

- (ii) Cash flow/income related receivables: Cash flow/income related receivables consists of fees, remuneration for services of any kind, including royalty, fees for technical know-how, lease rentals, hiring charges and compensation payable to and receivable by any person entitled thereto.

Security interest may be created over financial receivables by creating a charge or a mortgage on the financial receivables.

Security is created upon the rights under contracts or receivables by way of an agreement in writing which is in the nature of a security assignment agreement. The registration and other related requirements are dependent upon the nature of the agreement and the kinds of rights that are being assigned. Rights under a contract can also be charged.

#### Actionable claims (choses-in-action)

An actionable claim (referred to as a 'choses-in-action' in most common law jurisdictions) is defined to mean a claim to any debt, other than a debt secured by mortgage of immovable property or by a hypothecation or pledge of movable property or to any beneficial interest in movable property not in possession either actual or constructive of the claimant which the civil courts recognise as affording grounds for relief, whether such debt or beneficial interest be existent, accruing, conditional or contingent.

It is not unusual to create security interest on actionable claims. Transfer of actionable claims, with or without consideration, can be effected only by execution of an instrument in writing and subsequent to such transfer all rights, remedies of the transferor whether by way of damage or otherwise shall vest in the transferee.

#### (f) Bank accounts

Amounts lying in a bank account can also be assigned by way of security. The balance standing to the credit of the customer's bank account is an actionable claim and hence can be made the subject matter of a charge, effected by means of an assignment. However, the efficacy of such charge in favour of a person other than the bank with whom the account is held is doubtful unless such bank itself is made a party to the charge.

As regards charge-back, the same should under Indian law also constitute a valid security interest.

#### (g) Financial instruments (securities)

Please see our comments on: Shares

#### (h) Intellectual property rights

Creation of security interest over intellectual property rights is now increasing in India. Security over intellectual property is created by way of an assignment, hypothecation or by creation of a charge.

##### (i) Trade Marks

Trade Marks Act, 1999 mandates certain restrictions relating to assignment of registered trade marks. Subject to those restrictions, when a registered trade mark is assigned, the person who becomes entitled to such a trade mark upon the assignment has to apply to the Registrar (Trademark Registry) in the prescribed format for the charge to be registered.

##### (ii) Copyrights

Under the Copyright Act, 1957, the owner of the copyright in an existing work or the prospective owner of the copyright in a future work can assign to any person the copyright either wholly or partially and either generally or subject to limitations and either for the whole term of the copyright or any part of it. Such an assignment contract has to be in writing, signed by the assignor or by his duly authorised agent. Under the Copyright Act, registration of copyright is not essential, and hence, no requirement for the registration of a contract assigning a copyright is mandatory.

(iii) Patents

Under the Patents Act, 1970, an assignment of a patent or of a share in a patent, a mortgage, licence or the creation of any other interest in a patent is not valid unless the same is in writing and the agreement between the parties concerned is reduced to the form of a document embodying all the terms and conditions governing their rights and obligations and the application for registration of such document is filed in the prescribed manner with the Controller of Patents within six months from the execution of the document.

In practice, if the security provider is a company then the security holder is well protected by the registration requirement with the Registrar of Companies under the Companies Act, as the same serves as valid public notice. In the event, if the security provider is not a company then the security interest is to be structured in such a manner that the rights of the security holder are adequately protected.

(i) Plant and machinery

Security interest can be created on plant and machinery based on the classification of the machinery/equipment as immovable or movable property. Machinery/equipment would be deemed to be immovable property if it is affixed or embedded in the earth and a movable property if it is not. A pledge or hypothecation can be created over machinery/equipment, if the same is classified as movable property. A mortgage or a charge (fixed or floating) can be created over machinery/equipment, if the same is classified as immovable property.

(j) Other assets

(i) Ships

In India, laws permit the creation of a mortgage over ships subject to certain conditions as prescribed under the respective legislations. Any transfer of interest in the ship can be effected only by an instrument in writing, attested by at least two witnesses and is required to be (i) approved by; and (ii) registered with, the Registrar (of the ship's port of registry).

If there is more than one mortgage recorded on the same ship, the mortgagees shall (notwithstanding any express, implied or constructive notice) have priority according to the date on which each mortgage has been recorded in the register book and not the date of the mortgage itself.

It should be noted that any instrument for transfer of interest in any ship or vessel, or any part thereof, is exempted from payment of stamp duty in many parts of India.

(ii) Aircrafts

An aircraft is treated as movable property in India.  
Please see our comments on: Movables.

In addition, a security interest over an aircraft has to be compulsorily registered in the prescribed format with the Director General of Civil Aviation of India, the concerned statutory authority.

(iii) Motor Vehicles

Security interest can be created over a motor vehicle by way of a pledge or hypothecation of the motor vehicle. Typically, in India, motor vehicles are hypothecated in favour of a lender in respect of a loan taken from a lender to purchase such motor vehicle. The same is required to be noted on the registration certificate of the vehicle.

3. **Can a trustee or security agent be used? Or must security be granted in favour of all lenders? Whether parallel debt clause recognised?**

In banking transactions in India, security agents and trustees are recognised. In case of a consortium lending, security interest is usually created in favour a security trustee who holds such security for a fee, for the benefit of all lenders and acts upon the instructions of the lenders. A security trustee can also be appointed where the intent is to hold the loan on the books of the lender for a limited period and sell down the loan. Creation of security interest in favour of the security trustee for the benefit of the secured lender has multiple benefits such as (i) ease of assignment – it provides greater flexibility in assigning the loan to a third party without recreating the security interest in favour of the new lender; (ii) cost effective – as stated above a lot of cost is incurred (stamp duty and registration costs) in creation of security interest which would have to be borne by a new lender all over again if security is to be recreated unlike in the event where security is created in favour of the security trustee; (iii) ease of enforcement – the security trustee enforces the security as per the instructions of the lenders and distributes the amount realised as per the inter-creditor arrangement between the lenders, thus avoiding multiple suits being filed with respect to the same claim.

As a trust structure, as explained above, is recognised in India, a parallel debt clause is not required.

4. *Please explain the latest amendments to the law governing secured transactions in your jurisdiction. Are there any amendments which will be introduced in the near future (within one to two years) which might have an impact on the legal framework of secured transactions? Please also explain recent practical developments regarding secured transactions in your jurisdiction.*

- (a) A significant legislation that is likely to be introduced soon is the Companies Bill, 2009 ('Companies Bill') that has been placed before the Parliament of India. The Companies Bill seeks to repeal the existing Companies Act, 1956 and amend the provisions of law applicable to companies in India. However, there is a lot of debate on the Companies Bill and there is a distinct possibility that the same, when enacted will differ significantly from the Companies Bill in its present form. We expect that even after the passing of the Companies Bill by both houses of Parliament, it will still be several months before all the delegated legislation and the organisational framework, which will be required to operationalise it, is put in place.

Set out below, are a few of the significant issues in the Companies Bill which could materially alter our comments:

- (i) All charges created by a company on its property (both movable and immovable) are required to be registered. The definition of charge includes all forms of security interest created over the property of the company, including pledges (which, as stated above, are currently excluded from the registration requirements); and

- (ii) The Companies Bill provides for appointment of an administrator, his powers and duties, for the revival and rehabilitation of sick companies. It also provides for a moratorium against the enforcement of security interest against the property of such sick company. It is pertinent to note that the term sick company under the Companies Bill is wider in its import than the term 'sick industrial company' under the present provisions of Sick Industrial Companies Act, 1985 ('SICA') which is otherwise to be repealed (see our response to Q. 3 Part II below).
- (b) A chapter of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 ('SARFAESI') (the Act has been discussed in A.1 of Part II below) which deals with registration by the secured creditor of the transactions for creation of security interest in its favour, modification and satisfaction thereof, with the Central Registry set up under SARFAESI has not come into force yet. Upon coming into effect, a central registry would be set up and registration would become mandatory for all security providers and not just companies. This registration requirement is in addition to the provisions for registration of charges under the provisions of any other acts in India where such registration is necessary and will not affect priorities of charges or validity thereof under such other acts. However, failure to register such security interest, modification or satisfaction shall make, inter alia, the secured creditor and every officer of the secured creditor who is in default liable to fine of INR 5,000/- for every day during which the default continues.

## **Part II – enforcement of security**

1. *Please explain briefly general rules of enforcement of security indicated in answer to the Question 1 in Part I above (excluding rules in a bankruptcy or insolvency proceeding – see Question 3 below). In your answer please explain whether specific security may be enforced only through judicial proceedings or whether extra-judicial methods are also available. Furthermore, please provide estimate of costs (if they create significant obstacle in enforcement, including applicable taxes and any other duties/ costs) and timing for enforcing such security. Please also explain degree of difficulty (eg, burdensome formalities, whether enforcement requires actions of a state body) in enforcing security. Also please explain whether taking security by an entity from other jurisdiction influences possibility of establishing security and its enforcement.*

### **(a) Mortgage, hypothecation, charge, assignment**

Nature of proceedings: judicial and quasi judicial

A creditor (depending on its status ie, whether it is a bank, financial institution or other creditor) in whose favour a mortgage, charge, hypothecation has been created has recourse to remedies under different legislations. A brief description of the provisions of some of the important laws in order to enforce security is given hereunder:

#### **(i) Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 ('SARFAESI')**

SARFAESI primarily deals with securitisation and reconstruction of financial assets and enforcement of security interest specifically by banks (means only Indian banks and Indian branches of foreign banks) and certain class of government owned financial institutions in India. SARFAESI allows such secured creditors certain self help remedies upon default by the borrower without the intervention of the court.

Under SARFAESI, if a borrower owing a liability to a secured creditor under a security agreement, makes any default in repayment of such secured liability or any instalment thereof, and his account in respect of such liability/debt is classified by the secured creditor as a non-performing asset, then, the secured creditor may require the borrower, by notice in writing to discharge in full his liabilities/debts within sixty days (60) from the date of notice, failing which the secured creditor shall be entitled to exercise all or any of the rights given below:

- (A) take possession of the secured assets of the borrower including the right to transfer by way of lease, assignment or sale for realising the secured asset;
- (B) take over the management of the business of the borrower including the right to transfer by way of lease, assignment or sale for realising the secured asset;
- (C) appoint any person to manage the secured assets, possession of which has been taken over by the secured creditor; and/or
- (D) require at any time by notice in writing, to recover the amount of the secured debt from any person who has acquired any of the secured assets from the borrower and from whom any money is due or may become due to the borrower. This relates to receivables arising out of sale of a secured asset. For instance, if a machine or building was subject to charge of the lender bank, and the borrower rightly or wrongly, sells the same to some one, the receivables that arise from such sale can be attracted under the clause.

A borrower, after receipt of notice referred to above, is prohibited from transferring by way of sale, lease or otherwise (other than in the ordinary course of his business) any of his secured assets referred to in the notice, without prior written consent of the secured creditor.

Further, in case security over a particular financial asset of the borrower has been created in favour of multiple lenders or in case of a consortium lending, then action under SARFAESI can be taken only if secured creditors representing three-fourth in value of the amount outstanding agree to take such action and the same would be binding on all secured creditors.

The sale of both movable as well as immovable assets, in accordance with the rules laid down under SARFAESI, can be conducted in any of the following ways:

- (I) by obtaining quotations from parties dealing in the assets or otherwise interested in buying such assets;
- (II) by inviting tenders from the public;
- (III) by holding public auction; or
- (IV) by private treaty.

Although it is difficult to estimate the costs and expenses that would be incurred by secured creditors in enforcing the security as per the procedure under SARFAESI and rules thereunder, the same is currently the fastest and the most efficient option available to secured creditors, with eight to ten months being the ordinary time within which the security could be enforced.

Security interest created over an aircraft or ship or a pledge over movables cannot be enforced as per the provisions of SARFAESI or the rules thereunder.

(ii) **Recovery of Debts Due to Banks and Financial Institutions Act, 1993 ('RDDDB Act')**

A bank (means only an Indian bank and Indian branch of a foreign bank) and certain class of government owned financial institutions can initiate recovery and enforcement proceedings before special courts designated as Debt Recovery Tribunals ('DRTs') under the RDDDB Act. The essential difference between proceedings before a DRT and suits before a civil court lie first in the procedures required to be followed, second in the need of the applicant to establish existence of debt, and third in the scope for hearing of arguments over technical lapses of the creditor, if any.

It is pertinent to note that under the RDDDB Act, DRTs have exclusive jurisdiction to entertain and decide applications from banks and financial institutions for recovery of debts due to them when the amount due to such bank or financial institution, on the date of filing of the suit, is more than Indian Rupees Ten Lakh (ie, Indian Rupees 1 million). The provisions of the RDDDB Act bar the jurisdiction of the civil court to entertain any claim from a bank or financial institution if the amount of claim is above the said limit.

The DRT has the power to, through a recovery officer, order attachment of the whole or such portion of the properties as are secured in favour of the bank or otherwise owned by the borrower as appear sufficient to satisfy any certificate for the recovery of debt and/or arrest and detain the debtor.

Although, the DRTs were established to provide a speedier and efficient mode of recovery of debts for banks and financial institutions, due to various laches in the law and the need to follow the principles of natural justice while dealing with the matter, the enforcement proceedings before DRTs extend to 4-5 years and the costs are significantly lower than costs incurred for civil suits.. Hence, several secured creditors prefer enforcing their security as per the procedure established under SARFAESI. A bank or financial institution may, with the permission of the DRT, on an application made by it, withdraw the application filed with a DRT, for the purpose of taking action under the SARFAESI, if no such action had been taken earlier under that Act, although simultaneous proceedings under both Acts can also be carried on.

(iii) **Code of Civil Procedure, 1908 ('CPC')**

Under the CPC, civil proceedings can be instituted for recovery of debts if the claim is below Indian Rupees Ten Lakhs (Indian Rupees 1 million) or if security is being enforced by a creditor which is not a bank or a financial institution. In this context, banks mean Indian banks and Indian branches of foreign banks. The same can be done by way of filing an ordinary suit or a summary suit before the civil courts in India.

**Ordinary suit**

An ordinary suit can be filed under the provisions of the CPC for recovery of debts. Courts in India have the jurisdiction to try all suits of a civil nature, unless the cognisance of such suits by the courts has been expressly or impliedly barred. The procedure to be followed for the institution of an ordinary recovery suit has been prescribed in detail by the CPC. As per the prescribed procedure, the suit is decreed by the court and it is only upon the execution of such a

decree that the debt amount can be recovered by the party claiming the amount. Since ordinary suits may not be an expeditious remedy, provisions for what is known as a 'summary suit have been made in the CPC.

#### Summary suit

CPC also provides for a special procedure for trial ie, the institution of summary suits. Summary suits or proceedings are more expedient in nature than ordinary suits, and hence are generally preferred. Summary suits can be filed for:

- (a) suits upon bills of exchange and promissory notes;
- (b) suits in which the plaintiff seeks only to recover a debt or liquidated demand in money payable by the defendant, with or without interest, arising:
  - (i) on a written contract; or
  - (ii) on an enactment, where the sum sought to be recovered is a fixed sum of money or in the nature of a debt other than a penalty; or
  - (iii) on a guarantee, where the claim against the principal is in respect of a debt or liquidated demand only.

However, despite the aforesaid, litigation proceedings before civil courts in India are an extensive and somewhat expensive affair. There is a huge backlog of cases pending before the courts and there is no definite time line as to when the case would be disposed of. Further, costs awarded are meaningless and in fact create incentives to prolong litigation and avoid liability.

#### **(b) Pledge**

Nature of Proceedings: Judicial

Indian Contract Act, 1872 ('Contract Act')

Upon default by the debtor of secured debt secured by way of pledge or performance of promise, at the stipulated time, in respect of which the goods were pledged, the pledgee has the option to (i) bring a suit against the pledgor upon the debt or promise, and retain the goods pledged as a collateral security; or (ii) sell the goods pledged, on giving the pledgor reasonable notice of the sale.

The pledgee may retain the goods pledged, not only for a payment of the debt or the performance of the promise, but also for the interest on the debt, and all necessary expenses incurred by him in respect of the possession or for the preservation of the goods pledged. However the pledgee shall not, in the absence of a contract to that effect, retain the goods pledged for any debt or promise other than the debt or promise for which they are pledged, although in the absence of anything to the contrary, the goods are deemed to be pledged also for subsequent advances made by the pledgee. If the proceeds of sale are less than the amount due in respect of the debt or promise, the pledgor is still liable to pay the balance whereas in case of surplus proceeds, the pledgee shall pay over the same to the pledgor.

Where in a contract, time for the payment of the debt is stipulated, or performance of the promise, for which the pledge is made, and the pledgor makes default in payment of the debt or performance of the promise at the stipulated time, he may redeem the goods pledged at any subsequent time before the actual sale of them; but he must, in that case, pay, in addition, any expenses which have arisen from his default.

2. Please explain briefly specific features (if any) of enforcement of security established over following types of assets:

(a) Real estate

When the secured asset is an immoveable property, the officer authorised as per the rules prescribed under SARFAESI, takes or causes to be taken possession, by delivering possession notice to the debtor by affixing the possession notice on the outer door or at any conspicuous place of the property. Such notice is required to be published in two newspapers one being an English newspaper and the other being in the regional language of the state where the property is situated. In the event possession of immoveable property, as mentioned above, is actually taken by the officer authorised, such property shall be kept in his own custody under proper care.

Prior to selling of such property, the officer, so authorised shall obtain valuation of the property from an approved valuer and in consultation with the secured creditor, fix the reserve price of the property and may sell the whole or any part of such immoveable property by methods prescribed under the relevant rules. For bringing about the sale the officer so authorised shall give a thirty day prior notice to the debtor.

Except when security is enforced under SARFAESI, a mortgage (other than an English mortgage or a mortgage fulfilling the conditions set out below) or a charge can be enforced only by the intervention of a court. A mortgagee has the power to sell the mortgaged property without the intervention of a court, where:

- (i) the mortgage is an English mortgage;
- (ii) the mortgagor and the mortgagee are body corporate or where the mortgagee being an individual is not a Hindu, Muslim or Buddhist; and/or
- (iii) where such power of sale (without the intervention of a court) has been conferred on the mortgagee under the mortgage deed and the mortgaged property is (on the date of execution of the mortgage deed) situated within the (erstwhile) towns of Kolkata (Calcutta), Chennai (Madras), Mumbai (Bombay) or in any other town or area which the State Government has, by notification in the Official Gazette, specified in this behalf.

It should be noted however, no such power can be exercised unless and until a notice in writing requiring payment of the principle money has been served on the mortgagor, or on one of several mortgagors, and default has been made in payment of the principal money, or of part thereof, for three months after such service.

In addition please see our comments on Mortgage, Hypothecation, Charge, Assignment, in A. 1 of Part II above.

(b) Charging assets (inventory, stocks etc)

Please see our comments on: Movable (below) and A.1 of Part II above

(c) Movable: There can be two situations for the enforcement of the movable property, one where the possession is with the security provider (ie, pledge) and the other where the possession is with the security provider only (ie, hypothecation).

When possession is with the security provider, practically it is difficult to enforce the security as security is not in the possession of the security holder/ lender. They cannot sell or deal in the assets, it can be done by attaching the same by an order of the court and by an actual seizure. For this to take place a memo recording the taking of possession is drawn and signed by the witnesses and then subsequently

the authorised officer of the secured lender takes possession of such movable property in the presence of two witnesses. The attachment of movable property is to be done by actual seizure and the attaching officer is responsible for due custody of the goods. When goods are seized, the attachment is complete. There is no provision for symbolic possession ie, without taking physical custody of the asset.

When possession is not with the of the security provider, then in this situation the security holder needs to send a notice to the security provider before disposing off the assets and on receiving no reply to the same it can sell it off and any amount recovered more than the security, needs to be returned to the security provider.

In case of a hypothecation, the rights of the hypothecatee are governed by the terms of the underlying agreement. Where the agreement provides for taking of possession of the goods hypothecated for the purpose of enforcement without the intervention of a court, the hypothecatee can take possession of the said goods without intervention of a court. Where the goods are hypothecated only by creating a charge, then the hypothecatee has to take action to enforce the said charge according to law and enforce the same only with the intervention of a court.

In addition please see our comments in A.1 of Part II above.

- (d) Shares: For the enforcement of pledge on shares, on default the lender or security trustee in whose favour security is created issues a notice of sale to the pledgor specifying the same and also that on expiry of the notice period preferred, the security trustee acting for and on behalf of the secured parties or their nominees may, without further authority and without prejudice to its other rights under applicable law and under or pursuant to this agreement sell, transfer, transfer, dispose of and appropriate any or all the collateral, at the cost of the pledgor and may remit the net proceeds of any such sale, disposition or appropriation to the agent for being distributed among the secured parties pro rata towards the payment of the Obligations in the following order of priority namely, (i) interest then due and unpaid, (ii) principal amount of the facility/loan amount; and (iii) any remaining obligations.

In case of shares in dematerialised form, the pledge may be invoked by the pledgee as the terms of the pledge document and submitting the prescribed form to the depository. The depository on invocation amends the records and registers the pledgee as the beneficial owner of such shares.

- (e) Rights under contracts (receivables)  
Please see our comments on: Movables
- (f) Financial instruments  
Please see our comments on: Shares
- (g) Plant and machinery  
Please see our comments on: Movables
- (h) Other assets  
Ship: Where there is only one registered mortgagee of a ship or share, the secured creditor shall be entitled to recover the amount due under the mortgage by selling the mortgaged ship or share without intervention of the court. However nothing shall prevent the mortgagee from recovering the amount so due in the court. Every registered mortgagee of a ship or share who intends to recover the amount due

under the mortgage by selling the mortgaged ship or share hereunder shall give an advance notice of 15 days relating to such sale to the registrar of the ship's port of registry.

Where there are two or more registered mortgagees of a ship or share, all of them shall be entitled to recover the amount due under the mortgage in the High Court of the state having jurisdiction, and when passing a decree or thereafter the High Court may direct that the mortgaged ship or share be sold in execution of the decree.

Actionable claims: The authorised officer may prohibit the borrower from recovering the debt or any interest thereon and the debtor from making payment thereof and may direct the debtor to make such payment to the authorised officer.

3. *How does a commencement of bankruptcy or insolvency preceding influence the rights of the security holder to enforce its rights? In bankruptcy or insolvency proceedings, what are the suspect periods is claw-back possible, and what other types of rights (tax debts, employees, etc) have preference over security granted? Please explain briefly specific features (if any) of enforcement of security established over following types of assets in a bankruptcy or insolvency proceeding:*

(a) **Insolvency – general**

The Indian law of insolvency is based on English law (of the early 1900's) and is contained in the Companies Act as regards companies and primarily in the Presidency Towns Insolvency Act, 1909 ('PTIA') and the Provincial Insolvency Act, 1920 ('PIA') as regards individuals, etc. While the PTIA applies to the presidency towns of Mumbai (Bombay), Chennai (Madras) and Kolkata (Calcutta), the PIA applies to most other parts of India.

In the insolvency of an individual or the bankruptcy of a company, a secured creditor can 'stand outside the bankruptcy'. A secured creditor has three options open to him:

- (A) he may realise his security and then prove for the balance;
- (B) he may surrender his security and prove for the whole debt; or
- (C) he may state in his proof the value at which he assesses the security and prove for the balance after deducting the assessed value.

In relation to the balance owed to a secured creditor, (after realising his security), he is effectively an unsecured creditor. Statutory dues, salaries, wages and other dues (up to certain specified amounts/periods) have priority to all other unsecured debts.

As between secured creditors the following principals apply:

- (A) subject to what is stated below, the priority will be determined by contractual provisions;
- (B) as between agreements relating to security created over the same assets (which is, wherever applicable, required to be registered under the Registration Act), the agreement which has been entered into prior in time shall have priority over other security interest created over those assets irrespective of the date of registration (assuming however that it has been validly registered); and
- (C) a first charge will have priority over a second charge and a second charge will have priority over a third charge and so on.

(b) **Standstill**

(i) **Winding up by the Court**

In the event of bankruptcy of the company or on appointment of the official liquidator as provisional liquidator, no suit or other legal proceedings can be

commenced or if pending, continued with, without the express permission of the relevant court/tribunal. Such court/tribunal shall, notwithstanding anything contained in any other law for the time being in force, have jurisdiction to entertain or dispose off a suit or other legal proceeding including in relation to the enforcement of security unless the question at hand is such that it cannot be conveniently dealt with in the winding up, in which case leave for initiating or continuing proceedings in some other forum may be granted.

It is also relevant to note that in this regard the provisions relating to stay as detailed above would apply only to the stay of such enforcement rights which are required to be enforced through the intervention of the court.

Once insolvency proceedings have commenced, unless the insolvency/winding-up court issues an injunction or restraining proceedings, the secured creditors, who 'stand outside the bankruptcy' will be able to liquidate the collateral. However, this is subject to any moratorium imposed under SICA etc. (as described below).

(ii) **Sick Industrial Companies Act, 1985 ('SICA')**

SICA provides for the procedure to be followed for reviving industrial companies in financial difficulties.

As per the provisions of SICA, no proceedings for winding up or for execution or distress against the property of the company and no suit for recovery of money or for the enforcement of any security against such company can be filed or continued on reference being made by the company before the Board of Industrial and Financial Reconstruction ('BIFR') for declaring it as a sick company. Also, no proceedings for enforcement of any guarantee can be filed or continued with if the guarantee is given in respect of loan or advance granted to the company. Thus, there is a complete moratorium.

Further, on an order or declaration being issued by the BIFR, the operation of rights, obligations, etc., as specified by the BIFR in respect of such contracts, agreements, etc, as specified (in such order or declaration) shall be suspended (or enforced only to the extent and in the manner provided for by the BIFR).

Interestingly, where a reference is pending before the BIFR, such reference shall abate if the secured creditor(s), representing not less than three-fourth in value of the amount outstanding against financial assistance disbursed to the borrower of such secured creditors, have taken any measures under SARFAESI.

(c) **Claw-back**

(i) **Companies**

Under the provisions of the Companies Act, any payment or disposition of property made within six months prior to the commencement of the winding up (ie, the date of filing of the winding up petition) with the intention of giving a creditor (or his surety) a preference over the other creditors constitutes a fraudulent preference. To render a transfer or disposition as void on this ground it is essential that:

- (i) it is made with the deliberate intention of and results in giving a particular creditor preference over the other creditors; and
- (ii) it is a voluntary act.

Further, any transfer of property, movable or immovable, or any delivery of goods made by the company, not being:

- (i) a transfer made in the ordinary course of its business; or
- (ii) in favour of a purchaser or encumbrancer in good faith and for valuable consideration,

if made within a period of one year before the presentation of a petition for winding up or passing of a resolution for the winding up of the company is void as against the liquidator.

Additionally, a floating charge created 12 months immediately preceding the commencement of the winding up shall be void and have no effect.

The Companies Act further stipulates that any disposition of property (including actionable claims) of the company, made after the commencement of winding up shall, unless otherwise ordered by the court, be void. However, on a review of the various judgments passed by different courts in India, it clearly emerges that bona fide transactions entered into and completed in the ordinary course of business would ordinarily be protected and upheld by the court though the court has to rule that such transactions are not void.

(ii) **Individuals**

Any disposition of property, within two years of a person being adjudged insolvent, is deemed void unless ratified by the court. However, both PTIA and PIA have a 'safe harbour' clause in the sense that they expressly stipulate that except as provided for (avoidance of certain transfers, fraudulent preference, stay on execution, attachment, etc) the provisions of PTIA and PIA shall not invalidate:

- (A) any payment by the insolvent to any of his creditors;
- (B) any payment or delivery to the insolvent;
- (C) any transfer by the insolvent for valuable consideration; or
- (D) any contract or dealing by or with the insolvent for valuable consideration.

The above holds good only as regards payment/delivery/transfer/contract that takes place before the date of the order of adjudication and that the counterparty to such payment delivery/transfer/contract did not have notice of the filing/pendency of the insolvency petition.

(d) **Priority/preference over secured creditors**

(i) **Workmen/employees dues**

(A) The rights of secured creditors of a company are pari passu with the dues owed to the workmen of such body corporate. Thus, if the unsecured assets of a company are insufficient to pay the dues of workmen of that company, the amounts due to workmen and those due to the secured creditors will abate proportionately. The effect of this law is to create, by statute, a charge pari passu in favour of the workmen on every security available to the secured creditors of the employer company for recovery of their debts. The clear object of the law, so stated, is that the legitimate dues of workers must rank pari passu with those of secured creditors.

(B) Contributions to provident funds, etc. which have accrued but not paid by the employer constitute a charge on the employer's property.

(ii) **Sales tax authorities/crown debt**

With regards to the preference of sales tax authorities over secured creditors, certain States in India have amended their sales tax (value added tax) legislation resulting in creation of a statutory first charge on the assets of the assessee as regards sales tax (value added tax) dues and the Supreme Court of India, has held that provisions of the state legislation creates a statutory first charge that prevails over any charge that may be in existence. Therefore, the charge created in favour of the State in respect of the sales tax dues of the borrower prevails over the charge created in favour of the secured creditor in respect of the loan taken by the debtor. The same is applicable to all charges that are in force and give sales tax dues precedence over them.

(iii) Port trust

The Major Port Trust Act, 1963 ('MPT') deals with the administration, control and management of major ports in India. The Board of Trustees of a major port have the power to detain or arrest any vessel or any tackle, apparel or furniture belonging thereto or any part thereof and detain the same until rates or penalties payable under MPT or any regulations or orders made pursuant thereto and demanded by the Board of Trustees have been paid.

Such a lien of the Board of Trustees over a vessel or any part thereof is a paramount lien having priority even over the claims of secured creditors. The Board of Trustees of a major port are also entitled to sell the detained vessel or part thereof and realise dues without the intervention of a court. In addition to the above, any goods lying in the premises of a major port will be subject to a lien in favour of the port as regards any dues owed to it.

(iv) Charges of electricity boards, etc.

In India distribution of electricity is done through statutory bodies (i.e. state electricity boards) and in most cases states have enacted legislation that allow state electricity boards to have a first charge/priority over the assets of an entity for the recovery of dues payable to them.

(v) Income tax

If during the pendency of any proceedings under the income tax laws of India, an assessee creates a charge on/parts with possession /of any of his assets, such charge or transfer is void as against any claim in respect of any tax or any other sum payable by the assessee as a result of the completion of the proceedings. This can be avoided by procuring a no-objection certificate from the assessing officer at the time of creation of security interest over the assets of the borrower. The object of obtaining such a certificate is to ascertain that such proceedings are not in fact pending against the assessee borrower as the existence of such claim would affect the enforceability of the security interest to that extent and/or obtain a waiver from the assessing officer.

(vi) Contract Act

The Contract Act confers a particular lien on a bailee of goods and a general lien in favour of bankers, factors, wharfingers, attorneys and policy brokers and accordingly each of them may retain goods held by them in respect of amounts due to each of them in the absence of a contract to the contrary.

4. *Are there any specific features or problems of enforcement proceedings if the security is granted to a trustee or security agent or the parallel debt structure is used?*

As mentioned in A.4 of Part 1 above, security agents and trustees are recognised in banking transactions. In such cases, the terms of the inter-creditor arrangements or agreements are given effect to, once the security is to be realised through enforcement

proceedings. This is to say that the provisions in relations to assets on which the security is created, additional assets to be included, enforcement powers, novation, addition of lenders or secured creditors to the transaction, etc. are governed by the terms of agreements entered into between all the creditors, the security trustee and the borrower.

5. *Please explain the latest amendments to the law governing secured transaction in your jurisdiction in relation to a bankruptcy or insolvency proceeding. Are there any amendments which will be introduced in the near future (within one to two years) which might have impact on the legal framework of the enforcement of secured transactions in the light of insolvency law? Please also explain recent practical developments regarding secured transactions in your jurisdiction in relation to insolvency law.*

As set out in our answer to Q.4 in Part I above, the Companies Bill upon coming into effect will replace the existing Companies Act, including the provisions relating to winding up of companies, appointment of the liquidator, distribution of proceeds thereof, etc. Although, the provisions of winding up in the Companies Bill in its current form are not substantially different from the provisions under the Companies Act, as mentioned above, the Companies Bill is yet being debated and on coming into effect may be different from its existing form and accordingly there could be changes in the methodology of winding up of companies.