Derivative defaults studied in legal victory for banks

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In what is seen as a resounding victory for the banking sector, the Supreme Court, India's highest judicial body, recently held that banks could consider default in payment obligations under derivative transactions at par with default under other lending facilities, for the purposes of reporting of wilful defaulters. This effectively puts an end to the conflicting decisions previously passed by lower courts on this point and gives banks a fillip in enforcement of claims.

Woe to wilful defaulters

The Reserve Bank of India (RBI) had notified instructions from time to time to banks and other financial institutions in connection with reporting of wilful defaulters. These instructions were consolidated in a master circular on this subject in 2008, and subsequently updated on an annual basis.

The master circular states that an event of "wilful default" would occur upon any of several events of default of obligation to pay or repay a lender, including instances when a defaulting unit had resources to honour its commitments or had siphoned off or misused funds.

Being classified as a wilful defaulter has several adverse consequences, including prohibition on additional facilities being granted by banks or other financial institutions and a bar on promoter access to institutional finance for a period of five years. Lenders are also encouraged to proactively seek change of management of units classified as wilful defaulters and to seek removal of their promoters from the board of directors of any other company to which facilities have been made available.

The master circular also recommends initiation of recovery measures against borrowers in the event of siphoning of funds or perpetuation of any other fraud. Such measures may include foreclosure and civil and criminal legal action.

Underlying conflict

Many Indian exporters and other companies having exposure to foreign currency risk entered into forex derivative contracts in the early 2000s. Over the course of the decade, the volume of such contracts grew due to increasing speculation to exploit arbitrage opportunities in interest and conversion rates.

With the advent of the financial crisis in the West, the bubble burst and the resulting currency depreciation left these Indian companies in the red. Subsequently, companies which had obtained facilities from banks for this purpose refused to pay their dues and challenged their classification by banks as wilful defaulters. Due to conflicting decisions by Calcutta High Court (in *Kotak Mahindra Bank v Hindustan National Glass*) and Bombay High Court (in *Emcure Pharmaceuticals v ICICI Bank* and *Finolex Industries v RBI*) on an identical point of law, the matter was brought before the Supreme Court for a final ruling.

Supreme Court ruling

The principal question before the Supreme Court was whether a wilful default of payment obligations arising from a derivative transaction would be covered under the master circular. The main submission of the companies, which had challenged the action taken by banks, was that no borrower-lender relationship was created by entering into derivative transactions with banks as this did not constitute an act of lending. Therefore, any payment default would fall outside the ambit of the master circular.

After examining the origins of the master circular, the court held that the purpose of its notification by the RBI was to create a systemic mechanism for dissemination of information on instances of wilful default above ₹2.5 million (US$45,000) so as to caution banks and other financial institutions against extending further credit to those who, despite having the capacity to pay their dues, chose not to.

In this context, reading the master circular along with language used in banking legislation, the court interpreted the definition of the term "wilful default" as not restricted only to default by a unit of its repayment obligations, but also necessarily including wilful default by a client of the bank in meeting payment obligations to the bank under any kind of facility or transaction such as bank guarantees and derivative trades.

Between the lines

On the question of the binding nature of the RBI's interpretation of its circulars, the Supreme Court appeared disinclined to adopt a view merely because the RBI suggested it. Instead, in a passing reference in its judgment, the court was content to state that the interpretation of law was based on its own opinion.

With this judgment, banks will now have an additional weapon to aid them in enforcement and recovery proceedings. Besides acting as a potent deterrent to future instances of wilful default, it is expected that in the short term this decision will encourage defaulting clients to enter into settlement discussions with credit institutions.

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