

Is secured creditor really secured?

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The Supreme Court has held that the DRT Act and SARFAESI Act do not per se create preceding charge in favour of banks, financial institutions and other secured creditors, while, a specific statutory charge will prevail over rights of any other secured creditor.

The 'doctrine of priority of state debts' is a settled principle under common law, as per which the government ('State') has first charge over the priority of debts. However, in the recent past there have been conflicts between secured creditors who have initiated credit recovery proceedings under the provisions of the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 ("DRT Act") or the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interests Act, 2002 ("SARFAESI Act") and the State, with respect to priority of claim on the debts due to them.

It has been contended by the State that by virtue of the doctrine of priority of state debt, they have priority over the claim of secured creditors. While, banks, financial institutions and other secured creditors, who have initiated proceedings under the SARFAESI Act or DRT Act have maintained that the non-obstante clause contained under the SARFAESI Act and DRT Act has an overriding effect on the provisions of any other legislation providing for recovery of dues, including the debts due to the State.

A non-obstante clause is a legislative device, which is usually employed to give overriding effect to certain provisions over some contrary provisions that may be found either in the same legislation or in some other legislation.

In the recent judgment of the Supreme Court of India ("Supreme Court") dated February 27, 2009, in the matter of Central Bank of India v. State of Kerala and Ors, the Supreme Court tagged various appeals involving interpretation non-obstante clauses contained in the SARFAESI Act and the DRT Act in light of the specific clauses contained under the State Government revenue legislations, including the Bombay Sales Act, 1959 ("Bombay Act") and Kerala General Sales Tax Act, 1963 ("Kerala Act"), which provides for creation of first charge in favour of State Government over the property of the assessee who has defaulted in payment of State Government dues.

The Supreme Court noted that the non-obstante provisions contained under the SARFAESI Act and DRT Act merely gives an overriding effect to the credit recovery proceedings initiated under the said two legislations. Further, the said Acts regulate the distribution of money received by the secured creditor, and do not per se create a preceding charge in favour of the secured creditor.

The Supreme Court also clarified that the DRT Act and SARFAESI Act and the State revenue legislations are within respective competent legislative power of Central and State legislatures and there is no ostensible overlapping between two sets of legislations.

The Supreme Court further remarked that, it could have given effect to the non-obstante clauses contained in DRT Act and SARFAESI Act, only if there was a specific provision in creating first charge in favour of the banks, financial institutions and other secured creditors. For the same, the Supreme Court cited the non-obstante provisions of the Companies Act, 1956 and the Employees' Provident Funds and Miscellaneous Provisions Act, 1952 recognizing the priority of workers dues over other debts.

Similarly, in the year 2008, in Krishna Lifestyle Technologies Ltd v. Union of India, the Bombay High Court while considering the non-obstante provision of Central Excise Act, 1944 held that in absence of any specific provision creating first charge in favour of the State, the provisions of SARFAESI Act would override the provisions of the Central Excise Act, 1944 and the sale of the assets would be distributed in the order of priority of the creditor as provided under SARFAESI Act.

However, the Bombay High Court observed that, it is open to the State, to provide that its dues have priority of claims over the dues of a secured creditor (s). This understanding has been affirmed in the present case, where the Supreme Court has affirmed the provisions of the Bombay Act and Kerala Act, which provides for creation of first charge in favour of State.

Though, the Supreme Court has recognized the fact that the DRT Act and SARFAESI Act have been created for benefit of a banks, financial institutions and other secured creditors, it has been clarified that these two Central legislations do not per se create first charge in favour of the banks, financial institutions and other secured creditors. Thus, it can be concluded that the State would have priority of claim, if there is a specific provision giving priority to the State dues. However, if the dues are recoverable merely as arrears of land revenue, those debts cannot have priority of claim over the dues of a secured creditor.

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