

Dispute Resolution Hotline

March 12, 2009

IS SECURED CREDITOR REALLY SECURED?

Highlight of the judgment

The Supreme Court of India 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 and specific statutory charge will prevail over rights of any other secured creditor. The judgment lays down that the provisions contained in State/ Central revenue legislations providing priority of claim in favour of State dues are not inconsistent with the provisions of the DRT Act and SARFAESI Act.

INTRODUCTION

It is a settled principle under common law, that the government ("State") has first charge over the priority of debts. This principle is also known as the '*doctrine of priority of state debts*'. This common law doctrine of priority of State's debts has been recognised by the courts of India, as being applicable to British India before 1950 and hence the doctrine has been treated as "law in force" within the meaning of Article 372(1) of Constitution. 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.

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*¹ the Supreme Court dealt in detail with the issue relating to the scope and extent of application of the SARFAESI Act and DRT Act in light of the non-obstante clause contained under these two Acts and also considered the circumstances for the applicability of the '*doctrine of priority of state debts*'. After detailed analysis of the SARFAESI Act and DRT Act and the respective conflicting State Government revenue legislations providing for creation of first charge in favour of the State, the Supreme Court laid down that the State Government revenue legislations providing for recovery of dues from the seller as arrears of land and the SARFAESI Act and DRT Act have different domains of operation and there is no overlap or conflict in the application of the laws. Thus, if there is any right over property created by Statute, it would prevail over the rights of the secured creditors.

BACKGROUND OF THE CASE

In the present case the Supreme Court tagged various appeals involving interpretation of the non-obstante clause under the Section 35 of the SARFAESI Act and Section 34(1) of the DRT Act, giving priority of claim to the debts due to banks, financial institutions and other secured creditors.

The Supreme Court analyzed the aforesaid non-obstante clauses in light of the non-obstante clauses contained under the State Government revenue legislations, such as 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 non-obstante clauses contained under the SARFAESI Act, DRT Act, Bombay Act and the Kerala Act are reproduced herein below:

SARFAESI ACT

"Section 35 – **The provisions of this Act to override other laws:** The provisions of this Act shall have effect, notwithstanding anything inconsistent therewith contained in any of the law for the time being in force or any instrument having effect by virtue of any such law".

DRT ACT

"Section 34 – **Act to have over-riding effect:** (1) Save as otherwise provided in Sub-section (2), the provisions of this Act shall have effect notwithstanding anything inconsistent therewith contained in any other law for the time being in force or in any instrument having effect by virtue of any law other than this Act."

BOMBAY ACT

"Section 38C - **Liability Under this Act to be First Charge** - Notwithstanding anything contained in any contract to the contrary but subject to any provision regarding first charge in any Central Act for the time being in force, any amount of tax, penalty, interest or any other sum, payable by a dealer or any other person under this Act shall be the first charge on the property of the dealer, or, as the case may be, person."

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“Section 26 - **Tax payable to be first charge on the property** - Notwithstanding anything to the contrary contained in any other law for the time being in force, any amount of tax, penalty, interest and any other amount, if any, payable by a dealer or any another person under this Act, shall be the first charge on the property of the dealer, or such person.”

The Supreme Court has held that, the DRT Act and SARFAESI Act have been enacted by Central Government under Entry 45 in List I in the Seventh Schedule whereas Bombay Act and Kerala Act have been enacted by the concerned State Government under Entry 54 in List II in the Seventh Schedule, implying that the, two sets of legislations have been enacted with reference to entries in different lists in the Seventh Schedule. The Supreme Court held that, there is no conflict in the operation of the DRT Act and SARFAESI Act vis-a-vis against the provisions of Bombay Act and Kerala Act and there is no ostensible overlapping between two sets of legislations. Therefore, the said State Government legislation cannot be struck down as the same are not in conflict with the mentioned two Central Government legislations.

Interestingly, the Supreme Court has observed that both DRT Act and SARFAESI Act regulate the distribution of money received by the secured creditor, and do not create a preceding charge in favour of the secured creditor. The DRT Act and SARFAESI Act provides a credit recovery mechanism to secured creditors and ensures that priority is given to the claim of workers of a company in liquidation under Section 529A of the Companies Act, 1956 vis-a-vis secured creditors like banks and financial institutions is duly respected.

The Supreme Court further held that, it could have given effect to the non-obstante clauses contained in Section 34(1) of the DRT Act and Section 35 of the SARFAESI Act vis-a-vis Section 38C of the Bombay Act and Section 26B of the Kerala Act and similar other State legislations, only if there was a specific provision in the two Central Government legislations creating first charge in favour of the banks, financial institutions and other secured creditors. As the Central Government has not made any such provision in either of the enactments, the first charge created by the State Government legislations on the property of the dealer or any other person, liable to pay sales tax etc., cannot be destroyed by implication or inference, notwithstanding the fact that banks, financial institutions or other secured creditors fall in the category of secured creditors.

PRIORITY OF TAX DUES

The question to be considered is whether the dues to the State have priority over the claims of a secured creditor. It was held in *Collector of Aurangabad v. Bank of India*² that merely because sales tax arrears are to be recovered as arrears of land revenue does not make the dues, have priority over dues of secured creditors.

Similarly, in the year 2008, in *Krishna Lifestyle Technologies Ltd v. Union of India*³, the question arose before the Bombay High Court was, whether recovery under provisions of the Central Excise Act, 1944 have priority over the claim of secured creditors under the SARFAESI Act in view of the proviso introduced by the Finance Act, 2004, under which power was conferred on the revenue authorities to recover the dues by sale of the excisable goods, material, preparations, plant, machineries, vessels, utensils, implants and articles in custody of the person to whom the transfer as contemplated by the proviso is effected.

The Bombay High Court held that the dues owed to the State have preference only over the dues of an ordinary creditor, not a secured creditor. The Bombay High Court while considering the language of Section 35 held that the provisions of SARFAESI Act override the provisions of the Central Excise Act, 1944 and as such the priority given to a secured creditor would override State dues. A sale of the assets would be under the provisions of SARFAESI Act and the proceeds thereof would be distributed in the order of priority of the creditor.

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 it has been laid down by the Supreme Court that, the provisions of the Bombay Act and Kerala Act, which provides for creation of first charge in favour of State over the property of the assessee, has priority of claims over the dues of secured creditors.

CONCLUSION

Though, the Supreme Court has recognized the fact that the DRT Act and SARFAESI Act have been created for a 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 provisions giving priority to the State dues. However, if the dues are recoverable merely as arrears of land revenue based on a certificate issued by the recovery collector, those debts cannot have priority of claim over the dues of a secured creditor.

- Shikhar Kacker & Vyapak Desai

1. Civil Appeal Nos. 95 of 2005, 2811, 3549, 3973, 4174, 4909 of 2006, 1288/2007 and C.A. No. 1318 of 2009 (Arising out of S.L.P. (C) No. 24767 of 2005)
2. AIR 1967 SC 1831
3. 2008(110)Bom.L.R.456

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