Dispute Resolution Hotline

November 08, 2013

MASTER CIRCULAR ON WILFUL DEFAULTERS APPLIES TO DERIVATIVE CONTRACTS

- Supreme Court holds that RBI's Master Circular on wilful defaulters applies to non-funded transactions such as derivative contracts.
- Supreme Court holds that credit information of a defaulter on non-funded obligations to banks is information which the RBI can request from such banks. There is no right of confidentiality/privacy in respect of such information.
- Supreme Court applies principle of literal interpretation and holds that other RBI circulars cannot be relied on to interpret the Master Circular on wilful defaulters.

INTRODUCTION

In *Kotak Mahindra Bank Limited v. Hindustan National Glass & Industries Limited & Ors.*[1] ("**Ruling**"), the Supreme Court of India ("**Supreme Court**") considered whether the RBI Master Circular dated July 1, 2008, on Wilful Defaulters[2] ("**Master Circular**") would be applicable to defaults on derivative transactions.[3] This issue arose in appeals in three separate cases presenting an interesting scenario with the Calcutta High Court ruling that that the Master Circular was not applicable to derivative transactions ("**Calcutta Case**")[4] and the Bombay High Court ruling that the Master Circular applied to derivative transactions ("**Bombay Case**").[5] Analyzing the provisions of the Reserve Bank of India Act, 1934 ("**RBI Act**") and the powers of the Reserve Bank of India ("**RBI**") set out in the RBI Act and the Banking Regulation Act, 1949 ("**Banking Act**"), the Supreme Court held that the Master Circular applied to derivative transactions and that the Master Circular would also apply to non-funded obligations, such as a guarantee. The Supreme Court noted that the Master Circular was an initiative taken at the instance of the Central Vigilance Commission ("**CVC**") to ensure that there was greater coordination among banks regarding willful defaulters. Consequently, the Master Circular would have to be interpreted in the context of the purpose it sought to achieve, namely, sharing of credit information relating to defaulters and preventing access of finance to such defaulters.

BACKGROUND

In three separate and distinct transactions, three different entities[6] (the "**Company**") entered into a foreign currency derivative transaction and executed a Swaps and Derivatives Association Master Agreement ("**Derivatives Agreement**") with three different banks[7] (the "**Bank**"). The Company was sanctioned limits under the Derivatives Agreement and when the Derivative Agreements lapsed, the Company failed to pay the Bank as per the Derivatives Agreement. The Bank issued a notice to the Company classifying it as a willful defaulter under the Master Circular. The Company challenged the classification before the Bank's Grievance Redressal Committee which upheld the classification. The Company challenged the classification before the jurisdictional High Court in a writ petition. In the Calcutta Case, the High Court held that default on the Derivatives Agreement would not be covered by the Master Circular. The Calcutta High Court reasoned that the Master Circular applied only to lending transactions (since the Master Circular used the expression 'lender') and hence was not applicable to derivative transactions.

In contrast, in the Bombay Case after an analysis of RBI Act, Banking Act and circulars on prudential norms, asset classification, non-performing assets etc.[8], the court concluded that the Master Circular applied to derivative transactions.

The Supreme Court had to reconcile two conflicting judgments and the relevant laws. In the Ruling, the Supreme Court did not examine whether Company was in fact a willful defaulter – the scope of examination was restricted exclusively to whether the Master Circular would apply to derivative contracts and consequently, the Supreme Court did not consider facts specific to the Calcutta Case or the Bombay Case.

CONTENTIONS OF THE COMPANY

1. The Company contended that the Master Circular applied only in 'lender-borrower' transactions. Company contended that banks were permitted to engage in two kinds of transactions under the Banking Act, namely, core banking services and miscellaneous services and therefore, the Master Circular would apply only in the context of core banking activities and not miscellaneous services.[9] Further, Supreme Court had recognized this distinction in the activities of a bank.
2. Since Master Circular had severe consequences, it had to be strictly / narrowly followed / interpreted and consequently, would not apply in context of derivatives.[10]
3. The Company argued that even though RBI had provided an interpretation, the same was not binding on the Supreme Court and Supreme Court had to independently interpret the Master Circular. In this context, since there was no 'lender-borrower' relation and the Master Circular would not apply.

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4. Powers of RBI were only in respect of credit information and this information was only in context of lending and borrowing and could not be in context of derivatives as this was not 'credit information' as per the Credit Information Regulation Companies Act, 2005.

CONTENTIONS OF BANK AND RBI

1. Object of the Master Circular was to address non-performing assets and willful defaulters and hence it was applicable in all situations of default. .
2. As per Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations, 2000 ("**FEMA Derivative Regulations**"), foreign exchange derivative contract had been defined to mean a financial transaction or arrangement in whatever form and by whatever name called and hence a default in respect of the same would result in non-payment by a customer of dues to the bank.
3. Supreme Court should defer to interpretation of RBI as the Master Circular was issued by RBI itself. Banks and RBI argued that since the definition put forth was by RBI, this definition should be accepted as the correct interpretation of what the Master Circular intended and whether it applied to derivative transactions.

SUPREME COURT DECISION

The Supreme Court held that the Master Circular applied to derivative transactions. More importantly the court held that although RBI had articulated its interpretation, ultimately, it was incumbent on the court to interpret the Master Circular. The Supreme Court rejected the narrow approach in the Calcutta Case and the wide approach in the Bombay Case and held that the Master Circular had to be read in the 'context of the subject matter'[11], namely, Banking Act and the RBI Act. The Ruling noted that the purpose of the Master Circular was to have a system to disseminate credit information pertaining to willful defaulters among banks and financial institutions so that no further finance is available to such entities. The Supreme Court relied on a CVC letter, dated November 27, 1998, on the subject 'improving vigilance administration in banks' to ensure that RBI had all information relating to willful defaults and not just defaults by borrowers. The Master Circular was to 'put in place a system to disseminate credit information pertaining to willful defaulters..' and hence the purpose of the Master Circular was to share information and ensure that no credit was provided to defaulters. The Ruling noted that clause of 2.6 of the Master Circular covered even guarantee transactions and thus, non-funded transactions were also covered by the Master Circular. In conclusion, the Ruling also rejected the contention of violation of privacy and sets out the power of RBI to call for information for the purpose of regulating credit and monetary policy. In this regard, the Ruling has held that the Master Circular does not have the effect of blacklisting a client.

OUR ANALYSIS

The Ruling highlights the approach to be followed by RBI in interpreting notifications released by RBI – a notification should be applied in the context of the subject of the relevant notification and the relevant parent laws. Although this interpretation has been given in the context of RBI, it is arguable that a similar approach is to be followed in the context of other regulators such as the Telecom Regulatory Authority of India, Securities and Exchange Board of India etc. Therefore, the exercise of powers must be in relation to the subject notification and cannot extend beyond that.

From the perspective of the law on derivative transactions, the Ruling examined FEMA Derivative Regulations but did not examine derivative transactions either from an accounting perspective or with reference to the underlying transaction. It is possible that a closer examination of the underlying transaction or the derivative transaction could have led the court to a different conclusion based on the funding principle. The Supreme Court has instead proceeded on the basis of an overarching principle that a derivative transaction creates a payment obligation[12] and the object of the Master Circular. Interestingly, the International Monetary Fund has explained derivative transactions to be instruments unlike debt instruments in respect of which no principal is to be repaid.[13]

Companies must therefore take into account the above principle of interpretation of statutory notifications while engaging in transactions. Specifically, companies should be aware of the considerations that weigh with the RBI while evaluating whether a non-funded transaction would be covered by the Master Circular.

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You can direct your queries or comments to the authors

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[1] (2013) 7 SCC 369.

[2] 2.1 Definition of wilful default:
The term "wilful default" has been redefined in supersession of the earlier definition as under:
A "wilful default" would be deemed to have occurred if any of the following events is noted :-
(a) The unit has defaulted in meeting its payment / repayment obligations to the lender even when it has the capacity to honour the said obligations.
(b) The unit has defaulted in meeting its payment / repayment obligations to the lender and has not utilised the finance from the lender for the specific purposes for which finance was availed of but has diverted the funds for other purposes.
(c) The unit has defaulted in meeting its payment / repayment obligations to the lender and has iphoned off the funds so that the funds have not been utilised for the specific purpose for which finance was availed of, nor are the funds available with the unit in the form of other assets.
(d) The unit has defaulted in meeting its payment / repayment obligations to the lender and has also disposed off or removed the movable fixed assets or immovable property given by him or it for the purpose of securing a term loan without the knowledge of the bank/lender.

[3] The derivative contracts were essentially currency swaps to protect the company from adverse foreign exchange fluctuation.

[4] Kotak Mahindra Bank Limited v. Hindustan National Glass & Industries Limited & Ors. (Civil Appeal No. 8916 of 2013) on appeal from the High Court of Calcutta.

[5] Emcure Pharmaceuticals Limited & Anr. (Civil Appeal No. 8917 of 2012) from High Court of Bombay and Finolex Industries Limited and Anr. v. Reserve Bank of India and Ors. (Civil Appeal No. 8918 of 2012), both on appeal from High Court of Bombay.

[6] Hindustan National Glass & Industries Limited, Emcure Pharmaceuticals Limited and Finolex Industries Limited.

[7] Kotak Mahindra Bank and ICICI Bank.

[8] Master Circulars dated July 1 2009, August 8 2008, October 13 2008, October 29 2008, April 9 2009, July 1 2010.

[9] ICICI Bank Ltd. v. Official Liquidator (2010) 10 SCC 1.

[10] Tolaram Reluma v. State of Bombay (1955) 1 SCR 158, Chandigarh Housing Board v. Devinder Singh (2007) 9 SCC 67, Delhi Airtech Services (P) Ltd. v. State of U.P. (2011) 9 SCC 354.

[11] Applying the principle of interpretation that, first, the literal meaning of the words had to be ascertained and only in the event of ambiguity or where the literal meaning leads to inconsistency that it would be proper to look at other possible meanings.

[12] The Supreme Court came to this conclusion based on the transactions approved under FEMA Derivative Regulations.

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[13] "Financial derivatives are financial instruments that are linked to a specific financial instrument or indicator or commodity, and through which specific financial risks can be traded in financial markets in their own right. Transactions in financial derivatives should be treated as separate transactions rather than as integral parts of the value of underlying transactions to which they may be linked. The value of a financial derivative derives from the price of an underlying item, such as an asset or index. Unlike debt instruments, no principal amount is advanced to be repaid and no investment income accrues.", available at http://www.imf.org/external/np/sta/fd/.