

Introduction

Constitution of Working Group

Based on the recommendations of Joint Parliamentary Committee (JPC) the Reserve Bank of India advised the Indian Banks' Association to set up a Working Group to review and suggest changes in the laws relating to creation, enforcement and registration of Security Interest. Accordingly, with the approval of the Managing Committee, the IBA, in October 2003, formed a Working Group under the Chairmanship of Dr. Anil K Khandelwal, the then Executive Director of Bank of Baroda and presently, Chairman & Managing Director of Dena Bank to address the issues.

The Working Group comprised the following members:

1. Shri G M Ramamurthy
Executive Director
Industrial Development Bank of India Limited
2. Shri S C Gupta
Legal Advisor
Reserver Bank of India
3. Shri S K Sinha
General Manager & Advisor (Law)
State Bank of India
4. Shri K Prasad
General Manager (DBS, FID)
Reserve Bank of India
5. Shri R N Pradeep
General Manager (Law)
Bank of India
6. Shri M T Udeshi
Deputy General Manager (Law)
Bank of Baroda
7. Shri S Viswanathan
Asst. General Manager (Law)
Punjab National Bank
8. Shri V K Gupta
Asst. General Manager (Legal)
Dena Bank

9. Shri Sudhir Jha
Chief Manager (Law)
ICICI Bank Ltd.
10. Shri M R Umarji - Convenor
Chief Advisor (Legal)
Indian Banks' Association

Terms of Reference for the Working Group were:

1. To review the various methods of creation of security interest presently available under different statutes and the rights of secured creditors vis-a-vis other creditors, both secured and unsecured, suggest measures, including legislative amendments, to create security interest without any defect.
2. To review the present registration requirements and publicity aspects relating to various types of security interest, both under the SARFAESI Act and other statutes and suggest measures for developing comprehensive registration mechanism providing sufficient publicity and public access.
3. To examine the mechanism for enforcement of security interest provided in the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI) to suggest further measures to strengthen the enforcement of mechanism.
4. To examine the priority rule amongst the various claimants upon the property where security interest is created and measures to perfect the rights of secured creditors under SARFAESI Act vis-a-vis other secured creditors.
5. To suggest measures for protecting the rights of secured creditors under SARFAESI Act when the owner is under insolvency/winding up with reference to SICA/Part VIA of the Companies Act.
6. To suggest measures for enhancing the value and acceptability of the collateral

And

7. To examine any other issues

Meetings of the Working Group

The Working Group held seven meetings for discussing the issues and finalising the report.

At the first meeting of the Working Group held on 20th November 2003, two Sub-Groups were formed; one Sub-Group to deal with issues relating to movable properties and another Sub-Group to deal with issues relating to immovable properties. The first Sub-Group consisted to Shri M T Udeshi as Convenor and Shri V K Gupta and Shri Sudhir Jha as members. The second Sub-Group consisted to Shri G M Ramamurthy as Convenor with Shri S K Sinha and Shri S Viswanathan as members. The Working Group prepared a questionnaire and the same was circulated by the IBA to the banks, academicians and professionals, seeking feedback from them.

At the second meeting of the Working Group held on 22nd April 2004 the information compiled by the IBA on the feedback received from banks and others was deliberated by the Working Group.

Thereafter, the Working Group and the Heads of the Legal Departments of the banks met on 5th May 2004 and discussed several issues relating to security laws in India.

Both the Sub-Groups held separate meetings on 6th May 2004 and discussed the broad contours of the report.

The fifth meeting of the Working Group was held on 28th May 2004 in the IBA Office at Mumbai. At this meeting, both the Sub-Groups made presentation of the draft reports. The members deliberated and suggested modifications/changes to the draft reports.

At the sixth meeting held on 23rd July 2004, the draft reports were further deliberated and the Sub-Groups submitted their respective reports.

The reports of both the Sub-Groups were taken up for deliberations at the meeting of the Working Group held on 30th August 2004. Thereafter, the Working Group submitted its Report to the IBA.

Acknowledgements

The Members of the Working Group are thankful to the IBA for setting up the Group which gave them an opportunity to deliberate on vital issues relating to security laws in India and make recommendations. The Group is also thankful to the Member Banks of IBA and others for their valuable feedback which facilitated deliberations of the meetings.

The members of the Working Group are thankful to Shri M R Umarji, Chief Advisor (Legal), IBA and Convenor of the Working Group for his painstaking task in going through the draft report of the Working Group and crystallizing the same.

Background of Existing Law

The commercial laws in India were enacted in late nineteenth century and although they have stood the test of time and formed the foundation of commercial law in India, no major changes in such laws have been made to meet the demands of globalisation and market-oriented economy. There is a need to modify our commercial laws to reduce the legal barriers faced by individuals operating in the market on their own terms to produce wealth. In this connection, the Group noted the views of the Supreme Court expressed in the case of *Mardia Chemicals Ltd. Vs. Union of India and Others*. (AIR 2004 Supreme Court 2371). The Hon'ble Supreme Court in its judgement while examining the provisions of Transfer of Property Act as contained in section 58 & 69 had recognized the situation which has undergone a change when the Act was enacted and which prevails today by making observations (in para 43) as under:

“The position as prevailed in 1882 when the Transfer of Property Act was enacted has undergone a sea-change. What was conceived correct in the situation then prevailing may not be so in the present day situation. Functions of different institutions including the banking and financial institutions have changed and new functions have been introduced for financing the industries, etc. New economic and fiscal environment is around more than 100 years later after the enactment of the Transfer of Property Act. In this connection it has been pointed out on behalf of the respondents that Rajamannar Committee was appointed by Government of India which submitted its report in 1977 indicating the effect of the changed situation and the relevance of the provisions of the Transfer of Property Act in context thereof.”

The Hon'ble Supreme Court also referred to Rajamannar Committee Report, as quoted in the Narasimham Committee Report, 1998, which reads as under:

“Economic conditions have vastly changed since the enactment of the Transfer of Property Act in 1882. The role of the unscrupulous money lenders dominating in the field of credit is no longer valid, without reliance on institutionalization of credit, the banks and another Financial Institutions are the major moneylenders of credit today. In

their dealings with their mortgagors, it is anachronistic to assume that they will adopt the unscrupulous moneylenders.”

In fact, in extending credit, the necessity for suitable safeguards to banks and other financial institutions is now rightly stressed. It is understandable that the legal framework essentially is conceived to deal with unscrupulous moneylenders is no longer appropriate to deal with credit given by banks and other financial institutions.

The Group noted that the United Nations Commission on International Trade Law (UNCITRAL) has set up a Working Group VI for preparing a legislative guide on model security interest law. The Working Group has held six sessions so far and Shri M.R. Umarji, Chief Advisor (Legal), Indian Banks' Association, who is associated with UNCITRAL work, briefed the Group about the proposed recommendations of UNCITRAL which are expected to be finalized by September 2005. The Group also noted that UNCITRAL has prepared a Convention on Assignment of Receivables which needs to be considered while reviewing security Laws in India.

2.1. This report consists of following parts:

- a) Study of the present commercial laws in India and list of various shortcomings which need to be addressed.**
- b) Suggestions for reforms either by amendment of present law by new legislation.**
- c) Suggestions for reforms in certain related laws for simplification of process of creation of security interest and its enforcement.**
- d) Summary of recommendations.**

3.1. Laws relating to Transfer of Immovable Property

- a) The Transfer of **Property** Act (TP Act), 1882 does not recognize the concept of ownership rights in a portion of a multi-storeyed building whether residential or commercial. Consequently, it is difficult for a

person owning such property to raise a loan against the security of such property. In some States like Maharashtra, the structure of co-operative societies is being used for joint ownership of land and common amenities provided in a multi-storeyed building along with individual ownership rights in the apartments. In addition to this structure, Apartment Ownership Acts have been enacted in some States for the purpose of clearly defining rights in apartments but there is a need for uniform Central Law in this respect, for the purpose of recognizing ownership rights in a portion of a building/structure constructed on land, whether used for residential, commercial or industrial purpose.

- b) Section 69 of the TP Act provides for enforcement of the mortgage without the intervention of the Courts by an English mortgagee. This provision does not apply to a Hindu, Mohammedan or a Buddhist or a member of any other race, sect, tribe or class from time to time specified in this behalf by the State Government in the Official Gazette.
- c) The TP Act provides for a mortgage by deposit of title deeds without recording any writing and without any requirement of registration. But such mortgage can be created only at Presidency Towns of Kolkata, Chennai and Mumbai and such other towns as may be notified by the State Governments.
- d) There is no clear provision in regard to treatment of machineries embedded in land as immovable or movable property.
- e) The TP Act contains provisions relating to transfer of actionable claims. The definition of actionable claim in section 3 does not include a receivable which is secured by any security of pledge, hypothecation or mortgage. As a result, there is no specific statutory provision for transfer of a receivable which is secured by any security. Further, there is no clear provision for transfer of future receivables.

3.2. Registration Act

The Registration Act contains provisions for the purpose of maintaining land records Registry and registration of all transactions relating to immovable properties. However, the law does not provide for issue of title certificates by the registration authorities and the documents registered are sale deeds, mortgage deeds and lease deeds and similar other documents creating or transferring any interest in an immovable property. Since there is no system of issue of title certificate for the property owned by any person, it is difficult to offer such property as a security, particularly in cases where it is ancestral property occupied by the owners and they do not hold any sale deeds or any other document evidencing title. There are many cases where a person derives his title to property by succession or partition. There is further difficulty in rural areas where house properties located in a village are collectively known by the particular village name and are *abadi* lands without any specific title certificate in favour of occupant of any portion of the land.

3.3. Indian Succession Act

The law relating to succession to property whether testate or non-testate is not clear on account of multiple personal laws governing succession. Under the Indian Succession Act, 1925 a succession certificate is issued only in cases, where the claim pertains to debts, shares and securities. Where the assets are in the nature of other properties and valuables, succession certificate cannot be issued. Where the deceased has left a Will, it is not compulsorily required to be probated, in some States. There is no uniform system for grant of heirship certificate or legal representation or succession certificate by any authority constituted under statutory provisions.

3.4. Indian Contract Act, 1872

The Contract Act contains provisions in Section 172-176 regarding possessory securities. But there is no provision in the Act in regard to non-possessory securities such as hypothecation. The law relating to non-possessory

securities is therefore covered by the general principles of the contract and the decisions of the Courts from time to time. There are conflicting judgements on the rights of hypothecatee. One view is that a hypothecatee can take possession and sell hypothecated asset privately (Chirangilal Vs. SBI (1994) 80 Company Cases 537(MP). The other view is that the clause in hypothecation agreement empowering hypothecatee to take forcible possession is void. (Tarun Bhargava Vs. State of Haryana AIR 2003 P&H98). While the conflict is resolved by conferring powers of enforcement on banks and financial institutions under the SARFAESI Act, there is a need to make a statute in regard to non-possessory securities.

3.5. Stamp Duty Laws

The scheme of stamp duty laws under the Constitution of India provides for powers of the State Governments to prescribe the rates of stamp duty in respect of most of the documents relating to transfer or creation of interest in property, both movable and immovable. As a result, there are multiple stamp duty laws enacted by each State applicable in respective States. Such multiple laws and the multiple rates of stamp duty have become an impediment in the growth and development of new financial instruments having a character of transferability anywhere in India. Under the provisions of the Constitution, negotiable instruments, share transfer, insurance policies, letters of credit, receipts etc. that have a characteristic of transferability anywhere in India, are within the legislative competence of Union of India. But there is no provision in terms of which it is possible to include any new instrument introduced in the financial market to be given a characteristic of negotiability or transferability anywhere in India and provide a stamp duty for the same by Union of India to ensure uniformity of stamp duty rates in the country.

3.6.1. Recognition of rights of secured creditors

- a) As a legal principle, a secured creditor has priority over all other creditors and claimants and for recovery of secured loan he has the right to enforce the securities and realize the secured loan. In the event of insolvency or

winding up proceedings against the borrower, the secured creditor has a right to remain outside such proceedings and enforce the securities. These principles are recognised by various statutes as under:

- i) **Section 529 & 529A of the Companies Act, 1956**
- ii) **Sub-section (6) of section 28 of the Provincial Insolvency Act, 1920**
- iii) **Section 47 of the Provincial Insolvency Act, 1920**
- iv) **Proviso to section 47 of the Presidency Towns Insolvency Act, 1909**
- v) **Section 169(1) of the Maharashtra Land Revenue Code, 1966 (a State law recognizing the principle of priority).**

b) There are exceptions to above principle created by statute. If there is a statutory provision giving priority to arrears of tax over all creditors including secured creditors, such statutory rights prevail over the rights of secured creditors. Some States have afforded priority to sales tax dues by making specific provision in the sales tax Acts. The Supreme Court has also held such statutory provisions as valid in following cases:

- i) **State Bank of Bikaner & Jaipur vs National Iron & Steel Rolling Corporation (1995) 2 SCC 19**
- ii) **Dena Bank vs Bhikabhai Prabhudas Parekh & Co. (2000) 5 SCC 694**

c) In view of the enactment of special laws by the State giving priority to the dues of arrears of tax over security interest created, the rights of the secured creditors have been eroded and diluted. It is not clear whether the State laws giving priority to tax dues over secured creditors have been enacted after obtaining President's assent and are valid laws under Article 254 of the Constitution inspite of the inconsistency with Central Law. The above issue was not raised before the Supreme Court and it has been held that such laws are constitutionally valid. Possibility of more such enactments by the other State Government cannot be ruled out and therefore, uncertainty prevails in regard to rights of secured creditors. This aspect may have to be borne in mind while introducing VAT system and replacing sales tax laws.

3.6.2. The Securitisation & Reconstruction of Financial Assets and Enforcement of Security Interest Act, (SARFAESI) 2002

The SARFAESI Act, for the first time recognizes the concept of comprehensive security interest subject to certain modifications as under:

- a. The concept that any security created to secure due repayment of a loan shall be treated as a security interest and shall be enforceable without the intervention of the court in the event of default, has been duly incorporated in the SARFAESI Act.
- b. The concept of security interest under the SARFEASI Act includes a charge on or mortgage of immovable property also.
- c. Title retention contracts such as hire-purchase and lease are excluded from the concept of security interest.
- d. The concept of security interest has been made applicable only to the banks and financial institutions and the law has no universal application unlike possessory security regime contained in the Indian Contract Act, 1872.
- e. Although a power to set up a Central Registry has been provided in the SARFAESI Act, the system of comprehensive security interest is introduced without setting up the Central Registry and the system operates on the basis of the existing asset specific registration systems operating under various laws.
- f. Although the Act provides for securitisation of financial assets on account of requirement of capital of Rs.100 crores or capital adequacy of 15%, no securitisation transaction are being undertaken under the provisions of SARFAESI Act. Further, securitisation of financial assets other than financial assets of banks and financial institutions is not permissible under the Act.

4.1. Hire-purchase and financial lease transactions

There is no statutory provision covering hire-purchase and lease of movables. The Hire Purchase Act, 1972 has so far, not been brought into force. As a result, the transactions of hire-purchase and lease of movables are governed by the provisions of the Indian Contract Act, 1872. For the purpose of Sales Tax,

by the Constitution (46th Amendment) Act, 1982, clause 29A was added in article 366 of the Constitution providing that a tax on the sale or purchase of goods inter-alia includes, a tax on the delivery of goods on **hire-purchase and any system of payment by instalments**. Further, the Institute of Chartered Accountants of India has provided accounting norms for lease and hire-purchase transactions in terms of which any asset given on hire or lease is treated as an asset belonging to the hirer or lessee and it is permissible for such hirer or lessee to claim depreciation in respect of such asset. The Income Tax Act, on the other hand, permits such depreciation to be claimed by the owner of the asset or lessor. Since there are no specific statutory provisions, the contracts of hire-purchase and lease are treated as title retention contracts enabling the owner of the asset given on hire and the lessor to take possession of the asset in the event of default and thereby giving a super priority to such persons over secured creditors. The absence of law in this area also adversely affects the interests of the consumer because there is no specific requirement to give credit for the instalment already paid by such consumer when the asset is seized for default and sold and pay the surplus to the borrower. Conversely there is no provision for recovery of shortfall if the owner or lessor is unable to realize the balance value in full on sale of the asset.

5.1. UNCITRAL Work on Security Interest Law

It is clear from the above discussion that there is no single uniform law in India which deals with creation, registration, priority and enforcement of securities over property. Such law has been enacted in the United States of America and the same is contained in Article 9 of the Uniform Commercial Code. Further, United Nations Commission on International Trade Law (UNCITRAL) Working Group VI (Security Interest) is preparing a legislative Guide for a Model Law of security interest. So far the said Working Group has held six sessions and drafts of legislative Guide have been prepared by the Working Group. It would be worthwhile referring to the objectives of UNCITRAL Working Group and the contents of the legislative Guide proposed to be recommended to the member countries of the United Nations, before we consider changes in our legal system in regard to secured

transactions law. Key objective of security transactions legislative Guide proposed to be recommended are as under:

- (a) Promote secured credit;
- (b) Allow a broad array of businesses to utilize the full value inherent in their assets to obtain credit in a broad array of credit transactions;
- (c) Obtain security rights in a simple and efficient manner;
- (d) Recognize party autonomy;
- (e) Provide for equal treatment of creditors;
- (f) Validate non-possessory security rights;
- (g) Encourage responsible behaviour by enhancing predictability and transparency;
- (h) Establish clear and predictable priority rules;
- (i) Facilitate enforcement of creditor's rights in a predictable and efficient manner;
- (j) Balance the interests of the affected persons;
- (k) Harmonize secured transactions laws.

5.2.1. With the enactment of Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act) certain key objectives contained in draft recommendations of UNCITRAL have been implemented in India. The changes introduced by the SARFAESI Act in the law relating to creation and enforcement of security over property are as under:

- Financial assets are made freely assignable notwithstanding anything contained in any law or any agreement (Section 5)
- Security interest is defined in generic term giving effect to substance over form to a limited extent
- Powers of enforcement of security interest have been given to the banks and financial institutions
- Definition of property is made wide to cover variety of property rights

- Since the existing law in India does not permit enforcement of mortgages of immovable properties, the same are also included in the definition of security interest with power of enforcement without the intervention of the Courts.

5.2.2. Although the new concepts have been introduced by the SARFAESI Act, the focus of that Act is in regard to giving powers to the banks and financial institutions to enforce security interests. The SARFAESI Act does not address issues of creation of security interest, registration of such security interest and rules of priorities amongst different parties holding security interest and other claimants. It is therefore necessary to make changes in our existing laws to cover above aspects of secured transactions.

6.1. Objectives of secured transactions law

If we look at the key objective of a secured transaction law it is necessary to allow a broad array of businesses to utilize the full value inherent in assets to obtain credit in a broad array of credit transactions. For the purpose of achieving this object it is necessary to clearly define the concept of property.

6.2. Definition of Property

The expression “property” is defined in various laws in India, the latest being section 2(1)(t) of the SARFAESI Act which defines property as under:

“property” means –

- (i) immovable property;
- (ii) movable property
- (iii) any debt or any right to receive payment of money whether secured or unsecured
- (iv) receivables, whether existing or future
- (v) intangible assets, being know-how, patent, copyright, trade mark, licence, franchise or any other business or commercial right of similar nature.

While the above definition makes the concept of property very wide, facilitating creation of security interest over such property, the various types of movable properties are not specifically covered by the definition. It is true that by using the expression “movable property” in the definition of property, any asset which is movable will be covered by the definition but for the purpose of clearly defining the rights and obligations consequent upon creation of security over such property it needs to be considered whether the definition of property should be made more specific by classifying movables as under:

- (a) Intangible property
- (b) Investment property
- (c) Inventory
- (d) ‘Consumer goods’
- (e) Agricultural produce
- (f) Receivables
- (g) Equipments and Machinery
- (h) Fixed Assets
- (i) Document of Title to Goods
- (j) Consumer Goods
- (k) Certificate of Title

If the categorization of various movable properties is done as suggested above, it will facilitate making provision for rights and obligations of different parties having interest in such properties. Such categorization would also facilitate registration of interest in such properties by providing a suitable registration system so that persons dealing with such properties would be in a position to ascertain any encumbrances that may be existing on such properties. By exempting consumer goods from registration requirement it will be possible to permit free sale of consumer goods without verification of registration. **The Group is of the view that for having an effective registration system a detailed category wise definition of property may have to be introduced in our law, as under:**

- (a) **Intangible property**, being know-how, patent, copyright, trademark, brands, goodwill, licence, franchise or any other business, commercial or personal right of similar nature.
- (b) **Investment property**: In this category of property investments such as share certificates, units of mutual funds, debentures, bonds, government securities including Kisan Vikas Patra, Indira Vikas Patra, etc. which represent the value of the investment made by a person should be treated as investment property. Such investment property would also include all securities as defined under the Securities Contracts Regulation Act, 1956.
- (c) **Inventory**: As goods held by a person for sale or lease or to be furnished under contract of service or consists of raw materials, semi-finished goods, work in process or finished goods or materials used or consumed in a business.
- (d) **'Consumer goods'** means goods that are used or bought for use primarily for personal family or household purposes.
- (e) **Agricultural produce or commodities** including products of dairy, animal husbandry, aquaculture, horticulture, floriculture, other plantations and other farm products.
- (f) **Receivables**: As a right to payment of a monetary obligation for any sale, assignment or lease of goods or services. Such definition of receivable should exclude rights to payment evidenced by any bill of exchange or other instruments, deposit accounts, investment property.
- (g) **Equipments and Machinery**: As goods other than inventory or fixed assets.
- (h) **Fixed Assets**: As goods that have become so related to or part of the land that an interest in such fixed assets arises out of the right to the land.
- (i) **Document of Title to Goods**: This expression is defined by section 2(4) of Sale of Goods Act, 1930. But there is a need to provide a legal framework for negotiability of such documents of title and a system for gradation and valuation of the goods represented by such documents of title. The system needs to be devised to facilitate trade in commodities by dealing with the documents of title to such commodities.
- (j) **Certificate of Title**: As a certificate of title meaning a certificate with respect to which any law provides for recording the security interest for the property covered by such certificate of title (for e.g., registration certificate of motor vehicle issued under the Motor Vehicles Act).

7.1.1. Security Interests

Having considered the categorization of movable properties into different specific types of properties the Working Group considered various kinds of security interests that can be created over the movable properties. Broadly such security interests are divided into two parts as under:

- (i) Possessory Securities**
- (ii) Non-Possessory Securities**

Under the Indian law possessory security is covered by statute but there are no provisions in regard to non-possessory securities except the recently enacted SARFAESI Act.

7.1.2. Possessory Securities:

Sections 172-176 of the Indian Contract Act, 1872 contains provisions for pawn or pledge of movables and rights of the lender against such security are laid down by the Act, which can be exercised without the intervention of the Courts. This provision is in operation for more than hundred years and there is no need to disturb the settled law in this respect. However, in regard to specific assets that can be given in pledge, there is a need to consider certain changes in the existing legal provisions. There is extensive lending activity against the security of shares of listed public limited companies and under Section 19(2) of the Banking Regulation Act, it is provided that no banking company shall hold shares in any company whether as pledgee, mortgagee or absolute owner of an amount exceeding 30% of the paid-up capital of that company or 30% of its own paid-up capital and reserves, whichever is less. The shares of any company are taken as security by the banks and financial institutions in following cases:

- i) Overdraft facility against listed and approved shares of any public limited company.
- ii) Pledge of shares of listed companies as an additional or collateral security for a loan or overdraft given against some other prime security.
- iii) Pledge of promoter's shares in cases of project finance where the loans and advances are secured by a charge over the entire

block of assets of the borrower and the pledge of shares is taken by the bank to ensure that the promoter continues to be involved in the project and does not transfer his interest without the consent or knowledge of the bank. Such a pledge also enables the lender to sell or dispose off the securities along with management of the company by exercising the rights as a pledgee although in practice such rights are rarely exercised.

While the requirement of the provisions of Section 19 placing a ceiling of 30% of the share capital of the company may be justified in respect of loans referred to at sub-paras (i) & (ii) above, there is no justification for placing that restriction in respect of pledge of promoter's share holding with the lender. Further, in terms of the RBI instructions, it is necessary that the bank holding shares as a pledgee or mortgagee must get such shares transferred in its own name (refer to RBI circular no.DBOD.BC.90/13.07.05/98 dated 28th August, 1998). This means that promoter's shares in excess of 30% cannot be accepted in pledge. Further, where the bank takes promoter's share holding in pledge, if such shares are transferred in the name of the bank, the effect will be that the bank itself will become the promoter and may have to face various liabilities as the owner of the company. Such liability may be environmental or other statutory liabilities relating to labour dues, workmen compensation etc. This particular aspect of taking promoter's shares as a pledge by the banks has arisen for consideration because the provisions of Section 19(2) of Banking Regulation Act do not apply to financial institutions and the practice of taking pledge of shares is prevalent among the development financial institutions and the banks were only participating as a consortium member in the term lending. With the development of the concept of universal banking and banks' entry into the field of term lending on a very large scale, it will become necessary for the banks also to take pledge of promoter's shares as a collateral security along with other securities. **The Group therefore recommends that restriction on holding of such shares exceeding 30% be withdrawn in respect of pledge of promoters shares and dispense with the requirement of transfer of such shares in the name of the bank.**

7.1.3. Warehouse Receipts

In the past few years there has been a consistent growth in lending against agricultural commodities. For the purpose of protecting the interest of the lenders as also the farmers who need to realize the best price for the produce, it is essential to devise a system for storage of commodities in warehouses, gradation and valuation of the commodities and issue of warehouse receipt certifying the quality and quantity of the commodity stored in the warehouse and finally making such warehouse receipts a negotiable document. Under the provisions of section 2(4) of Sale of Goods Act, 1930, definition of 'documents of title to goods' includes warehouse keeper's certificate. The said definition incorporates following characteristics of a document of title:

- (i) use in the ordinary course of business as proof of the possession or control of the goods and
- (ii) authority to possessor of the document of title to transfer or receive goods represented by the document either by endorsement or delivery.

However, there is a need to make a separate legislation for the purpose of making warehouse receipts a negotiable instrument and devising a system for certification of the quality and quantity of commodities stored in warehouses. It is true that a warehouse receipt does not strictly conform to the definition of negotiable instrument contained in the Negotiable Instruments Act, 1881. But there can be no legal objection to treat such warehouse receipts as negotiable document by enacting a special statute for the purpose.

7.1.3. Changes recommended in Possessory Securities Law

- a) **No change in existing law contained in sections 172 to 176 of the Indian Contract Act, 1872.**
- b) **Suitable amendments may be made to Section 19 of the Banking Regulation Act or an Order exempting applicability of Section 19(2) may be issued by the Central Government under section 53 of the Banking Regulation Act, in respect of**

pledge of promoters shares taken as a collateral security by the term-lenders in project financing activity.

- c) A proposal to enact a separate law for the purpose of making warehouse receipts negotiable instruments is under consideration of the Ministry of Consumer Affairs, Food and Public Distribution. The Group concurs with the proposal and suggests that necessary provisions for treatment of warehouse receipts as negotiable instruments may be enacted to facilitate trade in agricultural commodities.**

Except the above suggestions, no other changes are suggested in the existing law relating to possessory securities.

7.2.1. Non-Possessory Securities:

The non-possessory securities may be of any of the following kinds:

- i) Hypothecation**
- ii) Floating charge**
- iii) Transfer of Title as a security**
- iv) Retention of Title**

Under our existing legal system except the definition of “hypothecation” contained in the SARFAESI Act and equating “hypothecation” and “floating charge” being Non-Possessory Securities with the concept of security interest as defined under the said Act, there are no other provisions in any other law in regard to creation of security of hypothecation, rights and obligations of hypothecator and hypothecatee and the rules of priority in regard to various claims on the hypothecated property. Similarly the concept of floating charge as recognized by the Companies Act, 1956 requiring that a floating charge created on the assets of the Company should be registered with the Registrar of Companies under section 125 of the Companies Act, 1956. But as far as the rights and obligations of the charge holders and the company creating the charge, etc., are all governed by the decided cases of the courts and there are no statutory provisions governing such non-possessory security interest over movable property.

7.2.2. UNCITRAL suggestions on Non-Possessory Securities

In this respect draft recommendations of UNCITRAL provide as under:

“Pre-default rights and obligations of the parties:

The purpose of the provisions of the law on pre-default rights and obligations of the parties is to:

- (a) **Provide rules on additional terms for a security agreement with a view to rendering secured transactions more efficient and predictable;**
- (b) **Reduce transaction costs by eliminating the need to negotiate and draft terms to be included in the security agreement where the rules provide an acceptable basis for agreement;**
- (c) **Reduce potential disputes;**
- (d) **Provide a drafting aid or check list of issues the parties may wish to address at the time of negotiation and conclusion of the security agreement, and**
- (e) **Encourage party autonomy.”**

Suppletive rules

The law should include suppletive, non-mandatory rules that would apply in the absence of contrary agreement of the parties. Such rules should, inter alia:

- (a) **Provide for the care of the encumbered assets by either the grantor (borrower) or the secured creditor in possession of the encumbered assets;**
- (b) **Preserve the security rights, including the right to proceeds or civil fruits derived from the encumbered asset;**
- (c) **Provide for the right to use, commingle and dispose of the encumbered assets by the grantor (borrower) in the ordinary course of business; and**
- (d) **Secure the discharge of a secured obligation once it has been performed.**

Basic approaches to security

- **The purpose of the recommendations on basic approaches to security is to specify that the law follows a unitary and functional approach.**
- **The law should include a comprehensive and consistent set of provisions on non-possessory security rights in tangibles and intangibles.**

- The law should also provide for possessory security rights in tangibles.
- The law should provide that devices that perform security functions, such as the transfer of title for security purposes, and, unless otherwise provided in the law, retention of title devices, including conditional sales, financial leases and hire-and-purchase agreements, are to be treated in the same way as secured transactions.

Creation as between the parties

- The purpose of the provisions of the law dealing with creation is to specify the way in which a security right in movable property is created as between the grantor and the secured creditor.
- The law should specify that a security right is created by agreement between the grantor and the secured creditor. [A creditor may retain title to goods to secure payment of the purchase price of the goods or its economic equivalent under a conditional sale, financial lease or a hire-purchase agreement as provided in law other than this law].
- The creation of a possessory security right requires, in addition to agreement, the delivery of possession of the assets to be encumbered to the secured creditor or another third party who holds the assets on behalf of the secured creditor (other than the grantor or an agent or employee of the grantor).
- The law should provide that the security agreement must, at a minimum, identify the secured creditor and the grantor, and reasonably describe the secured obligation and the assets to be encumbered. A generic description of the secured obligation and the encumbered assets should be sufficient.”

7.2.3. Recommendations on law for non-possessory securities

The Indian Contract Act, 1872 already contains provisions in regard to possessory security interest over movables. Further the Indian Law of Contracts also provides for party autonomy but in the context of non-possessory security interests it is necessary to make statutory provisions for the manner of creation of security interest, the rights and obligations of the person creating the security (grantor) and the person in whose favour such security is created (grantee). Such law can provide for the method of creation of security interest, by a written agreement, without any

further act or deed, the rules of priority amongst different claimants and the requirement of registration of any security interest created for such property.

7.2.4. The other important issue that was considered by the Working Group is whether to include transactions of hire purchase and financial lease as security interest transactions, as proposed to be recommended by UNCITRAL Working Group VI. It is also pertinent to note the law in USA in regard to hire-purchase and lease transactions. Under the provisions of the Uniform Commercial Code the concept of comprehensive security interest has been introduced, in terms of which, any transaction of hire purchase, financial lease or purchase money credit or conditional sale is treated as security interest. (Article 1-201(37) of the Uniform Commercial Code of USA). The basis for equating financial leases and hire purchase transactions with that of the security interest is that in substance, such transactions are loan transactions. If we adopt the same principles and equate hire purchase and financial lease transactions with security interest, there are advantages for both the parties to such contracts as under:

- As far as the consumer, who takes any movable property on hire or a lease or by availing loan against hypothecation of asset the form of transaction matters little. But if the transaction is not treated as a security interest the owner or lessor of the asset who takes possession in the event of default retains the entire sale proceeds. As a result, the consumer who has taken the asset on lease or hire loses the benefit of the money already paid for the asset.
- As far as lessors and the owners of such assets are concerned in the event of default their right is to take possession of the concerned asset and recover the balance amount payable by the lessee or hirer. Such owner or lessor have no right to claim the shortfall if any, after the asset is sold in the event of default. If the transaction is treated as a security interest in the examples given above, the consumer will be entitled to the surplus and the owner of the asset will be entitled to claim shortfall. Over and above the reasons stated above, the Working Group noted that at present there is no

law governing hire purchase transactions and lease of movables. All such contracts relating to hire purchase and lease are at present governed by the general principles of the law of contract contained in the Indian Contract Act, 1872.

7.2.5. Recommendation

The Working Group is of the view that there is a need to adopt the concept of comprehensive security interest and include all transactions of financial lease, hire purchase, conditional sales and purchase money credit as security interest by adding a new chapter in relation to non-possessory security rights over movable properties, in the Indian Contract Act, 1872.

7.2.6. Effect on NBFC Sector

The Working Group also noted that the above recommendation involves a change in the financial activities of the Non-Banking Finance Companies (NBFCs) who are mainly engaged in the activity of hire purchase and financial lease of movables. At present such NBFCs are exercising rights of ownership over the assets given on hire or lease in the event of default for the purpose of realization of the balance amount payable by the lessee or a hirer of the asset. The system is operating satisfactorily and such NBFCs are in effect having rights of enforcement without the intervention of the Court. If the recommendation as suggested above by the Working Group is implemented it would involve a decision to extend the SARFAESI Act to NBFCs. It needs to be noted that at present the NBFCs are exercising rights of taking possession of the assets given on lease or hire in the event of default in payment of agreed instalments, by virtue of retention of title to such asset in their favour. If the law is amended as recommended by the Working Group such NBFCs will be exercising same rights of taking possession and selling the assets given on lease or hire but the basis of such action would be as a secured creditor instead of as a owner retaining title to the property. As far as the borrowers are concerned, there will not be any change in the rights available to them and on the contrary such a change will be for the benefit of the consumers. Further, the rights and obligations of the parties would be clearly defined and governed by statutory provisions.

7.2.7. Hire-purchase / Lease treated as Sale

As stated in para 4.1 above, for the purpose of sales-tax, transactions of hire purchase and financial lease are treated as sale of goods and the transaction is made subject to sales-tax by the State Governments. Even if such transactions are treated as security interest transactions, it would be possible to classify such transactions as sales for the purpose of levy of sales-tax by the State Government on such transactions. Even in a loan transaction, where a bank or a financial institution gives a loan, say for purchase of a car and obtains hypothecation of the car in its favour, the borrower will be paying sales-tax when by using the loan with his own margin, he makes payment for purchase of the car. On the same analogy, when the lessor or the owner of the hire purchase asset pays for the asset, to be given on lease or hire, he will be required to pay sales-tax on such sale. The treatment of hire purchase and lease transaction as sales under the provisions of the Constitution and sales-tax laws of the States would not, therefore, come in the way of treating such transactions as security interest.

7.3. Finance against receivables

Although Section 130 of the Transfer of Property Act makes provisions for assignment of actionable claims, there are no statutory provisions for the purpose of creation of security interest over receivables or for transfer of receivables with underlying securities under the existing law. In this respect, the Working Group noted that the United Nations Convention on Assignment of Receivables in International Trade has been signed by five countries in December 2001. The object of the said Convention is to adopt uniform rules governing the assignment of receivables to promote the availability of capital and credit at better and affordable rates and thus to facilitate the development of international trade. The said Convention incorporates certain principles in regard to free assignability of receivables and other matters to protect the rights and obligations of debtors and lenders. Some of the important principles relating to assignment of receivables contained in the said United Nations Convention are as under:

- i) **An assignment is not ineffective as between the assignor and the assignee or as against the debtor or as against a competing claimant, and the right of an assignee may not be denied priority, on the ground that it is an assignment of more than one receivable, future receivables or parts of or undivided interest in receivables, provided that the receivables are described:**
 - a) **Individually as receivables to which the assignment relates; or**
 - b) **In any other manner, provided that they can, at the time of the assignment or, in the case of future receivables, at the time of conclusion of the original contract, be identified as receivables to which the assignment relates.**
- ii) **Unless otherwise agreed, an assignment of one or more future receivables is effective without a new act of transfer being required to assign each receivable.**
- iii) **An assignment of a receivable is effective notwithstanding any agreement between the initial or any subsequent assignor and the debtor or any subsequent assignee limiting in any way the assignor's right to assign its receivables**
- iv) **This article applies only to assignments of receivables:**
 - a) **Arising from an original contract that is a contract for the supply or lease of goods or services other than financial services, a construction contract or a contract for the sale or lease of real property;**
 - b) **Arising from an original contract for the sale, lease or licence of industrial or other intellectual property or of proprietary information;**
 - c) **Representing the payment obligation for a credit card transaction; or**
 - d) **Owed to the assignor upon net settlement of payments due pursuant to a netting agreement involving more than two parties.**
- v) **A personal or property right securing payment of the assigned receivable is transferred to the assignee without a new act of transfer. If such a right, under the law governing it, is transferable only with a new act of transfer, the assignor is obliged to transfer such right and any proceeds to the assignee.**

- vi) **A right securing payment of the assigned receivable is transferable notwithstanding any agreement between the assignor and the debtor or other person granting that right, limiting in any way the assignor's right to assign the receivable or the right securing payment of the assigned receivable."**

While incorporating the above principles and other provisions contained in the United Nations Convention, an exercise of comparing it with our existing law and modifying the Convention to suit our requirements will have to be undertaken, which can be done at the stage of actual drafting of the Bill for amendments. The Working Group has, therefore, not undertaken the exercise of identifying specific provisions of the Convention, which need to be **incorporated in the proposed amendment to the Contract Act. At the same time, the Working Group is of the view that there is a need to make specific provisions in our law for assignability of all receivables including future receivables and such law can be based on the principles contained in the United Nations Convention.**

8.1.1. Registration of Charges:

In regard to the priority between the security interest holders and other claimants, it will be necessary to introduce a system of registration of charges of movable properties. The SARFAESI Act contemplates setting up of such a Registry, but except charges on movables belonging to companies incorporated under the Companies Act, there is no requirement of registration of charges on movables. Such a registration system is operated under the Companies Act by Registrars of Companies. Insofar as movable asset owned by individuals, partnership firms and other non-corporate borrowers are concerned, there is no requirement of registration of charges over movable properties. Further, in respect of certain categories of movable assets, there are asset specific registration systems in operation and registration is required in respect of charges created on such assets irrespective of whether the asset is held by a corporate or non-corporate entity. Registration of motor vehicles is one such category of asset. The Group understands that such registration

systems have been set up in USA, Canada, New Zealand and Australia, which are operating on certain modified principles and are totally computerized registries. The broad principles applicable to such registries are contained in the draft report of UNCITRAL Working Group as under:

“Effectiveness as against third parties

(A) The purpose of the provisions of the law on the effectiveness of a security right as against third parties is to require an additional step before a security right may become effective as against third parties so as to:

- (k) To alert third parties dealing with the movable assets of the grantor of the risk that those assets may be encumbered by a security right; and**
- (l) To provide a temporal event for ordering priority among secured creditors and between a secured creditor and other classes of competing claimants.**

(B) The law should provide for the establishment of a general security rights registry having the following characteristics:

- (a) Registration is effected by filing a notice of the security right as opposed to a copy of the security documentation;**
- (b) The record of the registry is centralized; that is, it contains all notices of security rights registered under the secured transactions law of the enacting State;**
- (c) The registration system is set up to permit the indexing and retrieval of notices according to the name of the grantor or according to some other reliable identifier of the grantor;**
- (d) The registry is open to the public;**
- (e) Reasonable public access to the registry is assured through such measures as:**
 - (i) Setting fees for registration and searching at a cost-recovery level; and**
 - (ii) Making available remote modes or points of access;**
- (f) The registration system is administered and organized to facilitate efficient registration and searching. In particular:**

- (i) **A notice may be registered without verification or scrutiny of the sufficiency of its content;**
- (ii) **Subject to the financial and infrastructural capacity of the enacting State, notices are stored in electronic form in a computer database;**
- (iii) **Subject to the financial and infrastructural capacity of the enacting State, registrants and searchers have electronic access to the registry record, or telephone or telecopy access, and**
- (g) **The law provides rules on the allocation of liability for loss or damage caused by an error in the administration or operation of the registration and searching system.”**

8.1.2. Amendments to SARFAESI Act for introducing new registration system

The provisions contained in the SARFAESI Act empowering the Central Government to set up a computerized Central Registry do not provide for operation of the Registry on the above principles, as stated in UNCITRAL recommendation. It may be necessary to amend the provisions of the SARFAESI Act to facilitate setting up a computerized Central Registry on the lines of such registries operating in USA, Canada, New Zealand etc. Setting up of such a Registry would go a long way in providing a statutory backing to the security interest created in favour of the banks and financial institutions and enabling them to claim priority over other claimants while enforcing the securities. Introduction of such a registration system would be conducive to credit growth and access to credit would become easy resulting in competition amongst lenders and better interest rates for the borrowers. While considering amendment to the provisions of the SARFAESI Act for the purpose of setting up computerized Central Registry, it may also be considered whether movable assets need to be classified into different categories to facilitate registration and access to specific asset-wise data in the Registry. **The Group, therefore, recommends suitable amendments to the SARFAESI Act to facilitate setting up of Central Registry, operating on notice filing and first to file to get priority principles.** The SARFAESI Act is applicable to security interests created in favour of banks and financial institutions only and the law does not

apply to other lenders such as non-banking finance companies. Further, the registration system does not contemplate registration of attachment of properties or appointment of receivers by any Court, Tribunal or any other authority in exercise of statutory powers. **The Group, therefore, recommends that:**

- a) **provisions relating to Central Registry should be made applicable to all charges created on the movable property and**
- b) **registration system should be extended to any orders of attachment of properties pursuant to orders/decrees of any Court or Tribunal or any other competent authority empowered to issue such attachment orders.**

8.1.3. Other amendments to SARFAESI Act

As stated in clause (f) of para 3.6.2 of this report, no securitisation transactions are being undertaken under the SARFAESI Act. The Group is of the view that there is a need to segregate securitisation of standard assets from the SARFAESI Act and enact separate independent legislation for securitisation of financial assets as recommended by the Andhyarujina Committee. Such a law can provide separate regulatory framework for securitisation transaction for the purpose of protection of investors who invest in debt instruments issued under securitisation schemes. Such transactions may not be matter for concern for the Reserve Bank if there is a true sale of assets of the banks. **The Group, therefore, recommends a separate enactment for securitisation transactions which should encompass securitisation of all financial assets and receivables and not only financial assets of the banks and financial institutions as is the case under the SARFAESI Act.**

9.1. Priority Rules

In regard to the priority rules amongst different claimants on the same property as stated in para 3.6.1 above the principle that the secured creditors have a priority over all the claimants is recognized under different provisions of Companies Act and other insolvency laws. In spite of such clear provisions there is a misconception in the minds of Government authorities entrusted

with the function of recovery of taxes and other claims of the Government that dues of Government have a priority over all creditors including secured creditors. Some of the State Governments have amended the Sales-Tax Acts prevalent in the State for the purpose of giving priority to arrears of Sales-Tax over the claims of secured creditors. In order to encourage secured credit, it is necessary that the legal provisions in regard to rights of secured creditors are very clearly laid down. At present on account of the various State laws making a contrary provision the banks and financial institutions face number of difficulties in the matter of enforcing their claims as secured creditors. The Group is therefore of the view that there is a need to make a declaratory provision in the proposed amendment that the claims of the secured creditors shall have priority over all the claims including the claims of the Government. An express declaratory provision to this effect in a Central Law, which will be enacted later to the existing State laws will prevail over the State laws and such declaratory provision would have the effect of rendering the State laws invalid and non-operative being inconsistent with the Central Law, in view of the provisions contained in **Article 254 of the Constitution of India**.

9.2.2. Recommendations

- (a) The Group therefore recommends that a declaratory provision for the priority to the secured creditors over the unsecured creditors and other claimants including the Government may be incorporated in the amendment suggested to the Indian Contract Act, 1872 in respect of movables as also to section 48 of the Transfer of Property Act, 1882 which contains provisions for priority of rights created by transfer of immovable property. In the alternative, such declaratory provision may be incorporated in the Transfer of Property Act making it applicable to both movable and immovable property.**
- (b) Over and above the claims of the Government there are issues relating to claims inter se the various creditors as well as claims of third parties against the properties over which security interest is created. In regard to such issues the Group recommends that the registration requirements should be made compulsory for all secured transactions and the creditors whose security interest is registered should get the priority over all other claimants.**

9.2.3. LIS PENDENS

Section 52 of the TP Act deals with transfer of property pending suit relating thereto commonly known as lis pendens. The purport of the provision of section 52 is that during the pendency of a suit touching any right in the immovable property, the property cannot be transferred or otherwise dealt with by any party to the suit so as to affect the rights of other party thereto under any decree or order that may be made therein. By virtue of amendments made by Bombay Act 4 of 1939 (applicable to the State of Maharashtra and Gujarat) the notice of pendency of such suit is required to be registered under section 18 of the Indian Registration Act, 1908 and only if the notice is so registered the prohibition will apply. There is no requirement of lis pendens in other States. **Since it involves title to immovable properties based on which the banks and institutions provide financial assistance, the Working Group recommends that the Registration Act may be amended by a Central enactment requiring registration of lis pendens in order to safeguard the interest of the lenders.**

9.2.4. ATTACHMENT BEFORE JUDGEMENT, INJUNCTIONS, APPOINTMENT OF RECEIVER OR ANY OTHER INTERIM RELIEF CONFERNING IMMOVABLE PROPERTY

The Registration Act has been amended by some State Governments to facilitate registration of orders passed by the Courts and any other authorities for attachment before Judgement, Injunction, appointment of receiver, etc. The registration of such orders provides notice to the public. **As such, the Registration Act be amended to facilitate registration of such orders passed by Courts and Debt Recovery Tribunals to provide public notice of such orders.**

9.2.5 The Group noted that a Bill for setting up credit information companies is already introduced in Parliament and the Credit Information Companies (Regulation) Bill is expected to become a law in due course. In this respect, the Group suggests that in many cases of defaults, it is found by bankers that defaulters are giving different versions about their assets and income therefrom to the banks and tax authorities. The tax authorities can seek

information from banks about the accounts of their customers. But the banks do not have any powers to obtain information about the details of assets and income disclosed by any assessee in the tax returns, to facilitate recovery of defaulted loans. Since recovery of bank loans is in the interest of depositors whose funds are used for lending activity, banks can be given access to information available with tax authorities for the purpose of recovery of defaulted loans. **The Group, therefore, recommends that Income-tax Act may be suitably amended empowering banks to obtain information about any assessee from tax authorities in respect of accounts which are classified as non-performing assets.**

10.1.1. Amendment of Section 69

Section 69 of the Transfer of Property Act empowers the mortgagee to sell the mortgaged property in the event of default subject to the following conditions:

- (i) **In cases where the mortgage is an English Mortgage and neither the mortgagor nor the mortgagee is a Hindu, Mohamedian or Buddhist.**
- (ii) **Where the power of sale without the intervention of the court is expressly conferred on the mortgagee and the mortgaged property is located in towns of Calcutta, Madras and Bombay or such other towns as might be notified. It is clear from the above provision that a lender cannot exercise powers of enforcement of a mortgage in respect of any non-corporate borrowers, as also in respect of properties located outside the notified towns. There is a need to remove all the restrictions and conditions specified in section 69 and permit sale of mortgaged property in respect of English Mortgages irrespective of the caste, or race to which the mortgagees belong to and irrespective of the location of the mortgaged properties. Removal of such restrictions contained in section 69 of the Transfer of Property Act would facilitate lending against the security of English Mortgages even by lenders other than banks and financial institutions. The Group recommends amendment of section 69 of the Transfer of Property Act to empower any mortgagee holding mortgage of any property in India to enforce the English Mortgage without the intervention of the Court.**

10.1.2. Mortgage by deposit of Title Deeds:

Under the provisions of section 58(f) of the Transfer of Property Act a person can create a mortgage by delivery of document of title to immovable property to a creditor with intent to create security thereon. Such mortgage by delivery of title deeds can be created only in the towns of Calcutta, Madras and Bombay and any other town, which may be notified by the State Government. Most of the metropolitan and other towns have been notified by the State Governments for the purpose of above provision. However, with the growth and development that has taken place in the country and the extent of inter-state trade and commerce it is necessary that the restriction on creation of mortgage by deposit of title deeds only at notified towns is withdrawn.

10.1.3. Stamp Duty on Mortgage by deposit of Title Deeds

One other important issue which needs to be noted in regard to mortgage by deposit of title deeds is that no written document is required to be executed while creating mortgage by deposit of title deeds. The object of this provision was to facilitate raising a loan against security of a property in an emergency, without being required to execute a written document of mortgage and get the same registered. The purpose of the provision is to facilitate raising money without such formalities. In the past few years some of the State Governments have levied stamp duty on any memorandum or record or writing relating to deposit of title deeds. It is the practice amongst the bankers to record the memorandum containing particulars of the borrower, the loan sanctioned and the particulars of the property in respect of which mortgage by deposit of title deeds is created. Such memorandum or writing which is recorded only to link the holding of the title deeds with the particular loan is being treated as an instrument subject to stamp duty. Such levy of stamp duty by the State Governments defeats the very purpose for which the facility of raising money by creating a mortgage of immovable property by deposit of title deeds is provided. In order that a person can avail the benefit of raising a loan against security of mortgage by deposit of title deeds, it is necessary to provide that any memorandum or writing recording a past transaction of deposit of title

deeds by the lender shall not be construed or treated as an instrument for the purpose of stamp duty.

10.1.4. Security Interest over flats/apartments

The Transfer of Property Act does not recognize the concept of a flat or an apartment in the multi-storeyed building constructed on immovable property. Some States like Maharashtra and Gujarat are using the structure of co-operative society for the purpose of conferring ownership rights in the flat/apartment along with the right to use the common amenities provided in the building by the society. Some States like Maharashtra have also enacted Maharashtra Apartment Ownership Act giving statutory recognition to the ownership rights in an apartment. It needs to be noted that in many urban areas in the country, multi-storied structures are coming up and the portions of a multi-storeyed building are being used for industrial, commercial and residential purposes. But there is no formal legal recognition to the rights of a person in respect of the portion owned or purchased by him. It is therefore necessary to enact a new law for the purpose of recognizing property rights in a portion of a building along with the right to avail the common facilities provided in such building. Statutory recognition to such rights of ownership would facilitate availing credit against security of such assets. For this purpose either the Transfer of Property Act needs to be amended or a separate Central Law may be enacted on the lines of the Maharashtra Apartment Ownership Act. It may be added that such a law needs to cover not only residential but also commercial and industrial premises.

10.2.1. Definition of Immovable Property

The distinction between movable and immovable property is a thorny issue. In *Sirpur Paper Mills Ltd. Vs. Collector of Central Excise, Hyderabad* (AIR 1998 SC 1489), the Supreme Court did not interfere with the finding of the lower court that machine attached to the earth were merely for operational efficiency and was not immovable property. The Group feels that the distinction between movable and immovable property in relation to 'machinery' may be maintained on the lines of the said judgement of the Supreme Court.

The above classification, in so far as, "machinery" is concerned, may be legislatively recognized by adding an explanation to the definition of

“immovable property” in General Clauses Act and Transfer of Property Act. Hence, the Working Group recommends that in Section 3(26) of General Clauses Act and Section 3 of Transfer of Property Act, the following explanation be added to the definition “Immovable Property”.

Explanation: Machinery attached to the earth is not immovable property.

10.2.2. Certificate of Title to Property

The system of recording the ownership right of immovable property is with reference to registration of deeds and documents involving transfer of any interest in immovable property of the value of Rs.100 and more. But the diverse personal laws applicable in the country, acquisition of rights in immovable property are by means other than written document in one's favour. Thus a person may acquire interest or even ownership rights in immovable property by virtue of partition in a Hindu undivided family or by acquisition to the property belonging to the deceased or under a Will made by a deceased person. In the absence of a uniform civil code applicable in the country there is no system of issuing a title certificate to the owner of a land by any authority of the Government backed by any statutory provisions. This creates a situation where a person may be holding ownership rights for immovable property for number of years without holding any document or title deed in respect of such ownership right. Further in rural areas there is no system of demarcating land with reference to the ownership rights held in land by different persons. The name of the village land is normally referred to by the particular name of the village or as Abadi land. There is a need to set up a system for the purpose of grant of the certificate of title to any person who is entitled to the land by virtue of his succession as a legal heir or acquisition of rights by partition or by purchase or any other means. Such certificate of title should be issued by the Revenue or other Government authorities which would constitute a document of title clearly certifying the location or the area of the land owned by the holder of the title certificate. System should provide for procedure for modification of such certificate when there are changes in rights, title and interests in the property. Such a

system would facilitate recognition of the ownership rights and enable the owner to raise loans against the security of such property owned by him.

10.2.3. Power of Attorney Sales

The mode of transfer of property is also not uniform in the country. In certain States, the Development Authorities allot the housing units to various applicants and prohibit them from transferring such units. These persons have invented methods to overcome the restriction on transferability and have resorted to the grant of Power of Attorney coupled with interest. Creation of security interest by the occupant, namely the Attorney, in his own right, is not recognized under law. Though the said person has paid the consideration to the original allottee, he is not recognized as the person owning the property.

Banks and Institutions find it difficult to advance loans to such persons even for acquiring property from the true owner. Valid mortgage created on the properties are defeated by such imperfect transfers.

10.2.4. Recommendations

In conclusion, the law relating to transfer of immovable property needs to be amended for following purposes:

- (i) Restrictions contained in section 69 relating to the status of parties to mortgage and the location of the mortgaged property to be deleted and any English Mortgage created by any person in respect of immovable property located anywhere in India to be made enforceable without the intervention of the court.**
- (ii) Flats/Apartments and other portions of buildings to be given statutory recognition for ownership rights in such portions by a Central Law on the subject.**
- (iii) Provisions of section 58(f) of the Transfer of Property Act to be amended for permitting creation of mortgage by deposit of title deeds anywhere in India.**
- (iv) A system for issue of certificate of title to property to be introduced either by amendment of Transfer of Property Act and Registration Act or by enacting a new law for the purpose. Such a law should also cover grant of succession**

certificates both testamentary and non-testamentary in respect of all assets of the deceased.

- (v) Machinery attached to earth to be declared as not immovable property.**

11.1. Succession of Property:

One other issue related to recognition of ownership rights over property and title certification is the issue relating to succession to property both movable and immovable whether testamentary or non-testamentary. On account of multiple personal laws applicable in the country there is no uniform system in regard to issue of any succession certificate or legal heirship certificate. The provisions contained in the Indian Succession Act relate to succession certificate in respect of any debt payable to the deceased. Such succession certificate does not cover any other movable or immovable properties. In regard to probate of the Wills under the provisions of the Succession Act it is not compulsory to obtain a probate of the Will, except in Bombay, Calcutta and Madras in terms of sections 57 and 213 of the Indian Succession Act, 1925. In the absence of clear statutory provisions requiring compulsory probating of Wills and obtaining of succession certificates irrespective of the personal law applicable to the successors or location of the properties, it becomes extremely difficult to recognize the rights of persons to any such properties thereby affecting their ability to raise credit against the security of such property. It is therefore necessary to enact a new law or amend the existing legal provisions for following purposes:

- (a) A system for issue of title certificate to any person who is entitled to ownership or any other rights in any immovable property.
- (b) Appointing a statutory authority in various parts of the country for the purpose of grant of succession certificate in respect of properties owned by a deceased person as also legal heirship certificate to the legal heirs. In view of the diverse personal laws applicable such a new law setting up authorities for the purpose of grant of succession

certificates may also have to clearly specify the rules of succession and the various legal heirs entitled to succeed the property under various personal laws to facilitate issue of succession certificate. The list of such legal heirs applicable under various personal laws has been attempted by the Group and is enclosed to the report as **Appendix-I**.

The Group wishes to place on record that above suggestions regarding succession to property are being made to facilitate lending against security of property within the existing legal framework and there is no suggestion for any change in personal laws.

12.1.1. In addition to the above suggestion for amendments in relation to security interest over property, the Group wishes to suggest certain other amendments which need to be undertaken to create an environment conducive to secured lending.

12.1.2. The first suggestion relates to amendment of section 28 of the Indian Contract Act. As Section 28 now stands any guarantee issued by a bank in India remains operative during the limitation period for making a claim under the guarantee which is normally three years but if the guarantee is in favour of Government it is thirty years. By addition of a proviso to Section 28 it is proposed to permit banks and financial institutions to stipulate that rights under a guarantee shall be extinguished if no claim is made within the specified period which shall not be less than one year. Such provision in the guarantee will have the effect of curtailing the limitation period. Such an amendment will facilitate acceptance of guarantees issued by Indian banks at international level and enable the banks to remove such guarantees from their contingent liabilities. Such an amendment is necessary in view of stringent requirements of capital commitments and provisioning norms for banks in respect of contingent liabilities.

12.1.3. The second suggestion relates to section 58AA of the Companies Act, 1956. The said section was inserted w.e.f. 13.12.2000 with an objective to protect the

interest of small depositors. It inter alia provide for the companies raising public deposits to intimate the tribunal the details of the default of non-payment within the prescribed time disclosure of default and restrictions while raising fresh deposits etc. The sub-section (7) of the said section 58AA provides as under:

“Where a company had accepted deposits from small depositors and subsequent to such acceptance of deposits, obtains funds by taking a loan for the purpose of its working capital from any bank it shall first utilize the funds so obtained for the repayment of any deposits or any part thereof or any interest thereupon before applying such funds for any other purpose.”

12.1.4. In view of the above provisions a company which has accepted deposits from small depositors is under a statutory obligation to apply the working capital funds for payment to the depositors. The application of working capital funds which are intended and meant for manufacturing activity of the unit if made and utilized for any other purpose will affect the financial viability of the company and in turn will lead to default of repayment to the lender Bank. Provision contained in section 58AA(7) as stated above is obviously inconsistent with the lending norms for working capital and the effect of the provision will be that banks will be reluctant to lend or continue to lend to a company holding deposits from small depositors and the very object of the provision will be defeated. The Group, therefore, suggests deletion of sub-section (7) of section 58AA of the Companies Act, 1956.

13.1. Problem of Multiple Stamp Duties

Lastly, the Group wishes to suggest a change in the legal framework relating to power to levy stamp duties on instruments affecting property rights. There is a need to recognize a new kind of instrument which is derived from or relates to any transaction in the financial market, and has the characteristic of transferability anywhere in India and even globally, along with the benefit of underlying securities.

Such an instrument like a securitised debt instrument in a securitisation of housing loans, when transferred from one investor to other will involve transfer of undivided interest in underlying mortgages of houses. Under our existing stamp duty system, strictly in law such transfer of debt instrument will amount to transfer of interest in immovable property and will be required to be stamped as a conveyance and also registered. This impediment to financial transaction has to be removed by changing the law. It appears that there are two alternative solutions to the problem:

Alternative 1

Amend the Constitution of India and make a clear provision for legislative powers for Union of India in respect of stamp duty on any instrument which has the characteristic of negotiability and transferability anywhere in India or outside India.

Alternative 2

Assume legislative power of the Union under the residuary entry 97 in the Union List in the Seventh Schedule to the Constitution and amend the Indian Stamp Act and Registration Act, 1908 for the purpose of levy of stamp duties on and registration of any new instruments that are similar to negotiable instruments.

The Group is of the view that since alternative 1 may take time, the second alternative can be tried to achieve the object in view.

14.1. Whether diversion of funds to be made an offence:

The Working Group also considered whether siphoning off / diversion of funds borrowed from banks or financial institutions should be made an offence. This issue was clearly examined by the IBA in the past and the Working Group agrees with the following views of IBA conveyed to the RBI:

The question whether siphoning off / diversion of funds borrowed from a bank or financial institution should be made an offence *per se* is not amenable to a straight “YES”, because the dividing line between inability to repay banks’ loans and failure to pay on account of deliberate use of funds for some other

purpose contrary to the intents and purposes of the sanction of loan, is very thin. By making such acts like diversion / siphoning off funds criminal *per se* there is a danger that innocent and genuine borrowers, who are unable to repay the loan for the reasons beyond their control would be treated as criminals. The difficulties in clearly defining an offence to punish deliberate and wilful default arising out of diversion / siphoning off funds can be explained illustratively as under:

Facility	Instances of diversion	Whether should be made criminal offence
i) Term loan for machinery	a) Loan availed but machinery not purchased and there was never any intention to repay the loan or create an asset.	“Yes” should be part of cheating.
	b) Loan availed but cheaper or used machine purchased or over invoicing was done as to the value of machine, deliberately to deceive the bank.	“Yes” should be made criminal act. Since, amounts to obtaining loan by making false representation.
	c) Loan availed and machinery purchased. Manufacturing started but income not sufficient to pay interest and instalment of term loan.	This may be a mere default in repayment and hence may not be made an offence.
	d) Loan availed and manufacturing started. Adequate surplus generated to repay loan instalments but surplus used for buying another machine or more raw materials to increase capacity utilization or for any other purpose connected with manufacturing activity.	Default is more in the nature of breach of contract rather than a criminal conduct and hence should not be included.
	e) Adequate surplus generated in the business out of assets acquired from loan proceeds, but surplus is not used for servicing the loan. Funds are used for personal and other purposes and default is	These kinds of cases can be considered for inclusion.

	committed.	
Facility	Instances of diversion	Whether should be made criminal offence
ii) Working Capital	a) Loan availed but sale of product or conduct of business is at a loss. It may happen that surplus is adequate to pay Term Loan interest and instalment but not working capital.	These instances cannot be included.
	b) Loan availed but not used for business purpose. Fake proof of purchase of goods / raw materials, etc. produced. Stock statements, which are false or inflated in value furnished.	These instances can be included.
	c) Loan availed and used for intended purpose but the business activity is not generating adequate surplus. Inflated stock statements given to show that there is no irregularity.	These instances may be included as a part of an offence.
	d) Loan availed and business conducted profitably but there is a default in repayment of loan and interest.	The instance should be carefully studied, so that default due to genuine difference / dispute may not be included.
iii) Bills Purchase / Discounting	a) Bills drawn representing genuine trade transactions but dishonor on account defect in goods.	Conduct may not be treated as criminal.
	b) Bills are accommodation bills without genuine trade transaction and not retired.	These instances can be covered for the purpose of offence.

While we agree that there is a need for such a law, which would punish deliberate and wilful default arising out of diversion / siphoning off funds, as an offence under criminal law, it is necessary to ensure that sufficient care is taken to exclude those instances of loan defaults (as can be seen from the illustrations above) arising due to genuine reasons, so that the law encourages good borrowers and punishes only wilful defaulters. In our view, the provisions contained in the Indian Penal Code, 1860 adequately meet the requirement and no amendments to IPC need to be undertaken.

APPENDIX-I**Legal heirs under various personal laws****i) Hindus**

a) Primary heirs of a Hindu male are:

- i. Son(s)
- ii. Daughter(s)
- iii. Wife
- iv. Mother
- v. Children of Predeceased children
- vi. Widow of predeceased son
- vii. Children of predeceased grand children

b) Primary heir(s) of a Hindu female are:

- i. Son(s)
- ii. Daughter(s)
- iii. Husband
- iv. Children of predeceased children

ii) Muslims

a) Primary heirs of a Sunni Muslim are:

- i. Son(s)
- ii. Daughter(s)
- iii. Father
- iv. Mother
- v. Spouse (Husband/Wife)

b) Primary heirs of a Shia Muslim are:

- i. Spouse (Husband/Wife)
- ii. Mother
- iii. Father
- iv. Son(s)

- v. Daughter(s)

iii) **Christians**

- a) Primary heirs of a Christian are:

- i. Spouse (Husband/Wife)
- ii. Son(s)
- iii. Daughter(s)

iv) **Parsis**

- a) Primary heirs of a Parsi male are:

- i. Wife (Widow)
- ii. Son(s)
- iii. Daughter(s)
- iv. Mother
- v. Father
- vi. Children of predeceased children

- b) Primary heirs of a Parsi female are:

- i. Husband
- ii. Son(s)
- iii. Daughter(s)
- iv. Children of predeceased children
