

# Principles of natural justice in classifying bank loan accounts as fraud: DRAT KOLKATA

M/s. Ratna Earth Works

...Appellant

Indian Overseas Bank,

...Respondent

Case No: Appeal No. 122 of 2022

Date of Judgement: 19.07.2023

Judges:

Anil Kumar Srivastava, J – Chairperson

For Appellant: Mr. P. Nanda Kishore, Mr. Y. Sataya Kumar, Advocates.

For Respondent: Mr. Shiv Mongal Singh, Mr. Sudhir Kr. Senapati, Advocates.

## **Facts:**

*Appellant M/s Ratna Earth Works and another availed a loan of Rs. 38 lakhs from respondent Indian Overseas Bank for purchasing a Tata Hitachi vehicle. Appellant allegedly submitted fake documents regarding the purchase and took possession of the vehicle. Repayment of the loan was irregular. Bank issued notice under Sec 13(4) of SARFAESI Act and vehicle was sold in e-auction to respondent no.2. Thereafter bank obtained an order from CMM under Sec 14 of the Act. Appellant challenged the auction by filing a writ petition and obtained interim orders. Appellant paid over Rs 25 lakhs to the bank. Bank classified the account as fraud without giving any opportunity of hearing to the appellant.*

**Arguments by Appellant:**

**Appellant purchased the vehicle from the loan amount and submitted all relevant documents to the bank. Bank classified the account as fraud and NPA without giving any opportunity of hearing which is illegal as per the recent Supreme Court judgment in State Bank of India v. Rajesh Agarwal.**

**Arguments by Respondent Bank:**

**The documents submitted by appellant regarding purchase of vehicle were fake and account was classified as fraud. Loan was NPA and auction was validly held after due notice where respondent no. 2 was the successful bidder.**

**Issues Framed and Findings by DRT:**

**DRT framed three issues and held that appellant failed to prove purchase of vehicle and no grounds to set aside auction. Appeal dismissed.**

**Elaborate Reasoning and Conclusions by DRAT:**

**Referring Rajesh Agarwal case, opportunity of hearing must be given before classifying an account as fraud which leads to civil consequences like credit freeze. Principles of natural justice applies. Master Directions on Fraud do not expressly exclude hearing. Opportunity of hearing cannot be denied. DRT relied on paras 40, 41, 55, 62, 67, 81, 95, 98. In the present case, bank classified account as fraud without opportunity of hearing which is illegal. Order set aside. Bank to hear appellant and proceed as per RBI guidelines. Amount to be refunded to auction purchaser. Liberty given to bank to proceed as per master directions after hearing.**

**Sections and Laws Referred:**

**Sec 18 SARFAESI Act – Appeal against DRT order**

**Sec 13(2), 13(4), 14 SARFAESI Act – Procedure for asset sale**

**RBI Master Directions on Fraud**

**Cases Cited:**

**State Bank of India v. Rajesh Agarwal & Ors (2023) 6 SCC 01**

**Maneka Gandhi v. Union of India – Principles of natural justice**

## ***Audi Alteram Partem – Rule of fair hearing***

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### **Full Text of Judgment:**

1. Feeling aggrieved by the impugned judgement and order dated 20.07.2022 passed by learned DRT-I Hyderabad in S.A. No. 77 of 2021 whereby the S.A. was dismissed, appellant has preferred the appeal u/s 18 of the SARFAESI Act, 2002.

2. As per pleading of the party S.A. was filed by the appellant for quashing the e-auction sale notice dated 04.09.2021 and the auction sale held on 28.09.2021. Appellant has availed loan of Rs.38.00 lakh from respondent bank on 24.01.2019 for purchasing Tata Hitachi vehicle. Appellant took possession of vehicle in April, 2019 and documents were submitted to the bank. Repayment of loan was irregular, however, appellant paid Rs.2.00 lakh on 15.07.2021 to the Bank, but bank issued sale notice on 04.09.2021 and conducted auction sale on 28.09.2021. Thereafter respondent bank obtained an order from the Chief Metropolitan Magistrate u/s 14 of the Act of 2002 which was challenged by the appellant by filing a Writ Petition no. 32608 of 2021 before the Hon'ble High Court at Hyderabad wherein an interim order was passed. Appellant has paid total sum of Rs.17,81,853.24 on 30.11.2021. Total sum of Rs.25,03,698.65 is made available by the appellant to the bank for payment of the loan account.

3. Per contra, respondent bank submits that appellant has never purchased Tata Hitachi vehicle for the purpose of which loan was availed. All the documents produced by the appellant were found to be fake and forged. Despite notice issued u/s 13(2) of the SARFAESI Act outstanding dues were not cleared, as such, notice u/s 13(4) was issued. E-auction sale of the scheduled property was held on 28.09.2021 wherein respondent no.2 was a successful bidder at a sale price of Rs.49.00 lakh. The loan account was classified as a fraud account. Auction sale was confirmed.

4. While the documents relating to purchase of vehicle produced by the

appellant found to be fake and forged, fraud was report to the RBI and loan account was classified NPA on 31.03.2021.

5. While dismissing the application learned DRT has formulated following three points for consideration :

(i) Whether the applicants have established that they have purchased the Tata Hitachi vehicle with the loan provided by the bank?

(ii) Whether the applicants have established any ground for setting aside the auction conducted by the bank in respect of the application scheduled property on 28.09.2021?

(iii) To what relief ?

6. On the issue of point no. (i) and (ii) learned DRT has recorded finding that applicant has failed to establish that they purchased Tata Hitachi vehicle and applicant has failed to establish any ground for setting aside the auction sale. Accordingly, S.A. was dismissed. Feeling aggrieved appellant has preferred the appeal.

7. Heard learned counsel for the parties and perused records.

8. At the very outset learned counsel for the appellant submits that appellant admittedly availed the loan and purchased vehicle from the loan amount. All the relevant documents were submitted to the bank, but bank classified the loan account as fraud without affording opportunity of hearing to the appellant. Learned counsel for the appellant has placed reliance upon the judgement of the Hon'ble Apex Court in the case of State Bank of India Vs. Rajesh Agarwal & Ors. [(2023) 6 SCC 01].

9. Per contra, learned counsel for the respondent submits that appellant has availed loan amount for purchase of Tata Hitachi vehicle. The documents submitted by the appellant to the bank regarding purchase of vehicle are fake. Fraudulent documents were submitted to the bank. Certain inquiry was carried out and found that documents are fake and forged. Loan account was classified NPA and SARFAESI proceeding was initiated against the appellant. Secured asset was sold in e-auction and sale was confirmed.

10. It is admitted fact that appellant has availed loan from the

respondent bank. It is not in dispute that loan was availed for purchased of Tata Hitachi vehicle. As per the submission made by the learned counsel for the bank no such vehicle was purchased by the appellant and loan account was classified NPA for fraudulent transaction.

11. In State Bank of India Vs. Rajesh Agarwal (supra) Hon'ble Supreme Court has held that :

"40. The process of forming an informed opinion under the Master Directions on Frauds is administrative in nature. This has also been acceded to by RBI and lender banks in their written submissions. It is now a settled principle of law that the rule of audi alteram partem applies to administrative actions, apart from judicial and quasi-judicial functions. 24 It is also a settled position in administrative law that it is mandatory to provide for an opportunity of being heard when an administrative action results in civil consequences to a person or entity.

41. In State of Orissa v. Dr (Miss) Binapani Dei 25, a two judge bench of this Court held that every authority which has the power to take punitive or damaging action has a duty to give a reasonable opportunity to be heard. This Court further held that an administrative action which involves civil consequences must be made consistent with the rules of natural justice:

"9. [...] The rule that a party to whose prejudice an order is intended to be passed is entitled to a hearing applies alike to 24 A K Kraipak v. Union of India, (1969) 2 SCC 262; Governing Body, St Anthony's College, Shillong and Ors v. Rev. Fr. Paul Petta of Shillong, (1988) Supp SCC 676; Uma Nath Pandey and Ors v. State of Uttar Pradesh, (2009) 12 SCC 40.25 AIR 1967 SC 1269 judicial tribunals and bodies of persons invested with authority to adjudicate upon matters involving civil consequences. It is one of the fundamental rules of our constitutional set-up that every citizen is protected against exercise of arbitrary authority by the State or its officers. Duty to act judicially would therefore arise from the very nature of the function intended to be performed: it need not be shown to be super-added. If there is power to decide and determine to the prejudice of a person, duty to act judicially is implicit in the exercise of such power. If

the essentials of justice be ignored and an order to the prejudice of a person is made, the order is a nullity. That is a basic concept of the rule of law and importance thereof transcends the significance of a decision in any particular case.”

42. In *Maneka Gandhi v. Union of India* 26, a seven-judge bench of this court held that any person prejudicially affected by a decision of the authority entailing civil consequences must be given an opportunity of being heard. This has been reiterated in a catena of decisions of this Court.”

It was further held by the Hon’ble Supreme Court that :

“55. Classification of the borrower’s account as fraud under the Master Directions on Frauds virtually leads to a credit freeze for the borrower, who is debarred from raising finance from financial markets and capital markets. The bar from raising finances could be fatal for the borrower leading to its ‘civil death’ in addition to the infringement of their rights under Article 19(1)(g) of the Constitution. Since debarment disentitles a person or entity from exercising their rights and/or privileges, it is elementary that the principles of natural justice should be made applicable and the person against whom an action of debarment is sought should be given an opportunity of being heard.

62. Classification of a borrower’s account as fraud has the effect of preventing the borrower from accessing institutional finance for the purpose of business. It also entails significant civil consequences as it jeopardizes the future of the business of the borrower. Therefore, the principles of natural justice necessitate giving an opportunity of a hearing before debarment of the borrower from accessing institutional finance under Clause 8.12.1 of the Master Directions on Frauds. The action of classifying an account as fraud not only affects the business and goodwill of the borrower, but also the right to reputation.

67. The Master Directions on Frauds do not expressly exclude a right of hearing to the borrowers before action to classify their account as frauds is initiated. The principles of natural justice can be read into a statute or a notification where it is silent on granting an

opportunity of a hearing to a party whose rights and interests are likely to be affected by the orders that may be passed.

81. Audi alteram partem, therefore, entails that an entity against whom evidence is collected must:

(i) be provided an opportunity to explain the evidence against it;

(ii) be informed of the proposed action, and

(iii) be allowed to represent why the proposed action should not be taken. Hence, the mere participation of the borrower during the course of the preparation of a forensic audit report would not fulfill the requirements of natural justice. The decision to classify an account as fraud involves due application of mind to the facts and law by the lender banks. The lender banks, either individually or through a JLF, have to decide whether a borrower has breached the terms and conditions of a loan agreement, and based upon such determination the lender banks can seek appropriate remedies. Therefore, principles of natural justice demand that the borrowers must be served a notice, given an opportunity to explain the findings in the forensic audit report, and to represent before the account is classified as fraud under the Master Directions on Frauds.

95. In light of the legal position noted above, we hold that the rule of audi alteram partem ought to be read in Clauses 8.9.4 and 8.9.5 of the Master Directions on Fraud. Consistent with the principles of natural justice, the lender banks should provide an opportunity to a borrower by furnishing a copy of the audit reports and allow the borrower a reasonable opportunity to submit a representation before classifying the account as fraud. A reasoned order has to be issued on the objections addressed by the borrower. On perusal of the facts, it is indubitable that the lender banks did not provide an opportunity of hearing to the borrowers before classifying their accounts as fraud. Therefore, the impugned decision to classify the borrower account as fraud is vitiated by the failure to observe the rule of audi alteram partem. In the present batch of appeals, this

Court passed an ad-interim order restraining the lender banks from taking any precipitate action against the borrowers for the time being. In pursuance of our aforesaid reasoning, we hold that the decision by the lender banks to classify the borrower accounts as fraud, is violative of the principles of natural justice. The banks would be at liberty to take fresh steps in accordance with this decision.

98. The conclusions are summarized below:

- i. No opportunity of being heard is required before an FIR is lodged and registered;
- ii. Classification of an account as fraud not only results in reporting the crime to investigating agencies, but also has other penal and civil consequences against the borrowers;
- iii. Debarring the borrowers from accessing institutional finance under Clause 8.12.1 of the Master Directions on Frauds results in serious civil consequences for the borrower;
- iv. Such a debarment under Clause 8.12.1 of the Master Directions on Frauds is akin to blacklisting the borrowers for being untrustworthy and unworthy of credit by banks. This Court has consistently held that an opportunity of hearing ought to be provided before a person is blacklisted;
- v. The application of audi alteram partem cannot be impliedly excluded under the Master Directions on Frauds. In view of the time frame contemplated under the Master Directions on Frauds as well as the nature of the procedure adopted, it is reasonably practicable for the lender banks to provide an opportunity of a hearing to the borrowers before classifying their account as fraud;
- vi. The principles of natural justice demand that the borrowers must be served a notice, given an opportunity to explain the conclusions of the forensic audit report, and be allowed to represent by the banks/ JLF before their account is classified as fraud under the Master Directions on Frauds. In addition, the decision classifying the borrower's account as fraudulent must be made by a reasoned order;
- vii. Since the Master Directions on Frauds do not expressly provide an opportunity of hearing to the borrowers before classifying their account as fraud, audi alteram partem has to be read into the provisions of the



directions to save them from the vice of arbitrariness.”

12. Law laid down by the Hon'ble Supreme Court in Rajesh Agarwal case (supra) is squarely applicable to the facts of the present case. Admittedly, bank classified the loan account as NPA for fraudulent transaction wherein, as per the bank, vehicle for which loan was availed was not purchased and documents submitted were found to be fake and forged. In such circumstances, it was incumbent upon the bank to afford opportunity of hearing to the appellant, but that was not done. Accordingly, the procedure followed by the bank is against the law. Bank has to provide an opportunity of hearing to the appellant, thereafter they may proceed in accordance with law. Accordingly, appeal deserves to be allowed. Impugned order is liable to be set aside.

13. Appeal is allowed. Impugned order dated 20.07.2022 passed by learned DRT-I Hyderabad is set aside. Respondent bank should give an opportunity of hearing to the appellant before proceeding further in accordance with law. All the subsequent actions taken by the bank are accordingly quashed. Amount deposited by the auction purchaser shall be refunded to the auction purchaser with interest at fixed deposit rate prevalent at that time by the bank. It is made clear that this judgement and order in no way debar the bank to proceed further against the borrower/appellant as per the RBI guideline in accordance with law. No order as to costs.

File be consigned to record room.

Copy of the order be supplied to the appellant and the respondents and a copy be also forwarded to the concerned DRT.

Copy of the judgement/Final Order be uploaded in the Tribunal's website.

Order dictated, signed and pronounced by me in the open Court on this the 19th day of July, 2023.