

Whether SARFAESI Act is applicable to derivatives dues of banks

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The Securitisation Act (SARFAESI Act) marks the swinging of the pendulum – law was against the lender and for the borrower prior to 2002; the SARFAESI Act swung the pendulum in favour of banks. Unfortunately, as the pendulum swings for one side to the other, it is still not a case of a balance.

The passing of the SARFAESI Act, banks and legal fraternity is taking a highly optimistic, and in the opinion of the author, a wrong view that all the debts of the bank against the borrower are covered by the SARFAESI Act. This is not a correct view as the Act is applicable only where the dues arise out of a “financial assistance”.

A derivatives contract is a trade between the bank and the borrower. Note that in accounting parlance, all derivatives deals are accounted for as trading assets/trading liabilities of the bank – they are not recognized as a part of the “banking book”. There is no question of the bank granting a “financial assistance” to the “borrower” when the bank enters into a derivatives deal with an entity. There is no question of an any “assistance”, as it is not that the bank is assisting, and the counterparty is assisted. No one knows for whom the derivative deal with turn out of the money. Hence, it is beyond any banking sense to take a derivatives deal as a borrowing-type transaction.

However, here is a curious case where not only has a derivatives deal been treated by a court as a “financial assistance”, the court has even invoked sec. 34 of the SARFAESI Act to block the action taken by the borrower in injunctioning the bank from declaring the borrower as an NPA.

In *State Bank of India v Sharda Spuntex P Ltd*¹, an entity had been granted limit for purchase of forward contracts in foreign exchange. Upon the company failing to pay the dues of the bank, the bank characterized the account of the borrower as NPA. The borrower moved the civil court for a suit of injunction, which the lower court passed. The bank appealed to the High Court, citing sec. 34 of the SARFAESI Act as the reason to exclude the jurisdiction of the civil court in the matter. According to the bank, the amount owed by the borrower to the bank, albeit for purchase of foreign exchange, was debt owed to the bank, and that in the matter of recovery of debts, the jurisdiction of civil courts was excluded by sec. 34 of this Act. Analyzing the definition of “borrower”, the Rajasthan High court came to the conclusion that the grant of a limit for forward purchase of foreign exchange was a “financial assistance”, and the amount owed by the borrower was a “debt” and hence, the civil court had no jurisdiction in the matter.

With respect, the case is wrongly decided, on two counts. First, SARFAESI Act is limited to recovery of debts of the bank. In the instant case, the bank was not proceeding against the borrower for recovery of debt – instead, the borrower went against the bank claiming that the characterization of the debt as non-performing asset was wrongful. It is not even clear if the so-called forward purchase of foreign exchange by the borrower was backed by security interest – if not, the question of the bank using the SARFAESI Act for recovery of a derivative transaction did not arise at all. In any case, there was no proceeding under SARFAESI Act – hence, the question of bar of jurisdiction did not

¹ I(2010) BC 562 (Raj)

arise. Secondly, the forward purchase of foreign exchange is a derivatives transaction. The bank and the entity are two parties to a commercial transaction of purchase and sale. The bank is acting in its capacity as a derivatives dealer – it is not a case of grant of a financial assistance akin to a loan or credit facility. The Court went by the meaning of the term “debt”, without carefully analyzing the meaning of the term “borrower” and “financial assistance”. It is important to understand that the word “borrower” has no relevance unless the case is one of “financial assistance”. The word “financial assistance” has to be read *ejusdem generis* with other forms of financial assistance enumerated in sub-section (1) (k).