

(2025) 03 KL CK 1323

In the High Court Of Kerala

Case No : Writ Petition (C) No.3719 Of 2025

M/s Tip Top Furniture Land

APPELLANT

Vs

Reserve Bank Of India

RESPONDENT

Date of Decision : 17-03-2025

Acts Referred:

Constitution of India, 1950 — Article 19(1)(g)

Citation : (2025) 03 KL CK 1323

Hon'ble Judges : C.S.Dias, J

Bench : Single Bench

Advocate : Zakeer Hussain, K.A.Sanjeetha, C.Ajith Kumar, Varsha S.S.

Final Decision : Allowed

Judgement

C.S.Dias, J

1. The first petitioner is a firm and the petitioners 2 to 7 are its partners. The 1st petitioner is one of the units of M/s.Tip Top Furniture Group. The Group manufactures, trades, imports, and exports wooden and other allied furniture. The six units of the Group had availed financial assistance from the HDFC Bank, which was taken over by the 2nd respondent bank ('Bank', in short) in 2015. Since the petitioners defaulted in repaying some of the loans, the Bank initiated recovery proceedings, which are pending consideration before the Debt Recovery Tribunal - 1, Ernakulam. The Bank had also initiated proceedings for the liquidation of one of the Units of the Company under the Insolvency and Bankruptcy Code, 2016. The National Company Law Board, Kochi, had ordered the liquidation of the company, and the official liquidator conducted the sale of the company's assets in a public auction. The Group had submitted several one-time settlement proposals to the Bank, but they were all rejected. Surprisingly, the 1st petitioner was served with Ext.P5 show cause notice by the Bank stating that their competent authority had examined the utilisation of credit facilities by the petitioners and found that they had committed the acts of fraud in terms of Ext.P6 RBI Master Directions of Frauds issued by the Reserve Bank of India

(RBI) ? the 1st respondent. The main allegation in the show cause notice is that the petitioners had not conducted any Forensic Audit/Transaction Audit of the Group. Even though the names of petitioners 2 to 7 are mentioned in the show cause notice, no notice was served on them. The 1st petitioner had submitted Ext.P7 reply notice specifically requesting the Bank to provide the details of the audit report of the competent authority. Thereafter, nothing was heard from the Bank. While matters stood so, Exhibit.P6 Master Directions was superseded by Ext.P9 Master Directions of Frauds. Shockingly, the petitioners were served with Ext.P8 order passed by the 3rd respondent classifying the petitioners as fraud in terms of Ext.P9 Master Directions. It is stated in Exhibit.P8 order that the Bank would be taking a further course of action to report the names of the petitioners as fraud to the RBI. Exhibit.P8 order has been passed, ignoring the valid contentions put forth by the petitioners. Moreover, the petitioners were denied an opportunity of being heard. The actions of the respondents are illegal, unjust and arbitrary.

2. The respondents 2 and 3 have filed a counter affidavit contending that the Group had availed various financial facilities from the Bank. The borrowers had committed default in repaying the loan, resulting in the loan accounts being classified as Non-Performing Assets. Further, O.A 148/2020 was filed to recover an amount of Rs.53,19,81,574.94 as on 01.02.2020. During the pendency of the O.A., the private limited company, Tip Top Furniture Pvt. Ltd., went into liquidation. The 1st petitioner approached the Bank for a one-time settlement. To consider the same, the Bank appointed M/s. T.G.Sukumaran & Co., Chartered Accountants, to conduct the forensic audit of the accounts of the Group, including that of the 1st petitioner, for the period from April 2021 to October 2023. In the forensic audit report, it was revealed that the petitioners had (i) overstated/understated their assets/liabilities and profits in financial statements, (ii) drawn from cash credit account by submitting wrongful stock statements, (iii) disposed of/removed assets hypothecated without knowledge of the bank, (iv) non-routed purchase/sales transactions in Bank CC account, (v) indulged in large cash transactions in receipts/payments, (vi) diverted funds etc. In the said circumstances, Ext.P5 show cause notice was issued to the petitioners to submit their response on why they should not be classified as fraud. In response to the same, Ext.P7 reply was issued by the 1st petitioner, wherein they had shifted the blame onto the Bank for not considering OTS proposals rather than providing a substantial explanation regarding the fraudulent transactions. The 3rd respondent, after careful consideration of the documents available on record and analysing the conduct of the petitioners, concluded that the incidence of fraud had occurred and classified the petitioners as fraud. At the time of issuance of Ext.P5 show cause notice, Ext.P6 Master Directions were in force. The contention that the show cause notice was not issued based on Ext.P9 Master Directions does not assume significance. Hence, the writ petition may be dismissed.

3. Heard: Sri. Zakeer Hussain, the learned Counsel for the petitioner and Sri. C. Ajith Kumar, the learned Counsel for respondents 2 and 3.

4. The Bank issued Ext.P5 show cause notice to the petitioners asking them why they should not be classified as fraud as per the Ext.P6 Master Directions issued by the RBI. In response, the 1st petitioner submitted Ext.P.7 reply letter asserting that they are not wilful defaulters and requesting a copy of the audit report of the competent authority to enable them to submit a comprehensive reply. Nevertheless, the 3rd respondent, via Ext.P8 order, classified the 1st petitioner and its partners as fraud.

5. It is pertinent to highlight that Ext.P5 show cause notice was issued on 30.05.2024 as per Ext.P.6 Master Directions. During the interval between the submission of Ext.P7 reply letter dated 18.06.2024 and the passing of Ext.P8 order dated 04.01.2025, Ext.P6 Master Directions were repealed and superseded by Ext.P.9 Master Directions, which came into force on 15.07.2024.

6. Notably, the procedure for declaring a borrower as a fraud was not provided in Ext. P6 master directions.

7. In a challenge against a judgment of the High Court of Telangana, which held that the principles of natural justice should be read into the provisions of the Master Directions on Frauds, the Hon'ble Supreme Court in *State Bank of India and others v. Rajesh Agarwal and others* [(2023) 6 SCC 1] held that the principles of natural justice are not mere legal formalities. They constitute substantive obligations that the decision-making and adjudicating authorities must follow. The principles of natural justice guarantee protection against arbitrary action, in terms of procedure and substance, by judicial, quasi-judicial, and administrative authorities. The two fundamental principles of natural justice entrenched in Indian jurisprudence are (i) *Nemo judex in causa sua* ? no person should be a Judge in their own cause and (ii) *Audi alteram partem* ? a person affected by administrative, judicial or quasi-judicial action must be heard before a decision is taken. The classification of a borrower's account as fraud under the Master Directions 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 "civil death" in addition to the infraction of his rights under Article 19 (1) (g) of the Constitution of India. Since debarring 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 or debarment is sought should be given an opportunity of being heard. The Master Directions do not expressly exclude a right of hearing to the borrowers before initiating action to classify their account as fraud. Therefore, the principles of natural justice have to be read into a statute or a notification that is silent on granting an opportunity of hearing to a party whose rights and interests are likely to be affected by the orders that may be passed. Accordingly, the Hon'ble Supreme Court upheld the impugned judgment in the following manner:

"E. Conclusion

98. The conclusions are summarised below:

98.1. No opportunity of being heard is required before an FIR is lodged and registered.

98.2. Classification of an account as fraud not only results in reporting the crime to the investigating agencies, but also has other penal and civil consequences against the borrowers.

98. 3. 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.

98.4. 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.

98.5. The application of audi alteram partem cannot be impliedly excluded under the Master Directions on Frauds. In view of the timeframe 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.

98.6. 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.

98.7. 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.

99. In the result, the judgment of the Division Bench of the High Court of Telangana dated 10-12-2020 is upheld. The judgments of the High Court of Telangana dated 22-12-2021 and 31-12-2021, and of the High Court of Gujarat dated 23-12-2021 are accordingly set aside. The civil appeals are disposed of. Writ Petition (C) No. 138 of 2022 is also disposed of in the above terms. There shall be no order as to costs”.

(emphasis supplied)

8. Subsequently, the State Bank of India filed a review petition seeking clarification that the directions in Rajesh Agarwal’s case were only prospective. However, the review petition was dismissed.

9. After the elucidation of the law in Rajesh Agarwal’s case, the RBI promulgated

Ext.P9 Master Directions of Frauds and repealed all the earlier Master Directions of Frauds, including Ext.P.6 Master Directions.

10. Chapter II of Ext.P9 Master Directions delineates the procedure to be followed before declaring a borrower as a fraud. The relevant portion related to the present case reads as follows:

“2.1 Governance Structure in banks for Fraud Risk Management

2.1.1. There shall be a Board approved Policy on fraud risk management delineating roles and responsibilities of Board / Board Committees and Senior Management of the bank. The Policy shall also incorporate measures for ensuring compliance with principles of natural justice in a time-bound manner which at a minimum shall include:

2.1.1.1 Issuance of a detailed Show Cause Notice (SCN) to the Persons, Entities and its Promoters / Whole-time and Executive Directors against whom allegation of fraud is being examined. The SCN shall provide complete details of transactions / actions / events basis which declaration and reporting of a fraud is being contemplated under these Directions.

2.1.1.2 A reasonable time of not less than 21 days shall be provided to the Persons / Entities on whom the SCN was served to respond to the said SCN.

2.1.1.3. Banks shall have a well laid out system for issuance of SCN and examination of the responses/submissions made by the Persons / Entities prior to declaring such Persons / Entities as fraudulent.

2.1.1.4 A reasoned Order shall be served on the Persons / Entities conveying the decision of the bank regarding declaration/classification of the account as fraud or otherwise. Such Order(s) must contain relevant facts/circumstances relied upon, the submission made against the SCN and the reasons for classification as fraud or otherwise”.

11. The above clauses unequivocally illustrate that the RBI, through Ext.P9 Master Directions, has laid down a comprehensive procedure for financial institutions to follow before declaring a borrower as a fraud, ensuring compliance with the principles of natural justice as mandated in Rajesh Agarwal’s case.

12. It is undisputed that, Ext.P5 show cause notice was issued on 30.5.2024, i.e., after the judgment in Rajesh Agarwal's case, which was pronounced on 27.3.2023. The 1st petitioner submitted the reply on 18.06.2024 requesting the 3rd respondent to furnish them with a copy of the audit report of the competent authority to enable them to submit a detailed reply. Meanwhile, Ext.P9 Master Directions came into force on 15.7.2024, requiring a detailed show cause notice to be furnished to the borrower, including the details of the transactions based on which declaration and reporting of fraud is being contemplated.

13. Despite the directions in Rajesh Agarwal's case, the petitioners’ request in Ext.P7 reply and the coming into force of Ext.P9 Master Directions, the 3rd

respondent passed the impugned Ext.P8 order without furnishing the petitioners a copy of the audit report and without following the directions in Rajesh Agarwal's case or Ext.P9 Master Directions.

14. It is crucial to note that the plea of the review petitioner in Rajesh Agarwal's case to clarify that the judgment was only prospective was declined by the Hon'ble Supreme Court. It was after the dismissal of the review petition that the RBI formulated Ext.P9 Master Directions, specifically embedding the procedural formalities that have to be observed before classifying a defaulter as a fraud. It is well-settled that procedural law and guidelines are generally retrospective. Even otherwise, in view of the specific directions in Rajesh Agarwal's case, it was obligatory on the part of respondents 2 and 3 to have furnished the report of the competent authority to the petitioners and have adhered to the directions in paragraphs 98 of Rajesh Agarwal's case and also the procedure laid down in Chapter II of Ext.P9 Master Directions. The mere fact that Ext.P5 show cause was issued before Ext.P9 Master Directions does not negate the obligation to comply with the directions in the judgment and the Ext.P9 Master Directions. As there is an infraction of both the directions in Rajesh Agarwal's case and Ext.P9 Master Directions by respondents 2 and 3, I am satisfied that the writ petition is to be allowed.

In light of the above considerations, this writ petition is hereby allowed in the following manner:

- (i) Ext.P8 order is quashed.x
- (ii) The 2nd respondent is directed to furnish the petitioners a copy of the audit report of the competent authority and finalise the proceedings as per the procedure laid down in Chapter II of Ext.P9 and in Rajesh Agarwal's case.

The writ petition is ordered accordingly.