

## **Do trusts formed by Asset Reconstruction Companies have powers under SARFAESI Act?**

**Vinod Kothari**

The asset reconstruction companies in India is a curious case in itself – the concept was conceived as a device for resolution of bad loans that arise out of a banking crisis, and in fact, it has become a business model by itself. I have discussed this issue elsewhere – see my note <http://securitizationdossier.blogspot.com/2010/05/asset-reconstruction-companies-india.html>. Recently, there has been a spurt in formation of asset reconstruction companies as there is apparently keen interest in buying distressed NPLs.

ARCs in India commonly buy the NPLs in the name of trusts, of which ARCs act as trustees. This practice sprung because RBI Directions and Guidelines on asset reconstruction companies exempted the assets acquired in the name of the trusts from several requirements of the SARFAESI Act and the Guidelines. Specifically, paragraphs 4, 5, 6, 9, 10(i), 10(iii) 12, 13, 14 and 15 of the Guidelines and Directions do not apply to trusts formed by the ARCs. This is quite strange of a regulator – imagine someone writing a list of rules, and in the next breath, writing an exception line that if you form a trust, then the list of rules that I just wrote will not be applicable. So, this is a clear invitation to exploit the exemption to the hilt because most of the rules that apply to assets bought by the ARCs on their own books do not apply when the NPLs are bought on the books of the trust.

And truly, asset reconstruction companies have exploited the trust route to the hilt. The 31<sup>st</sup> March 2009 balance sheet of Arcil shows investments in security receipts of 344 trusts of which Arcil is the trustee. That would mean substantially all the NPLs that Arcil would have bought would be on the books of the trusts, with Arcil simply holding a fraction of the securities issued by the trusts.

And these trusts have been exercising powers under sec. 13 of the SARFAESI Act. Until recently, section 9 of the SARFAESI Act that empowers ARCs causing a takeover of the management of the borrower was lying in a dormant state as the RBI had not notified the guidelines on takeover, which it has now done.

Significant legal questions remain on the power of the trusts. Needless to say, the trusts are distinct from the ARC. The trust is not an asset reconstruction company – it is not a company at all. The books of the trust are different and those of the ARC are different. The assets of the trusts are not reflected in the balance sheet of the ARCs – if that were so, the whole purpose of forming the trusts would go away.

So, if the trust is not an ARC, neither a bank, does the trust have the right to exercise any of the powers granted to an ARC or a secured lender under the SARFAESI Act? People quickly look at the definition of “secured creditor” in sec. 2 (1) (zd) which includes exercise of powers by an ARC managing a trust set by the ARC.

But then, one should not overlook sec. 13 (2) which uses two significant words – “default” and “non-performing asset”. In order to invoke section 13 (2), there must have been a default, and the asset in question must have been characterized as a non-performing asset in the books of the secured creditor. The word “default” is defined in sec. 2 (1) (j) and “non performing asset” is defined in sec. 2 (1) (o). Reading both the provisions, it is clear that in order for constituting a default within the meaning of sec. 13 (2), the asset in question must have been classified as non-performing asset in the books of the secured creditor seeking recourse to the rights under sec. 13 (2).

Now, let us realize what happens in case of ARCs. There was originally a bank that held that asset. The asset was an NPA in the books of the bank. The bank sells the NPA to the ARC. In the books of the bank, the asset disappears – there is no question of the asset still being an NPA in the books of the bank. It cannot be said that the asset continues to be an NPA in the books of the buyer as well, since the RBI norms in case of sale of NPAs to financial system actually provide that where an NPL is sold by a bank, the buyer may treat it as a performing asset and observe the track record of recoveries versus expected recoveries. It is based on such track record that the asset may once again become an NPA in the books of the buyer, but surely, the NPA tag does not go with the asset. What is even more important is that the NPA classification norms are explicitly excluded in case of trusts of ARCs.

So, if the trust is not covered by the NPA norms of the RBI, it is clearly not possible for the trust to claim that the asset in question is characterized as an NPA in the books of the trust. If trusts use their discretion in doing so, it is still not an NPA as per directives of the RBI – which is mandatory to fall within the meaning of “default” under sec. 2 (1) (j).

That leads to the conclusion – the trusts have no power to exercise any of the rights under sec. 13 (2). And note that the powers under sec. 9 are not applicable to trusts at all, as the extended definition of “secured creditor” including the trusts is not applicable to sec. 9 – section 9 is limited to asset reconstruction company only.

Resultantly, neither sec 9 nor sec 13 (2) are available to trusts of ARCs. This may be quite a steep view to take – as thousands of crores of NPAs are sitting in these trusts. But when it comes to interpretation of law, it is not for the interpreter to cure the defects in language of the law – that is the job of the parliament. No one can contend that there was a great philosophy, discussed thread-bare, when the SARFAESI Act was drafted – actually, the very fact that clearly incompatible provisions of securitisation and enforcement of security interests were merged into a common law is a clear indication of lack of thinking. Nor can one contend that the powers that ARCs are enjoying in India is a globally accepted principle. So, if a fundamental challenge to the working of the ARCs forces a rethinking or rewrite of a very crude law, it should not be seen as legal vandalism.