

# Secured Debts Vis-à-Vis Crown Debts— Are They Really Secured?

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**D**ebt is an integral and vital form of funding for any business venture, moreso for medium and large corporates. The limited liability concept under the Companies Act has provided an ideal platform for debt leveraging to fund large scale and long gestation projects. Long term funding in essence and without exception can be sourced only in the form of secured debts, which also provides an add-on comfort to the investors. It is hence, imperative to have a clear perspective and comprehensive understanding of the conflicting legal tenets qua the secured debts.

## NATURE OF SECURITY

A debt may be secured by way of charge on movable or immovable assets or

both. A charge on movables is mostly in the form of hypothecation or pledge. Similarly, a charge on immovables may be created by way of legal or equitable mortgage, though the former route is seldom resorted to on account of huge stamp duty incidences. A charge may be a fixed charge over classes of assets or a floating charge over specified assets. A floating charge crystallises on the happening of specified default events and becomes fixed thereafter. A floating charge may cover both the present and future assets. The borrower in general has a higher degree of control over the assets that are subject to a floating charge.

## CREATION OF CHARGE

In order that a debt is secured, a charge is created on the assets of the business enterprise. The charge can be created only by the owner of the asset, who in most cases is the borrower or occasionally the

guarantor for the debt. All the above forms of charge are created by the specific and voluntary act of the owner of the asset. Of this, equitable mortgage is without written documentation where a charge is created by mere deposit of relevant title deeds. All other forms of charge are created by an appropriate documentation in writing. Section 100 of the Transfer of Property Act, 1882, also postulates and categorically envisages the creation of a charge by 'operation of Law' as well.

## RANKING OF SECURITY

A business enterprise is in perpetual need for funds and hence has to resort to periodical borrowings. Such borrowings from time to time are secured by appropriate documentation in accordance with the terms of the security stipulated by the lender. In terms of Section 48 of the Transfer of Property Act, "where a person

purports to create by transfer, at different times, rights in or over the same immovable asset and such rights cannot exist or be exercised to their full extent together, each later created right shall, in the absence of a special contract or reservation binding the earlier transferees, be subject to the rights previously created." Certain exceptions are carved out under Section 50 of the Transfer of Property Act. Accordingly, charges created would rank in the order of time of their creation. In commercial practice, however, there are specific covenants to overcome and overrule this general principle. Broadly, long term debts are secured by first charge over immovable assets and second charge over current assets. As a corollary, short term and working capital borrowings are secured by first charge over current assets and second charge over immovables. The legal implications arising from securing debts have been comprehensively outlined here. Under a

consortium arrangement or a multiple lending involving more than one lender, the charge amongst each class of lenders would rank *pari passu*. In the event of debt restructuring or debt recovery, the ranking of security assumes utmost importance.

### CROWN DEBTS - NOT ALWAYS SUPERIOR

A business enterprise may owe monies to Central and State Governments mostly in respect of fiscal levies. These are termed preferential payments under section 530 of the Companies Act but rank only after secured debts in the event of winding up. There have been innumerable disputes on the priority of Government dues over secured debts. The principle of priority of Government debts is founded on the rule of necessity and of public policy. The basic justification is towards recognizing the sovereign status of Government that must be facilitated to collect its taxes to raise requisite revenue for its functioning. The

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Supreme Court in *Dena Bank vs. Bhikhabhai Prabhudas Parekh & Co.* (2000) 5 SCC 694, dealt extensively with the doctrine of priority of Crown debts. The common law doctrine of priority or precedence of Crown Debts deals with general rights of the Crown in relation to

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Common law doctrine of priority of Crown Debts constitutes "Law in Force" in terms of Article 372(1) of Indian Constitution. However, a lot of confusion has prevailed in the industry due to conflicting provisions of various state statutes and enactment of SARFAESI Act. It is now clear from various judgments that secured creditors have priority over Crown Debt and Crown Debt has priority over any other unsecured debt unless any applicable legislation specifically

provides a 'statutory first charge' over assets of the borrower in favor of state agencies (e.g. Bombay Sales Tax Act, State Financial Corporation Act, etc.). Confusion was mainly driven by non-obstante

clause of SARFAESI Act giving its provisions precedence over any other law. However, it has been clarified by the apex court that SARFAESI Act only affords superior procedure for recovery in favor of banks and financial institutions and does not override specific provisions creating statutory first charge under other legislation.

The positive effect of various judgments on the above subject has been to settle the long standing debate on ranking of Crown Debts versus claims of secured creditors and it also reinforces *laissez faire* system of corporate governance desired for the country where secured creditors can breathe easy in respect of their rights over collateral security. This right also finds mention in Companies Act, 1956 which ranks claims of secured creditors *pari passu* with workmen's dues and in priority over Crown Debts in case of bankruptcy or liquidation of a company.

Priority of claims which are covered under statutory first charge warrant enhanced due diligence and financial monitoring of clients by banks and financial institutions to ensure clients are compliant with fiscal statutes and duly fulfill their tax obligations.

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A predicament has been historically seen to arise when the courts are faced with the task of deciding between the priority of debts due to the secured creditors and those to the State (or the Crown) under Revenue Acts in the event of any default by the borrower. Historically, there are various judgments where the courts have confirmed the Crown's prerogative over the secured creditors. The primary rationale for the said view of the courts has been the Common Law doctrine about priority of Crown Debts which was recognized by the Indian High Courts prior to 1950 and the rule of necessity and wisdom of conceding to the State the right to claim priority in respect of its tax dues.



However, in recent times and more particularly after the passing of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests Act, 2002, the judicial pronouncements including those by the apex court has somewhat settled the position that generally, the Crown Debts i.e., taxes, duties, etc. have priority over ordinary debts, but, they shall remain subordinate to the debts due to the secured creditors, unless a statute specifically creates a first charge on the property(ies) in favour of the Crown. However, if the dues are recoverable by the State under any legislation merely as arrears of land revenue, those debts cannot have priority of claim over the dues of a secured creditor. The Supreme Court has held that a debt which is secured or which by reason of the provisions of a statute becomes the first charge over the property, having regard to the plain meaning of Article 372 of the Constitution, must be held to prevail over the Crown Debt which is an unsecured one.

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property. It states that where the Crown's right and that of a subject meet at one and the same time, that of the Crown is in general preferred. This doctrine has been recognized by the High Courts of India as applicable in British India before 1950 by treating it as a "law in force" within the meaning of Article 372(1) of the Constitution. The Supreme Court further observed that, the Crown's preferential right to recovery of debt over other creditors is confined only to ordinary or unsecured creditors. There is, however, no preferential right for Crown to recover its debts over a mortgagee or pledgee of goods or a secured creditor. The Supreme

Court endorsed its earlier ruling in *Bank of Bihar vs. State of Bihar* AIR 1971 SC 1210, in this regard.

The superiority of secured debt over Government dues was further reiterated by the Supreme Court in *Bank of India vs. Siriguppa Sugars and Chemicals Ltd.* (2007) 8 SCC 353, where sugar was pledged with the Bank and the Cane Commissioner sought to enforce demand on behalf of the workmen. The Apex Court upheld the right of appellant Bank over the pawned sugar having precedence over the claims of the Cane Commissioner and that of the workmen. This doctrine may not apply to debts due to the State that are contracted in relation to commercial activities undertaken by the State towards achieving the socio-economic good. The States superiority is at best confined to its Sovereign role and does not extend to its commercial operations.

**GOVERNMENT DEBTS AND SECURITY BY LAW**

It is well settled that Government dues under the doctrine of Crown Debts do not have automatic priority over secured debts. Where, however, Crown Debt *per se* is also secured in terms of a legal fiction, there would be a substantive change in the legal position of other secured debtors. The Government is more concerned with the mounting tax dues and their irrecoverability. In order to secure their position for effective recovery of these dues, State legislations have increasingly come to incorporate specific and express provisions to create security for these dues by way of legal fiction. This *ipso facto* pushes the rank of Government debts ahead of other secured debts. For

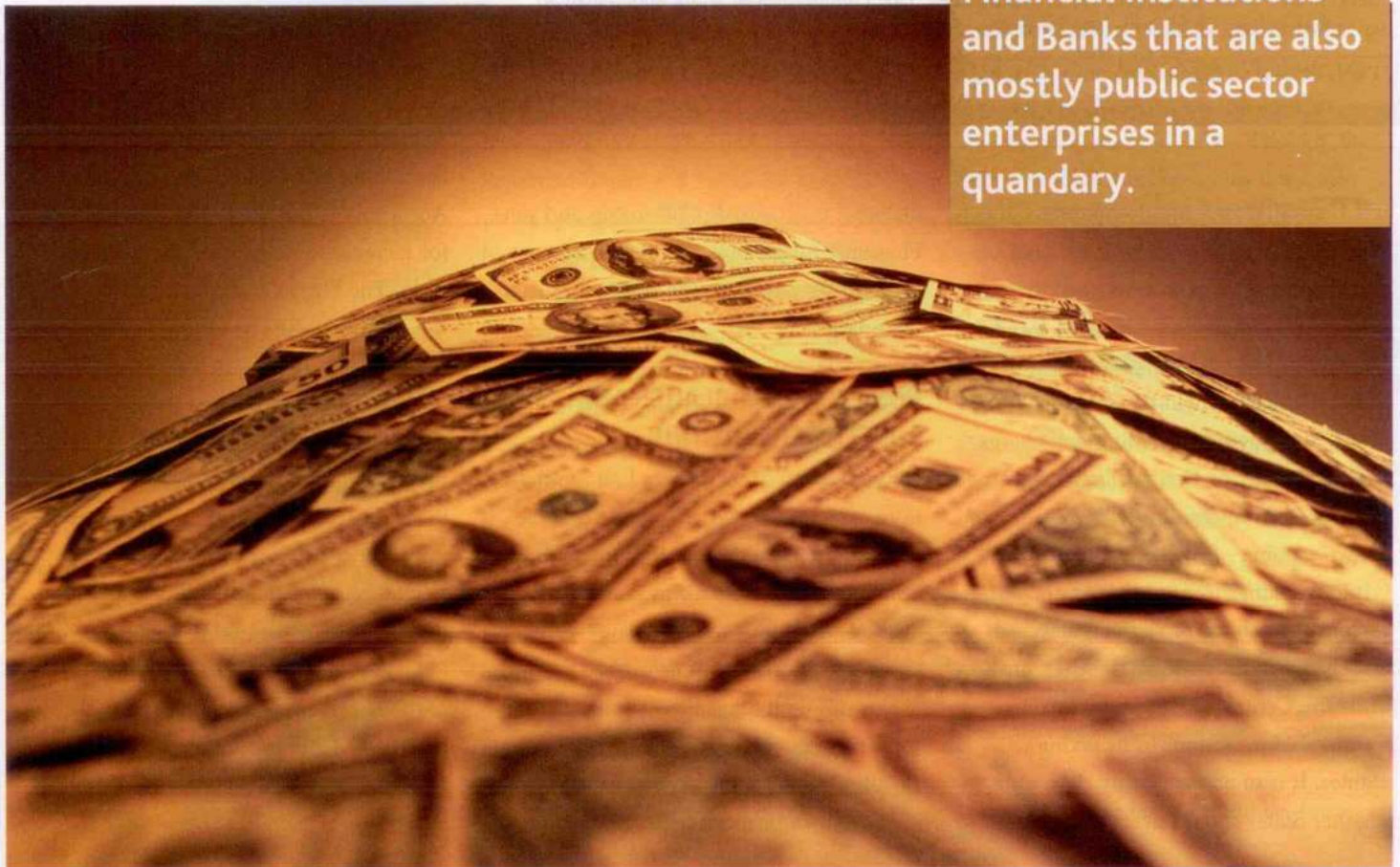
example, Section 24(1) and (2) of the Tamil Nadu General Sales Tax Act provides that Sales tax remaining in default shall become immediately due and shall be a charge on the properties of the persons liable to pay the tax or interest. It further asserts that the tax dues shall have priority over all other claims against the property of the defaulting dealer. Similar provisions are contained in the Sales Tax Laws of several other States.

### SECURED DEBTS – HOW MUCH SECURED?

The Supreme Court in *State of Bikaner & Jaipur vs. National Iron & Steel Rolling Corporation* (1995) 96 STC 612, dealt with the question of first charge over the property of a dealer for payment of arrears

of sales tax under Section 11 AAAAA of the Rajasthan Sales Tax Act vis-à-vis sections 58 and 100 of the Transfer of Property Act. The Apex Court with reference to first charge over the property of the dealer under the Rajasthan Sales Tax Act vis-à-vis earlier mortgage of the same property held that such statutory first charge has precedence over an existing mortgage. Following this, the Madras High Court in the case of *Indian Bank vs. Commercial Tax Officer, Ranipet* (2008) 18 VST 562, held that the statutory charge created under Section 24 of the Tamil Nadu GST Act overrides anything contained in the contract on the contrary to Section 24. It accordingly, upheld the priority of sales tax dues over the secured debts of Indian Bank. Contrary to the above, Customs Act

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Will of the legislature will prevail in our country and our Judiciary has to give a purposive interpretation, as and when called upon. However, due regard should be given to the secured debts granted by Banks and Financial Institutions (FIs), who are supposed to be the guardians of "public money". Without requisite credit support from Banks and Financial Institutions, no venture/projects (industrial/infrastructure etc.) are possible to come up in a country like ours. Only after creation of requisite productive infrastructure, can the State expect to collect various taxes and levies, which by legislation is conferred "overriding" priority status over the 'secured creditors' and is treated as a "Crown Debt". The term "crown debt" is much misused in the current context.



There is an urgent need for drastic changes in the existing legislations, which selectively confer "overriding preferential treatment" to certain so-called 'Crown Debts'. Equally there is a necessity to safeguard and insulate the Banks and FIs from the menace of Non-Performing Assets (NPAs), which may create systemic issues for the entire economy, if it is not arrested appropriately. Banks are marching towards Basle III norms, to a stricter self regulatory regimen. Hence, immediate legislative intervention is required to resolve the dichotomy in giving preference to the so-called "Crown Debts", which are arm-twisting legislative interventions made by certain State Legislatures. Law Commission of India and seasoned legislators as well as larger political parties should look into this issue immediately.

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and Central Excise Act do not seem to have express provisions for creating a specific prior charge in respect of these dues. The Madras High Court in *UTI Bank Ltd. vs. Dy Commissioner of Central Excise* (2007) 208 ELT 3 held that, in the absence of specific provision claiming first charge in Customs Act or Central Excise Act, the claim of secured creditor will prevail over Crown's Debts.

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dislodge contractual relationship and put Financial Institutions and Banks that are also mostly public sector enterprises in a quandary.

### NON-OBSTANTE CLAUSE AND CONFLICT RESOLUTION

Every piece of legislation lays emphasis to carry forward and effectively achieve the underlying objective. For this, it has now become customary to confer an exalted status for each such law by asserting supremacy of its provisions to the exclusion of all other legislations. This confers an overriding effect to a law vis-à-vis all other laws that are inconsistent with it. When two or more legislations contain

such non-obstante clause, the moot point is which one of them will prevail over the other. There have been well-settled legal principles that can broadly be summed up as under:

- (i) A Central legislation would prevail over a State legislation.
- (ii) A legislation that is specific on an issue or matter will prevail over a general provision in another legislation.
- (iii) A latter legislation will prevail over the former.
- (iv) An endeavour shall always be made to give effect to both statutes through purposive interpretation.

In the case of *Indian Bank vs. CTO* (*supra*), it was urged that the specific right of Bank under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests Act, 2002 ("SARFAESI Act") shall prevail over the rights of CTO under Tamil Nadu GST Act. It was on the premise that SARFAESI Act is a Central legislation and enacted much later to Tamil Nadu GST Act. Accordingly, the Bank claimed supremacy for its secured debts over the sales tax dues. The High Court, however, rejected this argument. It saw no conflict between the two legislations, each enacted for and dealing with independent issues. The prime objective of SARFAESI Act is to provide right of possession of securities of the borrower and sell them by enforcing the security interest of Financial Institutions and Banks. It no way seeks to define the *inter se* ranking of security of the lenders vis-à-vis Government dues. In particular, there is no provision in the SARFAESI Act providing for first charge in favour of Banks.

## APEX COURT'S VIEW

There have been several rulings of High Courts on the apparent conflict between State legislations creating first charge on the property of dealer to recover sales tax arrears on the one hand and the Central legislations, namely Recovery of Debts due to Banks and Financial Institutions Act, 1993 ("The DRT Act") and the SARFAESI Act. The Supreme Court in the case of *Central Bank of India vs. State of Kerala & Others* Civil Appeal No. 95 of 2005 decided on 27-02-09 has put its final stamp of clarity to resolve this conflict. The Supreme Court after a detailed analysis of earlier case laws observed that the primary object of DRT Act is to facilitate creation of special machinery for

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speedy recovery of the dues of Banks and Financial Institutions while the enactment of SARFAESI Act is, *inter alia*, to facilitate hassle free enforcement of security interest for fast-track recovery of debts. There is, however, no express or implied provisions under these Central legislations to create a first charge in favour of Banks and Institutions. Applying the rule of contextual interpretation, the apex court held that, there is no conflict or inconsistency between the Central and State legislations. Accordingly, the first charge created by State legislations for securing the recovery of sales tax dues shall prevail over the plenary powers of Banks and Institutions under the DRT Act or SARFAESI Act. The Supreme Court further observed that while enacting the DRT and SARFAESI Act, Parliament was aware of the law laid down by the Supreme Court wherein the priority of the State dues were recognized. If Parliament had intended to create first charge in favour of Banks and Financial Institutions on the property of borrower, then it would have incorporated suitable and specific provisions to that effect. However, the fact of the matter is that no such provision has been incorporated in either of these enactments despite conferment of extraordinary power upon secured creditor to take possession and dispose of the assets without intervention of Court or Tribunal. Evidently, Parliament did not intend to give priority to the dues of private creditors over the sovereign debt of the State. The law is thus well settled that dues specifically secured by first charge under competent legislations would have primacy over the contractual security creation by borrower in favour of Banks

and Financial Institutions. This ratio applies to the following statutory charges as well:

- Section 14-A of the Workmen's Compensation Act, 1923.
- Section 11 of the Employees Provident Fund & Miscellaneous Provisions Act, 1952.
- Section 25(2) of the Mines & Minerals (Development & Regulation) Act, 1957.
- Section 529-A of the Companies Act, 1956.

## CONCLUSION

A debt, whether secured or not, is principally decided by contractual terms. Crown Debt though superior to other unsecured debts remain only as unsecured, and hence, rank lower than Secured Debts. Where, however, a Crown Debt is secured by first charge through legal fiction in terms of express provisions of statutes, it gets upgraded above other contractually secured debts. Though, the Supreme Court has recognized the fact that the DRT Act and SARFAESI Act have been created for benefit of banks, financial institutions and other secured creditors, it has been clarified that these two Central legislations do not *per se* create first charge in favour of the Banks, Financial Institutions and other Secured Creditors. Thus, it can be concluded that the State would have priority of claim, if there is a specific provision giving priority to the State dues. □

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