LENDERS' LIABILITY: AN EVOLVING LEGAL CONCEPT

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1. INTRODUCTION : LENDERS' LIABILITY, CONTOUR OF STUDY

1.1 Lender-borrower relation

The relation between a borrower and a lender is contractual one and hence the liability between the parties is determined by terms and conditions within the framework of the contract. A lender is the person who extends the facility of lending based on mutually acceptable terms and conditions to the person who borrowed the money. The amount lent may be short-term lending to support a project or an overdraft facility extended to support working capital. Lending may also be long term lending against loan instruments like bonds, or debentures. Short term lending is the main business of banking institutions. Long term lending for supporting loan capital is one of the main business of the financial institutions. Person lending may be an individual, collection of individuals like partnership firm; joint venture or may be legal entities like, companies, co-operatives, or trusts. Similarly borrower may also be an individual, collection of individuals or entities. In case of individual lending-borrowing contracts, the relation can be established directly or through accredited agents. In case of entities, the relation is established through contracts between managements representing entities. As for example, if a General manager of a Bank negotiates a lending transaction for and on

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behalf of the Bank, the Bank is the lender; the General Manager only represents the Bank.

1.2 Liabilities of the parties

The liability of the parties in lending-borrowing transaction may be due to (a) execution of the contract according to terms and conditions laid down in the contract, (b) wrong lending and (c) bad lending. The extent of liability may be joint and several. Joint liability is the liability jointly owed by the borrower and the lender. The borrower as well as the lender may have exclusive and several liabilities, notwithstanding the primary liability of the borrower.

1.3 Jurisprudence of lenders' liability

In a lending-borrowing transaction the borrower has the primary obligation to bear the burden of meeting the obligation for borrowing. If the borrower is a *person-in-fact* the liability is unlimited. So the borrower has a primary liability to meet the obligation in case the lending becomes bad. If the borrower is a *person-in-fact,* the person has unlimited liability for bad borrowing, and if there are more than one borrower, the liability is joint and several. The borrower cannot argue that borrowing failed because of reasons beyond the reasonable control of the *person-in-fact* such as economic downturn, market failure etc. If the borrower fails to meet the obligation insolvency proceedings shall start for whatever is possible to be realised from the borrower. The law is not different in case of *person-in-law.* It is far more adverse to the interest of the borrower. The *person-in-law* (legal entity) having limited liability shareholders cannot realize the loss of bad lending from the shareholders. It has to absorb such loss from system management like, adequate provisioning, risk management etc. and pay up the loan. If the institution fails to meet the loss, it faces the challenge of bankruptcy and insolvency. When the borrowers fail to meet the obligation the lender bears the liability of bad lending. Lenders' liability is thus no new concept. The lender may have

contractual liability,[1] tortuous liability[2] and felonious liability.[3] He may have direct liability[4] or vicarious liability.[5] Finally, exclusive liability may fall on him for bad lending because he is the ultimate person to bear the loss of bad lending. Quality of lending is directly related to allocated responsibilities of discharging the liabilities of the parties according to the terms of the contract. The same is also measurable with the transactional cost of realization of the debt. The growing Non-Performing Asset (NPA) in the hand of the banking and financial sector is an indicator of the fact that (a) quality of lending in India is not high; and (b) the cost of realisation of debt is very high due to poor quality of direct and collateral security interest. The lender may be liable for wrong lending meaning thereby that (i) a right decision of lending is wrongly taken; or (b) a wrong decision is taken violating statutory provisions. Such a liability is due to malfeasance (wrong decision taken); misfeasance (right decision wrongly taken) and nonfeasance (right decision not taken). These liabilities are jointly reposed on the borrower and lender to other parties directly involved or to the society or Government. But in case the lender violates any term of the contract, the lender may be liable to the

' 'Contractual liability' means liability attached to the parties to the contract in view of the terms and conditions attached to the contract agreed upon by the parties. In a liberal democratic country with market economy there is freedom of contract. Whatever contains in the contract are the laws for and against the parties to the contract. The contract provides the law for the parties to the contract. Of course, the contract cannot create any obligation or impose any duty on any third party without his consent. But parties are completely bound by the terms and conditions. This is also known as contract sovereign.

[2] '.Tortuous liability' means a liability arising from the denial of a civil right of any person. For example, X has taken a loan for an industry using MIC gas and creates hazard in the neighborhood. Here X is liable for environmental pollution to all those in the neighborhood who have the right to clean environment. Individuals have right to life, freedom of speech and expression, freedom of trade etc. None of these rights can be put to danger by any lending activity. If it does, there can be a tortuous liability. Tortious liability is a common law liability in the absence of any definite law.

[3] 'Felonious liability' is a criminal liability. Violation of any criminal law provision gives rise to criminal liability.

[4] 'Direct liability' is the liability arising out of one's own action.

[5] 'Vicarious liability' is a liability that arises because of action of another, like an employee, agent or any other person for which another person may be held liable.

borrower. Sometimes the lender includes the management for the purpose of attachment of liability because the legislative process exposed the management by attaching personal liability or the judiciary may lift the veil of the entity to fix personal liability.

1.4 Transition from common law definition to rule-based system

To a reader who is not from legal discipline some of the terms used for the purpose of liability may be unfamiliar and technical. For them some common explanation is provided in the footnote.[6] 'Lenders' liability' is not a new concept in India, either. The Indian Contract Act, 1872, contains concepts of'misrepresentation'[7] and 'undue influence',[8] which *inter alia,* evolved along with other contractual aberrations, chiefly to control unhealthy contracts of private moneylenders. The Companies Act, 1956, already contains salutary norms for checking abuses by directors and other 'officers-in-default'.[9] Similarly, The Interest Act, 1974 and the very Act for nationalization of banks,[10] were to infuse greater 'responsibility' in those who take the decision on lending. The basic fabric of common law structure on lenders' liability has not changed much notwithstanding any shift from state controlled economy to globalization and privatization. Of course there has been some conceptual shifts. 'Lenders liability' has become a watchword of good governance in corporate banking. Specially, when in the Indian banking industry NPA management has become critical, lenders' liability cannot be shrugged off by any *ad*

[6] *Supra* notes 2 to 6.

[7] Section 18. 'Misrepresentation' defined - 'Misrepresentation' means and includes - (1) the positive assertion, in a manner not warranted by the information of the person making it, of that which is not true, though he believes it to be true; (2) any breach of duty which, without an intent to deceive, gains an advantage of the person committing it, or any one claiming under him; by misleading another to his prejudice, or to the prejudice of any one claiming under him; (3) causing, however innocently, a party to an agreement, to make a mistake as to the substance of the thing which is the subject of the agreement

[8] Section 16. 'Undue influence' defined. - (1) A contract is said to be induced by 'undue influence' where the relations subsisting between the parties are such that one of the parties is in a position to dominate the will of the other and uses that position to obtain an unfair advantage over the other.

[9] Sec. 5, Companies Act, 1956.

[10] The Bank Nationalization Act, 1978.

hoc financial design of provisioning, nor can the best judgment rule be used as a defense to existing contractual debts on the Balance Sheet. World over, reasonable forseeability, a standard defense to negligence is now being diluted in the West as will be expounded below.

1.5 Uncomfortable question on managements' liability

A lending decision is arrived on the appreciation of circumstances of investment, investment market conditions, standing of the borrower, the comfort level heightened by collateral through creation of security interest and a lot of other prudential norms. The natural market demand cannot vary based on the nature of ownership of the bank and financial institution. Whenever there is a talk on stricter regulation and widening penumbra of the term lender so as to attach liability of the management, the usual response is that 'in that event the officials would not be able to take any lending decision'! This argument shall confuse 'discretionary power' to be an 'arbitrary one'. That also puts question on the 'rule of law' based behaviour of the management, which is fundamentally opposite to the issue of good governance. Good governance is functionally 'transparent', organizationally 'accountable' and structurally 'responsive'. The debate is important because management is completely separated from ownership and the power of management is now statutorily based and not conceived in delegation alone. In a privately owned institution the quality of lending is based upon strict personal responsibility of the decision-maker. One minor error in the lending decision may cost the job of the management. In a privately owned institution no one would argue that on account of a strict regulatory system one would not lend. If you do not lend in a business of lending you are incompetent official and if you do bad lending you are inefficient. In both the cases you run the risk of loosing the job. In a public sector institution such an exceptional absolute power does not lie on any person. As such, it is very necessary to depend upon the 'rule-based' system and become highly effective and efficient at the same time. Otherwise, there would be no place for the public lending institutions in the lending

business. The silver line between discretionary power and arbitrary power is the best practice i.e. rule of law based.

1.6 Present position in India:

However, attention is drawn to the fact that at present there exists no 'Best Practice Code' (BPC) for the lending sector in India. This is in contrast to the fast developing focus on formalizing certain specified rules to determine 'lenders liability' in other countries such as New Zealand,[11] UK[12] and US.[13] The law in India is not only confusingly unclear but also uncertain and unpredictable. One or two court decisions can hardly clear the entire maze of confusion. Justice delivery system cannot but have a snail's space. The transaction cost of realisation of debt through disposal of security interest created is stupendously high. The standard of disclosure system is very poor in the context of world standard. There is no facility for timely renegotiation.

Hence, theoretically, the penumbra of the concept 'lenders liability' even in existing Indian law can seriously descend on the lender including the liability of the management. Whether the liability of the lender and borrower would be joint or several or both, might depend on the nature of the claim. An idea of emphasizing lenders' liability beyond the above parameter in Indian law is fairly radical. Indeed, it is a fairly contested area in the West as well. An attempt of introducing a legislative design on lenders' liability may affect the existing notion on rights and liabilities of the contracting parties and may necessitate a change in trade usage, which may ignite a jurisprudential debate. Besides, extension of the 'penumbra' of the term 'lender' so as to extend the term to officers-on-default' would require ascertainment of norms of lending decisions which may be a serious and complicated job. However, it is important to note, at this stage, that the notion of

[1] The Resource Management Act, 1992

[12] The Consumer Credit Act, 1974 and Guidelines on Non-status lending.

[13] Fair Credit Reporting Act and the Consumer Credit Act, 1974; Federal Deposit Insurance Corporation, Statements of Policy- 5000, and Truth in Lending Act, 1968

'lenders liability', though not in those precise terms, has always existed in India both in relative and in absolute terms.

2. Typology of Lenders' Liabilities

Who is a lender? A lender is a person who has indulged into the contractual relation of lending an amount to another who is called borrower on such terms and conditions as may be agreed upon by the contracting parties. The following are some of the types of liabilities arising out of the terms of the contract as well as outside the terms.

2.1 Lenders' contractual liability on wrong lending

The essence of a contractual obligation is *'consensus ad idem',* i.e. 'both the parties agreed upon the same thing in the same sense'.[14] The real import of this clause is that: (a) parties to the contract have symmetry of information on the subject matter of the contract or that no party is in a position to monopolize information-advantage to the detriment of the other; (b) parties have absolute freedom of applying their mind without interference by any external force either initiated by a party or otherwise; and (c) there is no enrichment without any cause to a party. Accordingly the theory of 'free consent' is instilled in the philosophy of contractual relation. Contractual relation of lending-borrowing is no exception. Any vitiating act on the part of the lender, such as, an act of coercion, undue influence, [5] fraud, misrepresentation or mistake[16] may not only vitiate the contract but may also bring liability to the lender. One issue may be made clear at the beginning. No party to the contract in ordinary circumstance has any additional burden of disclosure unless the law so demands due to special circumstances.

[14] Sec. 13 of the Indian Contract Act, 1872 codifies the definition of the free consent in the same terms.

[15] In an English case, an old man was advised by his bank to guarantee the advances given to his son. It was held by the court that the bank cannot recover against the guarantee, as the same was tainted by Undue influence. *See Lloyds Bank Ltd.* v. *Bundy,* [1975] Q.B. 326.

[16] These legal terms and the applicational situation of these vitiating factors are provided in sections 15 to 20 of the Indian Contract Act, 1872.

Such special responsibility on disclosure of information or interest is imposed if the position between the contracting parties is based on relation of trust or of special interest. A few examples taken from case law would make the point clear.

(i) Breach in free consent theory: The Indian judiciary applied 'undue influence' in many cases dealing with money lending in rural area and fixed up the responsibility Or liability to the lender.[17] The important issue here is that the judiciary is inclined to believe that the position of the lender is such that the lender can dominate the will of the borrower. Therefore, wherever the Court finds that the conditions of the lending is unconscionable or unreasonable and the same is enjoyed by the lender, the court presumed the undue influence and fixed the responsibility or liability on the lender.[18] Fraud is another vitiating factor, under which the court used to fix responsibility or liability on the lender. The fraud is committed when a party intentionally (1) *suggestio falsie,* that is, a false information that deliberately misleads to gain advantage, or (2) *suppressio vari,* that is, suppression of an essential fact, which the party is bound to disclose and which suppression materially affected the decision of the other party.[19] If the Indian position is examined as is provided in section 17 of the Indian Contract Act, the following is the situation in which a lender may be affixed with responsibility or liability on account of commission of fraud. The lender is responsible if (1) he makes a false suggestion of a fact with an intention of gaining materially, (2) knowing the statement of fact to be false, (3) with the intention that it should be acted upon by the borrower; (4) the borrower acted in reliance upon it;

[17] Out of four illustrations provided in section 16 to make things clear, three illustrations are from lending-borrowing.

[18] See, *Thammana Peda Thatayya* v. *Bhagwandas Atmasingh* (1970) 2 Andh.W.R. 75, at page 81, 84; *Barkatunnisa Begum* v. *Debi Baksh,* AIR 1927 P.C. 84 at 86

[19] A.G.Guest (ed.), *Chitty on Contract,* - vol. II, 120, (Sweet and Maxwell, London, 1994) runs as follows:

If the lender knows of defects in the chattel which are not apparent to the borrower and which make it unfit for the borrower's purpose, he is under a duty to inform the borrower of the defects; if he fails to do so, and the borrower suffers injury through such defects, the lender is liable. See, *Norwood* v. *Navan,* [1981] R.T.R. 457 and *Lunchbury* v. *Morgans,* [1973] A.C. 127.

and (6) the borrower thereby suffered injury. Similarly, misrepresentation[21] of financial condition of borrower may attract liability.[22] If the Lender is in a fiduciary relationship with the borrower, such as solicitors and client; trustee and beneficiary; guardian and ward; parent and child; spiritual leader and disciple; doctor and patient; husband and wife; principal and agent, etc., the lender may exercise undue influence[2] over the borrower because of the same relation. In bankruptcy proceedings the lender is held to have fiduciary duty where the lender exerted 'control' over the bankrupt borrower, resulting in adjustment in priorities as to other estate creditor. Lender may also be liable for coercion if the following elements are proved: (a) that, there is a threat to do something which a party threatening has no legal right to do; (b) that, there is some illegal exaction or some fraud or deception; and (c) that, the restraint is imminent and such as to destroy free agency without protection. *This liability is essentially to another third party whose interest is affected due to the vitiating factor. The third party includes liability due to employees claim, government claim, suppliers' claim, so on so forth affected by a wrong lending.* Here the borrower and the lender may be jointly and severally liable.

ii. Contractual failure of lender's obligation may attract lenders'" liability: A Lender may be liable if there is any breach of condition of contract on his part like for example, failure to fund the committed loans,[24] timely disbursement of loan;[25] not funding

[0] See also, sec. 17 of the Indian Contract Act, 1872.
[21] *Supra* note 9.
[22] *Kruse* v. *Bank of America,* (1988) 202 Cal. App. 3d 495.
[23] *Supra* note 10; See also, Sanjiva Rao, *Contract Act and Law Relating to Tenders,* 1105, (Delhi Law House, 1999).
[24] In *Gujarat State Financial Corporation* v. *Lotus Hotels Pvt.Ltd.* AIR 1982 Guj. 198, where sanction letter was granted but later on the loan was refused. On a writ petition filed by a customer, the Gujarat High Court by applying the principle of 'promissory estoppel' has ordered compensation to be paid by the lender. Commitment letter is an 'in-principal' approval for sanction of loan. This may be at the most called as executory contracts. By applying the principle that 'Contract by a deed poll is valid even if without consideration', courts in foreign countries have dealt with these kinds of cases, where it is basically a question of fact. However, this theory is not applicable in India because of an express provision in the Indian Contract Act, 1872 to that effect. Lenders'

working capital in time; violating conditions of privity and confidentiality[27] etc. However, in case of right to privacy, the court applies the common law principles in the absence of any clear statutory provision. The provision of contract may stipulate condition on the substance and extent of privacy right of the parties. Such a liability of the lender may be directly to the borrower as well as the third party.

(Hi) Failure to properly establish default: If the lender acts prejudicially to the interest of the borrower with an allegation of default on the part of the borrower under the terms and conditions of the contract that results in loss to the borrower, but fails to establish the default, the lender shall be liable to compensate the borrower.[28] Depending upon the form of debt instrument, contractual and statutory requirements, establishment of default, prior to proceed with liquidation of collateral, borrower may require notices and opportunity to cure the default. It is therefore necessary to define 'default' in the agreement between the parties. Any alteration or modification of a document must be reviewed prior to the declaration of default. In addition to this, factual circumstances between the lender and borrower must be reviewed to determine if there may be a claim of waiver or estoppel. If there is any action inconsistent with the strict conditions of the

liability in the case of refusal of loan after a commitment letter is yet to be tested within the realm of consumer law. It is pertinent to point out that Consumer forums have granted compensation in cases where there was delay in conveying the refusal to sanction loan. See also, *Conlan* v. *Wells Fargo* No. 82852 (Cal. Super Ct. Monterey County, 1987);

[25] In *Standard Investments Ltd.,* (1985) 22 D.L.R (4*) 410, the borrower sought a loan for take over of another company was not given loan and his take over bid failed due to actions of the chairman of the bank. The bank was held vicariously liable for loss of profits and business. It was held that the bank acting through chairman had a duty to disclose the interest of the chairman in thwarting the takeover.

[26] *Indian Overseas Bank, Madras* v. *Narayan Prasad Govindlal Patel, Ahmedabad,* AIR 1980 Guj. 158, in which overdraft facility was unilaterally withdrawn by the bank, which was held to be wrong commited by the bank for which, the bank was asked to compensate.

[27] For general information see, Tannan, *Banking, Law and Practice in India,* 236-240 (India Law House, New Delhi, 2002).

[28] See *infra* note 31.

documents that may constitute waiver or estoppel and prohibit the creditor from relying upon default provisions.

However, it is important to note that Lenders' actions within the context of the contract documents would not result in lenders' liability to the borrower. As observed in the celebrated case of *Farah,*[29] if the lender had simply exercised his contractual rights upon default, 'default... enabling the lenders to legitimately enforce their legal rights', there would be no lender liability. If the contractual provisions do not violate any statutory requirements, and if the performance is within the contractually agreed duties, the contracting parties should have no additional liabilities either against each other or against any third party. There will be no cause of action for unconscionable conduct if the conduct is authorized by the terms of the deed of contract to which both parties agreed.

(iv) Breach of privity and confidentiality: Right to privity and confidentiality is a natural associate of the freedom of contract. Right to privacy has been regarded as part of the right to life under article 21 of the Constitution of India. ° Right to privacy is not to be completely equated with the right to privity in a contract. In *R.Rajgopal* v. *State of Tamil Nadu,*[3] the Supreme Court reaffirmed that- the right to privacy is implicit in the right to life and liberty. This is a 'right to be left alone'. The court explained the right as: 'A citizen has a right to safeguard the privacy of his own, his family, marriage, procreation, motherhood, child bearing and education'. Thus, privity of contract is not to be confused with the right to privacy. Article 19 of the Constitution of India, does not include freedom of contract as a fundamental freedom to citizens to be ensured by the state. However, under article 19(l)(g) there is freedom to practice any profession, or to carry on any occupation, trade or business, which cannot be effected without freedom of contract. While the argument may be partially accepted, one

State National Bank v. *Farah Manufacturing Company,* 678 S.W.2d 661.

[30] *Kharaksingh* v. *State ofU.P.,* AIR 1963 SC *\295;Govindv.State of Madhya Pradesh,* AIR 1975 SC 1378, and *Malak Singh Singh* v. *State of Punjab and Hariyana,* (1981) 1 SCC420.

[31] AIR 1995 SC 264.

cannot argue that the two rights, namely freedom of contract and freedom of trade etc. are co-equal. Freedom of contract is very fundamental in a free and liberal society but it is not included in the list of article 19. Freedom of contract in India is therefore not a fundamental right, but only a natural right ensured by statute. As for example, if 'Lottery' is a contract and not a trade or business, any Act prohibiting lottery agreements cannot be called into question of constitutional validity. Similarly, any law requiring information on the credit obtained from banks and financial institutions to be recorded in a public or private registry cannot be challenged on *constitutional virus* unless it can be proved to be antithesis to trade, business or profession. Professional bodies keep the records of the respective professionals; trading and business bodies keep the record of such persons. Similarly all contracts dealing with immovable property are required to be registered with the public registry. So mere keeping of records in the registry cannot be questioned. The problem may lie with 'sharing of information'. Any instrument registered under the Registration Act, 1908 empowers any person to have access to the information by paying relevant prescribed fees. Under the Right to Information Act, 2002 right is accorded to the public to obtain information regarding certain operative facts. This Act does not provide anyone to obtain private information dealing with contractual relations. The state may, by legislation, require recording of information with the registration authority and sharing of such information on terms and conditions to be stipulated as is done by the Registration Act on all contracts dealing with immovable properties. Disclosure norms can also be built up within the contract domain. If in the contract of lending-borrowing, parties themselves agree that (a) all information are to be recorded with the registry; and (b) such information, according to rules laid down, are to be shared between the members of the trade in a given situation, there is no reason why such agreement cannot be enforced by a party. Confidentiality is a natural ally of right to contract. But since these rights are not fundamental rights, these rights are exercised according to law of the land. Presently, common law principles are applied in this area where law of contract is found inadequate. Parties to the contract are entitled to lay down the conditions for them to observe.

2.2 Lenders 'fiduciary liability

2.2.1 Stand of equity in court of justice

Lender-borrower relation is a creditor-debtor relation. As such, liabilities of parties are determined by the contractual terms and conditions in the manner prescribed under the statutory provisions. But occasionally courts extend the relation of trust, or attaches fiduciary obligation to determine the liability of the parties. Equity and natural justice are two pillars of justice delivery system of India. That is the reason why art. 141 of the Constitution of India gives primacy to the law declared by the Judiciary as the law of the land. The distinction between the Court of Law and Court of Justice is that the Court of law can decide cases on application of the law or its interpretation remaining within the four corners of the law stipulated, the Court of Justice has to apply the law with the sauces of equity and natural justice. So contractual terms are also subjected to the application of equity and natural justice. As such, in one case where the lender had an information, which was essential to take a decision of borrowing and which was not known to the borrower and the lender knew that the borrower did not know the information, it was held that lender had the duty to inform the same to the borrower. The lender was held liable for the injury caused to the borrower for not supplying the information.[32] In another case a Bank had a cash credit arrangement with one of its clients, a company. The Managing Director of the said company kept his personal account also with the same branch of the Bank. Money lent to the company was systematically transferred through cheques to the account of the Managing director. The bank never examined these transactions. The Bank was held liable to compensate the company.[33] There were number of cases of trust funds being transferred to the account of the Managing Trustee maintained in the same Bank, held to be a breach of trust.

[32] *In re Standard Investments Ltd.,* (1985) 22 D.L.R (4*) 10. See also, *Cornish* v. *Midland Bank Pic. [* 1985] 3 All.E.R. 513.

[33] *O. R. M* v. *Nagappa Chettiar,* 43 Bom.L.R. 440.

"Ibid.

2.2.2 Role of best practice code in equity

This part of lenders' liability is really difficult to predict in the absence of any *codified best practices.* It is always necessary to have 'best practice code' for the employees of the lenders to follow in order to prevent liability arising out of demand for equity and natural justice. Relation of trust may arise in three different ways. Firstly, the lender may be specifically appointed as a trustee by a deed of trust. Secondly, relational status may impute the relation of trust. And thirdly, transactional situation may demand trust relation due to the call of equity. In the second and third categories of events Indian judges did not behave very differently from the American judges and juries in appreciating demand of equity in contractual situation. A researcher catalogued the reactions of Judges and juries of US, which may seem very radical but when compared to Indian judgments in similar cases these would appear not very uncommon.[35] With increasing pressure by private interest in the business world the demand for 'fair deal' from the lenders, especially where the market is dominantly lenders' market seems to be the consideration of the community interest.

As the business and economic environment changed, the legal duties and obligations of the lenders began to change. Historically, the borrower/lender relationship was universally viewed as a business, creditor/debtor relationship. However, juries are asked to decide whether the borrower/lender relationship is one that will justify a borrower's reliance upon the lender for consultation, advice and an affirmative duty to disclose any and all matters relevant to the borrower's business decisions. If the borrower's business fails, its trusted confidant, the lender, certainly should not be able to collect the defaulted loan, and more probably, should compensate the borrower for its business losses. When juries are allowed to decide, without review by realistic legal standards, whether a lender should have a greater standard of conduct or duty of care, in an unsympathetic business and economic environment, the results are predictable - the big lender should not have let the poor borrower fail. The big lender understands the business jungle much better than the borrower - it should have guided the borrower through that jungle. The borrower was depending on the lender for the map. This may be an extreme characterization - but random juries, generally unsophisticated in the complex business dealings, are capable of extreme views of what is fair and just. This same analysis applies to the expanding duties of good faith and fair dealing, (para 1 A 5). See an article on current theories of lenders' liability by W.Mike Baggett Winstead, *et al,* presented in the Second Annual Construction Law Conference, 1989.

2.2.3 Complexity in affixing fiduciary duty:

The fixation of fiduciary duty in India has three complications. Firstly, Indian Judiciary has the same philosophical understanding as their counterpart in the US legal system, without having an appreciation of the fact that US is a borrowers' market and India is dominantly a lenders' market. In the borrowers market lenders try to allure the borrower into a contract and after lending becomes tough.[36] In the lenders' market the lender is always deceptive. Indian market being a lenders' market an analogy of US system and an economic explanation of US market behaviour shall not always hold good. The second complication is associated with organized and unorganized lending activities available in India. Unorganized lending industry is very strong notwithstanding the rapid growth of the formal sector of banking and financial institutions. And the third difficulty is related to industrial, trade and agricultural credit and also urban and rural credit. Can these credits be evaluated in the same index of measurement? Thus, transactional analysis in India in the context of equity is extremely complicated and tough.

2.2.4 Weakness of the lending industry

The above factors get further complicated when we look into the weaknesses of the lending industry. On account of the market so far remaining small and closed and dominantly belonging to lenders', there has been no systematic learning of art and science of lending practices and monitoring the borrowers' performance. The human resource employed in the lending industry is comparatively poor especially at the grass root level. The triangular relational process in the industry and possibility of

When soliciting borrowers, lenders are very agreeable - they take them golfing, to dinner, and are agreeable to give notices of default and otherwise modify contract provisions to protect their good friends - the pursued borrowers. Everything is hugs and kisses in the desired new relationship. After the loan is made, the lender must protect its depositor and shareholder loan proceeds. If the borrower begins to falter in the business or economic environment, the hugs and kisses quickly changed to suspicion and distrust. Lenders are taught to monitor their borrowers' performance. As the borrower's condition deteriorates, so does the lender's approach and attitude. (Para 1 B 1). *Ibid.*

considering the implication of equity at two relational processes is a complex and case-to-case phenomenon. To make the statement clearer, one has to understand that banking industry is dependent on the public deposit. Though the 'depositor-banker' relation is considered as creditor-debtor relation, but there is a possibility of application of the principle of trust at that level also. So in the triangular relation between the depositor-banker-borrower, equity may implicate at two levels, between the depositor & banker and between banker & borrower. When a banker is lending the money of the depositor to a particular borrower without the knowledge of the depositor, the banker being a professional operator becomes trustee of the depositor. The lender, therefore, may run the risk of double hazard. The lender functions as the trustee of the depositor.[37] The lender is also liable on equity for professional non-disclosure to the borrower. Whereas the former can also be covered by deposit insurance, the later is covered by professional conduct only. The third factor in the lending business that complicates the affair is that the economic reality is neither within the control of the lender nor of the borrower. The lender may have followed all economic parameters following all best practice guidelines and prudential norms. The borrower may have used adequate diligence and business prudence. Still the lending may fail. If borrowers are broken, can the lender be far off?

The lender is equally responsible to minimize the damage in the event of bottomline economic reality.[38] In macro financial assessment the lender is always considered to have better capacity of appreciation than the borrower. As such, any failure of the lender to assess the macro economic condition goes generally at the peril of the lender. *In lender-borrower litigation the sympathy of the court always lies with the borrower because of such inherent weakness of an individual.* The court has a feeling that often a timely restructuring of the debt considering the inherent weakness

In *Commercial Cotton Co.* v. *United California Bank,* (1985) 163 Cal. App. 3d 495 held that a depositor relationship with a lender was 'quasi fiduciary', ara D, *supra).*

'— emphasizes the lender's sympathy for the borrower's circumstances and the willingness of the lender to cooperate—'. *Id.* at para 1B.6.

of individual can provide a new lease of life to the borrower. Of course, one who comes to equity must come with clean hands!

'Lending' is a financial service that can be conducted in the usual business transaction. 'Banking' industry is special not because it is a lending institution but because the state is authorizing the bank to take public deposit for that purpose. Hence the state is responsible to see that there is no shaking of public faith, which will disturb the economy as a whole by causing public distrust on 'saving'. No other institution except a Bank can have access to the public deposit encashable by cheque or withdrawal slip and can also use the word 'bank' to its name. As such the Central Bank of a country is concerned with the business of lending. Quality of lending by a bank is a deep concern for the safety of the public deposit. Otherwise 'lending' as a financial service is not the consideration of the Central Bank. In India, Reserve bank is also responsible for the entire financial system. As such lending industry comes under its primary regulation. The most intricate challenge is that the Contract Act and the Transfer of Property Act presently cover the whole issue of creation of security interest for the purpose oi adding quality in the credit system. *The Transfer of Property Ac\ was intended in 1882 to regulate the feudal society under a 'statw quo' legal structure. Naturally, the same cannot hold the fort it steering the regulatory mechanism of a dynamic financial market* Unfortunately, that limited regulation for security interest creation and priority determination (by Registration Act) are the only lega process available to the banks. So the quality of lending cannot b< improved. As a result 'the spread' between the cost of borrowin] and cost of lending has to be pegged high to cover the risk of NPA The implementation system is also 'age-old' to suit a *'status quo* feudal society. Financial market requires a certain legal systerr with a fast justice delivery system. Both are absent here. *Th financial sector reform can only be meaningful if the legal systei is capable of adding quality in lending and fast track justice l both the parties.* Delay of justice does good to no body but injure both. As such, legal regime on security interest creation; publi registration with priority determination and enforcement of tr security interest at the quickest time, are essential features for £ efficient financial sector management.

In most of the countries the Banking Act does not talk about organisation and management pattern. That is the job of the Companies Act. Provisions are mostly focused on the functional regulation. As for example, the British Act provides for 'deposit' function; authorization of deposit taking institution; regulatory power of the Authority to regulate deposit taking power; constitution of the authority; tribunal; deposit guarantee fund creation and its management. There is no word about lending activity.

In India we have to take a mixed course because principle of good governance is not taken into account in organization and management of entities under the Companies Act. It is necessary that principle of good governance be essentially adhered to in the financial sector, especially to protect the interest of the depositor and investor. But functional regulation has to remain in the center-stage of the regulatory mechanism. Presently, the Reserve Bank enforces such regulation by its policy and guideline. But where the enforceable law is uncertain such policy and guideline can easily be ignored. As for example, Reserve Bank of India cannot issue a guideline on 'foreclosure' of asset kept in security against a banking transaction because the matter has a specific law meant for property transaction for all purposes. There is no differential in the legislative policy as reflected in the statutes between dealings in property transaction in a feudal society and that, which is needed in trade, commerce and industries. The objective of law and order in a state is taken independently of the question of determination of rights and obligations. As such, the Regulator does not have any clear power to stipulate the ground rules. That goes against the interest of the lending institutions.

2.3 Lenders" tortuous liability

2.3.1 Interference in the business of the borrower:

In *Farah,*[39] the lender caused two of their representatives to be elected to the Board of the borrower. These representatives acted in the best interest of the lender and not that of the borrower. The

Supra note 18.

Court applied the principle of tortuous interference with contract; found that the directors, as representatives of the lenders, breached their common law duty of loyalty to the corporation. This principle is quite well established in the corporate law and can apply to similar facts. However, one should keep in mind the principle that directors are not responsible for ordinary mistakes of business judgment. *Directors nominated in the Board of the borrowing institution may lead to two arguments. Firstly, lender may be held equally liable for the failure of the policy and function of the borrower and hence, equally responsible for the bad and default lending.* Secondly, if the nominated member informs back to the lender about the state of affairs, there may be a charge on insider trading. As such the lending institutions must have to take a policy as to how this conflict of interest can be maintained with arms-length distance in the management of the borrowing institution.

2.3.2 Good faith and fair deal

Tortuous liability, in most of the cases, arises from the duty of good faith and fair deal. In India there is no 'Codified Restatements' determining tortuous liability. There has been very marginal attempt in the financial sector to adopt Best Practice Code (BPC) that would apportion financial liability. Indian Judiciary would not agree to follow some of the US common law practices based on the principle of contract sovereign, such as:

(a) Good faith and fair dealing will not impose a duty contrary to express contract terms;
(b) Good faith and fair dealings arise only out of special relationship;
(c) If there is no contract, there is no implied obligation to good faith and fair dealing etc.

Indian Courts have also not decided any case of lenders' liability on the basis of equitable subordination.

2.3.3 Vicarious Liability

It is widely accepted that the vicarious liability issue in India has been restricted to establishing principal-agent relationship between

the bank and the defaulting employee. There is, however, no instance of cracking the corporate shell for affixing personal liability on the officer. But, in a surprisingly bold decision, the Supreme Court directed an amount of compensation of Rs. 10,000 awarded by the National Commission for Mental Harassment to be recovered from such officers proportionately from their salary.

2.4 Felonious Liability

Felonious tort is the liability of the principal because the felony is also tort. But there is no vicarious liability of the enterprise for the crime of the employee. No act of crime can be covered within the course of employment. *For all offences committed by an employee, the person committing the offence is personally liable and the institution is not liable.* No one can authorize any other person to commit an offence nor can promise to be binding for such an act. For all acts of cheating, forgery, criminal conspiracy, embezzlement of fund, criminal breach of trust, the person committing the offence will be personally liable.

Financial fraud not amounting to cheating, forgery, and criminal breach of trust or embezzlement of fund, is not an offence. Such an act may be in the borderline of felony and tort. Therefore, for financial fraud the person committing the financial fraud and the entity, both may be liable. The institution is vicariously liable for the tort[42] committed by the employee and the employee may be liable for felony.

In criminal breach of trust,[43] there has to be an existing duty of trust. Entrustment connotes ordinarily that the property is handed

[40] The well known case of *SBI* v. *Shyama Devi,* AIR 1973 SC 2451.
[41] *Lucknow Development Authority* v. *M.K.Gupta,* AIR 1994 SC 787.
[42] *Supra* note 43 and *Bank of Bihar* v. *Mahavir lal & others,* AIR 1964 SC 377.
[43] Section 405 - Whoever, being in any manner entrusted with property, or with any dominion over property, dishonestly misappropriates or converts to his own use that property, or dishonestly uses or disposes of that property in violation of any direction of law prescribing the mode in which such trust is to be discharged, or of any legal contract, express or implied, which he has made touching the discharge of such trust, or willfully suffers any other person so to do, commits 'criminal breach of trust'.

over by A to B in whom A reposes confidence for a specific purpose. In 'bad lending' a depositor's money is legally the bank's money, which an officer of the bank handles. Indeed, between bank officer and customer, there is no such duty of good faith and trust ascribed in the present law. Even in highly developed law of USA, there is no trust *simpliciter.* In fact, courts have had to evolve as 'fact-sensitive fiduciaries'.[44]

2.5 Statutory Liability on Environmental Assessment

Many tortuous liabilities are now codified as statutory liability. As for example, codification of environmental law reduced the tortuous liability in statutory breach of duty. In a recent research survey it was found that most of the financial institutions do not have any expert to evaluate environmental hazard arising out of implementation of a project. Institutions only insist on obtaining an environmental clearance certificate from the respective government authority. The financial institutions and banks have neither expertise to apply their mind nor do they have any system of absorbing the cost of environmental management within the project finance. That results in two types of liabilities of the lending institutions. *Firstly,* even if there is no legal liability of the financial institutions to apply their mind in clearing project finance in case they depend on the clearance certificate, ultimately the liability of the failure of the project shall fall upon the financiers. If the borrower ultimately could not take off or had to close on account of agitation on the ground of environmental hazard, the loan could not be recovered or recovery would become slow and at high cost. *Secondly,* in a plea of joint liability the lender may be held liable for not applying his mind for performing statutory duty. There is also some incidental responsibility, such as, the project cost would be under-valued. The project would be not properly financed. In the event of environmental hazard the lender may be liable to pay compensation. *No lender may escape liability if there is no reasonable evidence that the lender has sufficiently applied his mind on environmental issue. A* mere plea that on the advice of

[44] *Irish Bank Pic.* v. *Byran,* (1995) 2 F.L.R. 325 and *Berkeley's Bank Pic.* v. *O'Brien,* [1993] 4 All.E.R. 1417.

an authority the lender did decide the issue of passing a project finance, may not absolve from breach of statutory responsibility. The lender and the borrower may be jointly and severally responsible.

2.6 Lenders ' Ultimate Liability for Bad Lending

For bad lending, the lender has a serious direct liability. Like the borrower, the lender also cannot argue that the lending failed in spite of following the prudent policy of lending.

In case of bad lending, such a liability can arise: (a) in the scheduled issue of contractual relation like the lending activity or may also arise (b) in the non-scheduled issues, such as issuing a credit to develop an industry, say, which is injurious to environment. In the first case the liability is due to bad lending and in the second case the liability is on account of defective lending supporting activity, which leads to environmental pollution or hazard or, which is on account of breach of any statutory conditions or non-performance of a common law obligation. The first one is direct due to the bad lending but the second one is indirect by way of aiding and abetment in a wrong act. There is a vicarious liability in an action against tort. In the first case, the liability is due to bad lending, which cannot be passed on to the public depositors whose deposits have been used for lending purposes. In the second case, the liability is to the society at large and to the suffering party in particular.

If the lender is allowed to argue that since lender has followed all prudential norms and all basic principles of procedure, lender ought not to be liable for bad lending, who would then take the burden of liability? Would it mean that such sum of money would be omitted from receivables? What v,would be corresponding reduction in the liability side? If the concern has good profit, which can take care of the reduction of the receivables, there is no problem. It means the owner of the entity has to receive less because of reduction of profit. Suppose there is no profit or there is inadequate profit, what could be done and what is the argument? One thing can be argued that let the non-realizable receivables be

written off over a period of years. Or in other words, the owners may have to continue to be satisfied with less profit or none in future, until the loss on account of non-realization of the amount is recouped from the profit realized from other transaction. Or the institution should go for restructuring with necessary reduction in the Capital due to accumulation of non-performing assets, which in restructuring phase are required to be written off. Can the concern or the owners argue that since the credit was given scrupulously based on the principles of business prudence following all norms, the owner of the lending industry cannot take the responsibility? Their profit must not be reduced either in the current year or in the subsequent years and the credit risk has to be taken over by some one else? A bad lending is not necessarily an outcome of a wrong lending. It may be on account of the entire economy of the country in the downhill. It may be on account of global or national depression. Why should then one unit of the industry take the responsibility? Does it not sound better for the entire lending industry being treated alike for the entire loss on bad lending? Should there be credit risk insurance? Can one argue that bad lending is due to bad financial management and hence, a State responsibility! Is it a fair system to pass on the burden of bad lending to public exchequer for the failure in a private deal? Why should taxpayers bear the responsibility for the business loss of a person, even if the transaction is made prudently? However, if the Government is the owner of the financial institution, the taxpayers are denied to question the prudence of the fiscal measure to meet bad lending. The argument that the Government owns the concern on behalf of the people is a queer logic. If Government ownership would mean bad lending, and that the government does not know the art and science of lending, it may be argued, that government ought not do the business in the usual style of governance. It could hire the management who could take the lending decision with attached liabilities for bad lending. The decision of lending, including policy formulation shall not be ordinarily a government's job. So in all cases, for a bad loan, the lender, i.e., the concern or person lending the money, has to ultimately bear the responsibility. The owners have to bear the loss of capital and revenue, failing which it has to become bankrupt. However, the government may

bail out a public lending institution as if it is a sovereign guarantee to meet good the loss from the revenue collected from taxpayers.

Such a logic may give rise to inefficiency and bad management. Any industry cannot survive on creches provided by the State. A prudent businessman will not argue on the above line. A prudent businessman in their decision for lending appreciates entire fact situation, both internal and external. Any business decision is based upon several external factors including the economic downturn. Risks of all such factors, internal and external, ultimately determine the lending decision. Once the lending decision is made, the borrower and the lender take their respective position on their obligations. However, in risk management, insurance plays a significant factor. In the great depression, the government of USA had to take a decision on deposit insurance in order to restore the confidence of the depositors on banking business. Deposit insurance has also been introduced in India, predominantly because the banking business has to confront constantly the risk of bad lending. In the process, there is probability of asset depletion in the industry. With the slightest discomfort and doubt, depositors may run on the bank leading to the failure of any bank. Any doubt in the banking system is highly injurious to the country as a whole and that is the reason why, political economists designed compulsory insurance up to a certain limit. Insurance industry can however independently design a product for such risk management. The other alternative is instead of deposit insurance, there may be insurance of lending activities, which can be termed as project insurance. Such insurance cost may be even subsumed in the project cost itself. The problem of designing such insurance product is because of involvement of high moral hazard in calculating the risk in project lending insurance-cover.

[45] Banking Regulation Act, 1949.

3. Lenders' Liability Under Corporate Governance

3.1 Extent of management's responsibility

Now that it is clear that if somebody has to be liable for the bad and wrong lending the shareholders of the lending entity cannot refuse to bear the loss, both capital and revenue. The Banking Regulation Act, 1949 does not talk about any liability of the management though the power of the management is now vested by the authority of the statute[46] both for the private and public sector institutions. The power of the management is not conferred by way of delegated process. The CEO collects his power from the statute. As such, there is a need to have a review of the regulatory framework outlining strict and comprehensive direct responsibility for bad lending and allocating the management responsibility. It is time to ask a more substantive question at the normative level: what should this liability entail and who should be the 'lender'? Can the penumbra of 'lenders liability' law be advanced to expose the management (like, the concept of officer-in-default prescribed in the Companies Act), by cracking the corporate shell or lifting of the veil? How far is it prudent to insulate the management (of all stages) under the corporate veil? It is the management that takes lending decisions. Shareholders are no more connected with any business decisions. The Board of Directors, which is supposed to be at the helm of affairs and the apex center of power according to the Companies Act, is only a puppet or a mere ritual in the hands of the management. Why then the management is not to be exposed for bad and wrong lending? The Companies Act, 1956, already contains the core law of cracking the corporate shell,[47] but the Banking Regulation Act, 1949 is silent and does not contain any provision for exposure of management or officer-in-default.

Section 10(B) of the Banking Regulation Act, 1949, which provides for a banking company to be managed by a whole time Managing Director. [47] *See,* S.5 of the Indian Companies Act, 1956. It is in detail discussed further in this article.

3.2 Cracking of the corporate shell and lifting the veil:

The philosophy of corporate shell relates to the statutory insulation provided for the functionaries of the entity. In *Solomon* v. *Solomon & Co.*[4]* the judiciary explained this concept of liability of the company distinguished from the liability of the functionaries of the company. A corporate entity takes the liability of the functions undertaken for the company. No shareholder or manager is liable. It is the unlimited liability of the company for entire function of the functionaries. This is the essence of the *legal personality.* All liabilities are assumed by the entity arising out of the actions of the individuals. A company is a *principal-in-perpetuity.* It is always represented by its functionaries as the agent. This is referred to as the corporate shell, as strong as unbreakable unless broken by the same or any other legislation. In the nineteenth and twentieth centuries there have been many legislative designs and reasons for the legislature to crack the shell (which often is referred by the authors as piercing the viel).[49] Not only that, the court did make the shell look like a veil so as to lift whenever the judiciary, as the groom wanted to. In basic this is the corporate veil theory ensured by the judiciary for its bride, whenever it wants to lift it could! Limited liability is the second fundamental principle of corporate law. Under this principle, 'shareholders are not liable for the obligations of the corporate beyond their capital investment'.[51] The corporate is viewed as an entity independent of its shareholders, and it alone is liable for the consequences of its actions. One policy

[48] 1897 A.C 277.

[49] As for example, Income tax and other tax laws affix the personal liability of the 'officer-in-default' along with the corporate liability for the tax law violation; Company law itself punctured the corporate shell through several provisions attaching personal liability, like Section 45 on reduction of members below statutory minimum, Section 62 & 63 for wrong and non-disclosure in the prospectus, Section 147 for the improper[v]use of name of the company, so on and so forth.

[50] *Tata Engineering & Locomotive Co. Ltd.* v. *State of Bihar,* (1964) 34 Com. Cases 458. See also, *P.N.B.Finance Ltd.* v. *Sheetal Prasad Jain* (1983) 54 Com. Cases 66. In this case, the court attached the personal liability to the functionaries without extending the protection under the doctrine of corporate viel.

[51] Phillip I. Blumberg, *The Law of Corporate Groups: Substantive Law,* (1987).

reason offered in support of the limited liability form of business enterprise is that 'the notion of limited liability' encourages development of public markets for stocks and thus helps make possible the liquidity and diversification of benefits that investors receive from those markets.[52] Another purpose of the limited liability form of business is the 'ability to separate the parts of the firm that are subject to regulation from those that are not leaving the unregulated part of the business free to avoid the costs of regulation.' These purposes support the general rule that the separateness of a corporation from its shareholders will normally be respected.[53]

The above discussion is relevant to establish the point that any digression from the limited liability has to be a very cautious inroad.

The well-known theory of lifting the corporate veil is the exception to the sanctity of corporate liability. The link, the veil jurisprudence and lender liability is natural: lender liability can be a (potential) ground for lifting the corporate veil. Recent scholarly works have compared lender liability to piercing the corporate veil doctrine.[54] It is supported by the fact that the contours of this doctrine are in any case not clear; it remains fact-specific inquiry, which can, therefore, accommodate lender liability.[55] Hence, it is not a watertight compartment and can accommodate new principles like lender liability.

Hiding Behind the Corporate Veil: Employer Abuse of the Corporate Form to Avoid or Deny Workers' Collectively Bargained and Statutory Rights, 100 W.VA.L.REV. 537 (1998).

[53] Cynthia Nance, Affliated Corporation Liability under the WARM Act, 52 Rutgers L.Rev. 495, (2000)

[54] See, Lawrence J. Shehin , in Lender Liability and the Corporate Veil: An Analysis of Lender as Shareholders Under CERCLA, 25 B.C. ENVTL. AFF. L. REV. 687 (1998). This is in context of lender liability rules created by the widened 'owner/operator' concept in the Environment Protection Act, 1986.

'The law in this area has not crystallized. Case results are very fact specific, and the fact patterns that cause a court to pierce or not to pierce are not clearly understood. The area of uncertainty is broad enough that litigants have continued to bring a large number of cases'. Thompson, at 1036.

In any case, a broad principle can be derived thus: 'typically, veil piercing is a method by which liability is extended from the corporation *to the individuals causing the lending activity* for the purpose of preventing fraud or to right a particular wrong'. The very point of veil-piercing is to avoid injustice by disregarding the formal structure of a transaction or relationship in favor of its substance, to impose personal liability on persons who have, in substance, run their nominally incorporated business in a way that makes it unfair to allow them to deny their responsibility for the obligations of the business by interposing the corporation's separate legal personality.[57]

However, in the context of lenders liability especially for financial institutions, the corporate veil theory may be applied by the Indian Judiciary to examine the management's liability for 'bad lending'. It is widely accepted that the vicarious liability issue in India has been restricted to the establishing principal-agent relationship between the bank and the defaulting employee.[S8]There is no instance of cracking the corporate shell for affixing personal liability on the officer. However, in a surprisingly bold decision, the Supreme Court directed an amount of compensation of Rs. 10,000 awarded by the National Commission for mental harassment to be recovered from such officers proportionately from their salary.[59]

The inarticulate premise of the court seems to be based on the 'expectation principle' for damages under which the aggrieved debtor is entitled to that quantum of damages, which he

[16] *Middleton* v. *Parish of Jefferson,* 707 So. 2d 454,457 (La. Ct. App. 1998).

57 *West Va. Highlands Conservancy, Inc.* v. *Public Serv. Comm'n.,* No. 25048, 1998 WL 874963, at * 4 (W. Va. Dec. 14,1998).

58 The well-known case of 55/v. *ShyamaDevi,* **AIR** 1973 SC 2451.

[59] *Lucknow Development Authority* v. *M.K. Gupta,* **AIR** 1994 SC 787. Compliance of the Order was to be reported to the Supreme Court within one month from the date fixed for compliance. On another occasion, *Central Co operative Consumers Stores Ltd.* v. *Labour Court,* 70, *Taxman,* 6 (SC), under the COPRA, 1986 the officers were held liable personally for wasteful litigation, and the officers responsible were compelled to pay compensation to the , employer. The second case though promoting deterrence, does not change the vicarious liability rule.

legitimately expects to be shared by the lender or the officer-in-default. Often the liability is so huge that the Court may be reluctant to trigger off individual liability. It may be mentioned that the 'expectation interest' approach itself is not infallible. This is so because there is a strong case for the point that the expectation theory gives to the plaintiff, the debtor, a handle to expect his burden and obligation to be shared by his creditor who had no role in the execution of the project for which loan was taken and that led to any violation of statutory or non-statutory provision. Nevertheless, there is no real deterrence in penalizing a fictional entity[60] since due to separation of ownership and management; the only interest group to 'feel the pinch' is the 'shareholders group' who in any event do not manage their lending entity.

Let us examine the corporate veil theory from another perspective. The *corporate veil* insulates the management and as such the manager is not personally liable for his decision. What is the liability of a lender? The financial liability of a lender may arise due to bad lending. The bad lending may be on account of breach of a corresponding duty, such as, duty to take adequate care to examine the worthiness of the purpose for which lending-borrowing is necessary; and/or duty of *'creating sufficient comfort'* so that there is certainty of getting the loan amount back with interest. Here the credit becomes unworthy of realization and the lender becomes liable to financially make good of the loss. Though the actual lending decision is taken by a 'manager' the liability remains with the entity or the body corporate for two obvious reasons. Firstly, as was already stated, the manager is insulated by corporate veil; and secondly, the manager functions for and on behalf of the corporate entity, as if an agent. Function of an agent binds the principal based on the principle of'*qua facet per alliums facet per se,*' i.e., one who does something through another does it oneself. There is another liability due to breach of duty to take care of ascertainment that no statutory obligation is violated by performance of the contract, so on and so forth. These are statutory

A corporate entity is a collection of contracts: there is a contract between shareholders *inter se,* between the directors and the company, between the company and debtors/creditors and between the company and end users.

liabilities arising out of violation of some statutory obligation. Breach of all these duties may be due to fraud, or culpable negligence or wanton disregard to duties. Why should the actual lending officer be not liable for such fault? This question gives rise to the possibility of lifting the veil. It is true that in many cases the officer individually is so insignificant that the huge sum that is in stake cannot be recovered from such official. Lifting the veil thus can hardly achieve any goal. A professional manager may be broken, may be declared insolvent, or can be asked to pay an amount of compensation. He or a group of managers committing fraud or error of judgment or wanton disregard to duties, can not be asked to raise the fund to bear lenders liability.

3.3 Best Practice Code on lending decision

Is this a sufficient ground for making the management not liable for professional negligence or fraud or disregard to duties? In the absence of any statutory stipulation, an officer-in-default is not liable for any wrong and bad lending decision is taken in good faith and honest belief that the decision is taken in the best interest of the business though in fact the truth lies otherwise. The officer-in-default is personally liable only in the event of offence committed. In order to make management at any level liable on the ground of absence of proper care there is required to have 'Best Practice Code' codifying norms of taking lending decision. It is also be made legal requirement to place the matter where any decision is either taken or required to be taken deviating from the 'best practice norm' before the Board. The BPC has to be reviewed from time to time and the standard of care expected is expressly provided in the BPC.

Any discretionary power given to any level of management must be covered by BPC laying down the procedure of making the decision. BPC has to show that the discretionary power of rank manager is not an arbitrary decision. A codified procedure with checks and balances makes the exercise result-specific. In most of the scam incidents it is found the basis lies in the absence of any BPC on lending decision. In private sector discretionary power is result-oriented. Absence of positive result may result in the

removal of the official. In a public sector organisation the same is required to be based on rule based procedure with checks and balances. My personal experience is that there is no BPC in investment and lending decisions. As such these are gross demonstration of arbitrary power to the detriment of the institution. Such a gross violation of care and prudential norm must attach personal liability.

3.4 Liability on fraud

Under Companies Act there are provisions for the piercing the veil on the ground of fraud[61] and fixation of personal liability. Similar provision is required to be inserted in the Banking Regulation Act, 1949. The Act may also provide for restoration of the amount through tracing of assets. It is difficult to depend upon the court on each individual issue for lifting the veil, because of the delay involved in justice. It is therefore necessary to provide in the BRA to personal liability of the party participating in the fraud and also the power of the institution to trace the property without affecting the *bona fide* customers.

3.5 Traditional limit of the lenders liability

Traditional lenders' liability claims fall into three heads: fraud, breach of fiduciary duty and negligence.[62] In tort law an argument can be advanced that the act of bad lending was not done 'in the course of employment'. A master is not liable for the dishonest or criminal acts of his servants when the servant merely takes the opportunity afforded by his service to commit the wrongful act, which leaves the aggrieved party to proceed against the 'bad lender'. However, there exists no privity of contract between the officer and the borrower. As for torts, the 'duty of care'

[61] Section 542 of the Companies Act, 1956 prescribing personal liability of the ftinctionary for fraudulent conduct of business, when the company is in the course of winding up.

[62] *Scott* v. *Dime Savings Bank of New York,* 1995 U.S. Dist. LEXIS 4009(march 31,1995).

[63] Lord Denning in *Morris* v. *C.W. Martin & Sons Ltd.,* [1965] 2 All E.R. 725. Followed in *State Bank of India* v. *Dhyaam Devi,* AIR 1978 SC 1263.

jurisprudence in this regard has not developed to evolve into a rigid norm. Hence, in the US, there is a trend to establish a fact-specific 'quasi-fiduciary' relationship so as to make the officer a 'constructive trustee'. But firstly this is unpredictable, secondly there is zero deterrence, the only outcome is restitution!

3.6 Special personal liability of promoters

Special liabilities of players in the market are required to be specifically fixed either by the statute or by the regulator. One special issue must be remembered is that the regulator can never affix criminal liability; criminalization is absolutely a legislative prerogative. As such, the regulator can only affix civil as well as punitive fine on the players. There is a special liability of the promoters of private and co-operative banks asking them to contribute towards the paid up capital to the extent of 40% and the same is to be locked in for a period of five years. But there is no regulation affixing the special liability of the promoters. The policy is required to be determined as what is to be the special civil and contractual liability of the promoters of a private bank and the same to continue for how many years. Generally the following special contractual liability is fixed on the promoters at the time of issuance of license, viz., liability for misstatement and suppression of facts; misuse of provisions of the license and non-fulfillment of conditions stipulated in the license; act of deceit against creditors and investors; and not taking adequate provision to protect the interest of the depositors. The personal liability of the promoters for such an act is restricted for a period of five to ten years. Based on such provision the lock-in period is determined.

3.7 Special personal liability of directors

There are some special liabilities of the directors specially to bear personally prescribed in the Companies Act. Some of these liabilities are criminal in character including attracting imprisonment, such as misstatement in the prospectus[64]. But directors are not personally liable for wrong decisions; they are

Sections 62, 63 and 67 of the Companies Act, 1956.

protected by the corporate veil. But specific regulation can affix the directors for bearing personal liability. Some of these grounds respected world over are, misuse of power and over-stepping in decision making (removal of corporate veil); dealing with inside information; violating prudential norms without any due diligence and business prudence for doing so; neglecting audit report and not meeting the objections (as for example, if dividend is declared without making adequate provisioning or provisioning as directed by the regulator to protect the interest of the depositors, directors are personally laible); suppressing the information to the regulator and violating regulator's directive. We have very little of such specific liabilities affixed by the regulation. SEBI has formulated some regulation in some areas but by and large, banking sector is still in open to be infected with all the above *virus*.

3.8 Special personal liability of the management

The Reserve Bank has the power by virtue of statutory provision. But if there is a violation what is to happen is required to be fixed by the regulator. There are some provisions in the companies Act for affixing the special liability of the management. This has been discussed in the section dealing with corporate veil. Under the banking regulatory system there is no personal liability of the management. Generally speaking the following areas are areas of personal liability if the regulator so affixes by regulation, e.g., violating the prudential norms without recourse to the Board of Directors (When the matter is placed before the Board the management is insulated but that exposes the directors acting in disregard); failure to follow the instructions and guidelines of the regulator; dealing with inside information to the detriment of interest of the depositors; and any other matter of act of imprudence as may be prescribed by the regulator.

4. A CRITICAL ECONOMIC REVIEW OF LENDERS' LIABILITY IN COMPARATIVE LEGAL ANALYSIS

4.1 Wider ramification of the concept of lenders' liability

The quest of the enquiry 'who should be a lender' is essentially a policy issue: it is normative and not positive. The Banking

Regulation Act understands a bank as a company, which accepts for the purpose of lending on investment, deposit of money from the public, repayable on demand or otherwise. However, our current agenda is broader, as in India, there is a large presence of unincorporated lenders. It is suggested that reference could be made to the Financial Transactions Reports Act, 1988 of Australia. The Act creates the concept of a 'cash-dealer'.[65] Though the object of the Financial Transactions Reports Act is primarily to curb tax evasion, this notion of the 'cash dealer' can be captured in the limited context of identifying the unincorporated lender. Examining the issue from the Companies' Act perspective, sec. 5 of the Companies Act, 1956, defines 'officer-in-default' to include the managing director, the manager, the secretary, shadow director etc. 'Officer', as a term in sec. 5, is a functional and fact-specific inquiry. However, sec. 5 is merely an exposition of 'officer' as used elsewhere in the Companies Act and cannot be interpreted to mean that the officer is in default when the company is in default. The significance of sec. 5 lies elsewhere: this provision abolishes the defense of absence of *mens rea* for 'officers-in-default'. So,

Cash dealer, by S.3(a) of the Act means:-(a)
financial institution;
(b) a body corporate that is, or, if it had been incorporated in Australia, would be a financial corporation within the meaning of paragraph 51 (xx) of the Constitution.
(c) an insurer or an insurance intermediary.
(d) a Securities dealer.
(e) a futures broker.
(f) a Registrar or Deputy Registrar of a Registry established under Section 14 of the Commonwealth Inscribed Stock Act, 1911.
(g) a trustee or manager of a unit trust.
(h) a person who carries on a business of issuing , selling or redeeming traveler's cheques, money orders of similar instruments; (i) a person who is a bullion seller.
(j) a person (other than a financial institution) who carries on a business of: (i) collecting, holding, exchanging or remitting currency, or otherwise negotiating currency transfers, on behalf of other persons; or (ii) preparing pay-rolls on behalf of other persons in whole or in part from currency collected; or
(iii) delivering currency (including payrolls); (1) a person who carries on a business of operating a gambling house or casino; and a bookmaker, including a totalisator agency board and any other person who operates a totalisator betting service.

wherever the 'officer-in-default' liability applies, e.g., in non-disclosure of conflict of interest, the director is strictly liable. sec.633 though provides an escape route to the officers-in-default since it gives discretionary power to the court to relieve liability from officers-in-default for acts done in good faith, *it* is submitted that in context of the fact that sec. 5 of the Companies Act, post the 1988 amendment,[66] abolished the *mens rea* defense, S.633 should be read down to that extent. In other words, power of the court to give relief based on good faith where it concerns officers-in-default, should be understood as impliedly repealed. Else the purpose of the legislative amendment of sec. 5 would stand defeated.

Can product liability be linked to lender's liability? There is no direct answer to this question. It is applicable by way of analogy. In the Consumer Protection Act, 1986 (COPRA), the definition of a consumer is such that product liability can attach to the 'lender' viewing the loan transaction not as goods[67] but as 'service'.[6] There is Indian case law to this effect as well[69] and it is clear that bank customers are 'consumers' for the purpose of the COPRA. Fraud committed in the bank account,[7] delay in collection of salary cheques[71] and the like have triggered off product liability under the COPRA.

4.2 An economic analysis of lender liability

In agency theory of corporate law, the corporate is viewed as a 'nexus of contracts' between different factors of production. Shareholders possess antecedent rights as the company's owners to have it operated in their interests and ultimately to control it. The

Companies (Amendment) Act, 1988.

[67] The expression 'goods' in S.2(l)(d)(i) is to be interpreted in the light of the Sale of Goods Act which excludes a 'contract of cash' from its purview. However, a loan transaction can come under 'service'

[68] See *supra* note 26.

[69] In *Amrit Laal* v. *Instant Instant Growth Funds Pvt. Ltd.,* (1992) CPJ 647(Del), it was held that opening and maintaining accounts of customers is a contract and is therefore a service.

[70] *Hematnti Chutia* v. *United Commercial Bank, (*1994) CPJ 505 (A).

[71] *Madubhai R. Patel* v. *SBI,* II (1996) CPJ 132(NC).

stress on shareholders value is simply because it makes the company-itself nothing but a web of contracts, more efficient. But though ownership is divorced from management,[72] owners are interested in maximum profits at reasonable risk whereas the interest of management is less clearly defined.[73] This increases agency costs. The link of this discussion to the current context is that the liability of the management may be seen as imposing an additional cost on the shareholder-agency function of the corporate and result in inefficiency. This additional cost involves the risk of bad lending both on account of fault in the decision and circumstantial. But does it include fraudulent and culpably negligent bad decision?

It is true, therefore, that initially, it may appear that there is an inherent inconsistency in corporate governance and lenders liability. The aim of corporate governance is to maximize shareholder value[74](the premise being that this is the key to the two above-stated broader objectives of corporate governance). But, *prima facie,* lender liability seems to erode shareholder value. A lender liability claim, in the microanalysis, erodes shareholder value of the lending institution since it will either result in litigation costs or, by internalizing prevention controls, will nevertheless increase transaction costs of the lending firm.

Is lenders' liability then, inconsistent with corporate governance jurisprudence? It is submitted that it is not so. A two pronged reasoning can be provided for this. The first leg of the argument is that: (a) all lenders in some context or the other are borrowers as well; and (b) lenders such as banks have an interest in good governance of their channels of investment. In other words, though *prima facie,* lenders liability may be opposed to shareholders value maximization, internalization of lender liability law (in this sense it only means best practice rules for lending activity) will improve investment climate for the bank since the resultant improved business climate will ultimately benefit banks as well. So, on a macro-analysis, lenders liability law benefits everybody!

John Parkinson, *et al, The Political Economy of the Company,* 91 (2000).
Id. at 68.
Kumara Mangalam Birla Committee Report on Corporate Governance, 2000.

The second leg of the argument forces a challenge on economic efficiency as a value itself (this being the premise of shareholder value maximization) and makes social justice the ultimate goal of commercial law.[75] This analysis will result in favoring the creation of a lenders' liability law since typically, the borrower is less really empowered than the lender. An instance of this is the Truth in Lending Act, 1968 of the U.S., which imposes a high duty of full disclosure of material facts to credit consumers.

A logical answer lies in the 'default rule': the default rule in debtor-creditor relationship provides parties with "the type of contract that they would have agreed —[upon] if they had had the time and money to bargain over all aspects of their deal."

If in a contract paradigm of managing agency or asset management company (AMC) to be appointed such a personal liability can be attached with economic prudence there is no reason why fixation of liability cannot be made with cost efficiency in the contract of managerial assignment.

5. A Comparative Survey on Lenders Liability in the Developed World

Comprehensive Environmental Response Compensation and Liability Act, 1980 (CERCLA) of the U.S. has heralded lender liability for environmental issues but technically, it provides that a party who holds indicia of ownership to protect a security interest is not to be considered an owner or operator so long as it does not participate in the management of the facility. [6] Later cases extended this liability to situations where the lender was found to be in control of the borrower and more disturbingly to situations where the lender could be found to have been in a position to affect

[75] Dworkin says it is an unpleasant social goal , *c.f.* Daniel A. Fraber, Eco-pragmatism, (1992), But Posner says court should apply economic efficiency as parties themselves applied it impliedly. Richard Posner, *Economic Analysis oj Law,* 81 (1986).
[76] 42 USC, Section 9601 (20)(A).

decisions relating to the disposal of hazardous materials. The EPA responded to the confusion surrounding the liability of lenders by adopting a Lender Liability Rule in 1992.[78] The Rule provided a safe harbor for lenders and made it clear that lenders could safely engage in a wide variety of activities including requiring environmental audits; requiring compliance with state and federal environmental laws; engaging in loan workout activities and foreclosing on the property where necessary. While the Rule was not a perfect solution for lenders it was well received in the lending community. But the Rule was subsequently struck down[79] so as the position now stands, lender liability for environmental costs is nebulous: the EPA requires management participation of the lender but courts have interpreted it such that even if a creditor can affect the business decision of the defaulting debtor he may be held liable! Such a position is unwelcome in India and a lesson should be learnt from the U.S. experience in lender liability albeit in the context of environment law.

The Resources Management Act, 1992 of New Zealand makes every person prima facie subject to the jurisdiction of New Zealand for violation of a duty to avoid, remedy or mitigate any adverse effect on the environment arising from any activity carried on by or on behalf of that[80] Though the purpose of this Act is sustainable

[77] See *United States* v. *Fleet Factors Corp.,* 901 F2d 1550 (11* Cir. 1990). These decisions were based on the 'owner or operator' provisions of CERCLA, which provide that such a party may be found liable for clearup costs even if that party had nothing to do with causing the contamination.

[78] See 57 Fed Reg. 18382 (daily ed. April 29, 1992).

[79] *Kelly* v. *EPA,* 15 F3d 1100 (DC Cir), reh denied, 25 F3d 1088 (DC Cir 1994), cert, denied, *American Bankers Association* v. *Kelley,* 115 S Ct 900 (1995).

[80] 17. Duty to avoid, remedy, or mitigate adverse effects—(1) Every person has a duty to avoid, remedy, or mitigate any adverse effect on the environment arising from an activity carried on by or on behalf of that person, whether or not the activity is in accordance with a rule in a plan, a resource consent, section 10 (certain existing uses protected), or section 20 (certain existing lawful activities allowed).

(2) The duty referred to in subsection (1) is not of itself enforceable against any person, and no person is liable to any other person for a breach of that duty.

(3) Notwithstanding subsection (2), an enforcement order or abatement notice may be made or served under Part XII.

development and not lender liability, due to the U.S. experience of unexpected liabilities on creditors, the creditor lobby is apprehensive of the tentacles of this legislation. In the realm of lending to consumers for non-business usages, the Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996,[82] amended by the Truth in Lending Act (TILA) of the U.S. has set the trend. This Act authorizes federal Truth in Lending enforcement agencies to order creditors to make monetary and other arrangements to the accounts of consumers where an annual percentage charge was inadequately disclosed and even contemplates restitution of undisclosed errors. The stated purpose of this informed use of credit[83] is a context where creditors were creating unhealthy markets of credit.[84] The Truth-in-Lending Act requires lenders to disclose the terms and costs of all loan plans, including the annual percentage rate, points and fees; the total of the principal amount being financed; payment due date and terms, including any balloon payment where applicable and late payment fees; features of variable-rate loans, including the highest rate the lender would charge, how it is calculated and the resulting

(a) Require a person to cease, or prohibit a person from commencing, anything that, in the opinion of the Planning Tribunal or an enforcement officer, is or is likely to be noxious, dangerous, offensive, or objectionable to such an extent that it has or is likely to have an adverse effect on the environment; or

(b) Require a person to do something that, in the opinion of the Planning Tribunal or an enforcement officer, is necessary in order to avoid, remedy, or mitigate any actual or likely adverse effect on the environment caused by, or on behalf of, that person.

[81] Sec. 5 of RMA, 1992.

[82] Pub.L. 104-208, Div. A, Title II, Subtitle E, Sept, 30, 1996, 110 Stat. 3009-462.

[83] The Congress finds that economic stabilization would be enhanced and the competition among the various financial institutions and other firms engaged in the extension of consumer credit would be strengthened by the informed use of credit. The informed use of credit results from an awareness of the cost thereof by consumers. It is the purpose of this subchapter to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit, and to protect the consumer against inaccurate and unfair credit billing and credit card practices. Sec. 1601 of the Act.

[84] The Congress also finds that there has been a recent trend toward leasing automobiles and other durable goods for consumer use as an alternative to installment credit sales.

monthly payment; total finance charges; whether the loan is assumable; application fee; annual or one-time service fees; pre-payment penalties; and, where applicable, confirm for you the address of the property securing the loan. The TILA is intended to enable the customer to compare the cost of cash versus credit transaction and the difference in the cost of credit among different lenders. The regulation also requires a maximum interest rate to be stated in variable rate contracts secured by the borrower's dwelling, imposes limitations on home equity plans that are subject to the requirements of certain sections of the Act and requires a maximum interest that may apply during the term of a mortgage loan. TILA also establishes disclosure standards for advertisements that refer to certain credit terms. This legislation is an exposition of the failure of the efficiency doctrine. Lewis A. Kornhauser in *'Corporate Law and Maximization of Social Welfare* [85] states that the goal of efficiency in interpretation of legal rules for commercial and corporate law has been accepted by Western scholars: so corporate and commercial law should simply provide a structure in which society will function smoothly. One compelling understanding of efficiency rule is: wealth maximization.[8] *However he argues that both efficiency and social welfare are not intrinsically valuable and that law should only pursue them to the extent they provide reasonable and practical proxies for individual well being.* [7] This is what the TILA seeks to do.

It is interesting that the TILA differentiates lender liability on basis of the recipient (consumer). This translates into a higher liability for more vulnerable credit consumers. The justification provided is consumer detriment under imperfect information. Hence the lender is liable to reduce search costs for the vulnerable consumer and to provide him or her with greater access to market information. In the FDIC (Federal Deposit Insurance Corporation) Statements of

The Jurisprudential Foundations of Corporate And Commercial Law, 87 (2000). [86] Richard Possner's rule.
*,,Ibid_*

[88] The report of the Director General of Fair Trading's Inquiry on Vulnerable Consumers and Financial Services, 1999.

Policy- 5000, directors and officers of banks have obligations to discharge duties owed to their institutions and to the shareholders and to the creditors of the institutions... the *duty of loyalty* requires directors and officers to administer the affairs of the bank with candor, personal honesty and integrity. They are prohibited from advancing their own personal or business interests or those of others, at the expense of the bank.

The *duty of care* requires directors and officers to act as prudent and diligent businesspersons in conducting the affairs of the bank. The context of this is that FDIC will refrain from civil liability suit if this standard is maintained. The duty of care gives directors an obligation to act on an informed basis after due consideration of the relevant materials and appropriate deliberations including the input of legal and financial experts.

There is a distinction made, however in outside and inside directors. An insider director is understood to have greater knowledge and responsibility for the day to day running of the company.[90] In any case, the FDIC Guidelines do not impose a liability on officers. The Fair Credit Reporting Act and the Consumer Credit Protection by the FDIC, further strengthen lender liability law in the U.S.

The Office of Fair Trading under the Consumer Credit Act, 1974 in U.K, is evolving a best-practices code. For instance, this Office has issued Guidelines for debt management companies. The Office of Fair Trading has no objection in principle to companies charging for, or consumers choosing to pay for, debt management advice or services. However all consumers are entitled to have those services carried out with reasonable care and skill. Furthermore, the consumers using these services will often be feeling desperate because of the nature of their financial problems and, by definition, have the least available financial resources. Companies, which choose to charge such consumers for these

[89] 'Officers' are, according to the FDIC Statement of Policy, 'responsible for running the day to day operations of the institutions incompliance with applicable laws, rules, regulations and the principles of safety and soundness. [96] FDIC Financial Institution Letter(FIL..87..92) DATED December 3,1992.

services must accept an unusually heavy burden of responsibility to ensure that the advice and services they give, are appropriate and represent value for money.[91]

Finally, the Financial Transactions Reports Act, 1988 of Australia, creates a lender liability in the sense that it imposes strict reporting requirements on 'cash dealers'.

6. CONCLUSION: LEGAL PARADIGM ON LENDERS' LIABILITY

6.1 General remarks

Lender may become, therefore, liable at three stages, namely, at the stage of contract and performance, secondly, at the stage of wrong lending and finally, when the lending becomes bad. The liability at the first stage is against the borrower. If the borrower sustained any loss due to non performance of the contract by the lender or wrongly dealing with the performance, the lender may not only become liable to the borrower but also may become liable to third parties, because of the failure of the borrower. The lending business is generally based on standard form contracts. Often, it is found that standard form contract is inadequate, one sided and defective. It is inadequate because, empirically it is found that most of the standard form lending contracts do not contain provisions for circumstantial variation, liability for disclosure, statement containing the disclosure by the lender and straightening the lender's obligations, provision for *vis majure* and alternative dispute resolution. Standard form contract is one sided because conditions are arbitrarily imposed, some of the provisions are apparently against the borrower. Naturally, if and when the matter goes to the court, court has to strike down many of the provisions to the detriment of the interest of the lender. The standard form contract is often defective because, often it does not adequately take care of the moral hazards. Fraud committed by a lender's staff in collusion with borrower does not have adequate legal protection in India for protecting the interest of lender.

[91] http://www.oft.gov.uk/html/rsearch/reports/cca-debt/debtl .htm

6.2 Periodical review of contractual terms

The standard form contract has two types of fault, it is not contemporised and it is not customized. Every individual lending agreement has its own nuances. In most of the cases there is no application of the mind to review. Even losses of jurisdictional matters are also ignored more often than observed. As a result conditions are likely to be hit by the logic of undue influence. Individual variations are not seriously taken care of by the decision-makers.

6.3 Fraudulent contract

Even if no lender's staff is responsible for the borrower and the borrower commits it, legal provision is quiet inadequate and ineffective to protect the interest of the lender. This part requires legal intervention. A committee of the Reserve Bank of India as already suggested to make 'financial fraud' an offence. In the event, it is declared as an offence, the lender must have adequate protection to recover the amount with power to trace back & forward, attach and confiscate the amount defrauded or assets created out of that amount.

6.4 Wrong lending

If it is a wrong lending, the lender is generally liable to the borrower as well as third parties on account of the error of judgment on the part of its employees or due to negligence. The protection against lender's liability on this core depends upon the Best Practices code (BPC) and legal compliance system in the lending business. Legal compliance must be insisted in the case of major lending transactions. The use of discretionary power is required to be based upon BPC to make it completely free of arbitrariness. Most of the major frauds committed in India in the last twenty years are because of absence of BPC in using the arbitrary power. The principle of good governance in lending business is absolutely necessary. Wherever, a major decision is taken based on discretionary powers, matter must be brought to the notice of the Board of Directors and must be monitored closely by

a Board's committee on financial outlay, which is to be headed by an expert non-executive member. Unless financial fraud is made *ipso facto* an offence with all associated investigatory and reclaimable power, the lender has to allow its management to take decisions following rule of law even if it is discretionary power.

6.5 Best Practice Code on lending functions

Lender's lending power under the present legal system is highly subjective and discretionary. There is very little effort to standardize the procedure of taking decisions on lending. Procedural rules are extremely important in order to provide for a comparative scale of efficiency and operational behaviour. Discretionary power is not arbitrary power. It is, therefore, urgently necessary to prepare a best practice code on the procedure to be adopted for lending decision especially in case of corporate project finance, to start with. However, it is imperative that the officers responsible to lending function must internalize through intensive training these best practice rules. The BPC shall include procedure for application for borrowing; investigation; compliance of procedural rules; decision making; disclosure system; monitoring and use of funds for the purpose; defining default; investigation in the event of default, management's responsibility to place before the board or in the investment committee of the board; cooperation and restructuring; remedy for mismanagement and non-observance of best practice etc.

6.6 Bad lending

In the event of bad lending, it is a bad case. The lender may protect his interest only by sufficient business prudence even to the extent of using sniffing sense to appreciate investment claim. The lender may also protect his interest by taking insurance cover if available. Adequate provision on prudential norms can also be based on the BPC. It is not enough to keep provisions out of profit. But it is necessary that the same is required to be invested in absolutely secured systems, preferably in government bonds.

6.7 Regulatory law on lending function

There is no definite legal prescription to regulate function of banks and financial institutions. The Banking Regulation Act deals more with organisation and management structure than regulating banking functions. An omnibus Act is to be suggested with the regulatory codification on functional aspects of the banks as a depositor and a lender. The codified statute ought to contain general regulatory rules for (a) lending institutions, (b) lending instruments, (c) regulator's empowerment, (d) indoor management and jurisdiction for self regulation, (e) remedial and consequential power of the regulator in the event of non-observance, (f) lenders right to realisation and enforcement of security interest, (g) sharing of information of borrowers by the lending institutions through registry, (h) making insider trading impossible, if not prohibited (i) dispute resolution mechanism.

6.8 In-house dispute resolution mechanism and consumer protection

There must be a referee to deal with grievances immediately, which must be quick and efficient having the power under the present Arbitration Act. The institution must have power to make rules of procedure to notify.

6.9 Suggested regulative design

There are some important areas, such as, (a) Financial fraud or systemic fraud, which requires a legislative intervention because it has to be treated as serious offence, such an act being an act of financial terrorism endangering the entire system; and, (b) Security interest creation, priority determination and enforcement, which are critical areas of affixing liability of the directors and management, which require legislative intervention.

Otherwise the issue is to be covered by developing adequate ground rules and redressal method to deal with foul play by affixing the personal liability by regulation and also by encouraging the development of practice code, code of conduct,

code of ethics and legal audit. Some of the issues that are required to be addressed to affix personal liability are given above. Even in the above areas of statutory grounds the regulation may prepare ground rules of contractual relation and affix appropriate liability. As for example, a bank may be required to develop the practice code on investment and internally affix liability for violation of the norm. A detail scheme on such regulatory framework may be developed.