

This article tries to marry the concept of Transfer of Property Act with provisions of Companies Act regarding presentation of True and Fair View of Balance Sheet and creation of Charge. It aims to highlight the correct position about substitution of creditor and need to substitute charge on assets.

In the normal course, a debtor is legally and contractually bound to repay dues of his creditor together with all interest and other charges. However, a situation may come when the debtor himself may not be able to pay back the entire dues of the creditor. Either he may have suffered losses and therefore, is short of funds or for whatever reason his assets are not sufficient to pay the entire debt. In such a situation, a Good Samaritan has to be found out who may help such a debtor pay off his burden. The said Good Samaritan may safeguard his own interest by entering into suitable agreements with such debtor or if he does not do so, the law protects him by substituting him in the place of creditor and clothing him with all the rights of the creditor.

The essential feature of Substitution is that the encumbrance paid off does not extinguish, but is kept alive and is transferred/assigned to the person making the payment. He who removes other's burden, steps into the shoes of

the person, whose rights constitute the burden.

Substitution of creditor should also be truly and correctly reflected in the financial statements. This is just a corollary to the transaction carried out. The funds provided by the substituted creditor as loan may be unsecured, as no security might have been provided. With the funds so provided, the dues of the creditor might have been paid off and the charge satisfied, but as legal position stand, the substituted creditor gets clothed with all the rights of the previous



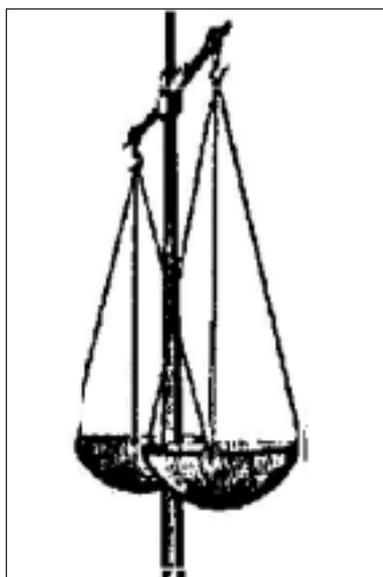
Sudhir Garg

creditor and steps into the shoes of the previous creditor. Therefore, he acquires same rights and remedies, which the previous creditor had. It, therefore, becomes a corollary that such substitutions should find suitable mention in the balance sheet of such a debtor. The loan provided by the new, substituted creditor acquires the character of secured loan, which also deserves to be registered with Registrar of Companies (ROC). Such registration would convey the true and correct position about encumbrances on the assets, names of assets so encumbered etc. It is only in such a situation that the balance sheet would be constituted as presenting the true state of affairs of the enterprise.

The position in this behalf is discussed in detail, herein below in light of provisions contained in Transfer of Property Act 1882 and Contract Act 1872 and Companies Act 1956.

Principles of Transfer of Property Act 1882 (TPA)

The provisions, relating to substitution of creditor are contained in the chapter dealing with mortgages. While Section 91 of TPA lists out the persons entitled to redemption of mortgage while section 92 of TPA relates to the right of



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Subrogation or Substitution in case of mortgages. Redemption of Mortgage means right to pay back the money of the lender-mortgagee and free the mortgaged property from encumbrance.

According to Section 91 of TPA, the following category of persons is entitled to redeem mortgage.

(a) Any person (other than the mortgagee of the interest sought to be redeemed) who has any interest in or charge upon the property mortgaged;

(b) Any surety or guarantor for the payment of mortgaged debt.

(c) Any creditor of the mortgagor who has in a suit for administration of his estate obtained a decree for sale of mortgaged property.

Besides the mortgagor, there may be other persons who may be interested either in mortgaged property or in the right of redemption. A subsequent mortgagee, a lessee of mortgaged property for a specified period, assignee of mortgagor's equity of redemption are few instances of the persons interested in redemption of mortgage.

A surety or a guarantor of mortgaged debt is also an interested person since he can be made to pay the debt if the primary borrower fails. If the debtor dies with his loan outstanding, the creditor has to file a suit for administration of estate and recover the debt out of the property of the deceased debtor. Therefore, the creditor of deceased debtor also has right of redemption.

Section 92 of TPA is as under:

"Any person referred to in Section 92 and any co-mortgagor shall on redeeming property subject to mortgage, have so far as regards redemption, for closure or a sale of such property, the same rights as the

Principle contained in Indian Contract Act 1872

Doctrine of Subrogation has also been adopted through section 69 of Indian Contract Act 1872. Section 69 of Contract Act provides as under: **"A person who is interested in the payment of money which another is bound in law to pay and who, therefore, pays it is entitled to be reimbursed by the other".**

Bound in law means an obligation, which is an effective bond in law. It also covers obligations of contract or tort. This also includes public duties imposed by statute or general law. Therefore, one important point to be noted is that the person paying on behalf of another should also be interested to some extent in such payment. E.g. payment of municipal dues by a mortgagee, on behalf of the mortgagor to save it from attachment or proceeded against for non-payment. If the person paying has no interest in the property, he is not entitled to benefit under section 69 of Contract Act, 1872. This section also does not come into lay where the person, paying on behalf of some, is himself bound to pay. Many courts have held that this section does not apply to a suit for contribution.

This section would apply in case of reimbursement, when a person who has an interest in the matter discharges the liability, which another is under law bound to pay but does not do so.

This section affords an opportunity to the person who pays the money in furtherance of some existing interest, an indemnity against the person who was originally liable to pay.

mortgagee whose mortgage he redeems may have against the mortgagor or any other mortgagee.

The right conferred by this section is called the right of Subrogation and a person acquiring the same is said to be subrogated to the rights of mortgagee whose mortgage he redeems.

A person who has advances to a mortgagor which the mortgagee has been redeemed shall be subrogated to the rights of the mortgagee, whose mortgage has been redeemed, if the mortgagor has by a registered instrument agreed such person shall be subrogated.

Nothing in this section shall be deemed to confer a right of subrogation on any person unless the mortgage in respect of which the right is claimed has been redeemed in full".

As per the provisions of the section, any person, other than the mortgagor, who, having interest in the mortgaged property and who redeems the mortgage, is entitled to be substituted in place of the mortgagee. Such a person has a right to recover his money from out of the mortgaged property just as the mortgagee would have done, had the debt not been paid by the mortgagor. The aforesaid process is known as Subrogation or Substitution in common language.

Subrogation is of two types. It could be legal or conventional. Legal Subrogation arises by operation of law and it does not depend on any agreement or consent of the mortgagor.

Conventional Subrogation means when a stranger (though one of the persons defined in Section 91 of TPA) to mortgage,

advances money to the mortgagor, under an agreement that he would be subrogated to the rights of the mortgagee, if the mortgagor redeems the mortgage from such money.

Section 92 of TPA applies when there is an obligation, express or implied, to repay and the principle of subrogation can never be applied to a mere volunteer. A person may be interested in the payment, but if in payment he is not actuated by the motive of protecting his own interest, he cannot avail benefit of this section. This section also provides that doctrine of Subrogation cannot be applied unless the prior mortgage is discharged in full. Partial redemption does not give rise to subrogation, nor does subrogation take place unless the whole debt is discharged.

Doctrine of subrogation was introduced for the first time in 1929 by an amendment Act. Prior to that, the principle was applied based on concepts of equity, justice and good conscience.

Position of Law Analysed

We observe from the position brought out above that the law treats such a person, who pays on behalf of some other, is clothed with same rights, remedies and powers, which the original creditor had. The mortgage or encumbrance is not extinguished but is kept alive. Therefore, in the fitness of things, such change of creditor should also be reflected in the financial statement. The secured creditor should be substituted with the person who has paid on behalf on another and charge should also be created in his favour. The same must also be registered with ROC, so that the creditors who have to

Salient Features about Charge under Companies Act

The provisions regarding charge are contained in Section 124 to 145 of Companies Act 1956. Creation of Charge with ROC determined the issue of priority, ranking and pari-passu. A charge does not give any legal right to possession of an asset but only gives the right to have the security made available, by an order of the court. A charge remains dormant until the undertaking charged ceases to be a going concern or until the person, in whose favour the charge is created, intervenes. The said charge-holder may make an application to court for appointment of Receiver. If a charge required to be registered is not so registered it does not render the loan irrecoverable, it only means that the security is void against the liquidator or the creditors. The money secured or purported to be secured by the charge becomes immediately payable, on account of non-registration.

Section 125 applies only to the charges, which are created by the company. Charge arising by operation of law e.g. vendor's lien on unpaid purchase money or right of subrogation arising under TPA are not registered automatically. Therefore, in such situations, the registration of charge can be got done, based on a proper agreement entered into between the debtor and the substituted creditor.

provide credit to the company are able to know which assets are encumbered, in whose favour and which assets would be available for payment of his debt.

The balance sheet should also reflect the loan of such substituted creditor as Secured Loan, property charged to him so that the financial statements reflect the true and correct position vis-à-vis the assets subject to any charge or encumbrance. To give effect to the positions contained in law, an agreement should be prepared and filed with the ROC with applicable forms.

Application of Substitution in country's scenario

It is normal practice followed by lending Institutions and Bank that they insist on execution of personal guarantee from promoters and/or their associates in addition to pri-

mary and collateral security provided. Primary security is by way of mortgage or hypothecation of borrower company's assets while collateral security could be mortgage of personal immovable properties of the promoters/guarantors. In all cases, the promoters of the borrower firm or company are required to stand as surety for guarantee for the due repayment of loan by the borrower firm or company. All these securities are insisted upon based on past experience and inability of Banks and FIs in recovering their NPAs.

As part of re-structuring of loan, Banks and FIs agree to a One Time Settlement (OTS) of their dues, under which the lender agrees to write off/waive a major portion of overdue interest, in consideration of repayment of principal dues within a short period of time. For

the purpose, a borrower or their promoter/guarantors may have to raise funds from outside like disposing off some of their properties, investments etc or by disposing off the surplus assets of the borrower company. The Institutions and Banks can enforce recovery of their dues through DRTs and suits can be initiated simultaneously against the primary borrower-company as well as the guarantors, since contract of guarantee between the creditor and guarantor is separate and distinct from contract between debtor and the creditor.

Suppose, let us presume the debtor arranges funds and pays off the settlement amount as agreed. In terms of provisions of law contained in section 92 of TPA and Section 69 of Contract Act, the promoter/guarantor steps into the shoes of lending Institutions or Bank and gets all the rights and remedies available to the lenders. Though the promoter/guarantor might have

inducted unsecured loans into the company to pay off the lenders, yet his loan should be treated as secured loan, if he discharges the entire loan of Bank/FI together with other means. However, the position



would be different if such promoter/guarantor decides to take equity for the amount inducted. Then he does not remain a creditor but becomes an owner.

Conclusion

To sum up, it can be said that the promoters/guarantors discharging the debt due by their companies should get the charge registered in

their favour also so that they may also be able to stake claim vis-à-vis other creditors, should the company be pressed into winding up or the assets are to be liquidated etc.

Substitution of creditor does not remove secured creditor from the balance sheet of a company and change in charge position should be properly disclosed in the balance sheet.

A balance sheet would not be disclosing true and fair position about charge on assets, if such charge created by operation of law is not disclosed. Such disclosure shall be possible only after registration, which can be accomplished by preparing a suitable agreement between the company and the substituted creditor. Such registration would also enable presentation of the true and fair view and our CA members may insist for it, to enable them discharge their attest function properly. ■

NATIONAL CONFERENCE ON NEW FOREIGN TRADE POLICY

ORGANISED BY

Corporate and Allied Laws Committee

DATE & VENUE

21st January 2005, Park Hotel, Parliament Street, New Delhi

CPE CREDIT
6 HOURS

Inauguration

Shri Kamal Nath*

Union Minister of Commerce and Industry

Presidential Address

Shri Sunil Goyal

President, ICAI

Lunch (1.00 p.m - 2.00 p.m)

Valedictory Session -4.00 p.m-4.30 p.m

Conference Director:

Shri Rajkumar S. Adukia,
Chairman, Corporate and Allied Laws Committee, Institute of Chartered Accountants of India

** confirmation awaited*

Technical Session I (11.00 a.m - 1.00 p.m)

Chairman: Shri K.T. Chacko, Director* Directorate General of Foreign Trade, New Delhi

I Highlights of Foreign Trade Policy -- Shri Sudhakar Kasture, FCA, Mumbai

II Export Promotion Schemes -- Shri Ajay Srivastava, Joint Director* ,
Directorate General of Foreign Trade, New Delhi

Technical Session II (2.00 p.m - 4.00 p.m)

Chairman: Shri Jayant Dasgupta*, Joint Secretary, Ministry of Commerce & Industry

III. Export Oriented Units/ Special Economic Zones -- The Export Development Commissioner*, Noida Export Processing Zone, Noida

IV. Services & AGM Export Zones -- Dr Vivek Debroy, Dean*, Jawaharlal Nehru University, New Delhi

Fees

Enroll with a fee by way of local cheque or demand draft of Rs. 750/- (rupees seven hundred and fifty only) drawn in favour of the Institute of Chartered Accountants of India, payable at New Delhi and address to: **The Secretary, Corporate & Allied Laws Committee of ICAI, C 1, Sector 1, Noida 201 301** (Corporatelaws@icai.org)