

IN THE HIGH COURT OF TELANGANA AT HYDERABAD

W.P.No.21223 OF 2023

Between:

Karvy Stock Broking Limited

... **Petitioner**

And

Union of India & others

... **Respondents**

JUDGMENT PRONOUNCED ON: 15.04.2024

THE HON'BLE MRS JUSTICE SUREPALLI NANDA

1. Whether Reporters of Local newspapers : Yes
may be allowed to see the Judgment?
2. Whether the copies of judgment may be : Yes
marked to Law Reporters/Journals?
3. Whether Their Lordships wish to : Yes
see the fair copy of the Judgment?

SUREPALLI NANDA, J

THE HON'BLE MRS. JUSTICE SUREPALLI NANDA

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< Gist:

> Head Note:

! Counsel for the Petitioner : TPS Harsha

**^ Counsel for Respondents : Mr.Gadi Praveen Kumar,
Ld.Deputy Solicitor
General of India for R1
Mr.V.Aneesh, for R3**

? Cases Referred:

(1) 2023 (6) SCC 1

THE HON'BLE MRS. JUSTICE SUREPALLI NANDA**W.P. No.21223 OF 2023****ORDER:**

Heard Mr.TPS Harsha, learned counsel appearing on behalf of the petitioner, Mr.Gadi Praveen Kumar, learned Deputy Solicitor General of India, appearing on behalf of respondent No.1, and Mr.V.Aneesh, learned counsel appearing on behalf of respondent No.3.

2. The Petitioner approached the Court seeking prayer as under :

"...to issue a writ of mandamus or any other appropriate writ, order or direction (i) Declaring the action of Respondent No.3 in classifying the Petitioner's account as 'Fraud', as arbitrary, illegal, unconstitutional, in violation of the principles of natural justice and the mandate laid down by the Hon'ble Supreme Court, and set aside the same; (ii) Consequently, declare all actions taken by the Respondents in pursuance of the action of the Respondent No.3 in classifying the Petitioner's account as 'Fraud' as arbitrary, illegal, unconstitutional, in violation of the principles of natural justice and the mandate laid down by the Hon'ble Supreme Court, and set aside the same; (iii) and pass such other order or orders.."

3. The case of the Petitioner, in brief, as per the averments made in the affidavit filed in support of the present writ petition :

The Petitioner i.e., KARVY Stock Broking Limited, Gachibowli, Hyderabad, account had been classified as 'Fraud' on 26.08.2021 by the Respondent No.3 and the same had been reported to the Respondent No.2. It is the specific case of the Petitioner that the classification of the Petitioner Company's Account as fraud was done without the issuance of prior notice to the petitioner and without providing the copy of any final forensic audit report to the Petitioner and the petitioner was denied a reasonable opportunity to be heard. It is further the case of the Petitioner that no reasonable opportunity had been provided to the Petitioner by Respondent No.3 prior to declaring Petitioner's account as 'fraud'. The main grievance of the Petitioner is that in the event of an opportunity of hearing had been provided to the Petitioner the Petitioner would have been able to demonstrate as to how there was no fraud in the operation of Petitioner's account. However, no such opportunity of being heard had been provided to the

petitioner. Aggrieved by the same the Petitioner filed the present writ petition.

PERUSED THE RECORD

4. The interim orders of this Court dated 16.08.2023 passed in W.P.No.21223/2023 read as under :

“Heard the learned senior counsel Mr.Avinash Desai appearing on behalf of the petitioner.

This Court vide its order dated 08.08.2023 permitted the learned senior counsel for the petitioner to take out personal Notice on the respondents through RPAD and to file proof of service into the registry.

The learned senior counsel for the petitioner represents that the order dated 08.08.2023 had been complied with and a memo has been filed vide USR No.77361 of 2023 on 14.08.2023.

A bare perusal of the contents of the Memo, dated 14.08.2023 indicates that the Notice has been served on the Respondent No.3 and in so far as 2nd respondent is concerned it indicates as "Item Dispatched".

It is the specific case of the petitioner that the petitioner's account has been classified as 'fraud' by the respondent No.3 and reported to the respondent

No.2 and the same was done without the issuance of any prior notice to the petitioner and without providing the copy of any such final forensic audit report to the petitioner in order to provide the petitioner with a reasonable opportunity to be heard.

The Apex Court in the Judgment reported in 2023 (6) SCC page 1 in State Bank of India and others vs. Rajesh Agarwal and others at paras 94 and 95 observed as under:

"94. Before concluding, we also want to address the argument by the borrowers that the requirement of passing a reasoned order must be read into the Master Directions on Frauds. The borrowers also relied on Jah Developers wherein it was held that a final decision of the Review Committee declaring the borrower as a "willful defaulter" must be made by a reasoned order. We agree with this contention of the borrowers because: (i) a reasoned order allows an aggrieved party to demonstrate that the reasons which persuaded the authority to pass an adverse order against the interest of the aggrieved party are extraneous or perverse; and (ii) the obligation to record reasons acts as a check on the arbitrary exercise of the powers. The reasons to be recorded need not be placed on the same pedestal as a judgment of a court. The reasons may be brief but they must comport with fairness by indicating a due application of mind.

95. In the light of the legal position noted above, we hold that the rule of *audi alteram partem* ought to be read in Clauses 8.9.4 and 8.9.5 of the Master Directions on Fraud. Consistent with the principles of natural justice, the lender banks should provide an opportunity to a borrower by furnishing a copy of the audit reports and allow

the borrower a reasonable opportunity to submit a representation before classifying the account as fraud not done. A reasoned order has to be issued on the objections addressed by the borrower. On perusal of the facts, it is indubitable that the lender banks did not provide an opportunity of hearing to the borrowers before classifying their accounts as fraud not done. Therefore, the impugned decision to classify the borrower account as fraud is vitiated by the failure to observe the rule of *audi alteram partem*. In the present batch of appeals, this Court passed an ad interim order restraining the lender banks from taking any precipitate action against the borrowers for the time being. **In pursuance of our aforesaid reasoning, we hold that the decision by the lender banks to classify the borrower accounts as fraud is violative of the principles of natural justice. The banks would be at liberty to take fresh steps in accordance with this decision."**

A bare perusal of the relevant paragraphs of the Apex Court clearly indicate that it is mandatory for the bank to provide a reasonable opportunity of hearing to the borrower and that the principle of *audi alterum partem* has to be necessarily followed prior to classification of the petitioner company's account as fraud which admittedly has not been done in the present case and the same is in clear violation of principles of natural justice.

Taking into consideration the above referred facts and circumstances and the law laid down by the Apex Court in the Judgment reported in 2023 (6) SCC page 1

in State Bank of India and others v. Rajesh Agarwal and others the action taken by the respondents in classifying the petitioner's account as 'fraud' is suspended for a period of six (06) weeks. List on 29.09.2023."

The said order's dated 16.08.2023 is being extended from time to time and are in force as on date.

5. **Counter affidavit has been filed by 3rd Respondent, in particular, paras 2 and 3 read as under :**

"2. It is submitted that the contents of the Affidavit filed in support of the present Writ Petition which are not specifically admitted herein shall be deemed to have been denied, except those contents which are matter of record. It is submitted that the present Writ Petition has been filed by the Petitioner on the ground that the action of the Respondent No. 3, in classifying the account of the Petitioner as 'fraud' under the Master Directions on Fraud dated 01.07.2016 (updated as on 03.07.2017) issued by the Reserve Bank of India ("Master Directions"), was done without issuance of prior notice and therefore is in violation of the principles of natural justice and the law laid down by the Hon'ble Supreme Court in **State Bank of India vs. Rajesh Agarwal, 2023 SCC OnLine SC 342("Rajesh Agarwal")**. The Respondent No. 3 had initially classified the Petitioner's account as fraud on 15.01.2021.

3. It is submitted that in compliance with the judgment of the Hon'ble Supreme Court in **Rajesh Agarwal**, whereby the principles of natural justice were read into the Master **Directions, the Respondent No.3 Bank has issued a Show Cause Notice dated 26.10.2023** thereby calling upon the Petitioner to show cause as to why the Respondent No. 3 Bank should not classify the account of the Petitioner as 'Fraud' in accordance with Master Directions of the RBI. A copy of the Show Cause Notice dated 26.10.2023(along with the postal receipts) issued by the Respondent No.3 to the Petitioner is annexed hereto as Annexure - 2. **It is further submitted that the Respondent No. 3 Bank has now initiated fresh steps in accordance with the Master Directions of the RBI. Therefore, in view of the Show Cause Notice dated 26.10.2023 issued to the Petitioner, the present Writ Petition maybe disposed of accordingly."**

6. **The reply affidavit filed by the Petitioner, in particular, paras 8 and 9, read as under :**

"8. The averments in Para No.3 are denied. It is submitted that mere issuance of show cause notice dated 26.10.2023, without revoking the fraud declaration is blatantly illegal and in violation of the orders of this Hon'ble High Court. It is submitted that even after the issuance of the show cause notice dated 26.10.2023, the answering

Respondent does not state whether the declaration of fraud on 15.01.2021 has been revoked and communicated to all the parties.

9. It is submitted that a bare perusal of the show cause notice dated 26.10.2023 makes it abundantly clear that it was issued to interfere with the orders of the Hon'ble High Court suspending the fraud declaration. It is submitted that the show cause notice dated 26.10.2023 does not mention about the pending writ petition, orders of the Hon'ble High Court or even the prior declaration of the fraud, which clearly shows that the Respondent No. 3 is acting to subvert the authority of this Hon'ble Court. It is therefore respectfully submitted that actions of the Respondent No. 3 in issuing the show cause notice dated 26.10.2023 is malafide. On this ground alone, the instant writ petition is liable to be allowed and the fraud declaration be set aside."

DISCUSSION AND CONCLUSION:

7. The latest legal position in so far as the essence of principles of natural justice in declaration of the borrowers account as fraud is explained in the judgment of the Apex Court reported in 2023 (6) SCC 1 in State Bank of India and Others Vs. Rajesh Agarwal & Others and the relevant paragraphs 50.3, 81 and 95 are extracted hereunder :

Para 50.3 : The above consequences show that the classification of a borrower's account as fraud under the Master Directions on Frauds has difficult civil consequences for the borrower. The classification of an account as fraud not only results in reporting the fact to investigating agencies, but has other penal and civil consequences as specified in Clauses 8.12.1 and 8.12.3.

Para 81: *Audi alteram partem*, therefore, entails that an entity against whom evidence is collected must : (i) be provided an opportunity to explain the evidence against it; (ii) be informed of the proposed action, and (iii) be allowed to represent why the proposed action should not be taken. Hence, the mere participation of the borrower during the course of the preparation of a forensic audit report would not fulfill the requirements of natural justice. The decision to classify an account as fraud involves due application of mind to the facts and law by the lender banks. The lender banks, either individually or through a JLF, have to decide whether a borrower has breached the terms and conditions of a loan agreement, and based upon such determination the lender banks can seek appropriate remedies. Therefore, principles of natural justice demand that the borrowers must be served a notice, given an opportunity to explain the findings in the forensic audit report, and to represent before the account is classified as fraud under the Master Directions on Frauds.

Para 95 : In light of the legal position noted above, we hold that the rule of audi alteram partem ought to be read in Clauses 8.9.4 and 8.9.5 of the Master Directions on Fraud, Consistent with the principles of natural justice, the lender banks should provide an opportunity to a borrower by furnishing a copy of the audit report and allow the borrower a reasonable opportunity to submit a representation before classifying the account as fraud. A reasoned order has to be issued on the objections addressed by the borrower. On perusal of the facts, it is indubitable that the lender banks did not provide an opportunity of hearing to the borrowers before classifying their accounts as fraud. Therefore, the impugned decision to classify the borrower account as fraud is vitiated by the failure to observe the rule of audi alteram partem."

8. A bare perusal of the averments made in the counter affidavit filed by the Respondents clearly indicates that the classification of the Petitioner Company's account as fraud was done without the issuance of any prior notice to the Petitioner and the counter affidavit also indicates at para 3 that the Respondent No.3 Bank has initiated fresh steps in accordance with the master directions of the RBI and the fresh Show Cause Notice dated 26.10.2023 had been issued to the Petitioner.

9. This Court opines that when the matter is *subjudice* before this Court and pending final adjudication of present W.P.No.21223/2023 and this Court vide its orders dated 16.08.2023 passed in W.P.No.21223/2023 had infact suspended the action taken by the Respondents in classifying the Petitioner's account as fraud and the said orders being in force as on date and when W.P.No.21223 of 2023 filed by the petitioner is pending final adjudication on the file of this Court, the respondents ought not have issued the show cause notice dated 26.10.2023. A bare perusal of the said show cause notice dated 26.10.2023 clearly indicates that there is no reference about the present pending writ petition or the orders of this Court in favour of the Petitioner which are in force as on date. **This Court opines that the action of the 3rd Respondent in issuing the show cause notice dated 26.10.2023 when the matter is subjudice and pending final adjudication on the file of this Court is intended only to subvert the Authority of this Court.**

10. Taking into consideration the above said facts and circumstances of the case and the law and the view of the Apex Court in the judgment reported in 2023 (6) SCC 1 in

State Bank of India and Others Vs. Rajesh Agarwal & Others (referred to and extracted above) and duly considering the averments made in the counter affidavit filed by the 3rd Respondent at paras 2 and 3 (referred to and extracted above), the writ petition is allowed as prayed for. However there shall be no order as to costs.

Miscellaneous petitions, if any pending, in this writ petition shall stand closed.

SUREPALLI NANDA, J

Date: 15.04.2024

Note : L.R. Copy to be marked.

B/o. *Yvkr*