



PARATE EXECUTION; ITS IMPACT ON DEBT RECOVERY BY BANKS AND RECENT DEVELOPMENTS

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Introduction

In terms of the Banking Act No 30 of 1988 a bank is a “body corporate engaged in opening, maintaining and managing deposits, savings and other similar accounts and also borrowing, raising, maintaining or taking up of money, lending or advancing of money either upon or without security and other activities laid down in the Section II of the Act.” Banks are financial intermediaries. They raise money from parties who provide excess cash and lend it to those who need it. Thus, the lending institutions carry a duty towards its depositors as well as borrowers. Nevertheless, it is a well-known secret that Banks enjoy substantially high margins of intermediation, which is around 6 – 8% in Sri-Lanka. It is often alleged that the high incidence of Non – Performing Loans prevalent in the market is one reason for this inefficient market condition. Often the blame is squarely landed on the ineffective and outdated legal system of the country. Against this background a large number of statutes were passed in 1990 with a view of accelerating the Debt Recovery Procedures in the island.

This article attempts to discuss the historical background leading to the enactment of “Recovery of Loans by Banks (Special Provisions) Act No 04 of 1990” (hereinafter referred to as “Act No 04”) important sections of the Act and certain recent developments.

Historical Background

Origin of Banking in Sri Lanka could be traced back to the early part of the nineteenth century with the establishment of Bank of Kandy (1828 – 1832) and Bank of Ceylon (then) (1841 – 1848). In the early days the banks were foreign dominated and they naturally catered to the needs of the Plantation Sector causing immense dissatisfaction amongst the local business community.

The adoption of the Donoughmore Constitution in 1931 saw the emergence of interest in economic diversification, industrialization and improvement in the banking sector. Setting up of the Ceylon Banking Commission, the first of its kind, led to the establishment of Bank of Ceylon in 1939. This was followed up with the establishment of a large number of indigenous private and public sector banks.



In 1979, the market economic policies were introduced to the country requiring the banks to become more competitive and sophisticated. A large number of foreign banks have, accordingly, opened branches in the country. In the early eighties, twelve Regional Development Banks were also opened. Thus, during the last century, particularly in the post independence era, there had been dramatic developments in the financial sector of the country. However, the ad-hoc nature with which these developments have taken place led to certain inefficiencies and weaknesses in the Financial Sector. This may have also directed to deficiencies with regard to the availability, cost and delivery of credit.

Prior to the introduction of special debt recovery laws, the legal procedure governing debts due to a financial sector establishment that is in the business of commercial lending activity, as well as due to any other private party was regulated by the "Civil Procedure Code". The legislation provided for a special procedure called "Summary Procedure" with regard to required claims for the recovery of moneys due on cheques, promissory notes and other similar instruments. Statutory provisions relating to the recovery of money granted on the security of a mortgage was entailed in the Mortgage Act No. 06 of 1946. No other Law carried any special or distinct procedures for debt recovery.

In the early part of 1980's a large number of representations were made to the authorities that the delays in procedures caused the cost of borrowing to go-up. The delays, it was argued, resulted from outdated legislation as well as procedural deficiencies. The borrowers on the other hand used to take undue advantage of these legal systems and procedures to deliberately evade payment of their dues. Impact of this situation on the demand for loanable funds was grave.

By about 1983, there had been further representations made to the Government regarding the acute slowness of debt recovery procedure in the country. Against this background the Minister of Justice in 1983 has appointed a Committee for the specific purposes of inquiring into the delays in the debt recovery process and its adverse effects. Accordingly, the Wimalaratne Committee named after Justice Wimalaratne who was the head of the Committee (which was also known as the DRC - Debt Recovery Commission) has handed over its report to the Minister in 1985.

At this stage the "Bar Association of Sri Lanka" which was one of the strongest opponents to these proposals argued that the proposed legislation was "*discriminatory, draconian in their nature and harsh and superfluous*". Thus, in 1986, a Committee of Central Bank Officers and Legal Officers of State Banks submitted a report on the "Wimalaratne Committee" recommendations. Another joint Committee headed by Presidents Counsel Mark Fernando also examined the "Wimalaratne Committee" report especially with regard to the powers of the Bank of Ceylon and the People's Bank. Their report was supportive of the "Wimalaratne Committee" recommendations.

Subsequent to a public seminar organized by the Minister of Justice, Mr. H.L. de Silva P.C. and Mr. N.U. Jayawardena, two members of the Wimalaratne Committee submitted a supplementary report to the DRC report. The Supplementary Report contained proposals for



modifying and amending certain proposals of the Debt Recovery Commission. It also suggested deletion of certain harsh sections of the report.

Consequent to widespread protest to the proposals and indefinite postponement of the implementation, at this stage the Governor of the Central Bank wrote to the President seeking his concurrence to implement the DRC proposals whilst giving due consideration for the protests of the Bar Association of Sri Lanka. As a result of this, another Committee consisting of members of the Ministry of Justice, Ministry of Finance and the representatives of the Bar Association was set up.

The Committee formulated that some of the existing Laws be amended to take care of the delays in debt recovery. However it hasn't recommended the enactment of comprehensive package of Debt Recovery Acts. By that time the International Bank for Reconstruction and Rehabilitation (IBRD – the World Bank) and the Asian Development Bank (ADB) started exerting pressure on the Government of Sri Lanka through their long term loan negotiations to ensure that the Debt Recovery procedures be strengthened and modernized.

Mr. Ross Cranston, a professor of Banking Law attached to the University of London was commissioned by the IBRD and ADB with the task of an independent review of the recommendations and proposals made by various Committees relating to speedy debt recovery in the country. Again in 1987, another Committee was jointly set up by the Minister of Justice and the Minister of Finance and Planning. Their scope was to review the proposals made by various Committees of the past and also the proceedings of the seminars that have been held in this connection.

The Committee rejected the proposals of the Wimalaratne Committee but made alternate suggestions. It expressed the view that it was not necessary for the proposed special Debt Recovery Acts to be enacted. However the two representatives of the Sri Lanka Banks Association on the Committee submitted a dissenting report. They stressed on the need to extend the “*Parate Execution*” powers to all the banks. They argued “*banks that have a reputation to guard will not resort to acts of impropriety in this regard. In any event all banks are answerable to the Central Bank for the conduct of their business and they would be loath to incur the disapproval of the Central Bank. In the final analysis, the aggrieved customer has the right of recourse to Courts for an injunction.*”

In July 1989, since there was further agitation from lending institutions, both local and international, that the debt recovery environment was not satisfactory, the Minister of Finance appointed a Committee chaired by Mr. P.B. Herath, (then) Secretary, Ministry of Justice.

However, even before the Committee could conclude its deliberations, the enactment of some fourteen statutes relating to debt recovery was in principle approved by the Cabinet in the early part of 1990. These included several that have been proposed by the Wimalaratne Committee. As proposed in the Dissenting Report of the Sri Lanka Banker's Association representatives and



also by Cranston, it was decided to extend the provisions of the “*Parate Execution*” powers to the private commercial banks.

In terms of article 122 of the Constitution, when these bills were presented to Supreme Court, in order to determine their constitutionality, as expected it was challenged by the Bar Association of Sri Lanka. Accordingly, the Supreme Court has ruled that certain provisions of the Act were unconstitutional and recommended modifications. Consequently, these amendments were moved at the Committee Stage of the Parliament to give effect to the decisions of the Supreme Court. Thus, the bills were so adopted and became legal.

The right of “*Parate Execution*” was earlier limited to the Bank of Ceylon, the People’s Bank and other state owned or sponsored financial institutions. With the new enactment, the licensed commercial banks were vested with “*Parate Execution*” powers. The expectation here is that it will act as a deterrent to the willful defaulters. However, it must be noted that Banks should not abuse the rights conferred on them in an arbitrary way, without due regard to actual reasons for default.

The *Parate Execution* legislature empowers the creditor who has been covered in the Act No 04 to take action to sell or take possession of the mortgaged property with the authority of a resolution passed by the Board of Directors.

Upto 1992, it was noted that due to different reasons the private sector banks were not prepared to make use of the might of these statutes very much. However, recently, Banks used to extensively resort to these provisions. But it is feared that any hasty process by banks may result in non-institutional, non-supervised, high interest charging informal lending sector sidelining the banking system.

The Salgado Commission, another Committee that was established for the purposes of inquiring and reporting on the performance of the financial sector of the country along with such recommendations as may deem fit and necessary, also acknowledged that a collateral based lending is a prudent practice yet suggested that different criteria in assessing the capacity of a borrower be adopted wherever possible. For instance, in the case of project based lending the viability of the project could be taken into account. The hypothetical situation where banks armed with the special super powers could resort to more and more mortgage based lending instead of relying on the repayment capacity or the viability of the project because they have the benefit of “*Parate Execution Rights*”. This is perfectly legal yet could pose serious undesirable social effects. It was also felt that most of the deficiencies witnessed in the legal process of enforcing securities in Sri Lanka is due to weaknesses in Sri Lanka’s Common Law namely “Roman-Dutch Law” based *law of property*. In the case of United Kingdom, a legal mortgage is a transfer of ownership but under the Roman-Dutch Law mortgagee merely enjoys servitude, a situation where a property is retained on trust.



It is, therefore argued that Roman Dutch Law is not relevant at all to modern commercial practices and therefore the law of property be completely revamped. However, the social and legal implications and complications in a move to change a centuries old legal system can't be gauged with that much ease.

It should be noted that Roman Dutch Law is mainly based on the legal principles formulated by well known Dutch jurists of yesteryear and was introduced to Sri Lanka during the Dutch colonization. The Englishmen who conquered the island subsequently chose not to interfere with the legal system even though English Law has been introduced to commercial matters. Interestingly, even in Holland, the Roman Dutch Law is no longer prevalent with the Napoleonic Code replacing the Roman - Dutch Law. The only other country in the world, which still adopts Roman Dutch Law as its Common Law, is the Republic of South Africa.

Commission was, however, fully aware of the dangers of super powers vested in the Banks through this legislation. The social and economic consequences of a party, which is being placed in liquidation without an opportunity being afforded to reschedule the loan enabling them to continue in business or restructure activities, could be grave. Similarly, if a large corporate body is forced to close down through "Parate Execution", it could result in dire social consequences such as loss of employment, loss of income etc.

The Salgado Commission acknowledged the need for the dual roles i.e. to safeguard the interest of the depositors whilst expeditiously recovering debts to be paid by the Bank and Financial Institutions. The need for strengthening of the supervisory and regulatory framework was also emphasized.

The Commission intended to add a word of caution here on the possible adverse consequences to the Banking Industry if the right of parate execution is used by the banks in an arbitrary manner and without due regard to the circumstances of default or the consequences of enforcement. In this context the Commission quoted from a judgment of Hon. H Basnayake, Chief Justice, in 1959 in a case where the exercise of the right of *Parate Execution* by a state lending institution was challenged (L A Mendis Silva, Appellant, and the Ceylon State Mortgage Bank, Respondent Vol. LXI of the New Law Reports - page 385); This case decided by the Supreme Court in 1959 is a good illustration of abuse of these powers by a lending institution. (Although this case was decided before this legislation, it deals with the same type of situation);

In that case, Mendis Silva, the debtor, had obtained a loan on the mortgage of valuable residential premises from the Ceylon State Mortgage Bank. Subsequently the debtor defaulted in repaying his loan installments and the Bank decided to exercise Parate Execution and sell the mortgaged property and recover its loan dues. Unfortunately for the debtor, at the public auction sale the mortgaged property, which was worth Rs. 342,000, was knocked down and sold to a sole bidder for Rs. 165,000 (only Rs.500 more than the upset price). There was no allegation of fraud, collusion or corruption against the creditor Bank, but it was contended that the Bank had acted negligently and was in breach of the duty, which it owed to the debtor to so conduct the sale as to obtain a fair value for the mortgaged premises.



On consideration of all the facts, however, the Supreme Court held that there was no negligence on the part of the Bank in the conduct of the sale and, in the absence of any proof of negligence, the Bank was not liable to pay any damages suffered by the debtor in consequence of Parate Execution levied by it.

But both judges who heard and decided the appeal (Basnayake CJ and Pulle J.) deplored the fact that a legislative measure intended to benefit the subject had in its operation in that case produced a result which, though not illegal, was revolting to one's sense of justice and fair play.

In spite of the superpowers vested with the Banks by virtue of the Act No 04, the Banks still encounter several problems when proceeding under this legislation. Some of them are

1. It is always possible for the aggrieved customer – debtor to obtain an enjoining order from a relevant Court of Law on grounds such as accuracy of amounts due for the recovery or the actual property value being much higher than the proposed auction value
2. The seizure of property mortgaged through parate execution procedure given by the legislation is much more difficult than seizure by the fiscal. Sometimes banks are resisted when they try to enter premises to take possession of mortgaged assets
3. Certain unscrupulous parties could resort to the fraudulent removal of movables, for which Parate Execution powers have been applied

Introduction to Act No 4 of 1990

The Act finds the fastest and easiest remedial action available to a Banker in dealing with the defaulting borrowers. It offers two expeditious routes for the affected banks to deal with such defaulters. One methodology which is dealt with under Section 5 of the Act authorizes it to appoint specified people by way of a Board Resolution to enter into any immovable property mortgaged to the bank in respect of the defaulted loan and take possession of such property and thereafter to manage and maintain the property until all dues to the Bank have been fully settled. In the case of agricultural and industrial undertaking, this provision covers even the movable properties such as plant, machinery etc, In such instances, the authorized person may enter and take possession of such undertakings where the immovable properties are situated and control and manage them. In terms of Section 4 of the Act which deals with the more frequently used remedy, when a facility which is secured by a mortgage, is in default, the Banker (the Mortgagee), having sent its final notice already, could next proceed to pass a resolution at the Board of Directors level giving written authorization for a person to sell by auction any property mortgaged to the bank as security. The notice of such resolution should be published in at least three national newspapers each in Sinhala, English and Tamil along with the government gazette at least fourteen days prior to the intended sale by public auction. It is also important that a copy of the notice be dispatched to the borrower and also being posted in the vicinity of the property to be sold.



The Act provides for the determination of an “*upset price*” below which the property will not be sold to anyone. However, if the auction is not successful, the Bank is authorized to purchase same at a nominal price. In the event of a successful auction the Bank is permitted to deduct all its dues and any other administrative charges such as “Auctioneer’s Fees” and return the balance money (if any) to the borrower. The Bank should issue a Certificate of Sale to the successful bidder, thereby vesting the property in the name of the bidder. In the case of a purchase by the Bank itself, the Certificate of Sale is issued to the Bank. In the event of this happening, the Bank should make it a point to re-sell the property within a reasonable time without holding on to it for a period longer than is necessary. The borrower may before the auction is held, approach the bank and re-negotiate the terms and get the auction cancelled. Alternatively the borrower may, again re-negotiate the terms with the Bank in case the Bank has purchased the property back and has not re-sold already. The bank may endorse a re-sale to the borrower by an endorsement on a certified copy of the certificate of sale. This same procedure could be adopted even in the case of a negotiated third party re-sale.

Important Sections of the Act

- Section 2: every person
 - (a) to whom any loan is granted by a bank on a mortgage of property, or
 - (b) who has obtained probate to the will or letters of administration to the estate of a person to whom any loan has been granted by a bank on the mortgage of property, or who, upon applications made in that behalf by the board, has been appointed by court to represent such estate, or
 - (c) to whom any right, title or interest whatsoever in any property mortgaged to a Bank as security for any loan, has passed, whether by voluntary conveyance or by operation of lawshall register with a bank an address to which all notices to him may be addressed.
- Section 3:

Action by Board (of Directors) where default is made (marginal note) Whenever default is made in the payment of any sum due on any loan, whether on account of principal or of interest or of both, the Board may in its discretion, take action as specified either in section 5 or in section 4;(summary)
- Section 10: Payment before sale (marginal note)
 - (I) If the amount of the whole of the unpaid portion of the loan together with interest payable and of the money and costs, if any recoverable by the Board under section 13 is tendered to the Board at any time before the date fixed for the sale of the property, it shall not be sold and no further step shall be taken in pursuance of the resolution under section 4 for the sale of the property.
 - (II) If the amount of the installment in respect of which default has been made and of the money and cost if any, recoverable by the Board under section 13 is tendered to the Board at any time before the date fixed for the sale, the Board may in its



discretion direct that the property, shall not be sold and that no further steps shall be taken in pursuance of the sale of the property.

- Section 13: deals with the recovery of expenses and costs incurred by the Bank.
- Section 14: deals with the payment of excess money recovered.
- Section 15:
 - (I) If the mortgaged property is sold, the Board shall issue a certificate of sale and thereupon all the right, title and interest of the borrower to, and in, the property shall vest in the purchaser: and thereafter it shall not be competent for any person claiming through or under any disposition whatsoever of the right, title or interest of the borrower to, and in the property made or registered subsequent to the date of the mortgage of the property to the bank, in any court to move or invalidate the sale for any course whatsoever, or to maintain any right title or interest to, or in, the property as against the purchaser.
 - (II) A certificate signed by the board under subsection (I) shall be conclusive proof with respect to the sale of any property, that all the provisions of this Act relating to the sale of that property have been complied with.
 - (III) If the purchaser is some person other than the Bank, the certificate shall be substantially in the prescribed form and, if the purchaser is the bank the certificate shall be substantially in such other form as may be prescribed.
 - (IV) Every certificate of sale shall be liable to stamp duty and charges as if it were conveyance of property and to any registration and other charges authorized by law, all of which shall be payable by the purchaser.
- Section 17:
 - deals with the cancellation of a sale where the property sold has been purchased on behalf of the Bank, the Board may at any time before it resells that property, cancel the sale by an endorsement to that effect on a certified copy of the certificate of sale, subject to fulfillment of certain conditions. (summary)
- In this Act unless the context requires – Bank means a licensed commercial bank within the meaning of the Banking Act, No: 30 of 1988, other than -
 - (a) The Bank of Ceylon established by the Bank of Ceylon Ordinance (Chapter 397);
 - (b) The Peoples Bank established by the Peoples Bank Act No; 29 of 1961;
 - (c) Any bank established under provisions of the Regional Rural Development Bank Act, No15 of 1985, and shall be deemed to include the Development Finance Corporation of Ceylon established by the Development Finance Cooperation of Ceylon Act, (chapter 165)



Recent Developments in the Area of Debt Recovery

However, more recently there had been four cases against the provisions of the *Parate Execution Powers* viz:

- Chellaiah Ramachandran and another as Petitioners Vs Hatton National Bank (HNB) & 3 others as Respondents (S.C. Appeal No 5)
- V Anandasiva and 12 others as Petitioners Vs Hatton National Bank & 3 others as Respondents with Sri Lanka Banks Association (Guarantee) Ltd acting as Interventient Petitioner (S.C. Appeal No 5)
- C. Ukwatte and another as Petitioners Vs DFCC Bank and another as Respondent (S.C.Spl.LA No 31/2004)
- M.D. Karunawathie and 5 others as Petitioners Vs DFCC Bank and another as Respondents (S.C.Spl.LA No 32/2004)

In the case of HNB, the Bank has granted a loan to a condominium property developer for the purpose of developing and selling twenty-four condominium residential properties. The condominiums were given as collateral for the loan. The property developer has de-defaulted the repayment of the loan. When the Bank attempted to proceed with the *Parate Execution Powers*, the condominium residents who are now the owners of the twenty-four properties already mortgaged to the Bank have taken legal action against the Bank stating that mortgagors were third party individuals.

McCallum Brewing Co. Ltd, whose Chairman was the plaintiff, has borrowed a large sum of money for the purpose of constructing a brewery from the respondent Bank namely the DFCC Bank. The Bank, after sending final notices in an appropriate manner decided to proceed with the *Parate Execution Rights* in order to recover its dues. Before the notice is issued, the plaintiff has obtained a “stay order” from the Court of Appeal staying the intended sale.

Due to the similarity of the cases and also because of the fact that some more similar cases were already pending before the Commercial High Court as well as the Court of Appeal, it was decided to amalgamate the four cases in to one. This has thus, become a landmark case for Sri Lanka. The case was heard before a Five Bench (Full Bench) of the Supreme Court.

In the judgment the Court analysed the *Parate Execution* rights as follows.

“*Parate execution*” is an anglicized rendering of a remedy recognizing Roman Law (*Parate executie*) where a mortgagee is invested with a power to sell the mortgaged property without recourse to Courts. This remedy has to be viewed in the context of the rights of Dominion or Ownership protected at Common Law. The three basic rights of ownership thus protected, are

- The right to possess
- The right to use and enjoy



- *The right to alienate*

The owners right of alienation could be deprived and an alienation or sale may be done by an order of Court in execution of a decree to pay money in terms of Section 217 (A) of the Civil Procedure Code following an elaborate procedure laid down.

It further argued that delays due to the powers vested in the Civil Procedure Code shouldn't be considered time consuming, frivolous or unnecessary. It insists that proper law and order must be followed. Citing a Sri Lankan case, "*Hong Kong and Shanghai Bank vs. Krishnapillai*", it was pointed out that *the right of a pledgee to sell the security without recourse to a Court of Law is peculiar to the English Law of Pledge and the Roman Dutch Law in the matter of rights of a mortgagee and a pledgee is not replaced by the English Law even when the mortgagee or pledgee is a bank.*

It was categorically stated that the right to sell without recourse to Court recognized in the Law of England didn't form part of our Common Law and here it could be done only with a decree of a Court. It is pointed out "*the Roman Dutch Law did not recognize any right on the part of the mortgagee to sell the secured property. It is significant that even the Roman Law did not recognize any right on the part of a mortgagee to seize and take possession of the secured property.*"

Then, it moves to deal with the statutes available in this connection. First, the Court deals with the creation of a "Hypothecary Action" which was introduced in the Mortgage Act No; 6 of 1949.

Hypothecary Action means an action to obtain an order declaring the mortgaged property to be bound and executable for the payment of monies due upon the mortgage and to enforce such payment by a judicial sale of the mortgaged property.

This provides a specific remedy to obtain an order from the Court declaring the mortgaged property to be bound executable for the money due and for a judicial sale of property. The decree should provide certain mandatory clauses such as sale of property within two months of decree, intervention of any party having interest in the property, registration of a "*lis pendens*". There are also adequate safeguards against delays.

**"All persons are equal before the law and are entitled to the equal protection of Law."
Article 12(1) of the Constitution**

The analysis in simple words explains that where there are two parties to a transaction, the Law can't strengthen the arm of one and deny its protection to the other. In another context, the law can't empower one party to a transaction to decide that there had been a default and enforce that decision against the other party. Such an empowerment would be contrary to the basic principles of natural justice.



The Act clearly lacks any provision as to the decision making process. It is noted that the Board of Directors by mere implication are empowered to decide that there has been a default and thereby trigger the statutory mechanism, which culminates in the borrower being deemed the judgment debtor. This is manifest from a perusal of provisions of Section 3, 4 and 5 of the Act. The Court contends that default or contravention of a loan agreement are matters that should be ordinarily determined objectively by the exercise of judicial power or may be it is agreed on arbitration. The current provisions allow the Board of Directors to decide on the matter of default or contravention in terms of section 3,4 and 5. The Bank, which is therefore one party to the transaction, is empowered to take action in addition to making the claim or allegation. The action directly affects the property rights of the other party, which should have happened only at the end of a judicial process.

Nevertheless the validity of the Law in terms of the Constitution is considered by the petitioner's lawyers. It is argued that the application of the statute should be strictly restricted only to persons and transactions that clearly come within its ambit.

Accordingly mortgaged property could be seized and sold in terms of the provisions of the Act only where such properties are mortgaged by the persons to whom the loan is granted, it is argued. In the aforesaid cases, it is seen that the mortgagor have not benefited from the loan but merely guaranteed the loans and provided the mortgages only to secure the guarantees, they contend that banks have no recourse to the Act.

On the other hand the respondents (Banks) counsel argued that Law was introduced for the speedy recovery of debts, with a view to economic benefit of the country and as such the provision should be equally well applied to guarantors or third parties as well.

Interpretations of the Court

The Court in conclusion, has agreed with the submissions of the counsel of the petitioner that the Act is a clear departure from the Common Law of the country, the exercise of judicial power, the equal protection of this law relating to procedure, the principle of natural justice. Therefore it should be limited in its application to the class of persons that directly explicitly come within its purview. The Court has also agreed that the provision of the Act be considered as a whole to decide on the limits of application. The long title of the Act restricts operation of the special provision of loans granted by banks for the economic development of Sri Lanka, whether a loan is granted for such a purpose may be an issue, which fails to arrive in these matters. The class of the persons against who the law will operate is the primary issue here.

There is a clear link in the provisions between the taking of a loan and the mortgage, The Law will apply where a mortgage is given by the person to whom the loan is granted. Sections 7, 14, 15, 16, and 17 identify this person as the *borrower*. In terms of Section 14 where the mortgaged property is sold and an excess amount is payable to the borrower, it could be clearly established that it is only the property mortgaged by the borrower which could be sold by a Bank to recover



a loan granted to him. If the provisions are extended by a process of interpretation to cover a mortgage given by a guarantor, Section 14 will bring about a preposterous result in which the guarantor's property is sold and the excess recovered is paid back to the borrower. The words **borrower**, **guarantor** and **debtor** have specific significance attaching to them in legal proceedings. These distinctions cannot be removed.

Summary of the Final Ruling

- The Act is a clear deviation from the Common Law, exercise of judicial powers, equal protection of the law, law relating to the procedures and the principles of natural justice.
- The Act should be taken in its entirety and be limited to the class of persons that directly and explicitly come within the purview of it.
- The words "**borrower**", "**guarantor**" and "**debtor**" have specific definitive significance attaching to them in the legal proceedings meaning of which can't be altered easily
- Guarantor not being an addressee in terms of the section 2 of the Act will not be in a position to learn about the transactions and other happenings between the borrower and lending organization.
- In case of the application of section 14 of the Act, which results in the refund of excess money, such monies will go back to the borrower.

Thus, the Supreme Court ruled that,

"These appeals are from orders of the Court of Appeal refusing interim relief in applications for writs of certiorari to quash resolutions of the Boards of Directors of Banks authorizing the sale of property mortgaged by guarantors not being to whom loans have been granted that come within the purview of Act No 4 of 1990. Since the impugned resolutions have been made in excess of statutory power the petitioners would be entitled to writs of certiorari to quash the resolutions. The order made by the Court of Appeal refusing interim relief is set aside. Interim relief is granted as prayed for and the Court of Appeal will enter judgment on the basis of proceedings findings."

However Justice Shirani A Bandaranayake a member of the Five Bench Panel had dissenting views and gave a separate judgment. In the dissenting judgment Justice Bandaranayaka referred to the judgment of the Court of Appeal dated 29.10.2003 where it refused to grant interim relief as prayed by the applicant, restraining the respondent banks from taking any step to "*Parate Execute*" the properties connected and *staying* the sale by the third party (the auctioneer) by public auction. This special leave to appeal in Supreme Court was allowed and leave was, thus, granted.

The counsel for appellants pointed out that the Banks would recover loans by way of *Parate Execution* only when the borrower himself is the mortgagor and not instances where non-borrowers have mortgaged their property as security in respect of loans granted to borrowers. According to the dissenting judgment which deals with cases "*Chellaiah Ramachandran and others Vs Hatton National Bank*" and "*Anadasiva and 12 others Vs Hatton National Bank*", the mortgage bond in question specified that appellants and the 4th respondent had jointly and severally agreed to repay



the loan taken by the 4th respondent, the said mortgage bond refers to the appellants as the mortgagors and the respondent as the obligor and the moneys are jointly and severally due from both parties. It must also be noted that when the repayment of the loan was in default the first respondent bank by their letter dated 11. 06. 2003 informed the appellants that moneys were due from them. The reply sent not only accepts the agreement, but also states that the 1st respondent has been paying monthly commitments regularly up to 02.05.2001.

Quite importantly, the appellants at that time requested to find out the total due and also informed the respondent bank to calculate interest at 10%. Hence, it is clearly seen that the appellants were fully aware of the responsibility placed on them by the fourth respondent, the borrower and their responsibility towards fulfilling the financial liability to the first respondent bank and the letter of 06.06.2003 sent by the bank to the appellant and the fourth respondent informing of the resolution of the Banks Board of Directors in terms of the section 4 of the Act No 04 need not have come as a surprise.

By referring to the section (3) and (4) of the Act Justice Bandaranayaka pointed out that

“If there is default in the payment of any sum due on any loan the bank could proceed in terms of Section (4) or Section (5) without having any restriction on the character of the mortgagee and only placing emphasis on the payment of the sum due on any loan.”

Section (5) furthermore refers to any immovable property mortgaged to the bank as security for any loan in respect of which default has been made.

“Subject to the provisions of the Section 7, the Board may by a resolution to be recorded in writing authorize any person in the resolution to sell by public auction any property mortgaged to the bank as security for any loan in respect of which default has been made in order to recover the whole of the unpaid portion of such loan and the interest due thereupon to date of the sale, together with other monies and cost recoverable under section 13”.

The sections (3) (4) and (5) of the Act No 04 of 1990 being the operative sections don't impose any restrictions on the bank to sell the property which is mortgaged to the bank as security for any loan in respect of which default has been made.

“It is not disputed that Section 3, 4 and 5 of the Act No 04 of 1990 are the operative sections with regard to the recovery of loans granted by banks for the purposes of recovery of the unpaid portion of the said loan, the bank does not differentiate mortgages given by the actual borrower from a mortgage given by a third party. A careful perusal of Sections 3,4 and 5 as well as other provisions contained in the Act No;04 clearly reveals that these provisions do not give any kind of an indication that the banks could adopt resolutions only in cases where the actual borrower gives the mortgage. It places no prohibitions against the bank from adopting a resolution in a situation where any person other than the actual borrower gives the mortgage”.



Under the circumstances confirming the interpretations solely based on section 17 of the Act is not correct. A liberal and broader view should be taken with regard to the section 17. Otherwise that will become totally meaningless. It is pointed out that in the case of a third party mortgage, if there is a cancellation in terms of section 17 of the Act the property has to be re-vested in its actual and proper owner and if such person is not the borrower it would be the duty of the bank to take appropriate action to do so.

“Section 4 of the Act No;04 of 1990 referred to earlier has placed emphasis not on the person involved with the bank but on the property which has been mortgaged. According to this section requisites for an authorization of sale of property are the following

- a. There should be property mortgaged to the bank*
- b. Such property should be mortgaged as security for any loan*
- c. Default should have been made in such a transaction*

*In terms of the mortgage bond in question the appellants were mortgagors to the transaction and were not mere guarantors. They were jointly and each of them severally liable to pay the money on demand. The respondents argued that the word borrower is synonymous with the word “**debtor**” and “**debtor**” is a person who has the liability to repay a bank.*

Sections 62 A of the Mortgage (Amendment) Act No 03 of 1990 clearly states that provisions in that part to be in addition to provisions of any laws which empower certain banks and other institutions to exercise the powers of Parate Execution.

Justice Bandaranayake emphasizes that section 04 of the Act No; 04 of 1990 doesn't include that the property mortgaged should be the property of the person who obtained money from the bank or that it precludes a third party in mortgaging his property to the bank as security for a loan. It was not necessary to give meaning to the Section 4 when the legislation is very clear.

The determination by a divisional bench on the constitutionality of the amendment bill of the Act No: 04 of 1990 should not be taken to apply to the existing bill. The determination is limited only to the amendments. It should be noted that Act No; 04 has come before the Supreme Court in 1990 to determine whether the bill or any provisions were inconsistent with the provisions of the constitution. Divisional Bench of the Supreme Court in January 1990 had determined at that time none of the provision of the bill was inconsistent with the Constitution. In the light of that, the determination by the Supreme Court in 2003 in the amendment bill of Act No; 4 of 1990 could not mean that there was an implied repeal of the provision of the Act No 04 of 1990.

At this stage only one enactment is there dealing with the recovery of loans by special provisions, the bill which was to be enacted as an amendment to the said special provisions act has not come in to being. Thus the question of implied or expressed repeal will not arise. Therefore, at this stage, there is no need to consider the determination of the Supreme Court at this stage.



It could also be noted that when the Commercial High Court had taken the view that there is no prohibition on the bank in adopting a resolution in the case of a mortgage given by a person other than the actual borrower and in the absence of any such restriction under section 4 of the Act No 04, it is not concernable or practicable to use section (15) as a prohibition against the Bank.

Next it was contended that if the respondent banks were allowed to sue the appellant's property, it would cause irreparable loss to the appellants. Similarly the respondent banks made submissions that irreparable damage would be caused to the banking systems of the country and as an advance consequence at large to the economy of Sri Lanka. In a preamble to the Act, it appears that equities were heavily in favour of the banks. A main purpose of the Act was the economic development of Sri Lanka.

Therefore, in her judgment, the Court of Appeal judgment dated 29.10.2003 refusing to grant interim relief was accordingly affirmed and both appeals were dismissed without costs.

There had been certain subsequent developments with regard the above case. Let's now examine the details of one such case, which was determined before a Three Bench Panel of the Supreme Court consisting of Justice C.N. Jayasinghe, Justice Shiranee Tilakawardane and Justice Saleem Marsoof P.C.

- Hatton National Bank (Defendant – Petitioner) Vs Samathapala Jayawardene, Peththa Thantrige Ariyawathie Jayawardene and another as Plaintiffs – Respondents

In this case, the first and second respondents who were the Managing Director and Director respectively of Nalin Enterprises Private Limited have hypothecated some of their personal properties with the Defendant – Petitioner Bank in order to obtain certain banking facilities to the said company. The company has failed in making payments to the bank as per the agreements. The Bank has adopted a resolution to sell the properties in terms of Section 04 of the Act. At this stage the Plaintiffs – Respondents urged that in terms of the judgment in the case of "Ramachandra and others Vs Hatton National Bank" property mortgaged by a third party who is not a borrower cannot be sold by way of Parate Execution. The case that commenced at the District Court of Colombo has ultimately ended up in the Supreme Court for its final determination. Having considered submissions made by some of the erudite legal professionals of the country, the court ruled that this is an instance where the veil of incorporation could be lifted. Relevant excerpts of the case are reproduced below.

"... the 1st and 2nd respondents cannot hide behind the veil of incorporation of Nalin Enterprises Private Limited, while being the "alter ego" of the said company of which the 1st respondent has been the Managing Director and the 2nd respondent, who is the wife of the 1st respondent, has been a Director. Although the independent personality of the company as distinct from its directors and shareholders has been recognized by the courts since the celebrated decision of "Salomon v. A. Salomon and Co. Ltd. [189] AC 22," Courts have in appropriate circumstances lifted the veil of incorporation. In particular, courts have been vigilant not to allow the veil of incorporation to be



used for some illegal or improper purpose or as a device to defraud creditors –*Merchandise Transport Ltd. v. British Transport Commission* [1962] and *Jones V. Lipman* [1962]. As Staughton L.J. observed in *Atlas Maritime Company. SA v. Avalon Maritime Ltd. (No.1)* [1991] 4 All ER 769 at page 779 -

“To pierce the corporate veil is an expression that I would reserve for treating the rights or liabilities or activities of a company as the rights or liabilities or activities of its shareholders. To lift the corporate veil or look behind it, on the other hand should mean to have regard to the shareholding in a company for some legal purpose”

*As far as this case is concerned, it is quite obvious that the 1st and 2nd respondents, being directors of Nalin Enterprises Pvt. Ltd. benefited from the facilities made available to the said company by the petitioner bank, and to that extent they cannot claim the mortgages which secured the said facilities fall within the category of “third party mortgages” as contemplated in the majority judgments of this court in *Ramachandra v. Hatton National Bank*. The 1st and 2nd Plaintiffs are integrated to Nalin Enterprises Ltd. and when Nalin Enterprises sought to obtain facilities from the petitioner bank, the borrowers are in fact the said Nalin Enterprises and 1st and 2nd Plaintiffs. It would be an exercise totally illogical to seek to differentiate the 1st and 2nd Plaintiffs as 3rd party mortgages within the meaning of *Ramachandra v. Hatton National Bank*...”*

Court held that the first and second respondents, being Managing Director and a Director of the said Nalin Enterprises (Pvt) Ltd couldn't alienate themselves from the company as they have benefited from the facilities made available to the company.

Thus, the Court has ruled that where the Directors of a company were the third party mortgagers and were directly involved in the operations of the company, they (Directors) will not be able to seek redress under the aforesaid landmark case.

Another case is now before the Supreme Court awaiting judgment based on the landmark case *“Chellaiah Ramachandran Vs Hatton National Bank”*. Under this, it is urged that the landmark case should not be introduced with retrospective effect.

Conclusion

The enactment of the Recovery of Loans by Banks (Special Provisions) Act No 4 of 1990 has taken well over ten years. Thrown from Commission to Commission, from phase to phase, the main intention of the Act No 04 was to provide the banks with speedy recovery of loans in default, which would have resulted in economic development especially through the reduction of cost of obtaining credit. It must be noted that a divisional bench in Supreme Court in 1990 has determined the constitutionality of the bill leading to the passing of the Act. But the recent cases with their special reference to the constitutionality of the Act appears to bring in to question the very spirit of the Act. This was so necessary in view of the fact that adoption Section 2 of the Civil Procedure Code could have been time consuming and laborious.



On the other hand, as pointed out by the counsel for the appellant, the provisions of the Act particularly Section 5 appears to be a clear deviation from the Common Law, exercise of judicial powers, equal protection of the law, law relating to the procedures and the principles of natural justice. This cannot be ignored altogether as the judgment indicated whether a loan is granted for a purpose of economic development is a contentious issue and did not, therefore, arise consideration. Whether the Act No 04 made the process of obtaining credit that much easier or on better conditions is a question that is best answered by the parties better equipped for making and answering those inquiries.

Undoubtedly the lenders should have some form of assurance from the law that their collateral and their interest would be protected especially because they borrow public funds to be on-lent to those who need funds, but it is also the duty of the law to protect mortgagors as well as borrowers whose properties are at risk as security.

Any debt recovery procedure should seek to balance the interest of both lenders as well as the borrowers. In this context, given the present scenario perhaps it may be pertinent to appoint another high-powered erudite Committee to study the present status quo and suggest the necessary modifications to the existing practices.

The main criticism of the Act was its seemingly unconstitutional nature where it seeks to empower and strengthen one party to a transaction, which primarily involves at least two. In that context, the mortgagee becomes the Claimant as well as the Judge. However, this has to be viewed in the light that these statutes were so passed in 1990 with a view to expediting the process of debt recovery, which should result in lower costs of credit and finally the economic development of the country.

Since determination of default by the borrower, which is contained in section 2, 3, 4 appear to be the trigger point for the mortgagee to proceed with "Parate Execution", perhaps as a solution it may be necessary to pass on this responsibility to an independent third party such as Arbitrator or the Financial Ombudsman. Without resorting to cumbersome, time consuming procedures, it should, then, be possible to establish whether there had been default on the part of borrower and if established, green light would be granted for proceeding with "Parate Execution".

In this regard, a recent article by Parakrama Karunaratne, Attorney-at-Law shed further light on the matter. He points out that efforts on the part of the Government of Sri Lanka to recover the staggering Rs.27.0 Bn is praiseworthy. But at the same time, the move to amend the Act No.4 in such a manner that a threshold of Rs.5.0Mn be introduced for the purposes of invoking the provisions of this Act should be viewed with due seriousness. The proposal was to prevent the application of Section 3,4 or 5 of the Act No 04 to any loan, which is Rs. Five Million, or less. The fact that the proposed amendment was limited only to the private sector financial institutions will further complicate the controversy prone piece of legislature. This would have compelled the private sector banks to effectively keeping away from the small and medium sector loans, which are generally around Rs.5.0Mn. However, saner counsel prevailed and the proponents of the



proposal appeared to have realized the adverse effects of it and it has been shelved, at least, for the time being.

Finally, one pertinent question to ask is

“Has the Parate Execution Law lost its effectiveness?”

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