Unincorporated Bodies : Prohibition of Acceptance of Deposits

BHAVESH D. PARIKH AND OTHERS V. UNION OF INDIA AND ANOTHER (AIR 2000 SC 2047)

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A writ petition was filed by the petitioners challenging the validity of Section 9 of the Reserve Bank of India (Amendment) Act, 1997 which amended, inter alia, Section 45-S of the Reserve Bank of India Act, 1934 mainly on the grounds of violation of Articles 19(1)(g) and 14 of the Constitution of India. The Bank opposed the same on the ground that the insertion of the section and further amendments were necessary to regulate the financial business conducted by the unincorporated bodies more effectively and in some cases to totally prohibit the said bodies from doing the business of acceptance of public deposits in the interests of public. The Supreme Court after hearing the contentions of the petitioners and Respondents and after considering the necessity of the said provision, upheld the validity of Section 45-S and dismissed the petitions. Consequently, the stay orders issued by the various High Courts were also vacated. In the same breath the Supreme Court also came down upon the manner in which the High Courts were issuing injunctions staying the operation of the legislation in cases where the legislation has been passed after taking into consideration the expert opinion, in the economic interests of the Nation.

Facts

The petitioners were shroffs engaged in the business of providing credit to the members of the public. The traditional mode of organising the business of shroffs over the past several decades had been by way of partnership firms. The nature of the services practiced by the petitioners generally involved maintaining a mutual current account where the customer may either place deposit on call or withdraw money on call without security. The financing activity of the shroffs firms was through capital contributions of the partners/ proprietor and deposits made by members of the public. Some of the other activities of the shroffs included cheque discounting, the issuance of hundis, the collection of cheques from different centres and providing other similar facilities to customers. The services extended by the petitioners are availed of by small and medium sized traders, professionals, salarised workers, agriculturists and individuals.

The petitioners impugned the validity of Section 45-S of the Reserve Bank of India Act as amended by the Amendment Act, 1997 on the ground that the said provision is violative of Articles 14 and 19(1)(g) of the Constitution of India.

Section 45-S, which is impugned in this writ petition, is as follows : “45-S(1) No person, being an individual or a firm or an unincorporated association of individuals shall, accept any deposit : (i) If his or its business wholly or partly includes any of the activities specified in clause (c) of Section 45-I; or (ii) If his or its principal business is that of receiving of deposits under any scheme or arrangement or in any other manner, or lending in any manner.

Provided that nothing contained in this sub-section shall apply to the receipt of money by an individual by way of loan from any of his relatives or to the receipt of money by a firm by way of loan from the relative or relatives of any of the partners.

(2) Where any person referred to in sub-section (1) other than body corporate holds a deposit on the 1st day of April, 1997, which is not in accordance with sub-section (1), such deposit shall be repaid by that person immediately after such deposit becomes due for repayment or within two years from the date of such commencement whichever is earlier.

(3) On and from the date of 1st day of April 1997, no person referred to in sub-section (1) shall issue or cause to be issued any advertisement in any form for soliciting deposit.

Explanation — For the purpose of this section : A person shall be deemed to be a relative of another if, and only if :

(i) they are members of a Hindu Undivided Family; or

(ii) they are husband and wife; or

(iii) the one is related to the other in the manner indicated in the list of relatives below :

List of relatives — 1. Father 2. Mother (including step-mother), 3. Son (including step-son), 4. Son's wife, 5. Daughter (including step-daughter), 6. Father's Father, 7. Father's mother, 8. Mother's mother, 9. Mother's Father, 10. Son's son, 11. Son's son's wife, 12. Son's daughter, 13. Son's daughter's husband, 14. Daughter's husband, 15. Daughter's son, 16. Daughter's son's wife, 17. Daughter's Daughter, 18. Daughter's daughter's husband, 19. Brother (including step-brother), 20. Brother's wife, 21. Sister (including step-sister), 22. Sister's husband.

Contentions of the Petitioners

The grievance of the petitioners was that the firms or individual shroffs, as a result of amendment to Section 45-S, will not be allowed to accept any deposit from the public for the purposes of their business activities. There is a complete prohibition on sharafi transactions (mutual current account transactions) which had formed the bedrock of the financing activities of the shroffs. This is because individuals and firms will no longer be entitled to accept deposits on current account and the minimum period for which a non-banking financial company may accept deposit is now one year. The shroffs will now be compelled to convert from partnership firms into limited companies.

The petitioners challenging the vires of Section 45-S, contented that the shroffs provided the facility of deposit and loan transactions 24 hours a day and this facility was traditionally extended to customers like agriculturists, such as cotton farmers, tobacco farmers, vegetable producers etc., who had a seasonal need for finance and a periodic

surplus of investible funds. The flexibility of deposit and withdrawal of the funds available to this sector which was provided by the shroff community will now cease. It was submitted that the impugned provisions are violative of the appellants' right to carry on their trade and business guaranteed under Article 19(1)(g) of the Constitution. Elaborating this contention it was urged that though it is open to the Government to impose reasonable restriction in the public interest under Article 19(6) of the Constitution, the impugned provisions neither met the test of reasonableness nor public interest. It was also submitted that the impugned provisions were violative of Article 14 of the Constitution being arbitrary, discriminatory and unreasonable.

Contentions of the Bank

The statutory history of the impugned provision is that by an amendment in 1963 a new Chapter III-B was inserted in the said Act incorporating Sections 45-H to 45-Q which were provisions relating to non-banking financial institutions. In the statement of Objects and Reasons it was provided that the existing enactments relating to banks did not provide for any control over companies or institutions, which, although are not treated as banks, accept deposits from the general public or carry on other business which was allied to banking. For ensuring more effective supervision and management of the monetary and credit system by the RBI, it was observed that the RBI should be enabled to regulate the conditions on which deposits may be accepted by these non-banking companies or institutions. Further, the provisions of the said Chapter III-B did not apply to individuals or firms like the appellants who are not incorporated but still do business which is akin to that of banking.

In order to place some restrictions on the acceptance of deposits by unincorporated bodies, by the Banking Laws (Amendment) Act, 1983 (Act 1 of 1984), Chapter III-C and Section 58-B(5A) were inserted into the Act. The relevant portion of principal restrictions in Chapter III-C which were contained in Section 45-S read as under :

"Deposits not to be accepted in certain cases —

(1) No person being an individual or a firm or an unincorporated association of individuals shall at any time, have deposits from more than then number of deposits specified against each, in the table below : in either case, depositors who are relatives of any of the individuals constituting the association.

TABLE

(i) Individual	Not more than twenty five depositors excluding depositors who are relatives of the individual.
(ii) Firm	Not more than twenty-five depositors per partner and not more than two hundred

		and fifty depositors in all, excluding, in either case, depositors who are relatives of any of the partners.
(iii)	Unincorporated Association of Individuals	Not more than twenty five depositors per individual and not more than two hundred and fifty depositors in all, excluding,

(2) Where at the commencement of Section 10 of the Banking Laws (Amendment) Act, 1983 the deposits held by any such person are not in accordance with sub-section (1), he shall, before the expiry of a period of two years from the date of such commencement, repay such of the deposits as are necessary for bringing the number of deposits within the relative limits specified in that sub-section."

The Bank stated in its affidavit that the growing volume of deposits with unorganised financial sector affected the operation of monetary and credit policy to the extent that it involved a loss of control by the central monetary authority on the use of these funds. Further, the unincorporated bodies were susceptible to default as the costs of funds and returns could not be matched in a viable way leading to adverse selection i.e., the funds being directed to risky illiquid investments. Whereas incorporated bodies were subject to regulatory controls, it was impossible to regulate unincorporated bodies was under observation and in 1984 when Chapter III-C was added to the Act, the prohibition to accept deposits was partial in the sense that unincorporated bodies were allowed to accept deposits from a limited number of depositors with no ceiling on the amount of deposit. The working of the provisions of Chapter III-C did not result in healthy development but there was a proliferation of such unincorporated bodies engaged in financial intermediation. As pointed out in para 3 of the Statement of Objects and Reasons the existing provisions were flouted by unscrupulous entities by floating different partnership firms when a firm reached the level of 250 depositors. This multiplication of firms took place with a view to circumvent the rigour of the law.

The Bank also contended that under the guise of being flexible and convenient to its clients, the said unincorporated bodies tried to fool the gullible public. Unquestionably high interest rates were charged by such firms from the borrowers, but when the time came for the return of money borrowed by such firms, a number of such firms had folded up resulting in great loss to the depositors. The RBI, being a statutory expert body entrusted with monetary management, came to the conclusion that these unincorporated bodies which were functioning as financial intermediaries in an informal and unorganised manner be restrained from having access to deposits from public. The spread of formal financial agencies such as, commercial banks, development financial institutions and non-banking financial companies etc. had taken care of the need to mobilise the domestic

savings of the nation and to deploy the same in a proper manner.
It was to rectify the imbalance where the non-corporate sector was virtually free from all disciplines even though its activities were same or similar to the corporate sector, the difference only in some cases, that first an Ordinance was issued which sought to completely prohibit any receipt of deposits by unincorporated associations in the non-corporate sector. When certain hardships were pointed out by those who did not carry on the business comparable to the companies which were under Chapter III-B i.e., who did not borrow money or receive advances to carry on business in the financial sector but borrow money for their own trade or manufacture, the Act, which replaced the ordinance, watered down the rigour to some extent.

It was submitted on behalf of the Bank that the amendments were introduced after taking into account the recommendations of successive committees, appointed by the Bank and Government of India, which had studied the functioning of these bodies. The question of restricting such financial activity by unincorporated bodies, is a question of economic activities by different constituents. The introduction of the impugned Section 45-S in the amended manner was therefore necessary and hence the same was inserted by the Parliament.

Further, the impugned Section 45-S does not in any way prohibit or restrict any unincorporated body or individual from carrying on the business that it likes. It is open to unincorporated bodies to carry on their financial business either from their own funds or the funds borrowed from the relatives or from financial institutions. The restriction, which is placed by Section 45-S is on the carrying on of such business by utilising public deposits.

Even after the introduction of a Section 45-S by way of the 1983 amendment, the Bank received a number of complaints with respect to many private financing firms circumventing the provisions and starting many firms for doing the business of accepting deposits and lending loans. These complaints were received mainly from the States of Kerala and Tamil Nadu, and they reported that they wanted the Bank to oversee the functioning of such firms and also to consider the banning of the said activities in public interest.

Issues

After going through the history of the legislation and arguments put forth by the respondent Bank, the Court had before it the following issues to be considered :

(1) Whether the right to carry on the business of financial transactions using the money of another, is a fundamental right under Article 19(1)(g) of the Constitution of India?

(2) Whether the provisions of Section 45-S of the Reserve Bank of India Act, violated such a right of the petitioners/appellants in any manner?

Observations of the Court

On Issue No. (1), the Court stated that the appellants cannot claim a fundamental right to carry on the business of financing with other people's money. In other words, there cannot be an unrestricted fundamental right to accept deposits from the public. The Court put forth the observation in an earlier decision in *Peerless General Finance and Investment Co. Limited v. Reserve Bank of India*[1] of the Apex Court in relation to the earlier version of the same provision (i.e.) Section 45-S, that there is no fundamental right to do any unregulated business with subscribers/depositors' money...Since the deposit acceptance by unincorporated bodies is incapable of being regulated by virtue of the large number of such bodies, the provisions in the nature of the amended Section 45-S are necessary and unincorporated bodies should do their business with their own money or institutional finance or money borrowed from relatives.

On Issue No. (2), the Court had to consider whether even assuming that the right to carry on financial business with other people's money is a fundamental right, the provision is violative of Article 19(6) of the Constitution which provides for the grounds on which the fundamental right guaranteed under Article 19(1)(g) could be curtailed. For this purpose, the Court considered the decision of the Delhi High Court in *Kanta Mehta v. Union of India*[2] where the constitutional validity of Section 45-S(1984 amendment) was challenged on the ground that it infringed the appellants' right under Article 19(1)(g) of the Constitution of India and was violative of Article 14 and 19 of the Constitution. The validity of the said provision was upheld on the main ground that expert reports by study grounds had recommended that it would not be in the interest of all, especially the depositors, if unincorporated bodies such as partnership were to work as companies without any control or supervision of the RBI. This decision of the High Court was affirmed by the Supreme Court in *T. Velayudhan Achari v. Union of India*[3] and it was observed as follows :

> "No doubt, the impugned legislation places restrictions on the right of the appellants to carry on business, but what is essential is to safeguard the rights of various depositors and to see that they are not preyed upon. From the earlier narration, it would be clear that the Reserve Bank of India, right from 1996, has been monitoring and following the functioning of non-banking financial institutions which invite deposits and then utilise those deposits either for trade or for other various industries. A ceiling for acceptance of deposits and to require maintenance of certain liquidity of funds as well as not to exceed borrowings beyond a particular percentage of the net owned funds have been provided in the corporate sector. But for these requirements, the depositors would be left high and dry with out any remedy."

The Court in this case, was guided by the principles enunciated in *Papnasam Labour Union v. Madura Coats Limited*[4], where it was considered whether Section 25-M of the Industrial disputes Act, 1947 violated Article 19 of the Constitution. The following principles and guidelines were laid down in that case to consider the constitutionality of the statutory provision upon a challenge of unreasonableness of the restriction imposed by it :

"(a) the restriction sought be imposed on the Fundamental Rights guaranteed by Article

19 of the Constitution must not be arbitrary or of an excessive nature so as to go beyond the requirement of felt need of the society and object sought to be achieved.

(b) there must be a direct and proximate nexus or a reasonable connection between the restriction imposed and the object sought to be achieved.

(c) No abstract or fixed principle can be laid down in all case. Such consideration on the question of quality of reasonableness, therefore, is expected to vary from case to case.

(d) In interpreting constitutional provisions, courts should be alive to the felt need of the society and complex issues facing the people which the legislature intends to solve through effective legislation.

(e) In appreciating such problems and felt need of the society the judicial approach must necessarily be dynamic, pragmatic and elastic.

(f) It is imperative that for consideration of reasonableness of restriction imposed by a statute. The court should examine whether the social control as envisaged in Article 19 is being effectuated by the restriction imposed on the fundamental rights.

(g) Although Article 19 guarantees all the seven freedom to the citizen, such guarantee does not confer any absolute or unconditional right but is subject to reasonable restriction, which the legislature may impose in public interest.
It is, therefore, necessary to examine whether such restriction is meant to protect social welfare satisfying the need of prevailing social valves.

(h) The reasonableness has got to be tested both from the procedural and substantive aspects. It should not be bound by processual perniciousness or jurisprudence of remedies.

(i) Restriction imposed on the Fundamental Rights guaranteed under Article 19 of the Constitution must not be arbitrary, unbridled, uncanalised and excessive and also not unreasonably discriminatory. *Exhypothesi,* therefore, a restriction to be reasonable must also be consistent with Article 14 of the Constitution.

(j) In judging the reasonableness of the restriction imposed by Cl.(6) of Art. 19, the Court has to bear in mind Directive Principles of State Policy.

(k) Ordinarily, any restriction so imposed, which has the effect of promoting or effectuating a directive principle can be presumed to be a reasonable restriction in public interest."

Examining the validity of the amended Section 45-S of the Act by applying the principles enunciated *supra,* it was stated that the said section is in no way illegal or bad in law. It was also observed that there was no total prohibition or ban from accepting deposits by unincorporated bodies. It is only such unincorporated bodies as are carrying on business referred to in Clauses (i) and (ii) of sub-section (1) of section 45-S of the Act which cannot accept deposits from the public. They can however, receive loans from

relatives. There was no impediment in the trade as long as it was carried on within the norms of Chapter III-B. In this context, it was emphasised that there was absolutely no restriction on any person to utilise his own funds (including the funds received from his relatives) for any purpose he likes including para-banking or financial activity. The Court was of the view that the institutional finance was available far more easily now than before. With these facilities now being available and in view of the inherent risks to the general public at the hands of the unincorporated bodies engaged in financial activities and accepting public deposits, the court agreed that the restrictions now imposed by the amended Section 45-S cannot be considered as being unreasonable.

The court was of the view that historically, only banks have been allowed to accept deposits repayable on demand because they were subjected to maintenance of cash reserve requirement which would enable them to meet liabilities as and when they are called upon or when any demand is made for repayment. Since non-banking financial companies were not subjected to such cash reserve requirement, it was not desirable to allow non-banking financial companies to accept demand deposits. Earlier attempts to adequately regulate the non-banking institutions not having achieved the desired result of protecting large number of depositors from unincorporated financial institutions which would suddenly mushroom overnight and then vanish without a trace, but taking with it depositors money, left the Bank with no alternative but to prohibit such unincorporated entities from conducting financial business which was more than akin to banking. Section 45-S no doubt prohibits the conduct of banking business by an unincorporated non-banking entity like a shroff, but this prohibition has come about, *inter alia*, in the interest of unwary depositors and borrowers (from shroffs) and with a view to prevent them from committing financial suicide. The restrictions imposed against acceptance of deposits by unincorporated bodies carrying on financial activity or the business of deposit acceptance or lending in any manner are in the larger interest of general public vis-a-vis few persons accepting such deposits. The need for such restrictions had become acute and imperative in view of large scale mismanagement of public funds by such unincorporated bodies.
In order to uphold the restrictions in certain cases and total prohibition in other cases, the honourable court took the view expressed in the case of
Srinivasa Enterprises v. Union of India[5] that "it is a constitutional truism that restrictions in extreme cases should be pushed to the point of prohibition, if any lesser strategy will not achieve the purpose."

The Court went further to sound two notes of caution, *one* with respect to the dealing with legislations having economic overtones and *other* with respect to the manner in which the High Courts were granting the injunctions against the operation of statutory provisions.

(i) In matters of economic policy, the Court is not to interfere with the decision of the expert bodies which have examined the matter. For this purpose the honourable Court appropriately quoted the observations made *in R.K. Garg v. Union of India*[6] . In this decision the Supreme Court quoted Justice Frankfurter in *Morey v. Doud*[7] and pointed out that – "Another rule of equal importance is that laws relating to economic activities should be viewed with greater latitude than laws touching civil rights such as freedom of

speech, religion etc. It has been said by no less a person than Holmes J. that the legislature should be allowed some play in the joints, because it has to deal with complex problems which do not admit of solution through any doctrinnaire or straight-jacket formula and this is particularly true in case of legislation dealing with economic matters, where, having regard to the nature of the problems required to be dealt with greater play in the joints has to be allowed to the legislature. The Court should feel more inclined to give judicial deference to legislative judgement in the field of economic regulation than in other areas where fundamental human rights are involved..."[8]

"That would depend upon diverse fiscal and economic considerations based on practical necessity and administrative expediency and would also involve a certain amount of experimentation on which the Court would be last fitted to pronounce. The court would not have the necessary competence and expertise to adjudicate upon such an economic issue. The court cannot possibly assess or evaluate what would be the impact of a particular immunity or exemption and whether it would serve the purpose in view or not."[9]

(ii) "When considering an application for staying the operation of a piece of legislation, and that too pertaining to economic reform or change then the courts must bear in mind that unless the provision is manifestly unjust or glaringly unconstitutional, the Courts must show judicial restraint in staying the applicability of the same. Merely because a statute comes up for examination and some arguable point is raised, which persuades the Courts to consider the controversy, the legislative will should not normally put under suspension pending such consideration. It is now well settled that there is always a presumption in favour of the constitutional validity of any legislation, unless the same is set aside after final hearing and, therefore, the tendency to grant stay of legislation relating to economic reform, at the interim stage, cannot be understood. The system of checks and balances has to be utilised in a balanced manner with the primary objective of accelerating economic growth rather than suspending its growth by doubting its constitutional efficacy at the threshold itself".

"While the Courts should not abrogate its duty of granting interim injunctions where necessary, equally important is the need to ensure that the judicial discretion does not abrogate from the function of weighing the overwhelming public interest in the favour of the continuing operation of a fiscal statute or a piece of economic reform legislation, till on a mature consideration at the final hearing, it is found to be unconstitutional. It is, therefore, necessary to sound a word of caution against intervening at the interlocutory stage in matters of economic reforms and fiscal statutes."

Decision

The Court concluded that there is no fundamental right to carry on financial business with another persons' money, that too unregulated and further that even assuming that there is a right to carry on such business, the restrictions and prohibitions imposed under Section 45-S are reasonable and are valid as they are based on expert economic studies and reports of expert committees and are actually issued in the interest of public. Accordingly, the court held the provisions of Section 45-S of the Act to be valid, and

dismissed the Writ Petitions.

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1. (1992) 2 SCC 343 : (1992) AIR SCW 854 : AIR 1992 SC 1033.
2. (1987) 62 Comp Cas 769.
3. (1993) 2 SCC 582 : (1993) AIR SCW 1201).
4. (1995) 1 SCC 501 = 1995 AIR SCW 1593 = AIR 1995 SC 2200 = 1995 Lab IC 735.
5. (1980) 4 SCC 507; AIR 1980 SC 504.
6. (1982) 1 SCR 947 at 969; AIR 1981 SC 2138.
7. (1957) 354 US 457; where the court observed : "In the utilities, tax and economic regulation cases, there are good reasons for judicial self-restraint if not judicial deference to legislative judgement. The legislature after all has the affirmative responsibility. The Courts have only the power to destroy, not to resconstruct. When these are added to the complexity of economic regulation, the uncertainty, the liability to error, the bewildering conflict of the experts, and the number of times the judges have been overruled by events self-limitation can be seen to be the path to judicial wisdom and institutional prestige and stability. The Court must always remember that "legislation is directed to practical problems, that the economic mechanism is highly sensitive and complex, that many problems are singular and contingent, that laws are not abstract units and are not to be measured by abstract symmetry" that exact wisdom and nice adaptation of remedy are not always possible and that "judgement is largely a prophecy based on meagre and uninterpreted experience." Every legislation particularly in economic matters is essentially empiric and it is based on experimentation or what one may call trial and error method and, therefore, it cannot provide for all possible situations or anticipate all possible abuses. There may be crudities and inequities in complicated experimental economic legislation but on that account alone it cannot be struct down as invalid."
8. AIR 1981 SC 2138 at 2147.
9. (1982) 1 SCR 947 at 988; AIR 1981 SC 2138 at 2157.