

Lenders beware, the property is leased

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The Supreme Court has given a very important judgment last week where the Court considered the validity of leases created on mortgaged property. The Court has examined whether the provisions of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 ("SARFAESI Act") have in any way affected the right of a lessee to remain in possession of the secured asset during the period of a lease.

While delivering the judgment, the Court has made a distinction between the leases made before and after the creation of mortgage. As far as the leases made prior to the creation of mortgages, the court has categorically stated that the lessee will have the right to enjoy the possession of the leased property till the expiration of lease. A secured creditor cannot oust the lessee in respect of the leases made prior to the creation of mortgage.

Thereafter, the court considered the validity of the leases made after the creation of mortgages. Section 65A of the Transfer of Property Act, 1882 ("TP Act") allows a borrower to create lease on the mortgaged property subject to certain terms and conditions. In this regard, the Court also considered Section 35 of the SARFAESI Act which provides that the provisions of the SARFAESI Act shall have effect, notwithstanding anything inconsistent with any other law for the time being in force. Hence, if a provision of law is not consistent with any provisions of SARFAESI Act, the provision of SARFAESI Act will be valid. Accordingly, a lease created on a mortgaged property shall be valid if it complies with Section 65A of TP Act, unless there is anything under the SARFAESI Act which affects the right of a borrower to create lease on the mortgaged property.

The Court examined provision of Section 13 of the SARFAESI Act which confers a right to the secured creditor to take possession of the secured asset and enforce the asset for the realization of the debt. Section 13 (2) requires the creditor to serve a notice on the borrower in case of any default. Section 13 (4) states that If the borrower fails to discharge his liability within 60 days of the notice, the lender can take various measures provided in the Section. One of such measure is the right to take possession of the mortgaged property from the borrower. In case of leased properties, the lawful possession of the secured asset is not with the borrower, but with the lessee. A lease allows legal right to the lessee to enjoy the possession of leasehold property during the lease period. It cannot be taken away without authority of laws. The court observed that there is no mention in Section 13 that a lease created on the mortgaged property will stand terminated upon the creditor deciding to initiate measures under Section 13. Hence, a secured creditor cannot take over the possession of secured asset until the lawful possession of the lessee gets terminated.

The Court observed an inconstancy between Section 13 (13) of the SARFAESI Act and the provision of the TP Act enabling the mortgagor to create lease on the mortgaged property. Section 13 (13) provides that no borrower shall create a lease on the mortgaged property, if a notice has been given to the borrower under Section 13 (2) unless a prior written consent of the mortgagor has been obtained. Hence, a lease of a secured asset made by the borrower after he receives the notice under sub-section (2) of Section 13 from the secured creditor intending to enforce that secured asset will not be a valid lease.

Accordingly, a secured creditor can take possession of the mortgaged property from the lessee if the lease has been created after a notice has been served on the borrower under Section 13 (2) provided no prior written consent of the Lender has been obtained. However, the lender cannot oust a lessee from the possession the leased property:

1. If the lease has been made prior to the creation of mortgage; or
2. If the lease has been made after the creation of mortgage in accordance with Section 65A of the TP Act but before the lender served a notice to the borrower under Section 13 (2) of the SARFAESI Act.

Section 65 A of the TP Act further provides that borrower will have power to create lease on the mortgage property only if the mortgage deed does not specify anything to the contrary. Hence, a lender can prevent the creation of lease on the mortgage property after the creation of mortgage by expressly prohibiting the same in the mortgage deed. However, it may not be practical to prevent the borrower from creating lease altogether. In such cases, appropriate provisions should be provided in the mortgage deed to ensure that the lender has a say in respect of creation of lease by the borrower. Similarly, lenders should also ascertain whether the property is leased and the period of lease before creating mortgage on the property.