

Criminal Liability in Commercial Transactions under Section 405 IPC

Attempts by lenders to criminalise ordinary loan defaults by invoking provisions such as Section 405 IPC have consistently been met with judicial resistance. Courts have underlined that every breach of repayment terms does not amount to criminal breach of trust or cheating, and that the criminal process cannot be used as a tool to recover debts. Unless fraudulent intent or dishonest misappropriation is clearly demonstrated at the inception of the transaction, the liability remains civil in nature. The Supreme Court in a line of cases, culminating in its recent decision in ***Sunil Sharma v. Hero Fincorp Ltd.***, has reiterated that such efforts to convert commercial defaults into criminal proceedings are an abuse of law and contrary to the principle that penal statutes must be strictly construed.

In this context, it is also noteworthy that the Reserve Bank of India (RBI) has laid down a comprehensive framework for classification of borrower accounts as *fraud*, which clearly enumerates the circumstances warranting such classification, such as furnishing of false information or documents, submission of manipulated financial statements, disposal of assets, diversion and siphoning of funds, or non-utilisation of loans for the sanctioned purpose. Upon such findings, banks are required to report the account as fraud to the RBI and initiate appropriate criminal action by filing complaints with the police or the CBI, depending upon the gravity and statutory provisions attracted under the Indian Penal Code. In parallel, banks are also empowered to designate borrowers or guarantors as *wilful defaulters*, which carries severe consequences, including restrictions on access to institutional finance and capital markets. Against this regulatory backdrop, the approach of the Indian judiciary, including the Supreme Court and various High Courts, has been consistent, in cases of ordinary loan default or non-repayment, without accompanying elements of fraud, dishonest misappropriation, or diversion of funds, the provisions of Section 405 IPC are not attracted. Courts have repeatedly held that such defaults give rise only to civil or financial liability, not criminal culpability, thereby insulating genuine commercial disputes from unnecessary criminalisation.

However, any attempt by the lenders to bring in the criminal intent by invoking principle of criminal breach of trust in commercial matters, especially loan transactions, has been criticised by the Courts. The courts have drawn a clear distinction between civil liability arising from breach of contract or failure to repay a debt, and criminal liability arising from misappropriation with dishonest intention. This is based on the legal position that when a loan is disbursed, beneficial ownership of the money passes to the borrower, creating a debtor–creditor relationship. This means the borrower is entitled to utilise the money for the purpose for which it is obtained, subject to repayment obligations. A mere failure to repay, does not amount to *entrustment* within the meaning of Section 405 IPC. Criminal liability arises only when the essential ingredients of the offence, *entrustment of property* and *dishonest misappropriation or conversion*, are clearly established.

In its judgement in the case of ***Anil Mahajan v. Bhore Industries Ltd.*** (2005) 10 SCC 228, the Hon'ble Supreme Court held that a mere failure to honour a financial commitment, even if deliberate, does not by itself constitute the offence of cheating or criminal breach of trust unless there is evidence of fraudulent or dishonest intention from the very inception of the transaction. It was observed that “*It is trite law and common sense that an honest man entering into a contract is deemed to represent that he has the present intention of carrying it out but if, having accepted the pecuniary advantage involved in the transaction, he fails to pay his debt, he does not necessarily evade the debt by deception.*”

Further, in the ***Indian Oil Corporation v. NEPC India Ltd.*** (2006) 6 SCC 736, the Apex Court also cautioned against the tendency of creditors to resort to criminal proceedings to pressurise borrowers. It held that a breach of contract, without the element of dishonest intention, is a civil wrong and cannot be stretched into a criminal offence. In ***Dalip Kaur v. Jagtar Singh*** (2009) 14 SCC 696, the Supreme Court reiterated that every breach of contract does not amount to cheating. There must be clear intention to deceive at the time of making the promise; subsequent failure to fulfil

the promise cannot be criminalised. In its judgement in the case of **V.Y. Jose v. State of Gujarat (2009) 3 SCC 78**, the Supreme Court underscored that in commercial transactions, the criminal process cannot be invoked unless fraudulent or dishonest intention is clearly made out. The primary remedy in cases of default lies in civil law. Similar approach has been followed by various High Courts (Delhi, Bombay, Madras, etc.) and applied this principle, holding that non-repayment of loans is essentially a matter of civil liability, to be addressed through recovery proceedings, arbitration, SARFAESI, or IBC mechanisms, unless there is clear evidence of fraud or entrustment coupled with dishonest misappropriation.

Legal Position:

To make out an offence under section 405 of IPC, there needs to be entrustment of assets, and loan disbursal typically transfers ownership, negating the concept of entrustment. Further, there must exist a dishonest intention at the inception of the transaction and a subsequent inability or failure to repay does not constitute a criminal offence. Civil disputes over non-repayment must be resolved through civil/financial recovery mechanisms, not through criminal prosecution. The Courts have also warned against criminalising ordinary commercial defaults, emphasising that criminal law is meant to punish fraud and misappropriation, not to enforce repayment of debts. In short, the consistent legal position enunciated by the Supreme Court and High Courts is that ordinary defaults in loan repayment, without fraudulent intent or misappropriation, do not constitute an offence under Section 405 IPC, and creditors must seek remedies under civil and regulatory frameworks (IBC, SARFAESI, arbitration) rather than invoking criminal process. The principle is rooted in the doctrine that **penal statutes must receive strict construction**. Criminal law is not meant to enforce commercial bargains; it is designed to punish acts involving moral blameworthiness or fraud. Thus, the use of criminal process to pressurise repayment in ordinary loan defaults has been consistently deprecated by the courts as an abuse of law.

Recently, the Hon'ble Supreme Court in **Sunil Sharma v. Hero Fincorp Ltd.** (Criminal Appeal No. 3467 of 2025, decided on 12 August 2025) reiterated that unless dishonest intention is evident at the inception of the transaction, breach of contractual terms cannot be criminalised. It observed that the fire which destroyed the borrower's plant forced circumstances beyond his control, and there was no evidence of misappropriation. Similarly, in earlier judgments such as **Indian Oil Corporation v. NEPC India Ltd. (2006) 6 SCC 736** and **Anil Mahajan v. Bhor Industries Ltd. (2005) 10 SCC 228**, the Court has emphasised that a breach of contract or non-repayment of loan does not constitute cheating or criminal breach of trust unless fraudulent intent is established. In Indian Oil Corporation case.

The jurisprudence reflects a deliberate judicial policy to insulate commercial disputes from unnecessary criminalisation. Courts have underscored that creditors must rely on civil and statutory recovery mechanisms, such as IBC, SARFAESI, or arbitration, rather than invoke criminal law in the absence of the essential ingredients of Section 405 IPC. The *Sunil Sharma* ruling strengthens this line by reaffirming that "mere failure to repay a loan gives rise to financial liability, not a criminal offence."

Thus, while the RBI has laid down a detailed framework empowering banks to deal with instances of fraud through classification of accounts, reporting, and initiation of criminal action in genuine cases of misrepresentation or diversion of funds, any further attempt by lenders to criminalise what is essentially a civil liability has met with strict judicial scrutiny. The courts have repeatedly underscored that criminal liability must be founded on a strict interpretation of penal provisions and requires clear proof of *mens rea*, dishonest intention at the inception of the transaction. Absent such elements, breach of repayment terms remains a matter of civil obligation, and efforts to invoke Section 405 IPC or similar provisions to pressurise borrowers have been checked as an abuse of criminal process.

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