

Case No. 14

1978 (Vol 114) ITR 213
(In The MADRAS HIGH COURT)

UNION OF INDIA AND ANOTHER

Vs

CT.SENTHILANATHAN AND ANOTHER

RAMAPRASADA RAO and RATNAVEL PANDIAN JJ

October 29, 1974

Nature of hypothecation explained - rights of hypothecatee - cannot prevail over a public debit payable to the State -

COMMENTS: This judgement confines the right of the hypothecatee to that of a bare private money creditor with the ancillary right to proceed against the goods hypothecated after obtaining a court decree. But this is qualified by the expression that it would be so in the absence of a constructive or express notice to the public at large. An endorsement in the R C book can be deemed to be a notice to the public and on this ground this judgement can be easily distinguished. In any case, the issue that arose in the said case was whether the arrears payable under the Income Tax Act by the assessee had a priority over his liability under the hypothecation agreement which the assessee had entered into with a private party. The Court held that public debts payable to the State would have priority over a private debt payable to citizen. Hence, the observations regarding the nature of hypothecation agreement are clearly in the nature of an obiter and would not constitute a binding precedent. Only that principle which was necessary for disposal of the case would amount to a ratio having a binding value. Other remarks are merely in the nature of obiter and hence not binding.

Hypothecation of goods is a concept which is not expressly provided for in the law of contracts but is accepted in the law merchant by long usage and practice. Hypothecation is not a pledge and there is no transfer of interest or property in the goods by the hypothecator to the hypothecatee. It only creates a notional and an equitable charge

in favour of the hypothecatee and the right of the hypothecatee is only to sue on the debt and proceed in execution against the hypothecated goods, if they are available. Delivery of possession is not a sine qua non for the creation of a national charge under a deed of hypothecation and where possession of the hypothecated goods is with the hypothecator, a wide door is open to him to deal with the goods without reference to the hypothecatee. If the hypothecator, contrary to the stipulation under the hypothecation deed, deals with the property, the breach on his part would certainly be noticed by the hypothecatee and he would be dealt with independently by him. It is in this context that the rights of a bona fide transferee for value of such goods are protected in law, for the hypothecatee who fails to sequester the goods and reduce them into his custody, takes the risk of such clandestine dealings of the hypothecator. If the hypothecatee expressly or constructively notified the equitable charge or where the hypothecatee has constructively possession of the goods, though not physical possession, matters would be different. In the absence of such a constructive notice or express notice to the public at large, the right of the hypothecatee is that of a bare private money creditor with the ancillary right to proceed against the goods hypothecated after obtaining a decree in a court of law. Thus, a hypothecation is a right in a creditor over a thing belonging to another and which consists in the power in him to cause the goods to be sold in order that his debt might be paid to him from the sale proceeds and this right is distinguishable from a mortgage of chattels.

S had obtained a hypothecation of, inter alia, a camera in respect of moneys advanced to the assessee. The camera, however, remained in the possession of the assessee. The income-tax department attacked and took possession of the camera to meet the income-tax arrears of the assessee S filed a claim petition before the income-tax department for the release of the camera to enable him to take steps to preserve the same for the realization of the amounts due to him under the hypothecation deed. The claim petition having been rejected, S filed a suit for a declaration that the camera was not liable to be attached as he had a prior charge over it and also for setting aside the order made by the income-tax department in which his application for recognising his prior claim to seek possession of the camera was not entertained. The suit having been decreed by the trial judge, the State filed an appeal:

Held, (I) on the date when the hypothecation deed was entered into, no possession of the goods was handed over to the creditor nor was it in the contemplation of the parties. It was only by a future overt act on the part of the creditor that he could sequester the goods, if he so desired, and that too by a process known to law. The

only right which the creditor had under the hypothecation deed was at best to file a suit on the debt and after obtaining a decree proceed against the properties specified in the said deed in realization of the decree.

(2) As between a public debt payable to the State and private debt payable to a citizen, the former has priority.

(3) The trial judge was wrong in holding that the creditor had a right, by virtue of the hypothecation deed, to be paid out in preference to the State, though the dues payable by the assessee was a public debt and was not a debt which arose in commercial dealings between the assessee and the State.

The appeal was therefore allowed.

Manickam Chettiar v ITO [1938] 6 ITR 180 (Mad) [FB] and
Builders Society Corporation v Union of India [1965] 56 ITR 91 (SC) applied.

Cases referred to:

Morritt, In re [1887]18 QBD 222 (CA)
Venkatachalam Chetti v. Venkatrami Reddy (1940) 2 MLJ 456;; AIR 1940 Mad 929.

Appeal No.493 of 1969.

V. Balasubrahmanyam and J. Jayaraman for the Appellants.
V.R. Nagarajan for the respondents.

JUDGEMENT

The judgment of the court was delivered by

RAMAPRASADA RAO J The first and the second defendants, the former being the Union of India, represented by the Finance department dealing with income-tax matters, and the latter being the District Collector of Salem, who were unsuccessful in O.S. No. 146 of 1965 on the file of the Subordinate Judge's Court, Salem, are the appellants. Certain relevant facts which led to

the present litigation may be traced. The plaintiff in the action appealed against, on

the foot of a hypothecation bond dated August 31, 1960 (exhibit A-1), filed O.S. No.106 of 1964 on the file of the Subordinate Judge's Court, Salem, for the recovery of a sum of Rs.69,778.99 with interest and costs by directing the sale of the hypothecated properties mentioned in the plaint and for the passing of the usual charge decree. In the above suit a Commissioner was appointed to take an inventory of the goods over which the plaintiff claimed to have a right of hypothecation, but which were admittedly in the possession of the hypothecator, namely, the third defendant. In the course of such an inventory prepared by the Commissioner, it was discovered that a camera, which is the subject-matter of the present action and which the plaintiff claimed was also included in the hypothecation bond as above, was missing. During the pendency of the above suit, the third defendant, as owner of the hypothecated goods and as an assessee, was subject to penalty and assessment proceeding under the provisions of the Indian Income-tax Act. For a period prior to the assessment year 1958-59, penalty proceedings as also assessment proceedings were initiated under exhibits B-1 to B-6 for the recovery of various sums due by him as assessee under the Act. Under exhibits B-7 and B-8 distraint proceedings were also issued directing the distraint of certain articles including the said camera. It is common ground that under exhibit B-8 the camera was attached by the second defendant pursuant to the usual orders of the tax recovery officers functioning under the Indian Income-tax Act, and it is also common ground that on February 22, 1963, the camera was attached pursuant to the tax recovery certificate issued by the authorised officer under the Act and it was brought under the possession of the second defendant. After the attachment was effected, which, as we said, was during the pendency of O.S. No.106 of 1964, on the file of the Subordinate Judge's Court, Salem, the plaintiff had to file a claim petition for the release of the said camera. Before we trace the necessary details connected with the claim petition and the orders passed thereon subsequently, it is necessary at this stage to notice the course which the attachment proceedings took and which were undertaken by the statutory officers functioning under the Indian Income-tax Act. As we said, the third defendant was in arrears of Income-tax for a period prior to the assessment year 1958-59 and for the said assessment year as well. Under exhibit A-19 dated September 17, 1963, consequent upon the payment of the amounts due by the assessee for the period earlier to the assessment year 1958-59, the attachment of the camera and other materials which were distrained earlier was raised on that date. But it is common ground that under exhibit B-10 a fresh warrant of attachment was issued for the attachment of the said camera in respect of arrears due for the assessment year 1958-59. Pursuant to the said order of attachment issued under exhibit B-10, the Thasildar of the District issued a notice calling upon the third defendant to pay

the amount by then due by him as defaulter under the Income-tax Act, 1961, within a period named by him in exhibit B-11. The third defendant having committed default, under exhibit B-13 a sale notice was issued where under it was proclaimed, inter alia, that the said camera would be the subject-matter of a public sale on the date named in exhibit B-13. Coming to know of such a sale which was duly announced by the statutory authorities, the plaintiff filed what is ordinarily known as a claim petition under exhibit B-15. After tracing the history of this litigation, which we have already briefly set out, the plaintiff referred to the fact that the Commissioner who was appointed in the earlier proceedings in O.S. No. 106 of 1964, on the file of the Subordinate Judge's Court, Salem, could not trace the camera and that it was only thereafter that the plaintiff came to know that the camera which was under hypothecation with him was taken away by the Thasildar, Salem, for income-tax arrears alleged to be due from the third defendant. Under these circumstances, he prayed in the said claim petition that his claim might be enquired into, that the attachment for the income-tax arrears at the instance of the first appellant of the camera might be released and that the camera might be handed back to him so that he could take necessary steps to preserve the same for the realisation of his dues under the hypothecation bond. This claim petition was enquired into by the Collector, and under exhibit B-16, it was rejected. Consequent upon the rejection of his claim petition, the present action has been filed.

In this suit the plaintiff seeks for the declaration that the plaintiff schedule camera is not liable to be attached by defendants 1 and 2 for the recovery of arrears of income-tax and that the plaintiff has a prior mortgage over it and incidentally he seeks to set aside the claim order made by the second defendant in which his application for recognition of his prior claim to seek possession of the camera was not entertained by the second defendant. The plaintiff traced the facts above stated and sought for the reliefs as above.

There first and the second defendants in their separate written statements pleaded that they were not aware of the earlier litigation between the plaintiff and the third defendant in O.S. No.106 of 1964, on the file of the Subordinate Judge's Court, Salem, as they were not parties. According to the 2nd defendant, the plaintiff camera was attached at the request of the first defendant and it was removed and kept in the custody of the second defendant for further proceedings in accordance with law. The contention of the first defendants is that they have rights as pledges over the camera in question, that, in any event, their action is bona fide and that they have rights of priority over the private debt of the third defendant payable by him to the

plaintiff.

Under these circumstances the following issues were framed:

"1. Whether the alleged attachment of the camera by the Government for income-tax arrears on March 22, 1963, will prevail over the hypothecation of the said camera to the plaintiff on August 31, 1960, which is decreed upon in O.S. No.106 of 1964 on June 25, 1964 ?

2. Whether the plaintiff is entitled to the declaration sought ?

3. Whether the suit is barred by limitation ?

4. Whether there is no valid notice of suit under section 80 of the Civil Procedure Code.

5. Whether court - fee paid is correct ?

6. To what relief or reliefs, if any, is the plaintiff entitled ?

The findings on issues 3,4 and 5 are not in dispute before us. On issues 1,2 and 6 the learned subordinate judge found that the attachment of the camera by the Government for income tax arrears on February 22, 1963, or at any later date would not give priority over the rights created in favour of the plaintiff under the deed of hypothecation, exhibit A-1, on the basis on which the plaintiff obtained a decree in O.S. No.106 of 1964 on the file of the Subordinate Judge's Court, Salem. In the result, he decreed the suit as prayed for. It is as against this, the present appeal has been filed.

Mr. Balasubrahmanyam, the learned counsel for the appellants, contends that the rights created under the hypothecation bond, exhibit A-1, are not equitable to the rights of a mortgagee under a deed of mortgage of movables, as no interest in the property has ever passed to the plaintiff under the said deed of hypothecation. His second contention is that, as between the State and the plaintiff, the debt due to the former, it being a public debt, prevails over the debt payable to the latter as a private debt and that, in the absence of any secured rights which the plaintiff could project in a manner known to law by virtue of exhibit A-1, the ordinary rule of priority applies and hence the claim of the first and second defendants in the matter of the attachment and sale of the camera pursuant thereto is unassailable and their rights of

priority should be recognised in the circumstance of the case.

The learned counsel for the plaintiff (first respondent), on the other hand, would submit that this is a case of mortgage of movables and that, in any event, the first and second defendants could not be characterised as bona fide transferees without notice of the earlier hypothecation. Alternatively it is pleaded that in the instant case the State cannot claim any rights of priority in the matter of the sale of the camera and the appropriation of the resultant sale proceeds.

The contentions, therefore, lead us on to the appraisal of the content and legal effect of exhibit A-1, the hypothecation deed. The nomenclature adopted by the parties to create the so-called rights under exhibit A-1 is "deed of hypothecation of movables". Under the deed, the plaintiff claims that he has lent money from time to time and that the third defendant as borrower has executed the deed of hypothecation, hypothecating, inter alia, the camera and other articles. Clause (1) states that the third defendant hypothecated the movables for the due discharge of the loan already received by him from the plaintiff and he undertook to discharge the amounts so borrowed together with interest, etc. The period during which the debt had to be discharged was fixed as six months. The default clause provided that, if the third defendant failed to pay off the debt as disclosed in exhibit A-1, the plaintiff was at liberty to seize the goods, sell them and appropriate the net sale proceeds towards the amounts due to the plaintiff. There is also a clause whereby the third defendant undertook not to remove or deal with the hypothecated goods outside the premises and imposed a prohibition on himself not to create any encumbrance or charge or deal with it in any other way to the prejudice of the plaintiff. We are not concerned with the other recitals in exhibit A-1. On a fair and reasonable understanding of the recitals in exhibit A-1, it is clear that what was contemplated between the parties was that the third defendant had to pay off the admitted debt due and owing by him at or about the time when the deed of hypothecation was executed and that for the due repayment of the loan, the camera and other articles were hypothecated but without possession of the same being delivered over to the creditor. The most conspicuous feature of exhibit A-1 is that, in case the borrower committed default in the payment of the debt as stipulated, the plaintiff was at liberty to seize the goods. The position, therefore, incontrovertibly is that on the date when the hypothecation deed was entered into, no possession of the goods was ever handed over to the creditor (plaintiff) nor was it in contemplation between the parties. It was only by a future overt act on the part of the creditor that he could sequester the goods, if he so desired, and that too by a process known to law. At best, the right which the

plaintiff had under exhibit A-1 was to file a suit on the debt and, after obtaining a decree therein, proceed against the properties specified in exhibit A-1 in realisation of the decree.

Hypothecation of goods is a concept which is not expressly provided for in the law of contract, but is accepted in the law merchant by long usage and practice. Hypothecation is not a pledge and there is no transfer of interest or property in the goods by the hypothecator to the hypothecatee. It only creates a notional and an equitable charge in favour of the hypothecatee and the right of the hypothecatee, as already stated, is only to sue on the debt and proceed in execution against the hypothecated goods, if they are available. As delivery of possession is not a sine qua non for the creation of a notional charge under a deed of hypothecation and as possession of the hypothecated goods is always with the hypothecator, a wide door is open to the owner to deal with the goods without reference to the hypothecatee. If, however, the hypothecator, contrary to the stipulation under the hypothecation bond, deals with the property, the breach on his part would certainly be noticed by the hypothecatee and he would be dealt with independently by him. It is in this context that the rights of a bona fide transferee for value of such goods are protected in law, for, the hypothecatee who fails to sequester the goods and reduce them into his custody, takes the risk of such clandestine dealings of the hypothecator. If the hypothecatee expressly or constructively notifies the equitable charge, matters would be different; even so, when the hypothecatee has constructive possession of the goods, though not physical possession of the same. In this case, it is not pretended that any such express or constructive notice of the existence of the hypothecation was ever given, nor it is claimed that the hypothecatee, namely, the plaintiff, did ever come into possession of the goods which were the subject-matter of exhibit A-1. In the absence of such a constructive notice or express notice to the public at large, the right of the hypothecatee is that of a bare private money creditor with the ancillary right to proceed against the goods hypothecated after obtaining a decree in a court of law. Thus, a hypothecation is a right in a creditor over a thing belonging to another and which consists in the power in him to cause the goods to be sold in order that his debt might be paid to him from the sale proceeds. This right is distinguishable from a mortgage of chattels.

Considerable reliance was placed by the learned counsel for the plaintiff on the decision of a Division Bench of this court in *Venkatachalam Chetti V Venkatrami Reddi* [1940] 2 MLJ 456 ; AIR 1940 Mad 929. That was a case where the learned judges were dealing with a mortgage in respect of the produce on the land and in

that context they expressed the view that the mortgage would operate as a mortgage of movable property. which was valid under the Indian law. The learned judges added that the moment the crop came into existence, the mortgagee got title to the crop in equity. Venkataramana Rao J., delivering the leading judgment, referred, among other decisions, to the principle underlying the mortgage of chattels. The learned judge quoted Cotton L.J. in *In re Morritt* [1887] 18 QBD 222, 232(CA) as follows:

“A pledge of personal chattels as a rule is and must be accompanied by delivery of possession. It is out of the possession given him under the contract that the pledgee's rights spring.....A mortgage of personal chattels involves in its essence, not the delivery of possession, but a conveyance of title as a security for the debt.”

Though the learned counsel for the plaintiff referred to this decision he was not able to satisfy us that under exhibit A-1 there was any transfer to such interest or title of the hypothecator in the goods in favour of the hypothecatee. Excepting for the bare assertion that the plaintiff as hypothecatee could seek for possession of the goods in case of default of the hypothecator no further right is thought of or claimed in and by the recitals in recitals in exhibit A-1. It is, therefore, clear that there was no transfer of interest in movable property under exhibit A-1 so as to sustain the contention of the learned counsel for the plaintiff that the case under consideration involves a mortgage of movable property. As we said, the best that can be claimed by the plaintiff in this action is an equitable charge. He could work out the equitable charge only after obtaining a decree on the private debt. After obtaining the decree he should seek execution as against the goods secured under the hypothecation deed, if available with the hypothecator at or about the time when he seeks execution. Under these circumstances; we are unable to accept the contention that this is a case of mortgage of movable property. This is a pure and simple case of hypothecation of goods under which no delivery of possession of the hypotheca was contemplated and the only right which the hypothecatee got under it was a right to seek for the sale of the hypothecated goods after obtaining a money decree on the debt.

In the rights of a hypothecatee are thus understood and so limited, has he a right to claim preference over a public debt in the nature of tax dues to the State? We have already referred to the fact that, though a hesitant argument was raised at one stage that there was no second attachment, though under exhibit B-10 a warrant of attachment was issued on September 17, 1963, yet by reason of the supervening events that took place, the learned counsel for the plaintiff was unable to satisfy us

that in the instant case there could not have been any attachment of the camera in respect of arrears of income-tax due for the assessment year 1958-1959. It is common ground that a warrant of attachment was issued under exhibit B-10. It was only, thereafter, that exhibits B-11 and B-13 were issued by the statutory officers. Under exhibit B-13 a public sale was threatened. The plaintiff filed a claim petition under exhibit B-15, in which he admitted that the camera which was under hypothecation with him was attached and taken away by the Tahsildar of Salem. It, therefore, follows that the parties proceeded, at all material times, on the basis that there was an attachment of the camera, that due possession of it was taken by the first or second defendant as statutory officers functioning under the Income-tax Act and that from that date onwards the camera was in their possession. Even otherwise, it can be presumed, under-section 114(e) of the Evidence Act, that, as official acts have to be presumed to be done in the normal course, the warrant of attachment should have been followed by an actual attachment of the goods at some point of time later than September 17, 1963.

If the State, therefore, has attached the camera and reduced it to their custody in exercise of their prerogative desire to sell the attached goods and pay themselves the public debt due to the State, can the plaintiff intervene and seek for cancellation of the said attachment and claim a right to be paid in priority to the public debt admittedly due and owing by the borrower to the State? In *Manickam Chettiar v. Income-tax Officer* [1938] 6 ITR 180 (Mad), a Full Bench of this court has held that an income-tax debt has priority over private debts and that the court has inherent power to make an order on the application for payment of moneys due to the Crown. In that case, Leach C.J. went to the extreme extent of laying down the proposition that there need not be a decree in favour of the State, that there need not be an attachment pursuant to the decree obtained by the State so as to enable the State to claim such a priority, that the State could intervene by a bare application and claim such rights of priority. *This decision was cited with approval by the Supreme Court in Builders Supply Corporation v. Union of India* [1965] 56 ITR 91. though the Supreme Court did not think it necessary to consider the question whether a bare intervention on the part of the State, with a decree in its favour or a process in attachment having been undertaken, would enable the State to claim such rights of priority, yet they approved the dictum of Varadachariar. J., who had observed - See [1965] 56 ITR 91, 99 (SC):

"The weight of authority in favour of the recognition of the priority in question even in this country is so strong that this expression of doubt cannot help the peti-

tioner to any material degree.”

This is sufficient for our purpose to negative the contention of the respondent that the state has no priority in the instant case. The Supreme Court considered the question further in full and observed (page 103):

“ It is essential that as a sovereign, the State should be able to discharge its primary governmental functions and in order to be able to discharge such functions efficiently, it must be in possession of necessary funds, and this consideration emphasises the necessity and the wisdom of conceding to the State the right to claim priority in respect of its tax dues. ”

The Supreme Court, however; made a distinction where the debts sprang from commercial activities of the State.

Having regard to the pronouncements of the Full Bench of this court and the Supreme Court referred to above, we are unable to accede to the proposition that in the instant case the State cannot claim right to priority for being paid out from the sale proceeds of the camera in question, which sale they have already announced under exhibit A-13 and which obviously could not be proceeded with because of the present supervening proceedings.

The learned trial judge went wrong in holding that the plaintiff had a right, by virtue of exhibit A-1, to be paid out in preference to the State, though the dues payable by the third defendant to the State was a public debt and was not a debt which arose in the course of commercial dealings between the third defendant and the State. As between a public debt payable on the State and a private debt payable to a citizen, the former has priority and this is too well established. Under these circumstances, we are unable to sustain the judgment of the learned subordinate judge and we hold that the plaintiff camera which has been admittedly attached by defendants 1 and 2 is capable of being attached by them for recovery of arrears of income-tax and that they have a right of priority in the sense that from out of the sale proceeds of the camera they are entitled to recover arrears of income-tax payable for the assessment year 1958-59, by the third defendant, on such sale of the camera. The order of the second defendant in the claim petition is, therefore, quite sustainable and within the limits of law. The learned subordinate judge has misconceived the entire legal position. The judgment and decree of the learned subordinate judge are, therefore, set aside and the appeal is allowed with costs.