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Contents

Articles

Investigation & whistle-blowing provisions under Companies Act, 2013 – An overview

By **Anup Koushik Karavadi**

The Companies Act, 2013 ("new Act") contains stringent provisions to contain corporate frauds. A new "investigation" procedure has been provided under Sections 210 to 229, as against Sections 235 to 251 of the Companies Act, 1956, ("old Act"). The new Act also provides whistle blowing provisions and ensures anonymity of the whistle blower. This article seeks to articulate the major differences between the old Act and the new Act, with regard to the provisions for investigation of the affairs of a company and discusses the vigil mechanism provided in the new Act and the draft rules framed thereunder.

Inspection and investigation

The new Act has brought together, in detail, all the provisions dealing with inspection, inquiry and investigation into a single chapter from Sections 206 to 229. As per Section 234 of the old Act, the Registrar of Companies ("Registrar") is the sole authority empowered to demand production of books, information and papers of a company for inspection whereas, Section 208 of the new Act allows and empowers an Inspector, apart from the Registrar, to inspect the records. Further, the Inspector/Registrar may give recommendations to conduct investigation in such report.

As per the provisions of the old Act the Central Government was obliged to order an investigation into the affairs of a company on receipt of a special resolution of a company. Whereas, as per Section 210 of the new Act, the Central Government may, at its discretion, decide as to whether or not an order to inquire and investigate into the affairs of the company in the following three circumstances (1) as per the report and the reasons stated therein as submitted by the Inspector/Registrar or (2) on receipt of an intimation of special resolution of the company or (3) in public interest. It may be inferred from above referred provision that the Central Government is vested with a *suo moto* power to order for an investigation to protect public interest. Further, it is obligated to order an investigation into affairs of a company if a court or a tribunal passes such order. It is pertinent to note that once the Central Government decides to investigate the matters of a company, the new Act allows it to either appoint one or more persons as Inspectors or the Serious Fraud Investigation Office (SFIO) for such investigation.

Serious Fraud Investigation Office (SFIO)

The new Act provides statutory backing to the SFIO under Section 211 for the purpose of investigating the affairs/frauds relating to a company. Further, Section 212(2) contemplates that once a case is assigned to SFIO, it shall be the sole authority to investigate such case and all the papers, documents and the information shall be transferred to SFIO.

By virtue of Section 212(15) of the new Act, the report submitted by an IO for framing of charges at the time of prosecution, is deemed as a report submitted by a police officer under Section 173 of the Code of Criminal Procedure, 1973. Section 212(6) lists out the cognizable offences and as per Section 212(8) the IO is empowered to arrest a person who is guilty of any of the offences listed therein. Section

217 of the new Act vests the IO with various powers like power to take assistance of any other officer or employees including the former officers, employees and agents (the former employees were not included in the old Act) to check all the books and papers of a company whose affairs are being investigated, or any other relevant material belonging to any other company, department or individual. He can examine a person on oath besides imposing fine if his orders are not complied with. This may also enable better coordination in respect of prosecution of offences under the Indian Penal Code.

Upon receipt of orders of the Central Government, the IO will have to submit an interim report and after the completion of the investigation, a final report is submitted. After the submission of the final investigation report, the Central Government decides whether to proceed with prosecution and in which case the SFIO would represent the case on behalf of the Central Government.

Few other notable changes

One of the major variations between both Acts is that through Section 221 of the new Act, the Tribunal is empowered to freeze assets of a company under inquiry/investigation for a period not exceeding 3 years. Such a power was not provided for under the old Act. The new Act, through Section 228, makes the procedure prescribed for inspection, inquiry and investigation of a company applicable *mutatis mutandis* to a foreign company while the old Act does not deal with such a situation.

Yet another change brought in by the new Act is that the Inspector is made more independent. Section 240A of the old Act mandates the Inspector to approach the Magistrate of First Class or Presidency Magistrate and seek an order permitting him to seize the books and papers of a company. However, Section 220 of the new Act contemplates that if the Inspector has reasonable grounds, he may seize the books and papers without obtaining any permission from any authority. Moreover, the Inspector has been granted freedom, to make copies of such books and papers, or take extracts from them or place identification marks thereon, as he deems fit before returning the same.

The new Act under Section 229 specifically enlists the situations under which a person shall be punished for fraud for a period extending between 6 months to 10 years (Section 447). The same does not find place in the old Act.

Vigil Mechanism

The new Act under Draft Rule No. 12.5 read with Section 177(9) makes it mandatory for the following types of companies 1) listed companies, 2) companies that accept deposits from public and 3) companies that borrowed more than INR 50 crores from banks or public financial institutions, to establish a vigil mechanism for directors and employees to report their genuine concerns. As per the said provisions, the companies which are required to constitute a vigil committee shall operate the vigil mechanism through its audit committee and in case of the other companies, the Board of Directors are obligated to nominate a director to play the role of an audit committee.

The Draft Rule 12.5(3) read with 177(10) mandates the vigil mechanism of any company to provide for adequate safeguards against victimisation of the persons reporting their concerns. Further, the vigil mechanism provides direct access to the chairperson of the Audit Committee or to the director, as the case may be. It may be noted that, in order to prevent the abuse of the mechanism, a penal clause has been adopted in Draft Rule 12.5(4) wherein it enables the audit committee or the director may initiate a suitable action against the directors or employees indulging in filing repeated frivolous complaints.

It may be noted that under the new Act, the fact that the vigil mechanism is related to the audit committee we may assume that the said mechanism is to deal with the financial aspects, disclosures, valuation of assets, independence of auditors, financial controls implemented by a company, or even issues related to breach of the code of conduct of a company, sexual harassment complaints etc., though such issues have not been categorically mentioned in the new Act.

Conclusion

Though the fundamental concept/ principles in relation to the investigation provisions are the same in both the Acts, the new Act has brought in few important changes to ensure better administration and to a certain extent pre-empt fraud and misconduct by providing for an effective complaint mechanism. Considering the number of corporate frauds that are surfacing in the country today, the old Act was evidently inadequate. Hence, it is anticipated that the new provisions of the new Act would bridge the gulf between increasing corporate frauds and the statutory regime. The new Act is a welcome improvement if the same is implemented appropriately.

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Class actions under the Companies Act, 2013

By Kritika Krishnamurthy

A class action allows a number of claimants with a common grievance against a company to file a lawsuit against it. Claimants can pool their resources, share attorneys' services and save the time and costs of litigation. The scale of economies associated with class actions seem especially critical to those individuals who have limited resources or small claims that render individual lawsuits expensive and unfeasible. Class action suits are well established in the US and have been used even by employees to file against discrimination and unfair policies.

Provisions of the Companies Act, 2013

Under Section 245 of the Companies Act, 2013 ("2013 Act"), shareholders or depositors (number defined below) may file an application with the National Company Law Tribunal (NCLT) alleging that the management or conduct of the affairs of any company other than banking companies[1] are being conducted in a manner prejudicial to the interests of the company, its members or depositors.[2] Such class action may include suits against the company, its directors as well as experts or consultants or any other person for any wrongful, fraudulent or wrongful act; suits may also be filed against the audit firm as well as the partners responsible for any misleading or improper statements in the auditors' report or any misconduct or fraud by act or omission.

The reimbursement of legal expenses undertaken in such class action shall be reimbursed from the Investor Education Protection Fund (IEPF)[3] and

1 Section 245(9)

2 Section 245

3 Section 125(3)(d)

the cost or expenses connected with the application for class action shall be defrayed by the company or any other person responsible for any oppressive act.[4] The feasibility of reimbursements from IEPF shall be an acid test for the 2013 Act.

The Tribunal, while considering an application, shall consider whether the members or depositors are acting in good faith, whether the cause of action in one which could be pursued individually instead of class action. It shall also consider evidence relating to involvement of persons other than directors or officers and views of those members having no personal interest in the derivative action.

A separate provision has also been made for 'Securities Class Action' under Section 37 of the 2013 Act. An interesting point to note is that if a misleading statement or the inclusion or omission of any matter is made in the prospectus affecting any group of persons, a suit instead of an application with the NCLT shall be filed for appropriate remedy. No minimum number of persons required for filing such a suit has yet been prescribed. The provision also states that '*any other action*' may be taken imposing civil or criminal liability on persons responsible for such misleading statements made in the prospectus.

Number of members/depositors who may bring class action[5]

Category	Number of members/depositors
Company having share capital	• Not less than 100 members of the company; or • Not less than 10% of the total number of its members, whichever is less, or • Any member or members singly or jointly holding not less than 10% of the issued share capital of the company, subject to the condition that the applicant or applicants have paid all calls and other sums due on their shares
Company not having share capital	not less than one-fifth of the total number of its members
Depositors of company having share capital	• Not less than 100 depositors; or • Not less than 10% of the total number of depositors, whichever is less; or • Any depositor or depositors singly or jointly holding not less than 10% of the total value of outstanding deposits of the company

While the 2013 Act allows waiver of the requirements related to number of persons eligible to make an application for oppression and mismanagement, no such relaxation has been provided in case of class action.

Causes of action and remedies

A derivative action may be brought by the members of the company on any one of the

4 Section 245(5)

5 Section 245 read with Draft Companies Rules, 2013 issued by the Ministry of Corporate Affairs.

following grounds:

- misleading statement or the inclusion or omission of any matter in the prospectus;[6]
- to restrain the company from committing an act which is *ultra vires* the articles or memorandum of the company;
- to restrain the company from committing breach of any provision of the company's memorandum or articles;
- to declare a resolution altering the memorandum or articles of the company as void if the resolution was passed by suppression of material facts or obtained by mis-statement to the members or depositors;
- to restrain the company and its directors from acting on such resolution;
- to restrain the company from doing an act which is contrary to the provisions of the 2013 Act or any other law for the time being in force;
- to restrain the company from taking action contrary to any resolution passed by the members; and
- to claim damages or compensation or demand any other suitable action from or against-
    - the company or its directors for any fraudulent, unlawful or wrongful act or omission or conduct or any likely act or omission or conduct on its or their part;
    - the auditor including audit firm of the company for any improper or misleading statement of particulars made in his audit report or for any fraudulent, unlawful or wrongful act or conduct; or
    - any expert or advisor or consultant or any other person for any incorrect or misleading statement made to the company or for any fraudulent, unlawful or wrongful act or conduct or any likely act or conduct on his part.

The orders of the Tribunal are binding and a company that fails to implement an order of the Tribunal may be fined between INR 5 lakhs and INR 25 lakhs and every officer responsible is liable for imprisonment besides a personal fine. It is important to note that if the Tribunal finds the application has been filed on frivolous grounds, it may in addition to dismissing an application also impose a fine of INR 1 lakh on the applicants. It is however questionable whether the amount of the fine will act as an adequate deterrent against vexatious applications under this section.

Conclusion

The recent collapse of a number of major corporations worldwide has created an environment requiring much greater vigilance with regard to corporate governance and the actions of key managerial personnel within companies. Companies are likely to face increased threat of litigation posed by 'class actions' and other multi-claimant proceedings seeking significant relief against companies, their directors, officers as well as external auditors and experts. There is also a trend worldwide for shareholders to bring class actions against companies and their directors for compensation claims associated with their investment in the company's shares, one recent example in India being the *Sahara* case.[7] Whether the powers to decide such securities class actions of listed companies shall be delegated to the Securities and Exchange Board of India is yet unclear.

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6 Section 37

7 (2013) 1 SCC 1

Notifications & Circulars

External Commercial Borrowings – Some recent changes: External Commercial Borrowing (ECB) is now allowed for not only first stage of acquisition of shares and second stage offer to public, but also for all subsequent stages of acquisition of shares in the disinvestment process under the Government's disinvestment programme of the PSU shares. A.P. (DIR Series) Circular No. 57 dated 30-9-2013, issued for the purpose, states that facility of ECB is available for multiple rounds of disinvestment of PSU shares under the said programme.

Definition of 'Infrastructure Sector' in relation to the policy on External Commercial Borrowings has been widened. Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000 has been amended in this regard and as per Reserve Bank of India A.P. (DIR Series) Circular No. 48, dated 18-9-2013, energy, communication, transport, water and sanitation, mining, and social & commercial infrastructure sectors have been expanded to cover many new sub-sectors.

Further, through A.P. (DIR Series) Circular No. 59, dated 30-9-2013, RBI has discontinued the facility allowing eligible borrowers to raise ECB at a higher all-in-cost to refinance/reschedule an existing ECB. This facility is not available from 1st October, 2013.

Buy back of securities – Compliances: The Securities and Exchange Board of India (SEBI) has notified the forms in which listed companies and merchant bankers are required to make regulatory disclosures as required by the recent amendment of SEBI (Buy Back of Securities) Regulations, 1998. The amended regulations require companies to submit information of buy-back to stock exchanges and merchant bankers to file a post offer report with SEBI. As per Circular No. CIR/CFD/POLICYCELL/10/2013, dated 17-9-2013, notifying necessary forms, the amendments were made in August this year with objective of aligning the regulatory requirements with the changing market realities and enhancing efficiency in the buy back process.

Import trade credits liberalized: Companies in all sectors have been allowed to avail of trade credit not exceeding USD 20 million up to a maximum period of 5 years for import of capital goods as classified by DGFT. This facility was earlier available only to companies in the infrastructure sector. As per RBI vide A.P. (DIR Series) Circular No. 53, dated 24th September, 2013 *ab-initio* contract period of 15 months for all trade credits has also been relaxed to 6 months.

Micro and Small Enterprises – Definition in relation to FEMA revised: The Reserve Bank of India has issued a corrigendum to Notification No.FEMA.230/2012-RB on 10-9-2013 whereby the definition to Micro and Small Enterprises (MSE) for the purpose of issue or transfer of security by a person resident outside India has been revised. Reference to definition of MSE in Micro, Small and Medium Enterprises Development (MSMED) Act, 2006 in the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000 has been omitted in favour of *Explanation* on scope of micro and small enterprises. As per the explanation in the case of enterprises engaged in manufacture or production of goods pertaining to any industry specified in the first schedule to the Industries (Development and Regulation) Act, 1951, a micro enterprise (ME) and a small enterprise (SE) shall mean where the investment in plant and machinery does not exceed INR 25 lakh or is more than INR 25 lakh but not exceeding INR 5 crore respectively; (ii) in the case of enterprises engaged in providing or rendering services, ME and SE would mean where the investment in equipment does not exceed INR 10 lakh or is more than INR 10 lakh but does not exceed INR 2 crore respectively.

SEBI – Permission required for sale/ purchase of securities: Companies are now required to take permission of the SEBI while entering into any contract for sale or purchase of securities. Some specific contracts excluded, i.e. those which do not require permission, are spot delivery contracts, contracts for sale or purchase of securities in derivatives, contracts for pre-emption, and contracts under shareholders agreement, etc. SEBI Notification No. LAD-NRO/GN/2013-14/26/6667, dated 3rd October, 2013 issued for this purpose also states that contracts entered prior to the date of this notification will not be affected by the provisions therein.

Ratio Decidendi

Central Electricity Authority – Jurisdiction of CEA for approval of schemes for generating companies and capital expenditure for project completion: The Supreme Court of India has held that Electricity Act, 2003 did not set out any role for the Central Electricity Authority (CEA) in the matter of approval of the schemes for the generating companies or the capital expenditure for the completion of projects, and that its role was limited to matter enumerated under Section 73 of the said Act. The Court in this regard observed that though Regulation 2.5 of the Central Electricity Regulatory Commission (Terms and Conditions for Determination of Tariff) Regulations, 2001 provided for such an approval, after enactment of the Act, the regulation became redundant.

Earlier, both CERC and the Appellate Tribunal had rejected the contention of the appellant that additional capital expenditure could not be taken into consideration for tariff fixation unless the same was approved by CEA as required under CERC Regulations. The respondent however justified action of CERC in considering additional expenditure as the said amount had in fact been incurred and also found to be of capital in nature.

The Apex Court observing that there was no contention by the appellant regarding the actual incurring of the expenditure and regarding the nature of expenditure and that both the CERC and the Tribunal had held that the expenditure was capital, also held that there was no evidence that there was a miscarriage of justice by not allowing the expenditure to be capitalized after a scrutiny by the CEA. [*U.P. Power Corporation Limited* v. *N.T.P.C Limited* - Supreme Court's Judgment dated 18-9-2013 in Civil Appeal No. 4117 of 2006]

No penalty for attempt to manipulate price of scrips: The Securities Appellate Tribunal has set aside the adjudication order of SEBI imposing penalty of Rs. 40 lakh for manipulating price of shares of particular company which distorted market equilibrium of scrip. The Tribunal while allowing the appeal observed that acts by the appellant to manipulate the scrip can at best be called an "attempt" to do so, which did not succeed ultimately and that an attempt only is not punishable, so long as it does not succeed and the act is not carried out.

The Tribunal in this regard noted that the adjudicating authority had held that sale of shares by appellant in off market transaction at low rate to related entities, who utilized these shares, to manipulate price of scrip by creating buy pressure, may be the "possible" reason and manipulation "might" have been done to have better valuation of scrip, on its merger with another company. It was held that mere possibility of an event, which has not happened, cannot form the foundation of punishment. [*Dhirendra Rajitram Shukla* v. *Securities and Exchange Board of India* – SAT Order dated 25-9-2013 in Appeal No. 226 of 2012].