Investor Protection Measures under Companies Act, 2013 – Lessons from the Past

Introduction

"Indian Enron" revealed the inherent fallacy of the Companies Act, 1956 to prevent white-collar crimes and assure investor protection. The 2009 Satyam fall out contained important lessons for stakeholders of India Inc. and brought the urgency of investor protection to the forefront. This led to significant focus of the Companies Act, 2013 ("**Act**") on establishing adequate investor protection measures. The Act introduces new provisions for ensuring accountability and transparency in a company's management for safeguarding stakeholders' interest such as prohibition of insider trading (*S. 195*), proscription of forward dealing of securities (*S. 194*), introduction of class action suits (*S. 245*), registered valuers (*S. 247*) and offence of fraud (*S. 447*), facilitating exit opportunities for dissenting shareholders (*S. 230, 27, and 13*) and enhancing penalties for breaches and non-compliances.

This newsletter provides an insight into certain investor protection measures, namely stricter regulation of board, class action suits and fraud, and aims at analyzing its impact on investors and the company.

1. Regulation of Board

In the wake of increasing number of corporate scams, the need for having an accountable and transparent board cannot be overemphasized. The Act lays stricter standards for functioning of board and management of the company. The standards are coupled with mandatory disclosures and increased penalty (*including criminal liability*) to act as deterrent for unscrupulous practices.

1.1 Duties of Directors

S. 166 codifies the duties of directors requiring them to act with good faith, due and reasonable care, skill, and exercise independent judgment in management. Conceptually, this existed under the old law too but as part of fiduciary duties. Now, breach of duties entail fine between INR 0.1 million (*US$ 1,583*)[1] to INR 0.5 million (*US$ 7,914*) on the defaulting director. But, the Act does not provide an objective standard of assessment and whether a director has fulfilled his duties will be determined on factual basis.

As an illustration, every director is required to disclose his "interest" at the first board meeting in which he participates and thereafter, at the first board meeting in every fiscal year or whenever there is any change.[2] For ensuring that transactions are in a company's best interests and to rule out vested interest of directors, an interested director must disclose his interest in the proposed transaction and refrain from the voting process.[3] A director is interested (*directly or*

[1] US$ 1 = INR 63 approx.
[2] See S. 184 of the Act. The disclosure is done in the prescribed format and the board is mandated to take note of such disclosure. The board noting is filed with RoC in Form MGT-14 within 30 days from date of the meeting in which noting is done
[3] S. 184 read along with S. 188 of the Act

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indirectly) in a contract, if he (*individually or with another director*) holds more than 2% shareholding, or is a promoter, manager, CEO of the other transacting company, and in case of any other transacting entity is a partner, owner or member. A contract or even an arrangement in breach of this i.e. without making the necessary disclosures where there is a need is voidable at company's option. It is, therefore, necessary to accurately record board proceedings, and specifically note dissent raised by a director for attributing liability on the defaulting director only. Further, under S. 188, related party transactions ("**RPTs**") beyond a certain threshold and which are not at an arm's-length[4] require prior shareholders' approval. Details of RPTs have to be maintained in registers and disclosed in the board's report. Such provisions should go a long way in guaranteeing that company's funds are utilized to maximize shareholders' interests. In India, closely held group entities undertake RPTs on a day-to-day basis for economies of scale and optimum utilization of resources. Such companies will have to review things afresh and change their mindsets so as to comply with the strict mandate.

1.2 Disclosure in Board Report

Annual board disclosures are tightened to facilitate transparency by presenting a true picture of a company's state of affairs. S. 134 mandates various additional disclosures to be made in the board report such as (a) details of RPTs undertaken in a fiscal year, (b) particulars on inter-corporate loans and investments, (c) directors' responsibility statement containing affirmations regarding following accounting standards for preparation of financial statements, exercise of independent judgment, discharge of duties with due care and skill, having adequate mechanism to prevent fraud, compliance with applicable laws, (d) development and implementation of risk management policy, and (e) details of corporate social responsibility initiatives, if applicable. The penalty for non-compliance has been enhanced and now, breach entails fine on the company up to INR 2.5 million (*US$ 39,572*), and imprisonment up to 3 years and/or fine up to INR 0.5 million (*US$ 7,914*) on every officer-in-default which includes every director.[5] As personal liability is imposed on every director, it is imperative that board functions diligently and makes adequate disclosures in its report to present a true and fair view. While these additional disclosures will increase accountability of the board, it also will provide more information to shareholders and enable informed decision making.

1.3 Increased Penalty

The Act has also enlarged the scope of penalty imposed on defaulting directors and key managerial personnel ("**KMP**") for ensuring responsible functioning of the board as a whole. KMP is a new concept and includes CEO, MD, manager, CS, whole-time director, CFO, and other officers as designated. For instance, S. 129 penalizes every director as officer-in-default (*in absence of MD, whole-time director, CFO or specified officer responsible for preparation of financial statements*) for non-compliance with accounting standards and the procedure for preparation of financial statements. Similarly, a director convicted for offence involving RPTs stands disqualified under S. 164. Conviction for offence involving RPT may be initiated by a company for recovery of

[4] Arm's length transaction means a transaction between 2 related parties conducted in an unrelated manner to avoid conflict of interest

[5] The Act enlarges the scope of officer-in-default. It includes (i) all key managerial personnel, (ii) in their absence, director(s) specified by the company as officer-in-default, (iii) all directors in absence of such specifications, and (iv) every director aware of a contravention

loss incurred due to such RPT. However, the possibility of company initiating proceedings against a director is less probable. The Act aims at establishing adequate checks and balances for ensuring efficient management but the implementation of the stricter penalty provisions is yet to be tested.

2. Class Action Suits

As a major change, the Act empowers the investor and minority shareholders by introducing "class action suits". During the Satyam scam, where US counterparts could institute such suits and recover damages, Indian investors were without any recourse.[6] In addition to the remedies under oppression and mismanagement, the yet-to-be notified S. 245 introduces this concept and provides collective remedies to investors and claim damages against erring companies. It vests a right with members or depositors or class thereof (*100 in number*) to file a representative application with the National Company Law Tribunal ("**NCLT**")[7], if they feel that management or company's affairs is conducted in a prejudicial manner. The positive determination that an alleged conduct is prejudicial is done if the conduct is prejudicial to the company's interest, or interest of stakeholders. There is no illustrative list for prejudicial conduct under the Act and the same may be decided on factual basis. Instances such as drawing funds for personal use, negligent action or omission, oppressive measures towards minority were considered as prejudicial conduct under the old law.[8] Factors such as good faith of applicant, availability of remedy in one's own right, evidence presented relating to involvement of officer, opinion of non-interested members or depositors, and whether the alleged conduct is or is likely to be ratified ought to be considered by NCLT.

Per S. 245(1), NCLT can grant a variety of remedies such as (a) restraining order for committing *ultra vires* act or breaching the charter documents or any resolution passed, (b) declaring a resolution which alters the charter documents and is passed in suppression or falsification of facts as void, (c) restraining directors from implementing such void resolution, (d) grant damages against the company, its directors, auditor, or an expert, advisor or consultant, and (e) any other remedy. Order in a class action suit shall be binding on the company and all its members, depositors, auditor or expert(s), consultant(s), or advisor(s). Non-compliance with NCLT's order may lead to fine between INR 0.5 million (*US$ 7,914*) to INR 2.5 million (*US$ 39,572*) on the company, imprisonment up to 3 years and fine between INR 25,000 to INR 0.1 million (*US$ 1,583*) for every officer-in-default. As a check on the potential abuse through frivolous or vexatious applications, S. 245(8) provides that such applications shall be rejected with reasons and the applicant shall be liable to pay cost up to INR 0.1 million (*US$ 1,583*) to the opposite party.

The detailed procedure is likely to be notified in future. Introduction of class action suits will result in reducing the multiplicity of lawsuits and litigation costs and, hopefully, avoid conflicting judicial pronouncements. But, institution of such suits is fettered with practical

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[6] Earlier collective suits such as public interest litigation, class petition for human rights violation, collective consumer suits were permitted under applicable Indian laws such as Consumer Protection Act & Code of Civil Procedure

[7] NCLT is yet to be constituted as the corresponding provisions are not notified as of date

[8] The old law did not provide for instances of prejudicial conduct in context of oppression and mismanagement. Instances were evolved on a case to case basis through jurisprudence

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roadblocks. For instance, while it is mandated that all applications concerning a particular cause should be clubbed, it is ambiguous as to how it will be done. The efficacy of this new regime shall be seen over time.

3. Fraud and Investigation

The Act has introduced "fraud" for the first time and given it a wide scope.[9] Apart from the definition, the Act also contemplates presumption of fraud in certain instances. For example furnishing false information or suppressing material information upon incorporation, providing misleading or false statements in prospectus, issuing duplicate share certificates to defraud, fraudulently transferring or transmitting shares and fraudulently applying for removal of company's name. For the board, this may have varied connotations. Proof of negligence or willful misconduct by a director may weigh heavily in adjudging guilt for fraud. It is immaterial if there is any actual wrongful gain or loss, and proof of intent to defraud will suffice. Thus, the directors will now be required to discharge their statutory duties in a reasonable and diligent manner while exercising independent judgment to provide a positive inference of non-involvement in any alleged fraudulent conduct.

Fraud is a non-compoundable, cognizable offence punishable with imprisonment between 6 months to 10 years and fine ranging between the amounts involved to 3 times of such amount. No bail will be granted to an accused unless the public prosecutor is provided with an opportunity to oppose and the court is satisfied that there are grounds for innocence. Further, an auditor has to report instances of fraud to the Central Government ("**CG**") within 60 days, if in the course of his duties as an auditor, he has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees.[10] Failure of auditor to report could lead to penalty between INR 0.1 million (*US$ 1,583*) to INR 2.5 million (*US$ 39,572*). An auditor may also be debarred from appointment for 5 years, if NCLT conclusively finds one guilty. The ambit of auditor's responsibility is wide enough to cover board irregularities of any nature if they are not backed by reasonable and adequate explanations.

For implementing fraud related provisions, statutory status is given to the Serious Fraud Investigation ("**SFIO**") to conduct investigations assigned by the CG.[11] Once a case is assigned to SFIO, jurisdiction of all other investigation agencies will be suspended. Officers of SFIO will be vested with the power to arrest the accused and the SFIO report will be considered as a charge sheet. On receipt of investigation report, the CG may also direct SFIO to initiate prosecution. Further, RoC has *suo moto* powers to call for information and records, and impose penalty for fraud on every officer-in-default where it concludes that fraud has occurred.[12] During an investigation if CG inspectors find that business is conducted to defraud

[9] In S.447 of the Act, fraud means any act, omission, concealment of fact, or abuse of position by a person, with deceitful intent, to gain undue advantage from, or to injure the company's interest, or interests of its shareholders, creditors or any other person

[10] S.143 of the Act read with Rule 13 of the Companies (Audit and Auditors) Rules, 2014

[11] The section is yet to be notified. SFIO investigation may be initiated on basis of the report of ROC/inspectors, or special resolution passed by company, or in public interest, or on request by any governmental department

[12] S. 206(4) of the Act

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stakeholders or for a fraudulent purpose, penalty for fraud will be levied on every officer-in-default including promoters.[13]

Conclusion

The concepts discussed hereinabove empower India Inc. investors with new mechanisms for their protection. However, the provisions relating to NCLT, SFIO, and class action suit have not been notified, and the actual implementation is yet to be tested. The mechanisms aim to check the abuse of power by directors but there are no substantive standards which will guide the process of investigation by NCLT or SFIO. Perhaps, the relevant ministry and departments will collectively come forward and provide an appropriate framework. In the meantime, increased caution has to be exercised by the board in its functioning. Proper maintenance of records, registers and pro-active participation in board meetings will help directors to avoid personal liability. Actual impact will be apparent only gradually. As of now, the picture promises a happy investor!

Author:
Arya Tripathy

[13] Investigation is conducted on application made by specified number of members or any person satisfying the need for investigation