Supreme Court on Sahara Ruling: Salute to the Judges, but huge question mark before financial regulators

Vinod Kothari
vinod@vinodkothari.com
Vinod Kothari & Company
September 1, 2012

Check at: http://india-financing.com/staff-publications.html for more write ups.

Copyright:
This write up is the property of Vinod Kothari & Company and no part of it can be copied, reproduced or distributed in any manner.
Disclaimer:
This write up is intended to initiate academic debate on a pertinent question. It is not intended to be a professional advice and should not be relied upon for real life facts.

Analytically Speaking

The ruling of the Supreme Court in Sahara Real Estate Corporation (Sahara case) is a landmark ruling, not so much for the technical interpretation of the apparently conflicting or unclear provisions of the Companies Act, Securities Contracts Act or SEBI Act, but on the extremely candid and sharp observations of the Judges on the conduct of the appellants, and for upholding the pride and faith in the judiciary that legal sophistry cannot obfuscate what is so apparently a gross violation of the regulatory regime of the country.

Misplacing private placement

In fact, the facts were so stark that commonest intuition alone, the contention of the appellants could have been rubbished at the very outset. To put in simple words, the contention of the appellants was that they were unlisted companies, and were not to be regulated by the SEBI, and that what they had done was to raise money by issue of "optionally convertible debentures" (OCDs) which were issued on "private placement basis". For the uninitiated, the concept of private placement is an issue where securities are offered by the company to persons who are associates, friends, relatives, employees etc., such that the offer will not be available other than to the person to whom it is made. In the heydays of IPO market in India, in 1980s, one would find see whole lot of the so-called private placements where application forms were being distributed by the newspaper vendor on the footpath, and it was yet said to be a private placement. Obviously, there was no SEBI then – the whole system was managed by the Controller of Capital Issues. Much later, a provision was inserted in sec 67 (3) of the Companies Act to mean that if securities were offered to 50 or more persons, the issuer could not take the contention that it was a private placement. Read this provision with sec 73 of the Companies Act – it is not a private placement, it has to be a public issue, and if it is a public issue, it requires mandatory issue of prospectus, and listing, thereby bringing the full jurisdiction of SEBI into the picture.

The contention of the appellants was that theirs was a private placement. Now just observe the sheer magnitude of the issuance. Though correct facts have not been disclosed by the appellants right through the process of investigation and even before the Supreme Court, the strands of facts are: nearly Rs 20000 crores of money has been raised, from 22.1 million investors, using services of nearly a million agents, at 2900 branches. And all this is claimed to be a private placement – as if these 22.1 million investors were friends, associates, employees or relatives of the company or company directors. If such an outrageous argument could be taken to

the highest court of the country, and argued by the best legal brains, all one needs to do is to admire the audacity of the argument.

Vikramaditya lives on

That the court would not allow technicalities to come in the way and hold a contention that would have put all justice to shame, maintains tremendous faith in the judiciary. The speeches of the judges are a real feast for a student of corporate laws. Don't be repulsed by the number of pages the ruling is written on – the PDF on the judis.in site looks like 263 pages. But then both the speeches are so interesting that almost like a favourite storyteller's work, one would not leave it once starting reading.

The speech of Justice Radhakrishnan takes the reader through a complete background of corporate laws, securities regulations in India and comparing the regulatory scenario in India with that in England. The speech is smooth as silk – unburdened by heavy legal arguments and texts of other rulings, and a marvelous reading.

The speech of Justice Khebar is sharp and scathing, when it comes to the almost obstinate resistance of the appellants in avoiding the jurisdiction of SEBI. While the entire judgement is full of sharp comments, here are some examples:

- The Judge has cited an example of an entry out of the so-called OCD register, and after perusing the particulars of the entry, and pooh-poohing the contents, the Judge says : "One would not like to make any unrealistic remark, but there is no other option but to record, that the impression emerging from the analysis of the single entry extracted above is, that the same seems totally unrealistic, and may well be, fictitious, concocted and made up."
- On the evasive policies adopted by the appellants towards supplying information to SEBI, the Judge says: "It is not easy to overlook, that the financial transactions under reference are not akin to transactions of a street hawker or a cigarette retail made from a wooden cabin. The present controversy involves contributions which approximate Rs.40,000/- crores, allegedly collected from the poor rural inhabitants of India. Despite restraint, one is compelled to record, that the whole affair seems to be doubtful, dubious and questionable. Money transactions are not expected to be casual, certainly not in the manner expressed by the two companies."

- And further: “One would therefore, have no hesitation in concluding, that a party which has not been fair, cannot demand a right based on a rule founded on fairness.”

Technical issues:

The judgement answers several technical questions.

Various questions have been raised on several provisions of the Companies Act, Securities Act and SEBI Act. Regrettably, while several other countries have consolidated their securities-related provisions in course of time, in India, the provisions remain scattered partly in the Companies Act, partly under the Securities Act, and now largely under the departmental guidelines issued by the SEBI known as ICDR regulations. In fact, until sec 55A was inserted in the Companies Act, even the administrative control of provisions relating to issue of securities was split between Ministry of corporate affairs (MCA) and the SEBI.

The language of sec 55A itself became an issue in Sahara litigation. The sections seems to suggest that in case of listed companies, or in case of public companies which intend to list securities, the jurisdiction shall vest with SEBI, and other cases, it shall vest with the MCA. The appellants were unlisted companies, and did not intend to list securities – hence, the question of SEBI’s jurisdiction did not arise. Sure enough the language of sec 55A is not sensible, but the Supreme court supplied meaning to flawed language of the section by holding that where the securities were mandatorily required to be listed in terms of sec 73, the question of the issuer intending not to list the securities did not arise at all. Hence, the question of SEBI’s jurisdiction was settled.

There were several questions raised about where an OCD, which is a “hybrid” (meaning, an instrument containing features of equity and debt) was at all covered by the provisions of the Securities Act. These questions have also been answered by harmoniously interpreting the inclusive definition of “securities” under the Securities Act. An OCD is after all a debenture, and hence, it is well covered by the provisions of the Acts.

The appellants also sought shelter under the provisions of the Unlisted Public Companies (Preferential Allotment) Rules 2003, which, prior to their amendment in Dec 2011, did not contain restriction on number of allottees as is there in sec 67 of the Act. This was apparently a lapse in the 2003 Rules which was plugged later. But one would expects judiciary of today not to be scuttled by the age-old principles of literal interpretation, and be the slave of the flawed language of a law. The court held that after all, the 2003 Rules could not have gone beyond the provisions of sec.

67. If an issue of securities has been made to 50 or more persons, and is therefore deemed to be a public offer under sec 67 (3), the contention that it is made a preferential issue under the Preferential Allotment rules will not hold any significance.

The apex court also held that DIP and ICDR Guidelines of SEBI are statutory instruments and have the force of law. In addition, the ICDR Regulations apply to all companies, listed or unlisted.

The ruling supplies meaning to the very flawed language of sec. 28 (1) (b) of the Securities Contracts Regulation Act. Section 28 (1) (b) is, in fact, an exception to the prohibition under the SCRA on issue of options. The section intends to exclude the option available to the holder of convertible bonds, but in the flawed language of the section, seems to exempt convertible debentures from the whole of the Act. The Apex court has made sense out of this erroneously worded section by holding that sec 28 (1) (b) excludes merely the entitlement of a convertible bondholder to the shares, and does not exempt convertible bonds in toto.

Huge question mark for the regulators:

The Apex court has delivered what is almost an administration order for the appellants – ordering them to refund all monies raised by the issue of OCDs within 3 months from the date of the order. A retired Judge of the Supreme Court has been appointed to oversee the compliance of the order, and the SEBI full time member has been given responsibility of carrying out the liquidation of the money.

Obvious enough, tens of thousands of crores are not lying liquid with the company, and it would not be easy, despite all efforts, to liquidate the money. Since even the details about the bondholders have not been supplied over more than 2 years of investigation process, fixing all details and repaying all monies will be nearly impossible. It is quite likely that of the 22 million investors, several millions lose their money. Who would these investors be? If you are reading these lines and you were feeling happy that you are not the one who has invested in the OCDs, the happiness may be wellplaced, but please do realise that none of the several millions will probably get to read these lines. In fact, none of them may get to read any line whatsoever, because several of these millions will be illiterate people. Daily wage earners, farmers, rural folks, and generally, anyone who could have been enticed with offers of a decent rate of interest, might have invested.

With life savings of millions at stake, the question that looms large is – why is it that the administration kept sleeping while these Rs 20000 crores were raised? Obvious enough, this money was not raised overnight. If services of a million agents were

utilised, it could not have been that it would not have come to the notice of the government.
The schemes in question are possibly 2008 schemes, but it is quite well known that money has been raised by floating similar schemes over the years. How is it that we let the problem reach to such massive scales, and then have to reach up to the apex court to pass an order which will, in all likelihood, be impossible to execute?

The Article is also published on moneylife, to view, click here.

Other relevant articles that may interest you

See our other write ups on Alternate Investment Funds (AIFs) and Collective Investment Schemes (CISs) at http://india-financing.com/alternative-investment-funds.html, http://india-financing.com/Article_on_Collective_Investment_scheme-_vinod_kothari_&_Nidhi_Jain_%281%29.pdf

See our write up on debentures at
http://india-financing.com/Understanding_Compulsory_Convertible_Debentures.pdf

See other SEBI related articles at
http://india-financing.com/staff-publications-corporate-law.html