

# NOTE

Vinod Kothari & Company

Vindication for MCA – IDs and NEDs to be aware!!!!

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## Note

In the year 2011 the Ministry of Corporate Affairs (“MCA”) had come up with a number of circulars on an array of topics. The frequency with which such circulars were issued almost created an atmosphere of apprehensiveness in the industry as the tenacity of the same was being questioned. It seemed almost like the MCA had set on a whirlwind trip to streamline the legalities of corporate sector. However, one such step taken by the MCA was vindicated by a recent order, which is discussed below. The same is also juxtaposed with the MCA’s circular on the same topic.

The market regulator Securities Exchange Board of India (“SEBI”) in its Order vide WTM/RKA/CFD-DIL-1/14/2012<sup>1</sup> dated April 18, 2012 opined that for the purposes of Section 5 of the Companies Act, 1956 (“Act”) read with Section 73 (5), independent/ non-independent directors (“ID/ NED”) can also be regarded as “officers in default” if such directors have been entrusted with responsibilities to comply with obligations by the Board of Directors and they have agreed to the same.

### Facts of the Case:

The facts of the Order (case) in the matter of SVPCL Limited (the Company) are given in brief below:

1. The Company came up with an Initial Public Offer (“IPO”) on October 22, 2007 and stated in its Red Herring Prospectus that shares in this public issue would be listed on Bombay Stock Exchange (“BSE”) and National Stock Exchange (“NSE”).
2. The BSE had refused the final listing permission of shares of the company stating the reasons in its Order dated January 21, 2008. The company’s application for listing also stood “deemed to be refused” u/s 73(5) of the Act.
3. The Company meanwhile contested the order of BSE and failed to pay the interest amount on the application money in time. The Company also failed to pay interest amount @15% for the period of delay on the interest amount as ordered by SEBI.
4. Thereafter, show cause notices (SCNs) were issued to the Company, its promoters and/or directors on December 02, 2008 to show cause as to why without prejudice to their liability as stated above , appropriate action including direction under sections 11, 11A and 11B read with Clause 17 of Disclosure and Investor Protection Guidelines, 2000 (“DIP Guidelines”) should not be initiated against them.

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<sup>1</sup> [http://www.sebi.gov.in/cms/sebi\\_data/attachdocs/1334831137213.pdf](http://www.sebi.gov.in/cms/sebi_data/attachdocs/1334831137213.pdf)

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5. The Company in its reply stated that the SCN issued under section 11 and 11B of SEBI Act is not maintainable against it as it is neither a listed company nor an intermediary nor any entity that is associated with the securities market. It also stated that its IPO failed due to negligence on part of the merchant bankers and that they are liable for the consequences of the failure of the issue.
6. Further, through common written submissions on December 23, 2011 through their advocates, the following were submitted:
  - a. The promoters and the NED/ID contended that in terms of Section 5 of the Act the promoters and independent directors do not fall within the meaning of 'officer who is in default'.
  - b. The declaration in the prospectus signed by the NED/ID states about the statements made in the prospectus and therefore the onus to pay the interest lies on the company and the directors being 'officer in default'.
7. The Company on its part attributed the delay in paying interest amount because of decreased turnover, among other reasons.

The member finally ordered that interest @9% be paid on the interest amount in 7 quarterly installments apart from interest @15% on the application money.

The following are the key points opined by Mr. Rajeev Kumar Agarwal, whole time member ("member") being relevant to Section 5 read with Section 73 (5) of the Act:

- a. As per section 73(2) of the Act the company and every director of the company who is an officer in default is jointly and severally liable, to repay all the money with interest at prescribed rate . (emphasis provided)

.In the words of the member, "the words "every director who is an officer in default" in this section will obviously include all the directors who are 'officers in default' as defined in section 5, irrespective of the fact whether they are independent or executive or non-executive directors.

Thus, the determinant factor in this case would not be the designation of the director, but more importantly the directors' involvement in any intentional violation of the section.

- b. Quoting the provisions of Section 5 of the Act, it was further opined that, promoters cannot be taken to be officers in default to pay interest u/s 73(2) of the Act. They were also not liable for payment of interest on account of delayed refund in terms of clause 6.13.2 of the erstwhile DIP Guidelines.

## Note

In this case, Ms. K Mahitha and Mr. K V Kondaiah were the promoters of the company. Since, section 5 only envisages the involvement of director and him being in default, the promoters were excluded from being considered u/s 5 of the Act. Hypothetically, if the promoters held the post of “promoter-director”, then the provisions of the section would have been applicable and their involvement would have also been scrutinized.

- c. The member also opined that the three of the IDs of the Company did not have anything material on record to prove that they were “officers in default” with respect to refund of application money and payment of interest.

Our analysis:

Although, the opinion of the of SEBI was not the very crux of the case, yet this Order has vindicated the Ministry of Corporate Affairs’ circular vide General Circular No. 08/2011<sup>2</sup> dated March 25, 2011 whereby it was given that the independent directors shall be equally held responsible, as the other whole time directors, for any violation of the company, in case the role of the independent directors in the same is proven by the Registrar of Companies. Thus, the ID/NED cannot be prosecuted in case of any violation of law or when any omission is on the part of the company or by any other officers of the company and which have occurred without his knowledge and consent but surely strict action will be taken equally against them in cases where it is very apparent and where it is proved that such directors were also a part of the lapse and that they did not exercise the power made available to them in curbing the transaction.

Independent directors are required to play the role of “whistle blower” in any company. Although, the listing agreement (“LA”) has made it mandatory for all listed companies to appoint independent directors under clause 49, yet it was always considered to be an initiative of good corporate governance for non-listed companies also, if they appointed independent directors.

The Act does not have any provision to the effect of defining who an “independent director” is and what shall the limited scope to determine the independence. It is the LA which provides clarity on the same. It only acknowledges the requirement of an ID in remuneration committees only.

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<sup>2</sup> [http://mca.gov.in/Ministry/pdf/Circular\\_08-2011\\_25mar2011.pdf](http://mca.gov.in/Ministry/pdf/Circular_08-2011_25mar2011.pdf)

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The role of the independent director is also not clearly defined, be it in the Act or LA. In this era of scams like Satyam or even in the present case, the role of independent directors has only increased manifold. If such directors also act in connivance and become a party to the mis deeds of the other directors, then the purpose of requirement and appointment of the independent director stands defeated.

So where does this judgment take us?

It has been made amply clear by the member that IDs/ NEDs cannot be held responsible for any violation on the part of the company in which they had not been actively involved. The Order and the MCA circular in a way have also amplified the importance of IDs by showing that acting in connivance with other directors in the shadow of being 'independent' will not simply exempt them from prosecution. The IDs need to be mindful of their role in the company and the position they hold. This should also serve as a deterrent to the IDs/ NEDs and right fully act as the "watchdog" in the interests of the shareholders. To be a critic, not sure if our corporate economy will ever witness such governance!