

# Shareholder Activism: A Necessity to prevent Corporate Frauds

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*Public Companies in India are largely family-run and promoter dominated entailing huge investments from shareholders. However, this corporate structure provides avenues to promoters for undue enrichment and the shareholders who have invested in such companies do not actively participate in the operations of the company neglecting the need for transparency. Shareholder activism in India is largely absent in comparison to other western countries especially USA.*

*The recent Satyam fiasco has turned out to be the biggest fraud by an Indian Corporate and has been popularly referred to as the Indian Enron. The episode marked the black letter day for the history of Indian Corporate System. Despite Satyam Promoters owning only 8.61 % of the Stock and pledging most of it to raise money they were able to unilaterally take decisions with respect to acquisition of Maytas and engage in enormous financial fraud to the tune of Rs. 7500 crores without the approval or knowledge of the other shareholders.*

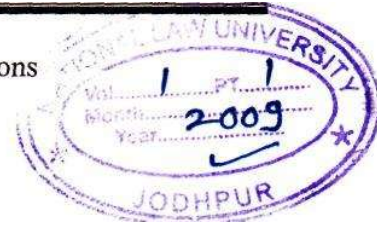
*Even with the increase in investments by foreign and Indian institutions and ordinary shareholders, Indian companies by and large continue to be run at the whims and fancies of the promoter group. Though shareholder activism is negligible in India, provisions of various statutes provide various recourses to shareholders to uphold their rights. This article aims to detail out the remedies available to the Shareholders in cases of fraud committed by the companies and suggests options to increase shareholder democracy in the functioning of the Companies. Further, we propose to examine the regulatory framework in India which makes committing fraud so easy and hard to detect, and would offer recommendations to close the loopholes and better the corporate governance in our country.*

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## I. Shareholders' Rights: Legal Provisions



### A. The Companies Act, 1956

*Right to Hold Extra Ordinary General Meeting (EGM)* -To call an EGM, shareholders have to hold a minimum of one tenth of the paid up capital of the company. The shareholders have to specify the agenda for which they consider the meeting to be necessary. In the landmark case of *LIC v Escorts*<sup>1</sup> the Supreme Court held that even institutional shareholders are statutorily entitled to call an EGM. No reasons are required to be given for requisition of an EGM and nor can the reasons be subject to judicial review. Once a valid requisition has been submitted, the Company should call a Board Meeting and the Board of Directors are obligated to call the EGM , even if some of the requisitionists have withdrawn their consent or ceased to be members.<sup>3</sup>

*Right against Oppression* - Under Section 397, any member of a Company can file an application to the Company Law Board<sup>4</sup> stating that there has been a continuous act of oppression on part of the majority shareholders upto the date of the petition.<sup>5</sup> According to Section 399, the application can only be made if a minimum of one hundred members or one

<sup>1</sup> (1986) 59 Com Cases 548 (SC)

<sup>2</sup> *V.G Balasundaram v. New Theatre Carnatic Talkies Pvt. Ltd.*, (1993) 77 Com Cases 324 (Mad.)

<sup>3</sup> Justice Y.V. Chandrachud, Dr. S.M. Dugar (eds.), A Ramaiya, *Guide to Companies Act*, (Wadhwa and Company, Nagpur, 16th edn., Part I, 2004) p. 1644

<sup>4</sup> It has been substituted by National Company Law Tribunal by Companies (Second Amendment) Act, 2002 but has not yet come into effect

<sup>5</sup> *Shanti Prasad v. Kalinga Tubes*, (1965) 35 Com Cases 351(SC)

•tenth of .the total members or members having not less than 10 percent of the 'total issued capital support it. For relief under Section 397, "a *conduct which lacks in probity, conduct which is unfair to and which causes prejudice to the petitioner in the exercise of his legal and proprietary rights as a shareholder*" must be shown to exist.<sup>6</sup> The scope of Section 397 is not necessarily limited to the strict legal rights but may extend to wider equitable considerations such as any legitimate expectations of a member.

*Right against Mismanagement* - Section 398 confers a right to

members of a company to apply to the Company Law Board in case of mismanagement in the affairs of the company. An application under this section can be made if it is shown that the affairs of the company are being conducted in a manner prejudicial to the interests of the company. The application should confirm to the requirements of Section 399 of the Companies Act, 1956. Mismanagement under Section 398 does not only include financial mismanagement<sup>10</sup> but also embraces absence of records and losses", sale of assets at lower price<sup>12</sup>, violation of statutory provisions<sup>1</sup> and Memorandum of Association<sup>14</sup>. While exercising jurisdiction under Section 398 the court can pass any order and lay down the procedure fo

<sup>6</sup> *Needle Industries( India) Ltd. v. Needle Industries Newey (India) Holding Ltd.*, (1981) 5 Com Cases 743 (SC)

<sup>7</sup> Justice Y.V. Chandrachud, Dr. S.M. Dugar (eds.), A Ramaiya , *Guide to Companies Act* (Wadhwa and Company, Nagpur, 16th edn., Part I, 2004) p. 3359

<sup>8</sup> It has been substituted by National Company Law Tribunal by Companies (Second Amendment) Act, 2002 but has not yet come into effect

<sup>9</sup> *Richardson & Cruddas Ltd. v. Haridas Mundra*, (1959) 29 Com Cases 549

<sup>10</sup> *Re Macro(Ipswich) Ltd.* (1994) BCLC 354, 404 ( Ch.D)

<sup>1</sup> *Chander Krishan Gupta v. Panna Lai Girdhari Lai Pvt. Ltd.*, (1984) 55 Com Cases 70 (Del)

<sup>12</sup> *Moorthy v. Drivers and Conductors Bus Service Pvt. Ltd.*, (1991) 71 Com Cases 136 (Mac DB)

<sup>13</sup> *Akbarali A. Kalvert v. Konkan Chemicals Pvt. Ltd.*, (1987) 88 Com Cases 245 (CLB)

<sup>14</sup> *S.M Ramakhshna Rao v. Bangalore Race Club Limited*, (1970) 40 Com Cases 674 (Mysore)

implementing its order.<sup>15</sup> Further, under Section 402, the Company Law Board has the power to replace *en bloc* all the directors as a relief against mismanagement.<sup>16</sup>

*Removal Of A Director By Shareholder* - Section 284 recognizes the inherent right of shareholders to remove the directors appointed by them. Section 284 provides the procedure to be followed for the removal of directors before the expiry of his term of office. The director can be removed by an ordinary resolution of which a special notice has been given. It is not even necessary that there should be proof of mismanagement, breach of trust, misfeasance or other misconduct on the part of the directors. Where the shareholders feel the policies pursued by the directors or any one of them are not to their liking, the shareholders can take the recourse of Section 284.

*Relief for Misstatement In Prospectus* - If any person (like the directors, promoters) provides misleading information or fails to incorporate the complete details in the prospectus, he is criminally liable and punishable with fine which may extend to fifty thousand rupees. The allottee can claim relief for misrepresentation in prospectus if he can

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prove :

1. That the misrepresentation was one of fact
2. That the allottee acted upon the misrepresentation

<sup>15</sup> *Gopal Shamsher Jang Bahadur Rana v. Jagdish Chandra Chowdhury*, 1981 Tax LR NOC 151 (Cal)

<sup>16</sup> *Shoes Specialties Limited v. Standard Distilleries and Breweries Private Limited*, (1997) 1 Comp LJ 243

<sup>17</sup> Justice Y.V. Chandrachud, Dr. S.M. Dugar (eds.), A Ramaiya, *Guide to Companies Act*, (Wadhwa and Company, Nagpur, 16th edn., Part I, 2004) p. 651

3. That the misrepresentation was material

However, a director or other person responsible for the prospectus shall not incur any liability if he proves that he had no knowledge thereof; or that the non-compliance or contravention arose from an honest mistake of fact on his part; or the non-compliance or contravention was in respect of matters<sup>18</sup> which, in the opinion of the Court dealing with the case were immaterial. *SEBI is also empowered to* punish the company for the contravention of section 56(3) of the Act.<sup>19</sup> Shareholders are eligible to file complaints against all offences under the Companies Act, 1956 as per Section 621 to any court not inferior to that of Presidency Magistrate or Magistrate of the First Class.<sup>20</sup> Apart from going to Court, Shareholders also have the alternative options of approaching the Registrar of Companies or SEBI or Stock Exchanges or Ministry of Corporate Affairs.

*Penalty imposed for False Statements* - As per Section 628, a shareholder can file a complaint to the Criminal Court (where the Company's registered office is situated<sup>21</sup>), if any person makes a false statement through any return, report, certificate, balance sheet, prospectus, statement or other documents or omits any material particular in any document required for the purposes of the Companies Act, he shall be punishable with imprisonment for 2 years and fine. The Satyam scam brought into light the crucial role played by the auditors in financial frauds. An auditor has a fiduciary relationship with

<sup>8</sup> Section 56(4) of the Companies Act, 1956

<sup>19</sup> [Notification No. 727(E) dated 18th September, 2000].

<sup>20</sup> Section 622 of the Companies Act, 1956

<sup>21</sup> *H. V. Jayaram v. ICICI Ltd.*, (2000) 99 Com Cases 341 (SC)

the shareholders<sup>22</sup> and in auditing the accounts maintained by the directors, the auditor acts in the interests of the shareholders who are in a position of beneficiaries.<sup>23</sup> For any mis-statement, non disclosure he can held guilty of professional misconduct as per Section 22 of the Chartered Accountants Act, 1949.

*Derivative Action* -The Board of Directors are in the position of trustees and owe a fiduciary obligation to the shareholders. If directors fail to live up to their duties, or involve themselves in ultra vire and illegal acts , Courts can authorize a shareholder or a group of shareholders under a *derived authority* to sue on behalf of the company for asserting the company's rights. The shareholders can seek any relief beneficial to the company.

*Application To Company Law Board* -As per Section 235 of the Companies Act, 1956 on an application from not less than two hundred members or from members holding not less than one tenth of the voting power to the Company Law Board; the Board would declare that the company be investigated. After the declaration by the Board or Registrar's report (under Section 234(6)] the Central government is empowered to appoint an investigator to look into the affairs of the company. Further, under section 635 of the Act, the Central Government may investigate the affairs of the Company including through the Serious Frauds Investigation Office. The Ministry of Corporate Affairs also accepts complaints from investors and refers complaints to the Serious Fraud Investigation Office.

*Institute of Chartered Accountants v. P.K Mukherjee*, AIR 1968 SC 1104  
*CITv. Dandekar* [1952] 22 ITR 235 (Mad.)  
*Satyacharan Lai v. Rameshwar Prasad Bajoria*, (1950) 20 Com Cases 39.

### *B. Application to SEBI*

Shareholders can complain to SEBI's office of Investor Assistance and Education for fraudulent activities and any violations of the SEBI Regulations by the company or its officers. Moreover, SEBI (Under Section 11 of SEBI Act, 1992) can *suo moto* investigate the non compliance by the listed companies and can impose penalties on the defaulters. Section 621 of the Companies Act, 1956 empowers SEBI to file complaints for offences relating to issue and transfer of securities and non-payment of dividend.

*Breach Of Clause 49 Of The Listing Agreement* - Working towards the best interests of shareholders through adequate and timely disclosures of financial situation, performance, ownership and governance of the company forms the very basis of corporate governance.<sup>25</sup> Clause 49 of the Listing agreement secures healthy corporate governance by companies. Clause 49 specifies the requirement as to the independence of directors . Such directors have a responsibility with respect to any of the decisions to be taken by the Board with respect to the Company matters. It is questionable whether today Indian Corporate Houses having family run businesses actually have independent directors in the true sense of the word. The role of independent directors and their scope of responsibilities have come under the scanner following the Satyam episode. One needs to reflect and deliberate on criterion for the qualification of the Independent Directors. Is it just independence that is the qualification or is independence and the capacity to understand the business that is required, when a company appoints independent directors on

Organization for Economic Co-operation and Development, (April 1999)  
Clause 49 (I A)(i) of the Listing Agreement.

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the Board?" Shareholders in such cases can exercise their rights by voting to remove the Directors from their office as per the Company Law provisions(Section 284 of the Companies Act, 1956) or can complain to SEBI for non compliance by the company with Clause 49 of the Listing Agreement.

*Related Party Transaction* - Related party transaction refers to a transfer of resources or obligations between related parties regardless of whether or not a price is charged. Such transactions require a high degree of disclosures, because conflict of interest can affect the ability of the decision maker to function objectively and effectively. Today principles of corporate governance are generally avoided by following them on paper but not adhering to them in the true spirit. Undue Enrichment of the promoters, directors and other officials by involvement in related party transactions smacks of abuse of the position of authority and amounts to breach of the principles of corporate governance. Shareholders can actively pursue deals undertaken by the Company and can revoke such deals to protect the best interests of the company

"interview with Rajeev Chandrashekhar , Nasscom FICCI call for revamp of corporate governance norms, MoneyControl, January 7, 2009, <http://www.moneycontrol.com/india/news/business/nasscom-ficci-call-for-revampcorp-governance-norms-/375191>, < visited on 10<sup>th</sup> March,2009>

Related party - parties are considered to be related if at anytime during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

Accounting Standard 18, [http://www.mca.gov.in/MinistryWebsite/dca/notification/pdf/AS\\_18.pdf](http://www.mca.gov.in/MinistryWebsite/dca/notification/pdf/AS_18.pdf), <Last visited on 10<sup>th</sup> March,2009>

<sup>29</sup> Accounting Standard 18, [http://www.mca.gov.in/MinistryWebsite/dca/notification/pdf/AS\\_J8.pdf](http://www.mca.gov.in/MinistryWebsite/dca/notification/pdf/AS_J8.pdf), Last visited on 9<sup>th</sup> March,2009<sup>0</sup> Clause 49 (IV A) of The Listing Agreement

*Insider Trading And Fraudulent & Unfair Trade Practices* - Price manipulation refers to artificially raising or depressing the prices of securities and thereby inducing the sale or purchase of securities by other investors. SEBI, through SEBI (Prohibition of Insider Trading) Regulations, 2002 and SEBI (Fraudulent and Unfair Trade Practices relating to Securities Market) Regulation, 2003 has targeted companies who engage in price manipulation to increase the market price of their shares. Shareholders in cases, where the acts of the companies in a premeditated manner creates a false or misleading appearance of trading on the securities market, when the company issues misleading advertisements or news that influence the decision of investors or induce the sale or purchase of securities etc.; then in such cases shareholders have the right to approach SEBI and get the company prosecuted for its deceptive activities. Contraventions by companies amounting to fraudulent and unfair trade practices attracts penalties extending from cancellation/suspension of registration of intermediary, impounding and retaining the proceeds or securities, suspending trading in the Company's shares etc. SEBI is further empowered to restrain persons from accessing the securities market and prohibit any person to deal in securities; suspend any office bearer of any stock exchange or self-regulatory organization from holding such position; and also to impound and retain the proceeds or securities in respect of any transaction which violates regulations.

<sup>31</sup> Regulation 4(b) of the SEBI (Fraudulent and Unfair Trade Practices relating to Securities Market) Regulation, 2003

### C. Application to Stock Exchanges

A Public Company whose securities are listed at a Stock Exchange has to previously enter into an agreement with the Stock Exchange called the Listing Agreement, under which they are required to make certain disclosures and perform certain acts, failing which the company may face some disciplinary action, including suspension/delisting of securities. The Listing Department of the Stock Exchange monitors the compliance of the companies with the provisions of the Listing Agreement, especially with regard to submission of periodical financial results, requirement of minimum number of shareholders etc. and takes action in case of any default. Shareholders in case of any objections against the company, non compliance by the company, have the right to approach the Investor Grievance Cell of the Stock Exchanges (BSE, NSE). Stock exchanges have the power to take *suo moto* cognizance of any non compliance of their norms by a Listed Company and take appropriate steps against the company.

### D. Provisions under the Indian Penal Code

*Criminal Breach Of Trust* - Section 405 deals with criminal breach of trust. It is the dishonest misappropriation of another's property or conversion of the property; to one's own use by a person to whom it has been entrusted, or into whose hands it has lawfully come. Directors are in a

*Section 405 of the Indian Penal Code, 1860* : Whoever, being in any manner entrusted with property, or with any dominion over property, dishonestly misappropriates or converts to his own use that property, or dishonestly uses or disposes of that property in violation of any direction of law prescribing the mode in which such trust is to be discharged, or of any legal contract, express or implied, which he has made touching the discharge of such trust, or wilfully suffers any other person so to do, commits 'criminal breach of trust'

fiduciary relationship with the shareholders. Any dealing with the company's property in a manner prejudicial to the interests of the shareholders, will amount to dishonest use of that property. A Director of a company is not only an agent but is also in the position of a trustee and being a trustee of the assets, which has come into his hand, he has dominion and control over the property of the company.<sup>33</sup> A director must use the company's assets entrusted to him for the company's purpose and interest. For any dishonest misappropriation of the company's property, regardless of whether or not he has personally benefited from it, he can be prosecuted by the shareholders under Section 409 of IPC. The Directors can be imprisoned for a term extending to three years with or without fine.

*Cheating* - Shareholders can bring the Directors to Court for cheating under Section 415 and 418. Cheating in relation to directors includes within its purview dishonest concealment of facts, or for intentional inducement to do something which a shareholder wouldn't have done in other circumstances (For Example the Directors of the company cooked up the balance sheet which they knew to be materially false and like to mislead the public as to the condition of the company and which induces an investor to buy the shares of the company<sup>34</sup>) The Directors can be imprisoned for a term extending to three years with or without fine.

*Criminal Conspiracy* - Directors can also be held criminally liable on the charge of criminal conspiracy on a complaint by the shareholders. The ingredients of Section 120A are that there must exist an agreement between

<sup>33</sup> *Dale & Carrington P. Ltd. v. P.K. Prathapan* (2004) 4 Comp. LJ 1 (SC)

<sup>34</sup> Ratanlal and Dhirajlal, *The Indian Penal Code*, (Wadhwa and Company, Nagpur, 31<sup>st</sup> Edition, 2006) p. 2255

persons alleged of conspiring and the agreement should be for doing an illegal act or for doing by illegal means an act which may not be illegal. Direct or circumstantial evidence to show that there was an agreement between two or more persons is essential. As Criminal conspiracy is considered an extremely serious offence it is punishable with death, imprisonment for life or rigorous imprisonment for two years or more.

*Falsification of Accounts(Section 477A of the Indian Penal Code, 1860):-*Investors can bring to book the Officers or clerks who engage in destruction, alteration, mutilation falsification of an book, electronic record, paper, writing, security, accounts with an intention to defraud under Section 477-A. As per this section, it is mandatory that the person charged has undertaken to perform and performs the duties of clerk, officer or servant regardless of whether he is a servant or clerk or officer. Deprivation of property is not an essential, but mere falsification with intent to expose some person to actual or risk of probable injury is sufficient to render the officer or clerk or servant criminally liable.<sup>35</sup> Under S. 477A of the IPC, a person may be imprisoned for maximum of 7 years' and/ or be asked to pay fine and is non- bailable.

#### *E. Action by Overseas Shareholders*

*Class Action by the ADR Holders* -A class action lawsuit is filed on behalf of a group of people who have been in some way injured by the actions of a company. Class action treatment is superior to the alternatives, if any, for

the fair and efficient adjudication of the controversy alleged herein. Such treatment permits a large number of similarly situated persons to prosecute their common claims in a single forum simultaneously, efficiently, and without the duplication of effort and expense that numerous individual actions would engender. For instance, following the confession by the Satyam founder and chairman B Ramalinga Raju's to a Rs 7,000 crore fraud in the company, the ADR holders reacted strongly to the entire episode; and filed two class action suits in United States District Courts against Satyam as per the provisions of the Securities Exchange Act, 1934. ADR/GDR holders can also bring criminal proceedings and civil shareholder lawsuits in their respective countries.

## II. Suggestions

Regardless, of the quality of our laws, the real test of the laws lies in its enforceability. Reduction in time, red tape-ism in adjudicating the case and the promptness in execution of the award would go a long way in boosting investor confidence to make use of the various avenues available. The following suggestions may be incorporated in so as to ensure that the system is strengthened :-

1. As shares and securities are by law defined as "goods" under the Consumer Protection Act, 1986, legal redressal of investor grievances should be encouraged to approach the Consumer courts under the Consumer Protection Act. To enable shareholders to take full advantage of the provisions of the Consumer Protection Act, the extent to which the jurisdiction of the Consumer Courts will apply would have to be specified