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LIABILITY OF COMPANY AND INTERMEDIARIES IN RELATION TO ISSUE OF SECURITIES - A COMPARATIVE PERSPECTIVE

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EDITOR'S NOTE

In an era of globalization and the proliferation of corporations around the world, there is no doubt that corporate affairs and corporate crimes has become an increasingly dynamic field. In such a scenario, the importance of academic debate on issues related to corporate law does not need to be elaborated. The Journal of Corporate Affairs and Corporate Crimes was founded with the aim of making a lasting contribution to corporate law scholarship and remedying the lack of authoritative writings on the same.

The Journal is a motley of articles on contemporary issues in the area by students and practioners alike. In the first article, *Trading Plans: A Shield Against Insider Trading Charges*, Mr Akash Chobey, Partner at Khaitan & Co., along with Mr Rohan Singh, Associate at Khaitan & Co. have provided an analysis of trading plans in India, specifically, the option to persons perpetually in possession of UPSI to trade in securities in a manner which is in compliance with the applicable law. The next article, *Reconstruction of Sick Industries over Recovery of Debt*, analyses the implications of the judgment rendered in *KSL Industries v. Arihant Threads Ltd,* in the Indian banking scenario. The third, *Corporate Criminal Liability and Securities Offerings,* also a case comment, deals with the decision of the Supreme Court in *Iridium v. Motorola,* and analyses the reasons as well as the justifications for corporate criminal liability. The legal framework of leveraged buyouts in India and the UK has been discussed in *Leveraged Buy Outs: Utility and Legal Issues- A comparison between the Position in India and UK*. The article also explains the characteristics of a typical leveraged buyout and

enumerates the advantages as well as the risks of opting for a leveraged finance structure. The detailed regulations on the procedure that must be followed in the issuance of securities in the UK and in India, as well as the sanctions imposed for violation of these regulations has been analysed in the next article, *Liability of Companies and Intermediaries in Relation to Issue of Securities*. And finally, *SEBI on Track- An Analysis of the SEBI (Research Analyst) Regulations, 2014*, provides the reader with a comprehensive deconstruction of the new regulations as well as the lacunae which remains in the legal framework in terms of implementation of the same.

This Journal would not have been possible without the patronage and aid of Prof. Faizan Mustafa and Mr Rohit Tandon, as well as T & T Law Associates, New Delhi, and Prof. K.V.S. Sarma, to whom the Board of Editors extends its heartfelt gratitude.

PATRON'S ADDRESS

It gives me great pleasure to present the third volume of the Journal of Corporate Affairs and Corporate Crimes, a publication conceived by the students of NALSAR, University of Law in collaboration with T & T Law Associates, New Delhi. The journal, an initiative of the students of NALSAR, aims to bring the fore important developments in the field of corporate law and laws on corporate criminal liability. It seeks to fill the lacuna created in the field of corporate law due to the lack of a student run forum to specifically address issues on the subject matter, inspite of its vast diversity and potential. The first two volumes of the journal, published in 2011 and 2014, made a bold attempt towards this end, providing a platform to law students and practioners alike to discuss to air their views on concerns which were much in vogue including the 2010 TRAC recommendations, transnational corporations and their relationship with international law, shareholder agreements, piercing the corporate veil, independent directors and the like. The third edition, I am proud to say, promises to do the same, under the capable guidance of our patrons and our esteemed advisory panel that boasts of the best in this field.

The Journal is the only student run journal in India that is exclusively dedicated to corporate affairs and corporate crimes. It strives to achieve glorious heights in its contribution to the jurisprudence of corporate affairs and corporate crimes in an era marred with the overhaul of the Companies Act 1956.

I have no doubt that the third volume of the Journal, which includes contributions from students and scholars in India, covering a wide range of issues, will prove invaluable to academia and the profession alike. I wish the Journal and the Board of Editors success in their endeavours and hope that they will keep up the good work. On behalf of the students and faculty of NALSAR, I wish to express my sincere gratitude to Mr. Rohit Tandon, founder and Managing Partner of T & T Law Associates for wholeheartedly supporting this student initiative.

PROF. (DR) FAIZAN MUSTAFA
VICE CHANCELLOR
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TRADING PLANS – A NEW SHIELD AGAINST INSIDER TRADING CHARGES

-Aakash Choubey[*] and Rohan Singh[#]

The regulation of insider trading has shot into prominence in the past few years as a result the prosecutions and subsequent convictions of Raj Rajaratnam and Rajat Gupta on charges including securities fraud, conspiracy and insider trading. The primary objective of framing laws prohibiting insider trading is to protect public investors from price manipulations and securities market distortions which result from persons trading on the basis of, or with the knowledge of, unpublished price sensitive information ("**UPSI**").

Given the difficulty in tracking down the accused in insider trading investigations, insider trading norms typically attribute liability to persons who possess, or are in a position to acquire UPSI. In the event that a particular trade or series of trades are investigated by securities market regulators, the general presumption is that insiders are liable for violations of insider trading norms, unless they can establish a recognised or prescribed affirmative defence. Recent instances of regulatory action include the Securities and Exchange Board of India ("**SEBI**") prohibiting Factorial Master Fund from dealing in securities and/ or accessing the Indian securities market, pending investigation,[1] based on a *prima facie* finding that it had

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Associate, Khaitan & Co.

1 For further details, please see the SEBI order (WTM/RKA/ISD/ 56/ 2014) dated 5 June 2014 under sections 11(1), 11(4) and 11B of the Securities and Exchange Board of India Act, 1992 in respect of Factorial Master Fund in the matter of L&T Finance Holdings Limited.

traded while possessing UPSI;[2] and the Securities Appellate Tribunal ("**SAT**") upholding the decision of SEBI pursuant to which VK Kaul, a former non-executive independent director of Ranbaxy Laboratories, and his wife were penalized where VK Kaul had traded on behalf of his wife in the shares of Orchid Chemicals and Pharmaceuticals Ltd ("**Orchid**") with the knowledge of proposed substantial investments in Orchid by Solrex Pharmaceuticals Ltd (for which funds were arranged by Ranbaxy Laboratories Ltd).

Insider trading is regulated in India by SEBI pursuant to sections 12A(e) and 15G of the Securities and Exchange Board of India Act, 1992 and the SEBI (Prohibition of Insider Trading) Regulations, 2015 ("**PITS Regulations**"). The PITS Regulations prohibit an insider from trading[3] in securities which are either listed, or proposed to be listed on stock exchanges when such insider possesses UPSI.[4] Notwithstanding this general prohibition, certain circumstances are recognised where an insider may be able to set up a defence against insider trading allegations. Where the insider is not an

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[2] In its order, SEBI had noted that a message stating 'likely to come in at a steep discount about 70 types' was circulated amongst the equity team of CS several hours before the formal announcement of the offer for sale ("**OFS**") and floor price, although however, the communication channel of such UPSI was untraceable at later stages due to the involvement of several stakeholders. Subsequently, there were media reports that SEBI had initiated investigation of the Indian arm of the Credit Suisse Group, which had been mandated by L&T to launch the OFS, and which had discussions with over 70 institutional investors (including Factorial) in order to gauge potential investor interest and prospective subscription price for the OFS.

[3] The definition of 'trading' has been broadly defined pursuant to the legislative mandate under sections 12A(e) and 15G of the Securities and Exchange Board of India Act, 1992. Accordingly, 'trading' is defined to include (but not remain limited to) subscribing, buying, selling, dealing (or agreeing to do any of these).

[4] Regulation 4(1) of the PITS Regulations.

individual, there are two circumstances which may be pleaded as defences. The first situation is where, in an organisation that has individuals who possess UPSI, the trading decisions were taken by individuals who neither possessed UPSI nor were in a position to obtain UPSI.[5] The second situation is where 'appropriate and adequate' arrangements are in place to ensure that the PITS Regulations are not violated, and individuals possessing UPSI do not communicate such UPSI to individuals taking trading decisions. Apart from these defences, the PITS Regulations provide that an insider may defend itself from an insider trading allegation if the relevant trades were executed pursuant to a trading plan approved, disclosed and set up in accordance with Regulation 5 of the PITS Regulations.

[A] TRADING PLANS IN INDIA

The concept of trading plans was developed in order to provide a transparent framework for insiders who are constantly in possession of UPSI to trade in securities throughout the year. Accordingly, an insider can proceed with a trade in securities specified in a trading plan, even when, at the time of the relevant trade, the insider is in possession of UPSI. The SEBI (Prohibition of Insider Trading) Regulations, 1992 did not provide an option to persons perpetually in possession of UPSI to trade in securities in a manner which was in compliance with applicable law. This option is now available under the PITS Regulations. Pursuant to Regulation 5 of the PITS Regulations, an insider is entitled to formulate a trading

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[5] An example of this a situation where a person may obtain UPSI is where such person is in the reporting line, or is a superior or subordinate of persons in possession of UPSI.

plan according to which trades may be carried on behalf of the insider. Any such trading plan should be approved by the 'compliance officer' (defined under the PITS Regulations) and disclosed to the public ("**Reg 5 Plan**"). At the time of approving a Reg 5 Plan, the person for whom the trading plan is created may need to provide additional undertakings as stipulated by the compliance officer.

The content of Reg 5 Plans and the ability to trade under a Reg 5 Plan are regulated under the PITS Regulations. Regulation 5 prescribes certain guidelines in relation to the execution and implementation of Reg 5 Plans which are briefly summarised below.

GUIDELINE FOR REG 5 PLAN	RATIONALE
Mere existence of a Reg 5 Plan does not provide immunity from market abuse proceedings[6]	Trading pursuant to a Reg 5 Plan should not lead to market abuse
Multiple, overlapping Reg 5 Plans are prohibited	Eliminates the possibility of an insider timing the publication of UPSI to allow them to execute particular trades
Mandatory duration of 12 months	Ensures the existence of a reasonable time period between the decision and the action to trade

[6] These are prohibited pursuant to Regulations 3 and 4 of the SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Markets) Regulations, 2003.

Either the value of proposed trades or the number of securities to be traded and the nature of the trade and the intervals/ dates on which such trades are effected	Details prescribed are required to be adhered to when trades are executed in the future
No trading is permitted before the expiry of 6 months from public disclosure of the Reg 5 Plan	Ensures a statutory cool-off period after the adoption of the Reg 5 Plan
Trading is prohibited between the 20th trading day prior to the last day of any financial period for which results are required to be announced by the issuer of securities and the 2nd trading day after the disclosure of such financial results	Prescribed to prevent situations in which UPSI would be generated, and used for trading

[B] RULE 10B5-1 PLANS

Section 10(b) and Rule 10b5 of the (United States of America (“**US**”)) Securities Exchange Act, 1934 (“**SEC Act**”) prohibits the sale or purchase of any security based on material non-public information (“**MNPI**”). The (US) Insider Trading and Securities Fraud Enforcement Act, 1988 provides for the liability of employers if they fail to prevent an insider trading violation (for example, failure to maintain an insider trading prevention policy). The (US) Securities Exchange Commission (“**SEC**”) adopted Rule 10b5-1 in August

2000, recording the SEC's position that the key factor in establishing liability in insider trading prosecutions is 'possession' and not 'use' of MNPI.[7] Rule 10b5-1 provides that a purchase or sale will constitute 'trading on the basis of MNPI' where the person trading was aware of MNPI at the time the trade was undertaken.

Pursuant to Rule 10b5-1, directors, officers and other insiders may take the defence that trades being investigated were made pursuant to a pre-existing, written trading plan ("**10b5-1 Plan**"). Accordingly, a person may have an affirmative defence if it can be established that his/her 10b5-1 Plan was set up in good faith and such person was unaware of the MNPI at a point of time in which 10b5-1 Plan was set up. In addition to the good faith and lack of MNPI requirements, a 10b5-1 Plan should specify the number and price of the securities to be traded and the date of the trade (or alternatively, a formula/ algorithm or computer programme for determining these amounts) and the person who trades under a 10b5-1 Plan should not be able to exercise any subsequent influence on how, when or whether to make trades.

There have been instances reported in the public domain in 2012 where executives of American public companies received above-market returns on securities traded pursuant to 10b5-1 Plans before major company announcements.[8] At the time, it was reported

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7 For further details, please see: https://www.sec.gov/rules/final/33-7881.htm.

8 Jean Eaglesham and Rob Barry, 'Trading Plans under Fire', 12 December 2012, The Wall Street Journal, available at: http://www.wsj.com/articles/SB10001424127887324296604578177734024394950.

that the US SEC and federal prosecutors had initiated investigations into such trades.[9] Given these regulatory investigations, the mere existence of a 10b5-1 Plan is not a safe harbour, and accordingly does not ensure immunity from regulatory action. However, proper implementation of 10b5-1 Plans in accordance with Rule 10b5-1 and market best practices would be a defence in such investigations.

Moreover, certain practices have been adopted by companies, as a matter of market practice, in order to self-regulate the use of 10b5-1 Plans. These standards include restricting the adoption of 10b5-1 Plans only during open window periods of companies and following earnings announcement, voluntary no-trade period extending up to 3 months from the date of execution of the 10b5-1 Plan[10], pre-clearance in accordance with a company's insider trading policy, refraining from adoption multiple 10b5-1 Plans simultaneously and avoiding multiple changes to existing 10b5-1 Plans.

[C] COMPARING REG 5 PLANS AND 10B5-1 PLANS

While 10b5-1 Plans and Reg 5 Plans are conceptually similar, there are certain differences in terms of how they are regulated. These are briefly summarised below

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9 Skadden Securities and Regulation and Compliance Alert – Getting Back to Basics with Rule 10b5-1 Trading Plans, p 1, available at: http://www.skadden.com/insights/getting-back-basics-rule-10b5-1-trading-plans.

10 WSGR Insight & Analysis (March 2013) – Rule 10b5-1 Trading Plans: Considerations in Light of Increased Scrutiny, pp 1-2, available at: https://www.wsgr.com/PDFSearch/Rule-10b5-1-trading-plans.pdf.

NO	PARAMETER	REG 5 PLAN	10b5-1 PLAN
	Public disclosure	Required	Not required, but best practice is to voluntarily disclose from a reputation protection standpoint
	Modification	Should be implemented as approved by compliance officer No modification permitted No deviation or execution of trades outside the scope of such Reg 5 Plan are permitted	Modification is permitted, but best practice is not to make too many changes
	Multiple, overlapping trading plans	Prohibited	Not prohibited, but best practice is to avoid overlapping 10b5-1 Plans relating to the same type of securities
	Duration flexibility	Must be for a minimum of 12 months	Can range from 6 to 24 months
	Termination	Cannot be terminated by the insider, it is irrevocable	Can be terminated by insider

[D] CONCLUSION

The introduction of Reg 5 Plans under the PITS Regulations is a progressive move by SEBI as it addresses a realistic concern in terms of trading by persons regularly in possession of UPSI, and allows flexibility in terms of allowing such insiders a route to invest in a compliant manner. The persons who may now be able to gain the benefit of formulating and trading in accordance with Reg 5 Plans include executives of companies (who are typically in a position to obtain UPSI), employees of investment/ legal advisors advising on transactions directly or indirectly involving listed companies on a regular basis and employees of investment entities which regularly undertake transactions directly or indirectly involving listed companies.

Notwithstanding the flexibility introduced by recognising Reg 5 Plans, there are complications in being able to trade once a Reg 5 Plan is put into place. For example, there are 'no trade' periods and prescribed minimum durations for Reg 5 Plans, which reduce the flexibility in trading in securities. Further, a Reg 5 Plan cannot be implemented if an insider possesses UPSI at the time of formulating a Reg 5 Plan, and such UPSI has not been become generally available information to the public by that time.[11] Nonetheless, keeping in mind the object of introducing Reg 5 Plans, the introduction of Reg 5 Plans under the PITS Regulations appears to be a step in the right direction. Given the above, trading plans has been relatively unused by investor groups.

[11] Proviso to Regulation 5(4) of the PITS Regulations.

While both Reg 5 Plans and 10b5-1 Plans affirmative defences available to insiders, they are not safe harbours, and accordingly, automatic exemptions from insider trading allegations. Further, given the recent introduction of Reg 5 Plans, their use as affirmative defences in India remains untested. That being said, reference may be had to the widespread use of 10b5-1 Plans in the USA as an indication of the implementation, regulation and regulatory investigation of trades executed pursuant to a Reg 5 Plan.

Finally, given the prescriptions under Regulation 5 of the PITS Regulations, a Reg 5 Plan should be carefully drafted to address commercial needs and remain within legal boundaries. The Indian regulatory landscape with respect to trading plans will develop as a greater number of persons adopt and implement Reg 5 Plans, and it will be interesting to observe regulatory action in relation to trades made pursuant to Reg 5 Plans.

RECONSTRUCTION OF SICK INDUSTRIES OVER RECOVERY OF DEBT: AN ANALYSIS OF *KSL INDUSTRIES V ARIHANT THREADS LTD & ORS*

Deekshitha Srikant[*]

In October 2014, the Supreme Court, by means of its judgment in KSL Industries v Arihant Threads Ltd & Ors, shed clarity on the hitherto contentious and delicate liaison between two special legislations, the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 and the Sick Industrial Companies (Special Provisions) Act, 1985. This comment seeks to study the repercussions of this judgment both in the context of the decision by Indian banks to lend against collateral as well as the wider impact of the judgment on the statutory interpretation involved in the consideration of two special enactments. The comment concludes by applauding the decision in the milieu of statutory interpretation, but seeks to highlight the unsolicited ripples it creates in the banking sector.

The judgment in *KSL Industries v Arihant Threads Ltd & Ors*[1] (hereinafter referred to as 'KSL Industries case') came at a time when the restructuring of corporate bonds was becoming an option increasingly exercised by banks, post the tremors felt by the banking sector largely due to the global meltdown, coupled with factors such as a gradual domestic standstill and reckless lending in the past.[2] Coupled with this factual framework, the decision also came in the wake of increased confusion on the question on the interpretive

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[1] 2014 SCC OnLine SC 846.

[2] Nilesh Sharma and Sandeep Kumar Gupta, *Chapter 13: India* in CHRISTOPHER MALLON ED., THE RESTRUCTURING REVIEW 164 (6th ed., Law Business Research Ltd.).

interplay between two legislations: the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (hereinafter 'RDDB Act') and the Sick Industrial Companies (Special Provisions) Act, 1985 (hereinafter 'SICA'), both enacted for specific purposes. Although the bearing of the *KSL Industries* case in these two contexts are to be viewed in their own separate realms, it is imperative to recognize the differential impacts this judgment has on these two planes and understand the decision in light of its repercussions on the banking sector as well as in the broader framework of statutory interpretation.

Part I of this paper, therefore, delineates the factual matrix that the decision was rendered in. Part II briefly lays down the main points of contention in the judgment vis-à-vis the previous judgment by the smaller, two-judge bench of the Supreme Court. Part III briefly examines the merits of the judgment in the realm of statutory interpretation, while Part IV studies the impact of the judgment on the decisions of the banking sector in the wake of increased debt restructuring (dubbed the 'narrower impact'). By weighing the pros and cons of both aspects of the judgment and applauding it in the wider context through the course of comment, the author simultaneously attempts to highlight the issues it creates in the narrower context.

[A] FACTUAL MATRIX AND PROCEDURAL HISTORY

The case revolves around KSL Industries ('the Company') entering a lease in order to set up a cotton yarn spinning unit for the purposes of export in Punjab. The lease for the premises, which was for a period of 99 years, was entered into on the condition that the

Company would not transfer any interest in the property without obtaining the prior permission of the lessor for the first fifteen years. However, the Company was permitted to transfer its leasehold rights to a bank as security to obtain a loan. Subsequently, the Company obtained a foreign currency loan from the Industrial Development Bank of India ('IDBI') to finance its project.

The Company, however, failed to repay the loan and IDBI initiated legal action against it under the RDDB Act in the Debt Recovery Tribunal, Chandigarh ('DRT'). The DRT passed an *ex parte* order directing the Company to discharge its debt, failing which IDBI could proceed against the mortgaged property. While tussles took place as to the valuation of the Company's property and the appellant was declared the highest bidder in the auction process, the Company appealed against the ex parte order under Section 30 of the RDDB Act.[3] The auction was set aside by the DRT in Delhi on the ground of improper valuation of the property, subject to the fulfillment of certain conditions, aggrieved by which the both parties approached the Debt Recovery Appellate Tribunal, Delhi ('DRAT').

The DRAT confirmed the sale in favour of the Appellant, but before the sale formalities could conclude the Company invoked the SICA and filed for a reference before the Board of Industrial Finance

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[3] Section 30 allows for appeals from the order of a Recovery Officer to a Tribunal within 30 days of issue, after which a Tribunal may modify the order as it deems fit in accordance with its powers under Sections 25 to 28 (both inclusive). *See*, The Recovery of Debts due to Banks and Financial Institutions Act, 1993 (51 of 1993), §30.

& Reconstruction,[4] and subsequently filed two Writ Petitions before the Delhi High Court on the maintainability of the suit in lieu of the prohibition in Section 22 of the SICA. The case moved to the Supreme Court on appeal, where it was first heard and decided by a two-judge bench and then referred to a three-judge bench.

[B] JUDGEMENT

The two-judge bench comprising of Thakker J. and Kabir J. took divergent stances on the issue of the interplay between the RDDB Act and the SICA. Thakker J. was of the opinion that the provisions of the RDDB Act took precedence over the SICA for the simple reason that the RDDB Act was a later enactment, as even in the absence of a specific provision stating its overriding effect, the Parliament was aware of the existence of earlier legislations. Kabir J., on the other hand, was of the view that the Section 34(2) carved out an exception to clause (1), effectively meaning that the RDDB act is supplemental to (but does not override) the SICA. The provisions of the SICA would, therefore, prevail.[5]

Upon reference to the three-judge bench comprising of Dattu J., Bobde J., and Sapre J., the Supreme Court enumerated the following findings:

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4 The Board of Industrial Finance and Reconstruction is a statutory body created under the SICA in order to facilitate the revival and rehabilitation of sick industrial companies. Its powers range from declaring a company to be 'sick' to sanctioning schemes of amalgamations or takeovers between a sick industrial company and other companies. The Board is constituted under Section 4, and comprises of a Chairman and other members ranging from two to fourteen in number, whom the Central Government shall appoint. *See*, Sick Industrial Companies (Special Provisions) Act, 1986 (1 of 1986), §4

5 *KSL Industries case, supra* n. 1

1. When interpreting two 'special' legislations, both of which in this case contained non-obstante clauses, the test to be utilized is determination of the purpose of both legislations and realizing the same. Part III will analyze this aspect of the judgment in detail.
2. Utilizing the above test in the interplay between Section 22 of the SICA and Section 34 of the RDDB Act, the former prevails over the latter. Part IV of this paper will scrutinize the same.

[C] WIDER IMPACT: INTERPRETIVE BREAKTHROUGH

In the *KSL Industries* case, the Court was faced with the unique quandary of resolving a clash of two equally applicable rules of interpretation in resolving which of the two special legislations took precedence over the other. On one hand, the well-settled principle of construction that a statute that was enacted later in time would override an earlier statute applied. In *Maharashtra Tubes Ltd v State Industrial and Investment Corporation of India*,[6] for example, the Court was faced with an inconsistency between the Financial Corporation Act, 1951 and the SICA. Both legislations were special laws and contained non-obstante clauses, but Ahmadi J. ruled that the non-obstante clause in the SICA had an overriding effect as it was a later enactment.[7] The Calcutta High Court later utilized the same principle in the inconsistency between certain parts of the Companies

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[6] (1993) 2 SCC 144; *See*, SRIVASTAV (REV.), SRIVASTAVA'S SECURITISATION & DEBT RECOVERY LAWS 656 (6th ed. 2009) .

[7] *See*, SRIVASTAV (REV.), SRIVASTAVA'S SECURITISATION & DEBT RECOVERY LAWS 656 (6th ed. 2009).

Act, 1956 (namely, Sections 442, 446 and 537) and Section 34 of the RDDB Act, and ruled that since the latter was a later enactment, it took precedence over the former.[8] However, in the context of a possible conflict between Sections 433 and 434 of the Companies Act, 1956 and Section 34 of the RDDB Act, the Court observed that the two legislations were not inconsistent with each other, as the former Sections are not solely for the recovery of debts, and are beneficial to the public at large. The two statutes, therefore, co-exist comfortably.[9] Both statutes can be considered to be special legislations, but the existence of a clause conferring an overriding effect on the RDDB Act (Section 34) settles the issue of a collision between the two.

The doctrine of of *generalia specialibus non derogant*[10] therefore applied on the other hand. The Court in *LIC v D.J Bahadur,*[11] for example, had utilized in the context of determining the 'special law' between the Industrial Disputes Act, 1947[12] and the Life Insurance Corporation Act, 1956.[13] The Court observed that the determination of whether a statute was general or specific is particular to the context; an LIC employee could not invoke the Industrial Disputes Act, as the LIC Act was special law in the context of nationalization of life insurance while the former was special law in

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8 Allahabad Bank v Canara Bank AIR 2000 SC 1535.

9 Bank of Nova Scotia v RPG Transmission Ltd 2006 133 CompCas 172 Delhi; *See*, SRIVASTAV (REV.), SRIVASTAVA'S SECURITISATION & DEBT RECOVERY LAWS (6th ed 2009) at 654.

10 That special provisions are to override general provisions.

11 (1981) 1 SCC 315.

12 Hereinafter referred to as the "ID Act".

13 Hereinafter referred to as the "LIC Act".

the context of resolution of disputes between employer and employee.[14]

In resolving this conflict of applicability of the above two rules of interpretation in determining the more 'special' statute, the Court in *KSL Industries* undertook a purposive interpretation of both statutes. Recognizing that the intent behind both statutes were different (SICA focused on reconstruction of sick companies, while the RDDB Act on speedy recovery of debt, as discussed in **Part X)**, the Court pointed out that the question of which statute was 'special' depended entirely on the context of the situation in light of the object of the statute, following the ratio laid down in the *LIC v D.J Bahadur* case. In this particular case, SICA was the more special legislation in the context of reconstruction of sick industrial companies, although it would be the more general legislation in the context of debt recovery.

The Court, therefore, utilized this purposive test to resolve the interpretive dilemma, as the contrary interpretation would result in an anomalous result where a creditors can file applications for recovery against sick industrial companies but execution against the property of such company is barred under Section 22.

[D] NARROWER IMPACT: EFFECT ON BANKING SECTOR

The tussle, therefore, essentially involved prioritizing between debt recovery and rehabilitation of sick companies, and transcends the interplay between Section 22 of the SICA and Section 34 of the RDDB Act and the interpretive predicament they pose. In India, secured and unsecured creditors can file a suit under the Code of Civil

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[14] *Supra* n. 11.

Procedure, 1908 for recovery, whereas creditors who are banks or financial institutions have the added options of filing an application under the RDDB Act for recovery through the Debt Recovery Tribunal (provided their claim amount exceeds INR 100,000). Further, secured creditors such as banks, financial institutions and asset reconstruction companies can also recover debts by taking over the assets or management of the debtor company without court intervention through the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.[15] If the tussle is indeed between debt recovery and reconstruction, the effects of this judgment are far more widespread in the narrower context of banking than in the sphere of interpretation.

Section 13 of SARFAESI empowers certain institutions to take possession of the debtor's assets without the intervention of any court or tribunal. The act was is to facilitated faster recovery of massive debts to financial institutions by securitization,[16] asset reconstruction[17] or exemption from registration of security receipt, to keep their non-financial assets from mounting in a country where default is the norm as opposed to the exception. It was enacted due to

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[15] Hereinafter referred to as 'SARFAESI'. *See generally*, Purti Marwaha and Varsha Banerjee, *Chapter 20: India* in THE INTERNATIONAL COMPARATIVE LEGAL GUIDE TO: CORPORATE RECOVERY & INSOLVENCY 2014 (8TH ED., GLOBAL LEGAL GROUP).

[16] Section 2(z) of the SARFAESI defines 'securitization' to mean acquisition of financial assets whether by raising of funds by such securitization company or reconstruction company from qualified institutional buyers by issue of security receipts representing undivided interest in such financial assets or otherwise.

[17] Section 2(b) of the SARFAESI defines 'asset reconstruction' to mean acquisition of a right or interest in any bank or financial institution for the purposes of realization of financial assistance.

recognition of the importance of liquidity and mobility of credit for keeping the economy afloat, and its constitutional validity was upheld in *Mardia Chemicals v Union of India*.[18] In fact, the Court earlier granted financial institutions the leeway to initiate action under both the SARFAESI and RDDB to recover their non-performing assets, by holding that both acts co-exist in *Transcore v Union of India.*[19] One of the primary arguments in the *KSL Industries* case was whether the scope of 'suit' or 'proceedings' under Section 22 of the SICA covered an application under the RDDB Act (which would entail an abatement of the said proceedings), to which the Court answered that Section 22 did not specifically cover applications as the RDDB Act was a later enactment. If the SICA is indeed 'special' in the context of reconstruction, could the same logic apply in a clash between the SICA and the SARFAESI, also a debt recovery law?

The Parliament, through Section 41 and 37 read with the Schedule of the SARFAESI Act, amended three acts including the SICA by the insertion of the third proviso to Section 15(1), and specified that where a reference is pending before the BIFR, the same shall abate if creditors representing three-fourths the value of the outstanding amount acted under Section 13(4) of the SARFAESI.[20] However, while this seems to put to rest any doubt, inconsistencies due to the existence of the phrase 'pending reference' – the Orissa

[18] AIR 2004 SC 2371.

[19] AIR 2007 SC 712.

[20] *See*, *Salem Textiles Limited v The Authorized Officer* Writ Petition No.26905 of 2011.

High Court in *Noble Aqua Pvt. Ltd vs. State Bank of India*[21] ruled that BIFR proceedings would abate as provided for by the proviso only where BIFR proceedings are pending at the stage of reference, and not where declaration of sickness had already taken place. This decision, however, has found no judicial support subsequently, as the Bombay High Court,[22] Gujarat High Court,[23] and Punjab and Haryana High Court[24] have all disagreed with the decision and held otherwise. In *Integrated Rubian Exports Ltd v Industrial Finance Corporation of India Ltd*, for example, the Kerala High Court found that the SARFAESI, as a later enactment, overrode the SICA.[25]

It is in light of this plethora of decisions that uphold the SARFAESI over the SICA that an anomaly arises when the *KSL Industries* case is considered. The logic used by the Kerala High Court is defeated upon the usage of the purposive test in *KSL Industries*, creating a situation where some debt recovery laws (i.e, the SARFAESI) take precedence over the SICA whereas others (the RDDB Act) do not, seriously hampering the already difficult process of debt recovery for banks. It is strange that recovery is allowed by a select class of creditors under SARFAESI only for secured interests without requiring BIFR permission, whereas claims under the RDDB

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[21] AIR 2008 Orissa 103.

[22] Nouveaw Exports Private Ltd v Appellate Authority for Industrial and Financial Reconstruction Company AIR 2010 Bom. 159.

[23] Paschim Petrochem Ltd vs. Authorised Officer, Kotak Mahindra Bank Ltd (2010) 51 GLR 1075.

[24] Nabha Industries Ltd vs. Punjab State Industrial Development Corporation (2010) 154 Comp. Cases 646 (P&H).

[25] AIR 2009 Ker. 76.

Act (which is wider in scope than secured interests)[26] require such permission, when (utilizing the purposive test used in *KSL Industries*) all three legislations are enacted for the primary purpose of reducing non-performing assets and enabling debt recovery.[27]

Indian banks have been facing a steep rise in their non-performing assets,[28] having resulted in the Finance Ministry to constitute a panel to address this in mid 2014,[29] and the RBI has raised alarms about the debt recovery process in India.[30] In addition to adversely affecting profitability, NPA's also affect a bank's liquidity as they reduce the funds available for a bank to recycle or lend.[31]

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[26] Vinod Kothari, *SARFAESI Act and woes of the 'abated'* Business Line (31 January 2011), available at http://www.thehindubusinessline.com/todays-paper/sarfaesi-act-and-woes-of-the-abated/article2327585.ece (last accessed 31 November 2014).

[27] *See generally*, Purti Marwaha and Varsha Banerjee, *Chapter 20: India* in THE INTERNATIONAL COMPARATIVE LEGAL GUIDE TO: CORPORATE RECOVERY & INSOLVENCY 2014 (8TH ED., GLOBAL LEGAL GROUP).

[28] Hereinafter referred to as 'NPA'. An asset becomes a 'non performing' asset when it ceases to generate income for the lender. *See*, RBI, Master Circular on Prudential Norms on Income Recognition, Asset Classification and Provisioning - Pertaining to Advances (30 August 2001) available at http://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?Id=449&Mode=0 (last accessed 28 November 2014).

[29] PTI, *Finance ministry sets up panel to give more teeth to debt recovery laws* Live Mint (30 July 2014) available at http://www.livemint.com/Politics/fMBl9FO7jNgtWAi28xQNyL/Finance-ministry-sets-up-panel-to-give-more-teeth-to-debt-re.html?utm_source=copy (last accessed 28 November 2014)

[30] Reuters, *RBI raises concerns about bank loans, debt recovery,* Reuters (21 November 2013) available at http://in.reuters.com/article/2013/11/21/india-rbi-banks-idINDEE9AK0B320131121 (last accessed 28 November 2014).

[31] Infosys Finacle, *Thought Paper on Non-Performing Assets: An Indian Perspective*, Infosys available at http://www.infosys.com/finacle/solutions/thought-papers/Documents/non-performing-assets-indian-perspective.pdf (last accessed 28 November 2013) .

One of the many prevalent reasons for the steep rise in NPA's, recognized by the Reserve Bank of India, is willful default by borrowers.[32] One of the consequences of such a reading between the SICA and the RDDB Act is that any defaulter could not apply to the BIFR for reconstruction and stay court proceedings, as Arihant attempted to, negatively impacting the country's recovery climate. Another cause was attributed to the complacency by banks on following up a loan due to the existence of collateral, and one of the consequences of such a reading entails a dent in the value of collateral to banks as defaulters can just ensure that a court junks the collateral on the basis of which the bank had initially extended the loan. Cumulatively, such a reading clearly points towards a future where banks will have to bear the burden of more bad loans.[33]

[E] CONCLUSION

The *KSL Industries* case shows us how the utilization of SICA even after the Eradi Committee report and the legislative shift to replace the BIFR with the National Company Law Tribunal can cause tremors in the already fragile sphere of debt recovery. The case also in a way emphasizes the importance that the BIFR retains in light of the decisions of *Union of India v R. Gandhi*,[34] since the path to the

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32 Shashidhar M. Lokare, *Re-emerging Stress in the Asset Quality of Indian Banks: Macro-Financial Linkages*, RBI (7 February 2014) available at http://rbi.org.in/scripts/PublicationsView.aspx?id=15720 (last accessed 30 November 2014).

33 B Jagannathan, *SC makes loan recovery tougher for banks, despite having valid collateral* Firstpost, (4 November 2014) available at http://firstbiz.firstpost.com/finance/sc-makes-loan-recovery-tougher-banks-despite-valid-collateral-107087.html (last accessed 30 November 2014).

34 2010 (5) SCALE 514.

creation of the National Company Law Tribunal replacing the BIFR is still far from clear. While its formulation of the purposive test to resolve the interpretive conflict may be applauded in the sphere of statutory interpretation, the consequences of the utilization of this test in the clash between debt recovery and reconstruction are many and varied, some of which could prove catastrophic for banks and financial institutions seeking to bring down their NPA's by efficient debt recovery.

CORPORATE CRIMINAL LIABILITY AND SECURITIES OFFERINGS: RATIONALIZING THE IRIDIUM-MOTOROLA CASE

-Roumita Dey[*]

"Corporate bodies are more corrupt and profligate than individuals, because they have more power to do mischief, and are less amenable to disgrace or punishment. They neither feel shame, remorse, gratitude nor goodwill".

– Hazlitt

Corporations today exist as an important actor in almost every sphere of individual's political and social activity. Across the globe, the position of law with respect to corporate criminal liability has been shrouded in speculation, inconsistency and controversy. The author proposes a theoretical justification by examining the different legal theories of corporate criminal liability for the wrongs committed by their employees. Moreover this paper seeks to explore the criminal liability of corporations in India, especially concerning itself with the recent decision of the Supreme Court in ***Iridium India Telecom v. Motorola Inc.*** *The object of this article is to analyze why the corporations are preferred as guilty and not the employees in case of corporate crime, to critically examine the theories of corporate crime, and to justify the reasons for corporate being held criminally liable. The conclusion summarizes the entire issue, briefly discussing the*

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consequences of the decision and putting forth suggestions for the future of the concept of corporate criminal liability.

[A] INTRODUCTION

A company, or corporation, enjoys a separate existence from its owners and from those who manage its day-to-day affairs. Although the separate legal personality of a company is a well-established concept, whether a company's wrongdoing can be subject to the sanction of criminal law has been a vexed question. While it is trite law that the individuals managing a company may be liable under criminal law for wrongful acts carried out by them, the thornier issue pertains to whether the acts of such managers can be attributed to the company (through its separate legal existence) thereby making it liable to the consequences of an offence under criminal law.

Iridium is arguably one of the most significant judgments of the Supreme Court on corporate criminal liability since the verdict of a bench of five Judges in *Standard Chartered v. Directorate of Enforcement*[1]. The Supreme Court in *Standard Chartered* had held that a company can be prosecuted for offences which are punishable with mandatory imprisonment[2]. In doing so, the Court overruled its previous decision in *Assistant Commissioner v. Velliappa Textiles Ltd*[3]., where it was held that a company cannot be prosecuted for an offence imposing mandatory imprisonment. In *Standard Chartered*,

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1 AIR 2005 SC 2622, (2005) 4 SCC 530 [hereinafter "*Standard Chartered*"].

2 The relevant legislation in that case, the Foreign Exchange Regulation Act, 1973, provided a sentence of imprisonment and fine to persons (including companies) who are convicted of an offence.

3 (2003) 11 SCC 405.

however, the Court left open the question of whether a company could be punished for crimes requiring *mens rea* (as opposed to statutory 'strict liability' offences)[4].

[B] IRIDIUM: FACTS AND DECISION

As per the factual matrix of the case, *Iridium India Limited* filed a criminal complaint against Motorola Inc. alleging offences under section 420 (cheating) read with section 120B (conspiracy) of the Indian Penal Code (IPC). The complaint alleged that Motorola Inc. had floated a Private Placement Memorandum (PPM) to obtain funds/investments to finance the 'Iridium project'. The project was represented as being "*… the world's first commercial system designed to provide global digital hand held telephone data ... and it was intended to be a wireless communication system through a constellation of 66 satellites in low orbit to provide digital service to mobile phones and other subscriber equipment locally*."[5] On the basis of the information contained in and representations made through the PPM, several financial institutions invested in the project. The criminal complaint alleged that the representations were false and that the project turned out to be commercially unviable resulting in significant loss to the investors.

Based on Iridium India's complaint, a judicial magistrate in Pune commenced criminal proceedings against Motorola. Aggrieved by this, Motorola filed a petition before the Bombay High Court

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[4] *See e.g.*, *Standard Chartered*, *supra* note 3, where Justice K.G. Balakrishnan, referring to the issue of *mens rea*, observed: "*we express no opinion on that issue*".

[5] *Iridium*, *supra* note 2, at 4.

under article 227 of the Constitution and section 482 of the Code of Criminal Procedure, 1973 (Cr.P.C.) to quash the proceedings against it. By way of an order dated August 8, 2003, the Bombay High Court quashed those proceedings[6]. Against this order, Iridium India preferred an appeal to the Supreme Court. As for substantive matters, the Supreme Court was concerned with the broad question of corporate criminal liability. It concluded that companies can undoubtedly be held criminally liable, as they immunity from prosecution can no longer be claimed[7]. In that sense, a company can be treated in the same manner as an individual for being convicted of an offence, including one that requires *mens rea*[8]. Relying upon its decision in *Standard Chartered*, the Supreme Court found that a company cannot escape liability simply because the offence requires mandatory imprisonment[9].

As to the specifics of an offence of cheating as defined in Section 415 of the IPC, the Supreme Court ruled that a complainant needs to prove that an inducement of the victim was caused by deception exercised by the accused[10]. Moreover, "*non-disclosure of relevant information would also be treated as a mis-representation of*

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6 *Motorola Inc. v. Union of India*, 2004 Cri. L.J. 1576 (Bom).

7 *Id.*, at ¶ 35 (noting that "*the companies and corporate houses can no longer claim immunity from criminal prosecution on the ground that they are incapable of possessing the necessary mens rea for the commission of criminal offences. The legal position in England and the United States has now crystallized to leave no manner of doubt that a corporation would be liable for crimes of intent.*").

8 *Id*. at 38.

9 *Id*. at 40.

10 *Id*. at 42.

facts leading to deception”[11]. On the facts of the case, the Supreme Court found that the High Court had exceeded its brief by examining the PPM and other documents in detail in exercise of jurisdiction under section 482 of the Cr.P.C. In doing so, the Supreme Court paid scant regard to the existence of risk factors and disclaimer language in the PPM that may have cautioned investors regarding risks of the investment and thereby dilute the allegation of deception. It therefore allowed the appeal and set aside the judgment of the Bombay High Court.

[C] EVALUATING *IRIDIUM*

The factual backdrop of *Iridium* as well as the Supreme Court’s observations therein provide an ideal opportunity to analyze Indian law on two questions: (i) attribution of *mens rea* to companies for the purposes of criminal liability, and (ii) criminal liability for misstatements in the context of securities offerings made to specific investors on a private basis. This note briefly explores both these issues in the context of the ruling in *Iridium*.

At the outset, however, it would be pertinent to note that the Supreme Court did not conclusively deal with the issue pertaining to securities offerings by companies on private basis and possible criminal liability for misstatements thereon. This is understandable given the nature of proceedings before the Court. In a petition involving quashing of criminal proceedings under Section 482 of the Cr.P.C., courts are required to only consider whether a *prima facie*

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11 *Id*.

case has been made out in the complaint[12]. They must consider whether the facts as disclosed in the complaint are sufficient to result in conviction, without examining questions of how those facts would be proved[13]. Thus, while courts considering a petition under section 482 would examine questions of law (in the sense of deciding whether, assuming the facts as stated in the complaint are correct, an offence is not made out), the standard of their review on questions of fact or on mixed questions of fact and law tends to be significantly less stringent[14].

(1) Principles of Attribution -

As a general matter, principles of attribution are invoked to ascertain the identity of individuals within a company whose mental element will be attributed to that of the company for the purpose of foisting criminal liability[15]. In *Iridium*, the Supreme Court held:

> *"The criminal liability of a corporation would arise when an offence is committed in relation to the business of the corporation by a person or body of persons in control of its affairs. In such circumstances, it would be necessary to ascertain that the degree and control of the person or body of persons is so intense that a corporation may be said to think and act through the person or the body of persons"*[16].

12 *State of Haryana v. Bhajan Lal* AIR 1992 SC 604 [hereinafter "*Bhajan Lal*"].
13 *Id*.
14 *Id*.
15 LEN SEALY & SARAH WORTHINGTON, CASES AND MATERIALS IN COMPANY LAW 152 (8th ed., Oxford University Press, 2007).
16 *Iridium*, *supra* note 2, at 38 [emphasis supplied].

The Court thus ruled on two aspects. *First*, it affirmed that a corporation is capable of possessing *mens rea*. *Second*, it laid down a somewhat rigid test – affirming the judgment of the House of Lords in Tesco *Supermarkets Ltd. v. Nattrass,*[17] that the person whose *mens rea* is to be attributed to the corporation must be the directing mind[18]. The Supreme Court appears to have accepted the rigid 'directing mind and will' test of *Tesco* and, in doing so, has failed to refer to a subsequent significant judgment of the Privy Council in *Meridian Global Funds Management Asia Ltd. v. Securities Commission*[19] that leaves scope for a more flexible analysis for attribution[20]. Some

17 [1972] AC 153 (HL) [hereinafter "*Tesco*"].

18 *Id*. Tesco was prosecuted under Section 11 of the (UK) Trade Descriptions Act, 1968. One of Tesco's supermarkets had advertised that it was selling certain packets of goods at the reduced price but a customer was told to pay the normal price. This was because the shop manager was negligent in failing to notice that the shop had run out of the low-price packets. Section 24(1) of the Act provided a defence for a shop owner, if he could prove that the commission of the offence was caused by "another person", and that he had taken all reasonable precautions and had exercised all due diligence so as "to avoid the commission of such an offence by himself or any person under his control." Tesco was able to prove that its board had instituted systems of supervision and training which amounted to taking reasonable precautions. The issue which arose was whether it was the precautions of the board which counted, or whether the conduct of the shop manager also had to be taken into account as being the conduct of the company. The House of Lords held that the precautions taken by the board were sufficient, and the manager's negligence was held to be not attributable to the company.

19 [1995] 2 AC 500 (PC) [hereinafter "*Meridian*"].

20 In *Meridian*, *id*., a case concerning the attribution of knowledge and not the attribution of actions, the Privy Council had to decide whether the knowledge of an investment manager employed by the company would be attributed to the company, so that the company would have the knowledge that it was a "substantial security holder" under the New Zealand Securities Amendment Act 1988. It was argued that the board of Meridian did not have knowledge that it had become a substantial holder; and consequently, the company could not be attributed with that knowledge. Lord Hoffman held (22):

further comment on both the aspects of this holding in *Iridium* is apposite.

(a) *Corporate Mens Rea*

As was noted earlier, the question of whether a corporation is capable of having *mens rea* is one which – until *Iridium* – was unsettled under Indian law. The fact that Indian courts have displayed ambivalence in holding a corporation guilty of acts involving *mens rea* raises an element of surprise given the robust developments in English law on the subject-matter, which have been extensive relied upon by Indian courts.

Under principles of corporate law, in certain situations, the acts or the mental state of certain individuals can be attributed directly to the company, where the company carries the primary or direct liability. In such situations, there is no requirement to invoke doctrines of either agency or vicarious liability[21]. This so called

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The policy of section 20 of the Securities Amendment Act 1988 is to compel, in fast-moving markets, the immediate disclosure of the identity of persons who become substantial security holders in public issuers. Notice must be given as soon as that person knows that he has become a substantial security holder. In the case of a corporate security holder, what rule should be implied as to the person whose knowledge for this purpose is to count as the knowledge of the company? Surely the person who, with the authority of the company, acquired the relevant interest. Otherwise the policy of the Act would be defeated…" He however also clarified (23), "… *their Lordships would wish to guard themselves against being understood to mean that whenever a servant of a company has authority to do an act on its behalf, knowledge of that act will for all purposes be attributed to the company. It is a question of construction in each case…*".

[21] In the case of agency or vicarious liability, the company carries secondary or indirect liability. For the difference between primary liability and secondary liability, see JASON HARRIS, ANIL HARGOVAN & MICHAEL ADAMS, AUSTRALIAN CORPORATE LAW 220 (LexisNexis Butterworths, 2009). Where the company carries primarily liability, law treats the company and its

"alter-ego" theory, which is premised on the company's primary liability, was initially propounded by Viscount Haldane as a basis of attribution distinct from agency or vicarious liability.[22]

The Supreme Court of India had earlier considered this theory in *JK Industries v. Chief Inspector of Factories and Boilers*[23]**.** The Court specifically approved of *Lennard's*, but then it proceeded nevertheless to state that the doctrine of vicarious liability comes into play. This deployment of the phrase 'vicarious liability' in that case was unfortunate. Although the court was dealing with a statutory strict liability case (where the mental element is immaterial or even unnecessary) and the issue turned on wordings of the relevant statute, the thesis under Indian law that the 'directing mind and will' doctrine relates to vicarious liability can perhaps be traced to this dicta of the Supreme Court. Subsequently, in 2005, the Supreme Court held that *Tesco* dealt simply with vicarious liability[24]. Again, this statement was dicta and the Court was engaged in interpreting a strict liability offence.[25]

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directing mind or will as one and the same; where the company carries secondary liability, law recognizes the company as separate from its employee or agent whereby the company becomes vicariously liable for the acts of the employee or agent.

22 Lennard's Carrying Co. Ltd. v. Asiatic Petroleum Co. Ltd., [1915] AC 705, 713-14 (HL) [hereinafter "Lennard's"] (holding that "the fault or privity is the fault or privity of somebody who is not merely a servant* *or agent for whom the company is liable upon the footing respondent superior, but somebody for whom the company is liable because his action is the very action of the company itself").

23 (1996) 6 SCC 665.

24 *P.C. Agarwala v. Payment of Wages Inspector, M.P.*, (2005) 8 SCC 104 [hereinafter "*P.C. Agarwala*"].

25 *Id.*

In India, several statutes impose vicarious responsibility (for strict liability offences) on officers who are in charge of and responsible to the company for the management of its affairs. The Supreme Court in *JK Industries* and *PC Agarwala* were both relying on *Lennard's* and *Tesco* in order to determine the identity of persons who would be "in charge of and responsible" for the purpose of the statute in question, which only imposed strict liability. The Court had to engage in this exercise as it was concerned with determining the criminal liability of directors or officers of the company. Under statute, a "person in charge of and responsible" is deemed to be an offender, and the Court was only expressing that the specific statutory formulation in that case made an exception from the general criminal law rule that there is no vicarious liability in criminal law. The Court was merely clarifying that under specific strict liability statutes, a person in charge of and responsible would be vicariously liable for the acts of the company. The principle of attribution in *Tesco* and *Lennard's*, however, was the reverse, namely whether the company will be held liable for acts of certain individuals.

Of course, even prior to *JK Industries*, the position in India was far from clear. As long ago as the late 1940s, issues of this nature arose before the Calcutta High Court. The view in Calcutta – from the 1940s to the 1990s – appeared to be that it was impossible for a legal (as opposed to a natural) person to have any *mens rea*. Judgments of the Calcutta High Court on the point proceeded on a rather simplistic reasoning – effectively, that the ability to have 'intention' was the exclusive prerogative (or curse) of natural persons, and it was

impossible for a legal person like a company to have intention[26]. The Bombay High Court, however, had taken a more convincing view, noting developments under English law until *Tesco*. It is worthy of note that in *Esso Standard Inc. v. Udharam Bhagwandas Japanwalla,*[27] arguments were advanced before the Bombay High Court not just on whether a company can have *mens rea*, but also on how the process of attribution would in fact operate, with the precise question being whose *mens rea* would be attributed to the company. Interestingly, the arguments proceeded on the basis of whether, for the purposes of criminal liability, a strict test of *mens rea* was required (*a la Tesco*), or whether a contextual flexibility (such as that subsequently adopted in *Meridian*) would be apposite. The Bombay High Court accepted the *Tesco* approach, rejecting the application of a flexible rule. The court was called upon, on the authority of *Moore v. I. Bresler Ltd.*[28], to decide whose *mens rea* is to be attributed to the company. The Counsel suggested before the court that a flexible test which allowed actions of branch-managers to be attributed to a company went too far and negated the element of certainty which ought to be inherent in criminal law. Support for the proposition that

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[26] Champa Agency v. R. Chowdhury, 1974 CHN 400; Sunil Banerjee v. Krishna Nath, AIR 1949 Cal 689; AK Khosla v. Venkatesan, 1992 (98) CrLJ 1448 (Cal).

[27] [1975] 45 Comp Cas 16 (Bom) [hereinafter "*Esso*"].

[28] [1944] 2 All ER 515 [hereinafter "*Moore*"]. In this case, a company was convicted of an offence requiring proof of an intention to deceive where those responsible were its secretary and branch manager; and not the absolute 'directing minds'.

Moore was wrongly decided was drawn from academic writings in leading English journals.[29]

These two judgments of the Bombay High Court are creditable in as much as they prophesied the debate which intensified in England after *Meridian* – over 25 years after the judgment in *Esso*: is a flexible, case-by-case, approach suitable to criminal law? Unfortunately, these Bombay judgments do not appear to have had the required influence on the development of the Indian principles in this regard. Part of the reason might have been that in intervening years, until the Supreme Court decision in *Standard Chartered*, this debate about *mens rea* did not really garner the requisite attention under Indian law: the other issue of whether a company can be prosecuted for offences which carry a mandatory punishment of imprisonment operated as a distraction to absorb judicial attention in the interim. Be that as it may, by 2010, the Bombay High Court accepted the view that a corporation cannot have *mens rea*.[30] This latest Bombay judgment was again based on the simplistic reasoning of the early cases of the Calcutta High Court.[31] Most surprisingly, *Esso* was not cited at all by the court.

In the backdrop of that prevailing confusion, the holding in *Iridium* has finally clarified beyond doubt that a corporation is capable of having *mens rea*. The Supreme Court has specifically approved of the decision in *Tesco*. However, rather surprisingly,

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29 For instance, R.S. Welsh, *The Criminal Liability of Corporations*, 62 L.Q.R. 345 (1946), which was cited before the Court by counsel.

30 Arvind Mafatlal, supra note 30.

31 Supra note 31.

Meridian does not even find a mention in the Supreme Court's judgment. The significance of this comment depends on how one understands *Meridian*, and to what extent did *Meridian* depart from *Tesco*? If it did indeed depart substantially from *Tesco*, was the Supreme Court justified in refusing to take the same path as of *Meridian*? We now turn our attention towards unravelling the jurisprudence on attribution as it has evolved more recently in England, with *Meridian* being a leading light.

(b) Evolution of Principles of Attribution – From Tesco to Meridian

At the outset, it will be useful to keep in mind that there are specific observations in case law stating the directing mind theory applies with equal force in civil law and in criminal law[32].40 Thus, Lord Justice Nourse in *El Ajou v. Dollar Land Holdings plc*[33] stated that the theory has been applied in civil and criminal cases alike, "*with no divergence of approach*[34]." *El Ajou* itself is in some ways the genesis of a more flexible approach[35]; and the Court of Appeal formulated the idea of there being different directing minds in respect of different activities[36]. It is also far too easy to fall into the trap of

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32 The most recent scholarly overview of the principles in Meridian is found in Eilis Ferran, Corporate Attribution and the Directing Mind and Will (forthcoming, 2011) L.Q.R. (draft available on file with the authors).

33 [1994] 2 All ER 685 (CA) [hereinafter "El Ajou"].

34 Id. at 695.

35 See Lebon v Aqua Salt Co Ltd. [2009] UKPC 2 [hereinafter "Lebon"], at 25, where El Ajou is explained as an earlier example of the application of the principles later laid down specifically in Meridian.

36 *There are, it seems to me, two points implicit, if not explicit, in each of these passages. First, the directors of a company are, prima facie, likely to be regarded as its directing mind and will whereas particular circumstances may confer that status on non-directors. Secondly, a company's directing mind and will may be found in different persons for different activities of the company…*

assuming *Meridian* to be a drastic change in the position of law. In the recent decision of *Stone & Rolls Ltd. (in liquidation) v. Moore Stephens (a firm),*[37] Lord Walker specifically stated that leading academic commentators had "overstated" the effect of *Meridian.*[38]

In *Meridian*, the Privy Council considered a case involving disclosure obligations under the securities regulations of New Zealand. On the facts of the case, it was held that the knowledge of employees who had acquired the shares for the company counted as the knowledge of the company. The Privy Council applied a contextual and purposive interpretation, and no emphasis was placed on whether the relevant employees were the "directing mind and will" of the company. *Meridian* was immediately preceded by two cases – *Re Supply of Ready Mixed Concrete (No 2)*[39] and ***Regina v. British Steel plc***[40] – which had distinguished *Tesco* as turning on the specific statutory language. Thus, at first sight, these three cases indicated that flexibility was the general rule, and the anthropomorphic[41] approach of *Tesco* turned on the statutory language in *Tesco*.

El Ajou, supra note 41, at 699 (per Rose LJ),

37 [2009] UKHL 139, at 134 [hereinafter "*Moore Stephens*"].

38 *Id.*, at 134.

39 [1995] 1 AC 456 (HL).

40 [1995] 1 WLR 1356 (CA).

41 The expression "anthropomorphic" literally means "relating to or characterized by anthropomorphism", and "anthropomorphism" is defined as "the attribution of human characteristics or behaviour to a god, animal, or object" – CONCISE OXFORD ENGLISH DICTIONARY (11th ed., 2006) at 56. The use of "anthropomorphic" in this context refers to the treatment of a corporate body as being similar to a human being, with the actions/intention of the "brain" of the corporation being treated as the actions/intention of the body of the corporation. By contrast, a flexible rule would not have any such predetermined anthropomorphism, such that the person whose intention is attributed to the

The reason why judges have favoured applying the flexible rule of *Meridian* more in civil cases, perhaps, is that certainty in result is much more desirable in imposing criminal penalties than in imposing civil penalties. Ultimately, once the matter is treated as one of construction, a flexible construction is much more suitable for civil law than criminal law[42]. In sum, it would appear that what *Meridian* does is to provide judges with the choice of rules – the strict enquiry continues as the default rule, but special circumstances may justify courts adopting a flexible analysis. What these special circumstances are would depend on the underlying legal rule, its language and policy[43]. In the law of crimes, these considerations are likely to lead to a strict approach *a la Tesco*. However, it is of course possible that on a fair construction of even a criminal statute, the policy underlying a rule may require a flexible approach. To that extent, it is arguable

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company, may well be situated at different levels in the corporate hierarchy. The classic "anthropomorphism" in this context may perhaps be Lord Denning's statement in *H.L. Bolton (Engg.) Co. Ltd. v. T.J. Graham and Sons*, [1957] 1 Q.B. 169 [hereinafter "*Bolton*"], when the learned judge stated (at p. 172) that a company "*has a brain and nerve centre which controls what it does. It also has hands which hold the tools and act in accordance with directions from the centre*". The anthropomorphic approach is thus a one-size-fits-all approach; where the 'brain' is to be identified, and the intention of the 'brain' is to be imputed to the company. A flexible approach on the other hand would leave open contextual enquiries of attribution, without an a priori determination that only the actions/intention of the 'brain' will be attributed to the company.

[42] See generally: Ferran, *supra* note 40. Professor Ferran writes:

> *Judicial caution in this sphere may also reflect the importance that is attached to preserving the certainty and predictability of the criminal law. These are features of the law that would be undermined by the rather ad hoc approach that could be the product of over-enthusiastic reliance on the concept of context-specific rules of attribution…*"

Id., at 34-35 (of the draft available with the authors).

[43] *KR v. Royal & Sun*, [2006] EWCA Civ 1454.

that *Meridian* is not a sea-change from *Tesco*, at least in its application to the law of crimes.

(c) Supreme Court's Analysis in Iridium

These developments in English law raise the question – was the Supreme Court in *Iridium* justified in invoking only *Tesco* and not *Meridian*? First, it is noteworthy that the *Meridian* approach could yet have been brought implicitly into Indian law. The court seems to have rejected this[44].However, on the facts of the case, given the nature of proceedings (based on the premise inherent in proceedings under section 482 of the Cr.P.C. that the allegations in the complaint were true), the Court was not required to express an opinion conclusively as to the test for attribution. What was in issue was the 'whether' question; not the 'how' question: whether a corporation can have *mens rea* – not how can *mens rea* be proved. Thus, these remarks are *obiter*; and though the *obiter* of the Supreme Court is considered binding on High Courts, what will be binding is that at the stage of proceedings under section 482, when the requisite allegations have been made, the mode of proving *mens rea* should not be taken into account as a relevant factor. Nonetheless, it is unlikely that Courts will feel free to reject a *Tesco* approach; particularly considering that *Meridian* finds no mention whatsoever in the Supreme Court judgment. Instead, the Supreme Court has preferred to rely on cases such as *Bolton*[45] – which were rejected in *Meridian* as being too anthropomorphic.

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[44] *Iridium*, *supra* note 2, at 38, *see* extract accompanying *supra* note 20.
[45] *Supra* note 49.

Consequently, the researcher argues that while there may have been reasons for the Court to adopt an apparently rigid approach in *Iridium*, caution must be exercised to ensure that the Court's decision is not treated as the final word on all aspects relating to attribution under Indian law. *Iridium* should be seen as the first step on the road to rationalizing Indian law on the point – not as the final destination in and of itself.

(2) <u>Criminal Liability for Misstatements in Securities Offerings</u>

We now deal with the second principal issue at hand in *Iridium*, namely the criminal liability of companies for misstatements in the context of securities offerings. At the outset, it is necessary to note that the scope of the Supreme Court's pronouncement in *Iridium* was limited only to issues that have a bearing at the relatively premature stage of deciding on an application for quashing proceedings under section 482 of the Cr.P.C.[46] Nevertheless, since the court was compelled (while making its determination on the case) to comment on legal issues arising out of the specific facts, we consider it essential to dwell upon some of those issues of substance.

(a) The Offence of Cheating

The Supreme Court was concerned with the precise requirements for showing a charge of cheating in cases involving an issue of securities by a company on a private basis using an offer document such as a PPM. In this regard, the facts of *Iridium* present a somewhat peculiar situation. Liability (whether criminal or civil) for

[46] We subsequently return to the appropriate scope of review under section 482 of the Cr.P.C. See *infra* sub-part 2.

misstatements in a prospectus are governed by specific provisions in corporate and securities laws, which in India are represented primarily by the Companies Act, 1956[47] and the Securities and Exchange Board of India Act, 1992.[48] However, these specific provisions apply only to a public offering of securities that are to be listed on one or more stock exchanges.[49] Since the issue of securities in *Iridium* involved a private placement rather than a public offering, the transaction was essentially within the domain of private contract law and these specific provisions in corporate and securities laws were inapplicable, thereby requiring the complainant to resort to general principles of criminal law under the IPC. In that sense, *Iridium* represents a relatively less trodden path involving the use of the wider offence of "cheating" to a more specific situation that is otherwise within the purview of corporate and securities laws.

Cheating is defined under section 415 of the IPC as follows:-

> *Cheating.- Whoever, by deceiving any person, fraudulently or dishonestly induces the person so deceived to deliver any property to any person, or to consent that any person shall retain any property, or intentionally induces the person so deceived to do or omit to do anything which he would not do or omit if he were not so deceived, and which act or omission*

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47 The provisions pertaining to issues of prospectus are administered by the Securities and Exchange Board of India (SEBI). Companies Act, 1956, § 55A. For criminal liability for misstatements, see Companies Act, 1956, § 63.

48 By way of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009, SEBI has stipulated the detailed requirements regarding disclosures in a prospectus

49 For factors that differentiate a public offering of securities from a private placement, see Companies Act, 1956, § 67.

causes or is likely to cause damage or harm to that person in body, mind, reputation or property, is said to "cheat".

Explanation- A dishonest concealment of facts is a deception within the meaning of the section."

Essential to the offence of cheating is fraudulent or dishonest inducement or deception (defined to include a dishonest concealment of facts). It has been held that *bona fide* mistakes in a prospectus do not amount to cheating – this is obvious; when something is established to be *bona fide*, no question of dishonesty or deception would arise.[50] More interestingly, and rather less obvious is a holding that even a "*scheme (in a prospectus) which was speculative in the highest degree*" is not a dishonest statement.[51] Furthermore, the Supreme Court has held.[52] "*It is for the legislature to intervene if it wants to protect people who participate in these schemes knowing that sooner or later the scheme must fail.*"

In *Iridium*, the Bombay High Court had placed weight on the "Risk Factors" and the cautionary statement contained in the PPM.[53] In the view of the High Court, a dishonest intention could not be

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[50] *Anil Khandelwal v. Maksud Saiyed*, 9 January 2006 (Guj), Crl. Misc. App. 5389/2005.

[51] *Radha Ballav Pal v. Emperor* AIR 1939 Cal 327; *Kamal Chopra v State of UP* 1999 (105) CrLJ 2345 (All).

[52] *State of MP v. Mir Basit Ali Khan* AIR 1971 SC 1620 [hereinafter "*Basit Ali*"], at 14.

[53] The relevant clause in the PPM reads:
An investment in Iridium involves certain risks, many of which relate to the factors and developments listed above, prospective investors should carefully consider the disclosures set forth elsewhere in this memorandum, including those under the caption 'risk factors' (1992 PPM Pg. 5)
Iridium, *supra* note 2, at 43.

made out and the case was essentially in the nature of a civil dispute between the parties. Before we discuss the Supreme Court's decision, it would be important to note the context in which the phraseology of "civil dispute" arises.

Under the IPC, several cases have discussed whether a breach of contract is a case of cheating. Often, complainants have initiated criminal proceedings in contractual disputes, alleging that a breach by the counter party had resulted in the offence of cheating. In this context, the Supreme Court has stipulated that it is important to determine whether an essentially civil dispute is being given the colour of a crime.[54] A mere breach of contract is not cheating – what needs to be established is a dishonest intention at the *time of entering into the contract.*[55] Unless such a pre-existing dishonest intention is established, the dispute should be treated as civil in nature; and no criminal case would be made out[56]. In *Iridium*, the High Court drew on such reasoning – which is fairly settled in Indian law – and applied the same to the somewhat different facts of a securities offering. In the High Court's view, no intention to deceive was evident at the time of issuing the PPM. The High Court placed substantial reliance on the fact that the PPM contained elaborate "Risk Factors".

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[54] For example, in *G. Sagar Suri v. State of Uttar Pradesh*, AIR 2000 SC 754, the Supreme Court observed (at 7): "*It is to be seen if a matter, which is essentially of a civil nature, has been given the cloak of a criminal offence*".

[55] *Hriday Ranjan Verma v. State of Bihar*, JT 2000 (3) SC 604; 2000 Cri. L.J. 2983.

[56] *Id.*

(b). Scope of Review Under Section 482, Cr.P.C.

To answer the questions raised above, it is essential to understand the rationale behind the exercise of powers under Section 482 of the Cr.P.C. The plain text of section 482 does not indicate that it is concerned mainly with petitions for quashing criminal proceedings. Indeed, Section 482 is only a provision saving the inherent powers of the High Courts. The text states:

> *Nothing in this Code shall be deemed to limit or affect the inherent powers of the High Court to make such orders as may be necessary to give effect to any order under this Code, or to prevent abuse of the process of any Court or otherwise to secure the ends of justice… .*

Thus, in substance, the High Court can quash proceedings before lower courts when those proceedings amount to an abuse of process. The Supreme Court has elaborated the guidelines to be kept in mind while exercising the power of quashing under section 482. The leading case on the point is the Supreme Court's judgment in *Bhajan Lal.*[57] Hence, the High Court would exercise the powers of

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[57] *Supra* note 16. In a passage which has been cited frequently in subsequent judgments, the court observed:

In the … exercise of the extra-ordinary power under Article 226 or the inherent powers under Section 482 of the Code [of Criminal Procedure], … the following categories of cases [are given] by way of illustration wherein such power could be exercised either to prevent abuse of the process of any Court or otherwise to secure the ends of justice…

1. *where the allegations made in the First Information Report or the complaint, even if they are taken at their face value and accepted in their entirety do not prima facie constitute any offence or make out a case against the accused.*
2. *where the allegations in the First Information Report and other materials, if any, accompanying the F.I.R. do not disclose a cognizable offence,*

quashing when the allegations against the accused do not qualify as an offence under law, even when the allegations are assumed to be factually true. Such tests have meant that courts do not usually consider defences of an accused – the logic is that if a case is such that a *prima facie* charge is made out, allowing matters to finally be decided at trial cannot be an abuse of process.[58]

It is arguable, however, that an absolute refusal to consider the effect of Risk Factors in an offer document (such as the PPM in *Iridium*) is not justified on such a basis. The Risk Factors are after all

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justifying an investigation by police officers under Section 156(1) of the Code except under an order of a Magistrate within the purview of Section 155(2) of the Code.

3. *where the uncontroverted allegations made in the FIR or 'complaint and the evidence collected in support of the same do not disclose the commission of any offence and make out a case against the accused.*
4. *where the allegations in the FIR do not constitute a cognizable offence but constitute only a non-cognizable offence, no investigation is permitted by a police officer without an order of a Magistrate as contemplated under Section 155(2) of the Code.*
5. *where the allegations made in the FIR or complaint are so absurd and inherently improbable on the basis of which no prudent person can ever reach a just conclusion that there is sufficient ground for proceeding against the accused.*
6. *where there is an express legal bar engrafted in any of the provisions of the Code or the concerned Act (under which a criminal proceeding is instituted) to the institution and continuance of the proceedings and/or where there is a specific provision in the Code or the concerned Act, providing efficacious redress for the grievance of the aggrieved party.*
7. *where a criminal proceeding is manifestly attended with mala fide and/or where the proceeding is maliciously instituted with an ulterior motive for wreaking vengeance on the accused and with a view to spite him due to private and personal grudge.*

Id., at 105.

[58] For example, see the judgment of the Supreme Court in *Bharat Parikh v. CBI*, (2008) 10 SCC 109, as applied by the Kerala High Court in *P.K. Sulaiman v. State*, Crl. MC. 1246/2010 (judgment dated 20 April 2010) (Kerala High Court).

part and parcel of the very representation which is relied on by the complainant itself; the Risk Factors are inseparable from the representation.[59] Any representation must be looked at in its entirety before determining whether a *prima facie* case exists for continuation of proceedings.[60]

Since the Supreme Court in *Iridium* was only dealing with an appeal from an order section 482 of the Cr.P.C., its ruling in respect of Risk Factors is at best a preliminary determination without a detailed examination of countervailing arguments of the parties. We therefore caution against treating *Iridium* as the final word of the highest court of the land on the effect of Risk Factors in a securities offering document. More generally, the significance of Risk Factors cannot be undermined, as we note below.

Companies that issue securities are not expected to guarantee future prospects and results to prospective investors. Hence, they tend to include cautionary language in offer documents that moderates

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59 Recently, in *Harshendra Kumar*, *supra* note 68, the Supreme Court has clarified that in appropriate cases, a defence emerging *ex facie* from uncontroverted documents can be considered even in the exercise of jurisdiction under section 482 – to not do so could amount to a "*travesty*". So too, "*[i]t is one thing to say that the Court at this juncture would not consider the defence of the accused but it is another thing to say that for exercising the inherent jurisdiction of this Court, it is impermissible also to look to the admitted documents…*" *All Cargo Movers v. Dhanesh Jain*, (2007) 12 SCALE 39. An analogous principle can well be applied insofar as the question of the relevance of risk factors is concerned.

60 Of course, we do not claim that the mere inclusion of risk factors may be sufficient to avoid all criminal liability at the stage of section 482 proceedings. Our point is narrower – which is that risk factors are at least *relevant* in section 482 proceedings, while assessing the 'representations' made by the issuer. At the stage of trial, the risk factors would have greater weight – a point which the Supreme Court in *Iridium* does not seem to have disregarded.

investor expectations. It is in this background that securities regulations governing public offerings of securities require issuers to include detailed Risk Factors. Even the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 provide detailed guidelines on the types of Risk Factors to be included in a prospectus. These regulations in fact encourage rather than restrict the inclusion of Risk Factors.[61] Surely, it cannot be intended that these Risk Factors would become immobilized once criminal proceedings are initiated against the issuer company for misstatements in the prospectus. That would make Risks Factors rather redundant, a position that would operate against the goals of full disclosure to prospective investors. An extreme approach of disregarding Risk Factors would not only dis-incentivize full and fair disclosure of future prospects by issuers that would enable investors to gauge their investment appetite, but it could chill securities offerings by imposing too onerous a cost on issuers.

Finally, the Supreme Court in *Iridium* pays scant regard, if at all, to the sophistication of the investors while determining whether they were subjected to 'deception' so as to constitute an offence of cheating. In that case, the securities offering was made to institutional investors on a private placement basis and not to individual investors

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[61] A useful parallel is contained in the U.S. context where the "bespeaks caution" doctrine provides protection to issuers of securities from liability that arises from forward looking statements as long as they are tempered by cautionary language. The doctrine has largely been used in civil claims for securities frauds and has also received statutory recognition in the Private Securities Litigation Reform Act of 1995. See Palmer T. Heenan, Jessica L. Klarfeld, Michael Angelo Roussis and Jessica K. Wash, *Securities Fraud*, 47 Am. Crim. L. Rev. 1015, 1064-66 (2010).

or the public in general. Institutional investors generally possess levels of sophistication that enable them to make investment decisions without advice from the issuer company. Moreover, Risk Factors and disclaimers of the nature contained in the PPM in *Iridium* seek to pass on the risks of uncertainty to the investors. Where Risk Factors form an important mitigating feature for public offerings of securities to even unsophisticated investors, as we have seen earlier, there seems to be no reason to grant better levels of protection to sophisticated investors who have the information, expertise and wherewithal to absorb greater risks. Any reading of *Iridium* that suggests complete disregard of Risk Factors in a private offering of securities would place sophisticated institutional investors on an even higher pedestal than unsophisticated public investors, a matter surely not intended by the scheme of regulation of securities offerings.

[C] CONCLUSION

The Supreme Court's decision in *Iridium* is momentous as it clarifies the previously ambiguous position under Indian law that a legal person such as a company is capable of having *mens rea*. It is an important step in promoting the use of criminal sanctions to regulate corporate behaviour. At the same time, it is crucial to note that the Supreme Court stops short of ruling convincingly on the methods by which *mens rea* of a company can be proved. It places reliance on the anthropomorphic approach of the English courts in *Tesco* without in any way considering the subsequent crucial development in the form of the more flexible approach in *Meridian*. Similarly, the Supreme Court does not conclusively deal with the effect of Risk Factors in

determining the existence of 'deception' as an ingredient of an offence of cheating due to misrepresentation in a private placement offering document. Of course, it is hard to be critical of the Supreme Court as it was concerned only with an appeal on preliminary aspects relating to an order of quashing under section 482 of the Cr.P.C. In sum, we argue that while *Iridium* must hold the field on the ability of a company to have *mens rea*, its rulings on the other aspects must be accepted in measured terms only as possible guidance for further specific judicial determination.

LEVERAGED BUY OUTS: UTILITY AND LEGAL ISSUES- A COMPARISON BETWEEN THE POSITION IN INDIA AND UK

Megha Krishnamurthi and Haya Arif[*]

Despite the growing investment into India in some form of Leveraged buyout, there is very little discussion regarding it within and amongst the regulators in India such as the RBI, FIPB and SEBI. The sensation that leveraged buyouts have created across the global market cannot be overemphasized. Some of the greatest acquisitions in the past few decades have been financed through a high degree of leverage. The primary objective of this paper is to draw comparisons between the legal framework in which leveraged buyouts operate in the UK and in India, while also explaining in brief the characteristics of a typical leveraged buyout and enumerating the advantages the associated risks of opting for a leveraged finance structure. While recognizing that Leveraged Buyouts are beneficial at the micro economic level one needs to be wary of its impact in the economy as a whole. An analysis of the financial crisis post 2012 makes clear the dangers to the financial system of using too much leverage and therefore the question that most economies are facing today and which we attempt to highlight through this paper is "How much restriction is too much?

[A] INTRODUCTION

The sensation that leveraged buyouts have created across the global market cannot be overemphasized. Some of the greatest acquisitions in the past few decades have been financed through a

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high degree of leverage. Even though acquisitions financed through leveraged buyouts have always been considered to be lucrative to both private equity firms and lending banks, they have faced considerable amount of restrictions in the legal environment of most jurisdictions. The global financial crisis of 2008 has further resulted in leveraged buyouts facing scathing criticism and an increased scrutiny.

The primary objective of this paper is to draw comparisons between the legal framework in which leveraged buyouts operate in the UK and in India. The structure and characteristics of a typical leveraged buyout are briefly explained at the outset, followed by enumerating the advantages of opting for a leveraged finance structure, while also listing out the associated risks and disadvantages that might arise from the high degree of leverage used to finance an acquisition. The development of the Leveraged Buyout Market in the UK is then traced, in context of the legal impediments posed to leveraged buyouts in the form of the restrictions against financial assistance. The change in the position of law over time, and the impact of the global financial crisis on the leveraged buyouts has been discussed at length in an attempt to understand the change in trend of leveraged buyout activity in the UK, following which the focus is shifted to the story of leveraged buyouts in India. In this part, the operative legal restrictions and the behaviour of regulatory authorities towards financing leveraged acquisitions are discussed at length. Interestingly, it was observed during the course of research that despite legal restrictions, there is considerable amount of leveraged buyout activity in India. This is primarily done by structuring

transactions in a manner so as to not infringe on the restrictions in the law.

The researchers have relied on secondary sources for research. Various secondary sources like literature, working papers of various governmental bodies and contemporary newspaper articles have been utilized by for the purpose of carrying out their research. Due to a paucity of time and space, the scope of this paper is restricted to typical leveraged buyout transactions in context of private companies and consequently management buy-outs, buy-ins, etc. are not dealt with in this paper.

[B] LEVERAGED BUYOUTS (LBOS): CHARACTERISTICS AND UTILITY

A leveraged buyout is a transaction wherein a company is acquired by an investment firm; usually a private equity firm financing a large portion of the acquisition through debt, or leverage.[1] Because of the highly leveraged nature of these transactions, such transactions have likewise been alluded to as 'bootstrap acquisitions'.[2] This debt portion of the financing is repaid by the future receivables and the cash flow of the target, and the assets of the target are used as a security for the debt obtained, thus making the target finance its own acquisition in a way.

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1 Steven N. Kaplan & Per Stromberg, *Leveraged Buyouts and Private Equity*, JOURNAL OF ECONOMIC PERSPECTIVES, Vol. 22(4) (Sept., 2008), http://faculty.chicagobooth.edu/steven.kaplan/research/ksjep.pdf.

2 Suresh A.S. & Sharavanth S.S., *A Study on leveraged Buyouts- Opportunities and Challenges*, ASIA PACIFIC JOURNAL OF RESEARCH, Volume III(X) (Oct., 2013), http://apjor.com/files/1383065450.pdf.

This acquisition, or buy-out is financed with 60-90% debt and the remaining is paid in equity. Usually, a 90:10 debt to equity ratio is employed in a typical leveraged buyout, however the ratio of debt to equity to be used is ascertained by a cost-benefit analysis keeping in view the financial state of the target and thus differs from acquisition to acquisition. Thus, a relatively smaller portion of equity is used, compared to a significantly larger portion of debt. Even though the capital structures in the financing of a leveraged buyout vary from one transaction to the other, it typically involves different levels of financing, from senior debt, to various subordinate or mezzanine debts and finally to an element of equity.[3] Major investors of the equity portion of the financing are private equity firms, management of the target companies, or other companies, in some cases.[4]

As a general rule, a leveraged buyout comprises of three elements – the 'leverage' (financing the acquisition through considerable amount of borrowing), 'control' (assuming role in the management of the entity) and 'going private' (removing the firm from public markets and converting it to private in case of public companies).[5]

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[3] Loan Market Association, *A Guide to Syndicated Loans and Leveraged Finance Transaction*, http://www.lma.eu.com/uploads/files/LMA%20Guide%20to%20Syndicated%20Loans%20144801-3-472%20v0%203%20_2_.pdf.

[4] Chen Liu, *Debt Structure, Private Equity Reputation, and Performance in Leveraged Buyouts*, (Sept. 10, 2014),http://web.business.queensu.ca/Faculty/fmoneta/Seminar/2013_2014/Job%20Market%20Paper_Chen%20LIU.pdf.

[5] Aswath Damodaran, *The Anatomy of an LBO: Leverage Control and Value*, CFA INSTITUTE CONFERENCE PROCEEDINGS QUARTERLY, Vol. 25(3), 2 (Sept., 2008), http://www.cfapubs.org/doi/pdf/10.2469/cp.v25.n3.4.

(1) Utility of these Buyouts

Leveraged buyouts have been perceived to be highly advantageous to both acquiring private equity companies as well as banks. One of the greatest advantages of going for a leveraged buyout is that in most jurisdictions, the interest paid on debt financing is tax deductible, as opposed to cash flows to equity, which are not tax deductible in most cases.[6] Thus, the higher the tax rate, greater would be the consequent tax benefit of using leverage or debt. Another advantage arising out of a leveraged buyout is often known as the 'discipline of debt', a concept that means that the high levels of interest and principal payments act as a driving force to improve performance and efficiency of the management through focusing on cost cutting and improvement enhancement initiatives. Furthermore, leveraged buyouts are seen to reduce agency problems. When a company is acquired through a high degree of leverage, there is usually a concentrated ownership that is in control of the private equity firm; as opposed to a dispersed ownership that otherwise exists in a public company which is the root cause of agency problems i.e. an externality that occurs when A controls the assets of B. When the ownership is concentrated instead, the performance of the

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[6] Tim Jenkinson & Rüdiger Stucke, *Who benefits from the leverage in LBOs?,* (Feb., 2011), http://economics.ouls.ox.ac.uk/15362/1/Who_Benefits_from_the_Leverage_in_LBOs.pdf.

management improves, as there is a close connection between the pay and their performance, in addition to an increased leverage.[7]

Another potential advantage is that leveraged buyouts can sometimes act to revitalize an adult organization. Also, by expanding the organization's capital, leveraged buyouts empower it to enhance its market position. And not only for the company, effective acquisitions through leveraged finance could be profitable for the shareholders of the company as well, as well as the post acquisition speculators who stand to earn vast returns from the date of the acquisition completion to the period of the IPO or resale.[8]

(2) Associated Disadvantages

However, even though the leveraged buyouts are considered to be generally advantageous to the lender, they are nonetheless risky. Any form of financial distress, for instance events like recession (as was more than clear from the global financial crisis of 2008), litigation, or changes in regulatory environment can have a highly negative impact on the acquirer private equity firm, the banks as well as the target company.[9] Furthermore frail administration at the target organization or misalignment of motivations in the middle of administration and shareholders can likewise pose threats to a

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[7] Joacim Tåg, *The Real Effects of Private Equity Buyouts*, RESEARCH INSTITUTE OF INDUSTRIAL ECONOMICS, IFN WORKING PAPER NO. 851 (2010), http://core.kmi.open.ac.uk/download/pdf/6396753.pdf .

[8] Pooja Tripathi, *Leveraged Buyout Analysis*, JOURNAL OF LAW AND CONFLICT RESOLUTION, Vol. 4(6), 85-93 (Dec., 2012), http://academicjournals.org/article/article1379862777_Tripathi.pdf.

[9] Jonathan Olsen, *Note of Leveraged Buyouts*, CENTRE FOR PRIVATE EQUITY AND ENTREPRENEURSHIP, TUCK SCHOOL OF BUSINESS AT DARTMOUTH, http://pages.stern.nyu.edu/~igiddy/LBO_Note.pdf.

successful leveraged buyout transaction. The high degree of leverage does in a manner also increase the risks of bankruptcy, in an extreme scenario. However, this exists as a theoretical possibility because there are no empirical studies to indicate otherwise. In a study conducted in 2009 with a sample of 17,171 buyouts, for a period from 1970 and 2007 and mapping buyouts globally, a bankruptcy rate of 6% was found.[10] Furthermore, even though the benefits of leveraged buyouts are indeed real, yet they are often criticized severely by labour unions and worker groups, as the pressure of the debt results in layoffs and wage cuts. Also, since private equity firms are seen only as short term investors, always on the lookout of a quick exit, critics hold that leveraged buyouts result in a detrimental impact to the long term investment of a company.

(3) Legal Issues

Leveraged buyouts are a controversial subject in most jurisdictions and invite legal restrictions in most countries. Courts in some jurisdictions like Italy had also gone to the extent of deeming leveraged buyouts to be out rightly illegal, though safe harbor provisions have been created now. In most other jurisdictions, however, while leveraged buyouts per se are not illegal, they nonetheless infringe the rule against financial assistance present in the company law of most states. The rationale behind the financial assistance prohibition rests on the idea that if a company bears the costs of the purchase of its own shares it leads to the penury of shareholders. Thus, one of the key reasons leveraged buyouts are

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[10] *Supra* no. 1.

frowned upon by the company laws of most jurisdictions is that these transactions often do not entail a full disclosure to shareholders with the knowledge often restricted to insiders of the company.[11] This amounts to a serious breach of the fiduciary duty that the management of the company owes to the creditors and shareholders.

In the following sections, a comparative analysis is drawn between the legal restrictions on leveraged buyouts between the jurisdictions of India and the UK.

[C] THE LEVERAGED BUYOUT MARKET IN THE UK

The leveraged buyout market has its roots in the United States, however this phenomenon spread quickly to the UK as well, and has seen rapid growth in UK ever since. UK has the largest buyout market in the Europe today, with leveraged buyouts accounting for about half the acquisitions in terms of value in 2005.[12]

Prior to 2008, leveraged buyouts in the United Kingdom were restricted by the rule against financial assistance embodied in the Companies Act, 1985[13] of the UK. According to Section 151 of the 1985 Act, any company (whether public or private) and its subsidiaries were prohibited from providing any financial assistance

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[11] Douglas Cumming & Simona Zambelli, *Illegal Buyouts*, JOURNAL OF BANKING AND FINANCE, Vol. 34(2), 441-456 (Aug., 2009), https://www.ecb.europa.eu/events/pdf/conferences/ecbcfs_conf9/Buyouts_Revision.pdf?93907ef27e0bbeff1220f24bc62d331f.

[12] Mike Wright, Luc Renneboog, Tomas Somins & Louise Scholes, *Leveraged Buyouts in the UK and Continental Europe: Retrospect and Prospect*, ECGI WORKING PAPER SERIES IN FINANCE, FINANCE WORKING PAPER NO. 126/2006, (July, 2006), http://ssrn.com/abstract_id=918121.

[13] Hereinafter referred to as the '1985 Act'.

for the purpose of acquisition of shares.[14] This restriction extends to providing any sort of financial assistance to discharge or reduce any debt (for instance, a loan) or liability for the same purpose. An often raised problem with this limitation was that the 1985 Act did not provide any clear definition for the term 'financial assistance' and this led to an ambiguity in the law. Section 152 merely gives certain examples as to the transactions that qualify as financial assistance.[15] However, these instances were highly fact based and did not provide clarity as to the scope of the restriction.

Despite these stringent restrictions, however, the 1985 Act provided for certain 'whitewash' procedures given for private companies in Sections 155-158 that relax the absolute restriction embodied in Section 151. The whitewash procedure cleanse out what would otherwise be considered to be an illegal buyout. According to Section 155(2), financial assistance could only be provided if it did not reduce net assets of a company, or to the extent of reduction of net assets, if the assistance was provided from the distributable profits of the company.[16] Section 155(6) laid down the requirement that Directors of the target company had to furnish a statutory declaration in accordance with the requirements prescribed in S. 156, stating that the company shall be able to pay its debts when due for a minimum period of 12 months after the financial assistance had been provided.[17] Furthermore, S. 156 also required a report by the auditors of the

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14 Sec. 151, UK Companies Act 1985.
15 Sec. 152, UK Companies Act 1985.
16 Sec. 155(2), UK Companies Act 1985.
17 Sec. 155, UK Companies Act 1985.

company confirming the same.[18] In addition to this, there is also the requirement of passing a special resolution by the general body provided in S. 155(5).[19] Thus, even though the rule against financial assistance was indeed diluted by the exceptions in the whitewash procedures, the threshold of requirements was indeed very high and made it a highly cumbersome procedure.

This procedure was highly time consuming and entailed high costs. Public to private deals have been completed after the public company re-registered itself as a private company and only then could its assets be used as a security for the lending banks.[20] Thus, compliance with this whitewash procedure was problematic because it created complexities and delays and was highly expensive as well. In 2000, the Law Commission of the United Kingdom's estimate was that the whitewash procedure cost the economy about £20 million ($39.45 million), and since leveraged lending has exponentially increased ever since, these costs can reasonably be assumed to have increased as well.[21]

This existing requirement to comply with the whitewash procedures has changed from 1st October 2008, after the passage of the new Companies Act, 2006 of the UK and the rules corresponding to financial assistance, which came into force on 1st October, 2008

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[18] Sec. 156(4), UK Companies Act 1985.

[19] Sec. 155(5), UK Companies Act 1985.

[20] Private Equity and Venture Capital Review, *United Kingdom: Liberating LBOs*, INTERNATIONAL FINANCIAL LAW REVIEW, (Jan., 2008), http://www.dechert.com/files/Publication/5840e57f-c4e7-4594-ace3-a9c016d9ebaf/Presentation/PublicationAttachment/bc5c7bc6-9ab4-49cc-b092-b741ebc337b5/Liberating%20LBOs.pdf.

[21] *Ibid.*

and have eased the restrictions regarding financial assistance in case of private companies. For public companies, the restriction still operates. This change in the law has come forth after a Directive to this effect was issued by the European Union in 2006 following which the 'financial assistance' regulations were eased in most member states.[22] The main reasons for this policy were the increasing complexity and costs associated with the whitewash procedure, the ambiguity in the law as to what precisely amounted to 'financial assistance' and the ever increasing frequency of leveraged buyouts and their perceived benefits to both private equity firms and the lending banks. When leveraged buyouts rose in popularity in the years following the 1980s, it was predicted that this would become the dominant form of corporate restructuring.[23]

The financial crisis of 2008 altered the scene completely. The impact of the financial crisis has invited increased restrictions from lending regulatory authorities due to its considerable impact on banks. In its recent publication, the Bank of England has expressed its concerns over the risks to the UK financial system over the high debt levels.[24] According to this, leveraged buyouts are increasing the

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22 Directive 2006/68/EC of the European Parliament and of the Council, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:264:0032:0036:EN:PDF

23 Michael Jenson, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, THE AMERICAN ECONOMIC REVIEW, Vol. 76(2), 323-29 (May, 1986), http://www.jstor.org/stable/1818789.

24 David Gregory, *Private Equity and Financial Stability*, MARKETS, SECTORS AND INTERLINKAGES DIVISION, BANK OF ENGLAND QUARTERLY BULLETIN, (Q1, 2013), http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2013/qb130104.pdf.

vulnerability and the frailty of the corporate sector in the UK, because steeper debt levels could result in companies showing reluctance to undertake long term investment as the costs of servicing the debt and the regular interest payments reduce the free cash flow of the company. This lower investment would in turn affect the profit generating ability of the company in the long run and could indirectly result in a deleterious impact on an already fledgling economy.[25] Higher levels of debt also increase the likelihood of the company to default on the debt obligation. This has a direct effect on the financial system due to losses incurred on lending through banks and a high risk exposure of banks to private equity firms. Since the percentage of exits of private equity firms is quite low, and if this is taken in context of the economic crisis of 2008, which paints a dark picture of a weak economic stage, and the possibility that private equity firms will not be able to repay the debt, even the options of refinancing seem bleak as banks already have a high degree of exposure to the private equity firms. This would negatively impact the resilience of the entire financial system, at a time where the country is still staggering from the effects of the 2008 crisis.

Thus it is submitted, that in the case of the UK, it is not the legal restriction as such, but rather the impact of the financial crisis and its repercussions like the freezing of loan markets, and a general reluctance on part of banks that has actually impacted leveraged buyout activity in the country.

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[25] *Ibid.*

[D] THE STORY OF LEVERAGED BUYOUTS IN INDIA

Unlike UK, the restrictions in India against LBOs are not only economic but also legal. Before delving into Leveraged Buyout scenario in the Indian context, it is important to draw a distinction between the Leveraged Buyouts of Indian Companies from those Buyouts that an Indian company does of foreign target companies. This is because in the case where the Buyout by an Indian Company of a target situated in foreign countries, the buyout is governed by the laws of the country where such a target is situated. On the other hand, the leveraged buyout of an Indian Company by an Indian or foreign company needs to comply with the legal framework in India and the scope of execution permissible in India. An analysis of such transaction would give us a clear picture of the legal and regulatory hurdle against a successful Leveraged Buyout in India.

(1) Restrictions to Leveraged Buyouts in India:

Generally, three factors are considered essential for a successful buyout. An acquiring company must have the ability to borrow significant sums for the acquisition. It should be able to retain or attract a strong management team and have the potential to enhance the values of each investment. And last, the ability to service the principle and interest payment obligation as well as to exit with a significant profit on the investment.[26]

On analysis of the Indian legal and commercial/economic scenario, one is appalled by the number of barriers that are in place in

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[26] NEW AGE INTERNATIONAL, MERGERS, ACQUISITIONS AND TAKEOVERS 184, 185 (2007).

the Indian legal as well as commercial environment which render the process of Leveraged Buyout difficult. Although there is no direct statutory restriction against leveraged buyouts in the commercial laws of India, the requirements and the structuring of a leveraged buyout is hit by a lot of small but significant restrictions. It should then not be surprising that Buyouts comprise a mere 3-5% of the PE activity in India.[27] In this paper, these restrictions have primarily been divided into three parts. Each of these part corresponds to the restriction on the three factors illustrated above which are essential for a successful buyout.

1.1 *Restrictions on the ability of the potential acquirer to borrow:*

(a) <u>Restrictions on Indian Banks from financing such acquisitions:</u>

Historically, the policy of the Reserve Bank of India discouraged bank financing of share acquisition on the ground that it could lead to lending towards speculative activities resulting in undue risk being posed on the banks.[28] RBI has issued a number of guidelines to domestic bank in regard to making advances against shares of a company which cumulatively prohibit banks from granting loans to acquirers to take up equity shares of other companies. This is because it promotes the principle that promoters' contribution towards the equity capital of a company should come from their own

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[27] Deepti Chaudhary & Shraddha Nair, *Buyout firms find the going tough in India*, (Oct. 14, 2009), http://www.livemint.com/Companies/DIsuQZEAGZCrSCbaw6pl3L/Buyout-firms-find-the-going-tough-in-India.html.

[28] C. Achutan (Chairman), *Report of the Takeover Regulations Advisory Committee*, 19, 20 (July 2010), http://www.sebi.gov.in/cms/sebi_data/attachdocs/1287826537018.pdf.

resources.[29] The RBI is more concerned with what the advances by the banks are for, rather than what the advances are against and therefore it obliges the banks to exercise particular care when advances are sought against large blocks of shares. The banks should ensure that advances against shares are not used to enable the borrower to acquire or retain a controlling interest in a company.[30] These restrictions have been made more stringent when in 2010 the RBI extended these restriction on grant of bank advances for financing promoters' contribution towards equity capital to payments related to such acquisitions like payment of non compete fee, etc. Further, these restrictions would also be applicable to activities by overseas branches/subsidiaries of Indian banks [31]

Such a restriction does not only throttle leveraged buyouts of Indian companies but also creates a huge disparity between potential foreign acquirers who have better access to financial support from the banks and financial institutions of their own countries as compared to the potential domestic acquirers. And therefore we see a higher number of foreign acquirers indulging in leveraged buyouts as compared to Indian acquirers.

Although RBI has made certain exceptions to this restriction, the exemption is only made with regard to acquisition finance when the target is a foreign company and when such acquisition is of

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[29] Para 8, RBI Master Circular Dir.BC.90/13.07.05/98 (August 28, 1998).

[30] Para 2.3.1.8, RBI Master Circular on Loans and Advances – Statutory and Other Restrictions, DBOD.No.Dir.BC. 6/13.03.00/2011-12 (July 1, 2011).

[31] Para 2, RBI circular on Bank loans for financing promoters contribution**,** DBOD.No.BP.BC.42 /21.04.141/2010-11 (Sept. 27, 2010).

benefit to both the potential acquirer as well as the country on the whole.[32] And therefore this does not in any way relax the restrictions in the way of acquiring an Indian target by way of leveraged buyout.

Additionally, there is a blanket restriction on foreign acquirers from borrowing from an Indian bank to buy into or acquire a company in India.[33]

(b) Restrictions against funding acquisitions from External Commercial Borrowings:

External Commercial Borrowings refer to commercial loans availed from non-resident lenders in the form of bank loans, buyers' credit, suppliers' credit, securitised instruments etc. These usually have a minimum average maturity of three years. Under Indian exchange control laws, foreign currency loans, including the proceeds of External Commercial Borrowings (ECBs) cannot be availed of for the purposes of leveraged buyouts of onshore Indian target companies. This is because under the present regulations, ECB proceeds both under the automatic and approval route have specific end use restrictions. Therefore although ECB can utilized for investment in new/existing projects in specified sectors in India, it cannot be utilized for acquisition of a company or part thereof. This restriction virtually makes external debt funding unavailable to Indian acquirers.[34]

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[32] Para 2-3, RBI circular on Financing of acquisition of equity in overseas companies (June 7, 2005).

[33] FIPB Press Note 9 (April 12, 1999).

[34] Para I.(A)(vii) and I.(B)(ix), RBI Master Circular on External Commercial Borrowings and Trade Credits (July 01, 2013).

(c) Underdeveloped Corporate Debt market:

The studies conducted by RBI on company finance bring out two prominent observations, *first* that Indian companies do not follow the pecking order theory (the commercial theory that profitable firms tend to finance through internal sources and the external sources) as they dominantly depend on external sources for their funding. And *second* that bank loans dominate the source of borrowing for Indian companies. For eg: for the period of 2006-2010, 67.4% of the total corporate borrowings were financed through bank loans and only 7% was financed through the corporate debt market. This trend actually increased further in the year 2010-11 when the share of borrowings as loan increased to 71.1% and the share of debt market was 10.7%. This shows that bank loans continue to be the major borrowing source for companies. The reason for such prevalence as analysed by this study conducted by the RBI is the prevalence of the cash credit system in the banks in which the cash management of the company is actually done by the banks themselves.[35]

The Indian corporate debt market has to go a long way despite the fact that existing literature suggests that corporate debt market yields would be much more efficient that bank lending rates in reflecting the risk return trade off.[36] This underdevelopment of the corporate debt market pushed potential issuers to foreign debt

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[35] Angshuman Hait, Saurabh Ghosh, Sunder Raghavan & Ashok Sahoo, A STUDY OF CORPORATE BOND MARKET IN INDIA: THEORETICAL AND POLICY IMPLICATIONS 4 (2014).

[36] Shri Deepak Mohanty (head), REPORT OF THE WORKING GROUP ON BENCHMARK PRIME LENDING RATE (BPLR) (Oct. 20, 2009).

markets, and this in turn will increase the inactivity in the Indian debt market, the consequences of which will be further stagnation and underdevelopment of the Indian corporate debt market. Hence this is a circular problem that needs to be resolved.

1.2 *Restrictions on the ability to retain a strong managerial team:*

Another predominant factor that creates a barrier is attributable to business culture in India. Most businesses are owned by the promoter families who have a considerable say in the management decisions and therefore the distinction between ownership and management is diluted to a great extent.[37] This is also the biggest reason why private equity firms are unable to enter into hostile takeovers in India. However a bigger problem posed by such a business environment is the relatively small pool of professional management in corporate India.[38]

1.3 *Restriction to service its loan and to exit with a substantial profit:*

(a) Restrictions on the acquirer from using the assets or cash flow from the target to service his principle obligation and interest:

Pursuant to Section 77(2) of the Companies Act 1956 and its complementary provision in the 2013 Act (Sec 67(2)), a public company or its subsidiary (even if it is a private company) cannot

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[37] Sumesh Swahney & Rishi Gautam, *Investment Opportunities in India's M&A market*, CLIFFORD CHANCE, 3 (2010), http://www.cliffordchance.com/content/dam/cliffordchance/Feature_topics/PDFs/MA_in_india_2.pdf.

[38] Afra Afsharipour, *NSE Working Paper on The Indian Private Equity model*, 10-11 (July, 2013), http://www.nseindia.com/research/content/res_WorkingPaper8.pdf.

provide any financial assistance for the purpose of or in connection with a purchase of the shares of the company itself or the holding company. This financial assistance could be either direct or indirect, it could be in the form of loan, guarantee, the provision of security or otherwise.[39]

Therefore, due to this provision, no company unless it's a private company which is not a subsidiary of a public company which can provide its assets as security for raising a loan to finance the buy-out. Consequently, if an acquirer intends to acquire a public listed company through a leveraged buy-out, the company would have to first delist under the SEBI (Delisting of securities) Guidelines, 2003 and then convert itself into a private company under the Companies Act 1956, which would need not only consent form shareholders but also approval by the registrar of companies. The reason behind such a restriction placed on public companies and their subsidiaries is primarily to protect the interests of the general public who have invested in the company as shareholders.

(b) Restrictions relating to exit of the acquirers:

Private equity firms restructure the companies they buy and hope to sell them or "exit" at a much higher price, either by selling the business to another company or private equity firm, or through an initial public offering.[40] A lucrative option for the acquirer would be to list the shares of the target on international capital markets through

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[39] Sec 77(2), Indian Companies Act 1956.

[40] Kaplan, Steven N. & Per Stromberg, *Leveraged Buyouts and Private Equity*, JOURNAL OF ECONOMIC PERSPECTIVES 23(1), 121-46 (2009).

the issue of Global Depository Receipts. However, until September 2013, SEBI guidelines required mandatory listing of Indian companies on domestic stock exchange before a foreign listing.[41] Under such regulatory mechanism the acquirer company who acquires through an Indian company through an LBO and who is looking for exit options would have to indulge into dual listing of the company which would cost him tremendous time and energy. This restriction was out in place by SEBI since it believed that it would help the development of domestic capital markets. However in light of the relatively weak domestic capital markets with very few successful Initial Public Offers of Indian companies in recent times and India's increasing current account deficit,[42] this restriction has now been removed by the Ministry of Finance through a press release on September 27, 2013 which permits unlisted Indian companies to list directly on offshore stock exchanges without prior or simultaneous or subsequent listing in India on a pilot basis for the next 2 years.[43] This change would now enable PE investors to require their investee companies to list in jurisdictions that are favourable to the certain sector/ industry in which the investee company operates, thereby making IPO a potentially more viable exit option. But, the PE

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41 SEBI Issue Of Foreign Currency Convertible Bonds And Ordinary Shares (Through Depositary Receipt Mechanism) Scheme, 1993.

42 Abhinav Harlalka, Shinoj Koshy & Pratibha Jain, *India: Indian Unlisted Companies Allowed To List Internationally: Another Exit Route For Investors?* (Nov. 29, 2013), http://www.mondaq.com/india/x/278408/Corporate+Commercial+Law/Indian+Unlisted+Companies+Allowed+To+List+Internationally+Another+Exit+Route+For+Investors.

43 http://finmin.nic.in/press_room/2013/lisitIndianComp_abroad27092013.pdf .

investors that would be able to benefit from this relaxation may be limited.

Therefore the biggest limitation with regard to exit of the acquirer is the provision regarding minimum contribution of the promoter and the promoter share lock in when a private company goes for an IPO under the SEBI Issue of Capital & Disclosure Requirement regulations. These provisions provide that if a private company undergoes an IPO, the promoters who are controlling the company should necessarily offer 20% of the post issue capital. Further, they are mandated to hold a minimum amount of shares in the company even after the issue for at least a period of three years. Therefore in India, the IPO route does not offer a clean exit to the acquirer.

[E] ANALYSIS & CONCLUSION

Despite the growing investment into India in some form of Leveraged buyout, there is very little discussion regarding it within and amongst the regulators in India such as the RBI, FIPB and SEBI. The only document closely doing this is the RBI's paper on "Evolution of Global Private Equity Market" which is regarding Private Equity players in India who majorly engage in Leveraged Buyouts in various jurisdictions.[44] An analysis of this document makes it clear that the regulatory authorities are not opposed to the concept of Leveraged buyouts itself as they recognise the various

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[44] R. K. Jain and Indrani Manna, *Evolution of Global Private Equity Market: Lessons, Implications and Prospects for India*, RESERVE BANK OF INDIA OCCASIONAL PAPERS, Vol. 30, No. 1, (2009), http://www.rbi.org.in/Scripts/bs_viewcontent.aspx?Id=2109#1

studies have shown that Leveraged Buyouts help companies to perform in better ways due to factors such as pressure of servicing debts, professional governing and metering structures brought in by the acquirer etc.[45]

But, while recognising that Leveraged Buyouts are beneficial at the micro economic level (i.e. level of a single company), RBI is also wary of its impact in the economy as a whole. An analysis of the financial crisis post 2012 makes clear the dangers to the financial system of using too much leverage. Regulatory authorities' failure to limit the leverage is widely understood to have contributed to the economic crisis. And in order to avoid the mistake being repeated, jurisdictions like US which is the most liberal economic environment in March 2013 issued guidelines that encourage banks to refuse to make loans that would raise the debt levels of a company beyond 6 times earnings before interest, taxes, depreciation and amortization (Ebitda).[46] Further, in April regulators began an annual review of the loans banks make, and this has encouraged greater compliance. KKR's request for a $725 million buyout loan, for example, was refused in May by three banks with which it had long-standing relationships on the grounds that regulators would find the loans too risky.[47] It is also true that it was because of the blanket cushion

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[45] Kaplan, S. N., *The Effects of Management Buyouts on Operations and Value*, JOURNAL OF FINANCIAL ECONOMICS, Vol.24, 217-254 (1989).

[46] Eileen Appelbaum, *Private Equity at Work: Limit Leverage to Limit Risk*, CENTRE FOR ECONOMIC AND POLICY RESEARCH, (June, 2014), http://www.cepr.net/index.php/blogs/cepr-blog/private-equity-at-work-limit-leverage-to-limit-risk.

[47] Greg Roumeliotis & Lauren Tara LaCapra, *Banks search for loopholes in leveraged loan guidelines*, Reuters, Jun 10, 2014 at

provided by the economic regulations in place in India that economic trends affecting developed markets do not influence us directly.

Therefore the question boils down to: "How much restriction is required and how much can be done away with?" Now this question is not something that India is solely dealing with. As can be seen before in this paper, even UK has been changing its policies trying to grapple with this issue. Another example is the USA which we recently illustrated has brought in a change in its policy. Another example is Italy where till 2004, LBOs in themselves were considered illegal by the Courts.[48]

The restrictions that are present in the Indian legal system can be called excessive especially when we are aiming to be an economy growing at the GDP of 7%.[49] A better and economic way ahead would be to relax the rigid rules that restrict Leveraged Buyouts and still keep in place certain precautionary measures to prevent excessive leverage in the economy. Although a deeper analysis by the regulators is required to come up with the final policies, certain areas that they could look at would be to remove the absolute restriction on the ability of banks to provide acquisition finance; rather there could be policies in place as to when and to what extent banks can provide such leverage. Another suggestion would be providing leveraged

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https://in.finance.yahoo.com/news/banks-search-loopholes-leveraged-loan-110630583.html .

[48] Bottazzi , *Private Equity Regulation: Lesson from Italy*, RGE, (May 2008).

[49] *Budget 2014: Aim for 7-8% GDP growth in 3-4 years says Arun Jaitley*, Economic Times, Jul 10, 2014 at http://articles.economictimes.indiatimes.com/2014-07-10/news/51301043_1_fiscal-deficit-target-finance-minister-arun-jaitley-fiscal-prudence.

buyout as an additional fourth exception to the rule against financial assistance and at the same time incorporate protections for the minority shareholders and creditors. A reanalysis of these policies is imperative for India to energize the entrepreneurial climate in India. And to facilitate the productive use of the existing assets and resources of companies with untapped potential by reorganizing their operations in ways that increase their value.

LIABILITY OF COMPANY AND INTERMEDIARIES IN RELATION TO ISSUE OF SECURITIES- A COMPARATIVE PERSPECTIVE

Ashwini Vaidialingam and Mannat Sabhikhi[*]

Public issuance of securities is one of the most important ways by which companies seek to raise capital. By its very nature, however, there is information asymmetry between the company and the market. It is important for this gap to be bridged to ensure that there is investor confidence in the market, which will lead to greater efficiency and profitability. Mandatory disclosure regimes seek to achieve this while balancing the interests of the company, which tend to take a myopic view by promoting their own interests. Different jurisdictions have devised various procedural mechanisms to this end, by formulating rules and regulations and setting up regulatory authorities. This focuses on making certain heads of information available to the general public through the issue of prospectus, which is a public document. The law in India has undergone changes in the recent past due to the enactment of the Companies Act, 2013. This paper adopts a comparative perspective by analyzing these changes in light of the position in the UK, which was also modified in the aftermath of the 2008 financial crisis. This paper examines these changes through the lens of investor protection and its effectiveness in achieving the same.

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[A] INTRODUCTION

The raising of capital, which is vital for financing the business activities of a company, invariably depends on the preferences of the directors and financial advisors, on the nature of the proposed business activity, as well as on the vagaries of the market, resulting in companies adopting different policies in this regard.[1] One of the most common ways of raising capital is through the issuance of "*securities*".[2] To regulate such issuance, and ensure that the rights of the investors and the company are balanced, most jurisdictions, including India and UK, have mandatory disclosure regimes. One way of ensuring such a balance is by regulating the offer document, which is the first step a company must take in issuing securities. The prospectus, which is the offer document in case of public issues, has to contain all information that is necessary for an investor to make an informed decision. Such disclosure increases market confidence, and boosts the securities market. This is particularly important in initial public offerings, as investors have no prior knowledge of the securities involved. Therefore, both jurisdictions have detailed

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1 For instance, a small company may not wish to bear the potentially disproportionate costs of raising capital through a public offering, and would prefer to take a short-term bank loan to finance its business activities. On the other hand, a large public company may choose to raise capital through a rights issue, or by issuing debentures/loan stock to the public.
Pennington, COMPANY LAW, 290 (7th edn., 1995)

2 The definition of securities given in S. 2(h) of the Securities Contracts (Regulation) Act, 1956 ["*SCRA*"] is very broad in its scope. This definition has been espoused by other statues such as in S. 2(i) of the Securities and Exchange Board of India Act, 1992 which established the Securities and Exchange Board of India ["*SEBI*"], the regulator of the Indian securities market.
'*Security'* under English law is defined by section 3(1) of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.

regulations on the procedure that must be followed in the issuance of securities.

India and UK provide for both civil and criminal statutory liability, which can be imposed on the company and all persons involved in the issuance of the securities, including involved intermediaries. Apart from statutory liability, all those who are aggrieved by any deviation from the specified procedure have recourse to common law remedies as well. In addition, regulatory authorities in India and UK have certain powers which enable them to enforce compliance.

The main focus of the paper is to do a comparative study of the liability regimes in both jurisdictions. Given that there have been significant changes with the introduction of the Companies Act, 2013, this paper also addresses the differences between it and the Companies Act, 1956. Part I deals with the evolution of the securities market and the related liability regime is examined. Part II addresses the liability that may be incurred when procedural requirements are not fulfilled. In Part III the different liabilities arising out of untrue or misleading statements in a prospectus in UK and India have been examined. This includes civil, criminal and common law liability. Finally, in Part IV, the differences in the role and liability of intermediaries in the issuance of securities have been analysed.

[B] EVOLUTION OF STATUTORY LIABILITY

To fully understand the nature of the existing regulatory regime for the securities market, it is important to understand how it has evolved. This includes the formation of rules and regulations, and

the creation of regulatory bodies. In this section, this evolution in both the UK as well as in India has been traced.

(1) United Kingdom

The current law on prospectus liability has its origins in the common law tort of deceit. Imposing liability under the common law regime was extremely hard.[3] In conjunction with this, due to numerous frauds and busts, the public in nineteenth century England viewed Directors as *'predatory creatures who exploited public ignorance for personal profit'*.[4] It was in this context that the case of Derry v. Peek[5] came before the courts. Lord Herschell in his judgment held that *first,* for an action of deceit, there must be proof of fraud and *second,* fraud is proved when a false representation is made (i) knowingly or (ii)

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[3] GOWER AND DAVIES' PRINCIPLES OF MODERN COMPANY LAW, 935 (9th edn., 2012). This is because to establish deceit, the plaintiff had to prove- (i) that the maker of the statement knew that it was false or was reckless as to its truth (ii) reliance was placed by the recipient on the statement and (iii) the maker of the statement intended for the recipient to rely on it.

[4] Michael Lobban, *Nineteenth Century Frauds in Company Formation: Derry v. Peek in Context,* LAW QUARTERLY REVIEW 20 (1996).

[5] Derry v Peek, (1889) 14 App.Cas. 337, HL.
The Plymouth, Devonport and District Tramways Company issued a prospectus which stated that, "*The company had the right to use steam or mechanical power instead of horses.*" However, at the time of issuance of the prospectus, the company, in fact, did not have the right to use steampower, which was under consideration by the Board of Trade.
The test that Lord Herschell employed in this case was whether the defendants made a false statement knowingly or alternatively, whether they honestly believed what they stated as a true and fair representation of facts. On the facts of the case, Lord Herschell was of the opinion that the plaintiff has not established fraudulent misrepresentation. This is because the defendants believed that the consent of the Board of Trade was practically concluded. Hence, they honestly believed what they asserted to be true. Therefore, the charge of fraud was not made out against the defendants.

without the belief in its truth or (iii) recklessly, careless whether it be true or false.[6]

The House of Lords adopted the rationale given by Stirling J. of the Chancery Division that if any other interpretation was taken, it would cause mercantile men to 'cry out'. However, the judgment was seen to take a narrow view of principles such as good faith in commercial transactions.[7] Public opinion of this judgment was that it gave fraudsters a free reign to trick the public into buying shares in bubbles.[8] This reaction of the public led to the passing of the Directors' Liability Act, 1890.

The Directors' Liability Act, 1890 was the first legislation in the United Kingdom that gave statutory backing to a claim by security holders that they had been misled by a company's prospectus.[9] Section 3(1) of the Directors Liability Act, 1890 provides for the liability of directors, promoters and persons authorizing the issue of a prospectus to all persons who subscribe to the shares relying on the prospectus for any damage they sustained due to an untrue statement.[10] The defences available were reasonable ground for believing the statement, fair representation of an expert's opinion, fair representation of an official statement or document, or that the director had withdrawn consent before the publication of the prospectus, or that it was issued without his or her knowledge and

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[6] Derry v Peek, (1889) 14 App.Cas. 337, HL.

[7] M. Loban, *supra* note 4, at 1.

[8] M. Loban, *supra* note 4, at 22.

[9] A. Alcock, *Liability for Misinforming the Market,* JOURNAL OF BUSINESS LAW 1 (2011).

[10] Section 3(1), Directors' Liability Act

consent.[11] This Act did not provide for liability extending to market purchases of shares.

These provisions were integrated into mainstream company law legislations through the Companies (Consolidation) Act, 1908. Section 84 of this act, which provided for the liability for statements in the prospectus, was not substantially different from Section 3 of the Director's Liability Act, 1890.

The Companies Act, 1948 made some additions to the extent of liability. *First,* it made it unlawful for shares to be issued without a prospectus, which had to carry certain mandatory provisions.[12] *Second,* experts were also made liable for any statement they contributed to the prospectus, and *third,* shares allotted to an issuing house with the view to ultimately sell them to the public, were included within the ambit of offer for subscription.[13] Similar provisions were reenacted in the Companies Act, 1985.[14]

It was with the Financial Services Act, 1986 ["*FSA, 1986*"] that a clear distinction was drawn between listing particulars for shares sought to be listed on the Stock Exchange, and a prospectus for unlisted securities.[15] The FSA, 1986 established the Securities and Investments Board ["*SIB*"], which was the authority that framed regulations.[16] The SIB was supported by self-regulatory organisations

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[11] Section 3(1), Directors' Liability Act,1890.
[12] Section 28, Companies Act, 1948.
[13] Section 43, Companies Act, 1948.
[14] Section 56 to 71, Companies Act, 1985.
[15] Chapters IV and V, The Financial Services Act, 1986.
[16] Section 114, The Financial Services Act, 1986.

["*SRO*"] which regulated various different financial services and participants.[17]

It should be noted that with respect to the question of who can sue for damages for a breach of a statutory duty, the FSA, 1986 provided for a remedy to all purchasers of securities i.e. it to *'any person who has acquired any of the securities in question'*.[18]

Though, the FSA, 1986 was initially perceived as the first major reform in the modern financial sector, subsequently, firms viewed the system as too expensive and costly while stakeholders viewed self-regulation as a mechanism for facilitating industry self-interest.[19]

It was in this context that the different regulatory bodies under the FSA, 1986 were merged into one body called the Financial Services Authority.[20] This body exercised statutory powers under the Financial Services and Markets Act, 2000 ["*FSMA, 2000*"]. As per the power to make rules, granted by the section 73 of the FSMA, 2000 the Financial Services Authority has framed *Prospectus Rules*, *Listing Rules* and *Disclosure and Transparency Rules*. It also used to be the

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17 Section 8, Financial Services Act, 1986.

18 Section 150, the Financial Services Act, 1986. Providing for a statutory remedy to all people who bought securities and suffered loss in relation to a misleading statement, is different from the common law position, which will be discussed *infra* Part III(C).

19 L. Cox *et al, United Kingdom Regulatory Reform: Emergence of the Twin Peaks,* COMPLIANCE OFFICER BULLETIN 4 (2012).

20 *Id.* Another reason for the formation of the Financial Services Authority was that given by Gordon Brown, the then Chancellor of the Exchequer, to the House of Commons that the boundaries between traditional banking, insurance and investment business were becoming blurred. Therefore, there was a requirement for a consolidated regulatory body that could address the inefficiencies that a structure based on regulation by function could not.

'*competent authority'* for administering the statutory regulation of the issue of share capital of companies on the London Stock Exchange and associated options exchange.[21]

The FSMA, 2000 tries to balance between creating a powerful regulator, while at the same time ensuring that the regulator does not restrict the free market in the general sense.[22] Through the Financial Services Authority, it also sought to promote four core regulatory objectives: market confidence, public awareness, the protection of consumers, and the reduction of financial crime.[23]

In 2010, the Financial Services and Markets Act 2000 (Liability of Issuers) Regulations 2010 introduced new aspects into the statutory regime for issuer liability for misstatements. These changes were incorporated in section 90A of the FSMA, 2000. Three things need to be emphasized in context of liability for misstatements: *one,* liability can be imposed for all information published by issuers via a recognized service; *two,* liability can be imposed for dishonest delay by the issuer in publishing information; and *three,* issuers may be liable to buyers, sellers or holders of securities.

However, the inadequacies of the functioning of the Financial Services Authority were exposed by the financial crisis that took place in 2008. A report by the Conservative Party identified four weaknesses of the system- (i) poor evaluation of and response to emerging threats to financial stability; (ii) lack of appropriate

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[21] PALMER'S COMPANY LAW VOL. 1, 5024 (25th edn., 2008).

[22] *Id*, at 5025.

[23] Section 2(2), Financial Services and Markets Act, 2000.

instruments to mitigate emerging risks; (iii) inadequate prudential regulation; and (iv) expertise and preparation for crisis handling.[24]

In light of this, the UK government passed the Financial Services Act, 2012 [“*FSA, 2012*”]. This Act did not repeal the FSMA, 2000 but just introduced some amendments. The FSA, 2012 however did abolish the Financial Services Authority. Its responsibilities are now exercised by two bodies: the Prudential Regulation Authority,[25] and the Financial Conduct Authority.[26] This new regime came into effect on April 1, 2013, and it remains to be seen how effective it will be.

(2) <u>India</u>

The securities market in India can be traced back to the colonial period, when the first companies were set up. Stock exchanges were set up in the presidency towns, with the Bombay Stock Exchange being the most prominent of them all. However, the securities market was largely unregulated. India, for the first 40 years of independence, followed a model of self-reliance. Consequently, due to high trade barriers and strict regulation of the market, the Indian securities market was both underdeveloped and unregulated. It could not compare with its well regulated counterparts in the

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[24] The Tripartite Review: a Review of the UK’s Tripartite System of Financial Regulation in relation to Financial Stability, *as cited in supra* note 21, at 7.

[25] The Prudential Regulation Authority is a quasi-governmental regulator which is responsible for the regulation and supervisions of banks, credit unions, insurers, building societies and investment firms.

[26] The Financial Conduct Authority is an independent body which regulates financial firms providing services to consumers and focuses on regulating their conduct.

developed world.[27] After independence, the Capital Issues (Control) Act of 1947 and the Securities Regulation Act of 1956 had held the field. The Securities Contracts (Regulation) Act, 1956 ["*SCRA*"] was the primary legislation regulating stock exchanges in the country.[28]

The year 1992, however, acted as a watershed. Among the other financial reforms undertaken in that period, the Securities and Exchange Board of India ["*SEBI*"] and the National Stock Exchange were set up to regulate and modernize the securities market.[29] The SEBI in particular was given the power to enforce the SCRA, the Capital Issues (Control) Act, 1947, and to pass all necessary regulations. In the last two decades, with the financial reforms and positive actions taken by these new regulatory bodies, the securities market in India has expanded considerably.

[B] ISSUE OF SECURITIES: PROCEDURE

Before a company issues securities, it must comply with a series of complex procedures. Failure to do this leads to liability being imposed on a number of persons, depending on the stringency of the regulations imposed by the relevant jurisdiction. In this section, the procedural framework in India and in the UK have been analysed and compared.

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[27] S. Vattikuti, *Accelerating Towards Globalization: Indian Securities Regulation Since 1992,* 23, NORTH CAROLINA JOURNAL OF INTERNATIONAL LAW AND COMMERCIAL REGULATION, 105, 109-116 (1997).

[28] *Id.*

[29] The SEBI was set up under the Securities and Exchange Board of India Act, 1992. The NSE was incorporated in 1992, and officially recognized as a stock exchange under the SCRA in 1993.

(1) India

Offer Document: Form and Content

The first step in the process of raising capital through securities is to issue an offer document. The nature and specifications of this offer document depends on the law governing the issue. In the case of a public offer, offer documents include a prospectus,[30] a shelf prospectus,[31] a red herring prospectus,[32] or an information memorandum.[33] In the case of a rights offer, a letter of offer is issued.[34]

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[30] Section 2(36), Companies Act 1956 defines prospectus as, "…*any document described or issued as a prospectus and includes any notice, circular, advertisement or other document inviting deposits from the public or inviting offers from the public for the subscription or purchase of any shares in, or debentures of, a body corporate*." The definition contained in Section 2(70), Companies Act, 2013 includes within its scope red-herring prospectuses and shelf prospectuses, and excludes public deposits. It also broadens the definition from "*shares or debentures*" alone to "*any securities of the company*".

[31] Section 60A, Companies Act, 1956. Explanation (b), Section 60A states: ""*shelf prospectus" means a prospectus issued by any financial institution or bank for one or more issues of the securities or class of securities specified in that prospectus.*" Section 31, Companies Act, 2013 defines shelf prospectus in the Explanation as "*a prospectus in respect of which the securities or class of securities included therein are issued for subscription in one or more issues over a certain period without the issue of a further prospectus.*" Clearly, the definition in the Companies Act, 2013, is broader as it includes all classes of companies and not only financial institutions. It also prescribes one year validity for a shelf prospectus commencing from the first offer of securities.

[32] Section 60B, Companies Act, 1956 refers to both an information memorandum as well as a red herring prospectus.

[33] An information memorandum is defined under Section 2(19B), Companies Act, 1956 as: "…*a process undertaken prior to the filing of a prospectus by which a demand for the securities proposed to be issued by a company is elicited, and the price and the terms of issue for such securities is assessed, by means of a notice, circular, advertisement or document*". The concept of an information memorandum seems to have been dispensed with in the Companies Act, 2013, which only discusses red-herring prospectuses.

[34] Section 2(x), The Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009.

Section 56(3), Companies Act, 1956 requires every application form for shares or debentures to be accompanied by a memorandum that contains all the salient features of the prospectus. Any person can ask for a copy of the whole prospectus while subscription is still open.[35] This specifically relates to public offerings, not amounting to an underwriting agreement.[36] Such a prospectus must state all company-related matters as specified in Parts I and II of Schedule II of the Companies Act, 1956. If any person violates any of the mandatory requirements under Section 56, with particular emphasis on the disclosure requirements, he may incur liability extending to Rs. 50,000.[37]

The contents of the offer document are very important, and must be drafted carefully. The Companies Act, 1956 specifies the form and contents of the prospectus in Schedule II.[38] This mandates, among many other things, the disclosure of information about the company, management, all proposed projects, information regarding 5 years of financial performance, and the perceived risk factors. The company must also furnish information regarding other listed companies which are governed by the same management.[39] In addition to Schedule II of the Companies Act, 1956, Schedule VIII of

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[35] First Proviso to Section 56(3), Companies Act, 1956.

[36] Second Proviso to Section 56(3), Companies Act, 1956.

[37] Section 56(3), Companies Act, 1956. The prosecution powers in such cases are exercisable by the SEBI and the DCA concurrently.

[38] Schedule II of the Companies Act, 1956 was introduced by Notification No. SO 666(e) of October 3, 1991, and this replaced the erstwhile Schedule II.

[39] "*Same management"* is defined under Section 370(1B), Companies Act, 1956 which has been repealed since October 31, 2010. However, the concept of "*same management*" as laid out therein persists.

The Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009 ["*ICDR Regulations*"] exhaustively lays out what must be disclosed.[40] In the event that the company does not issue a prospectus, but only a "*Memorandum containing salient features of prospectus*" i.e. an abridged prospectus, the form and content requirements are laid out in Form 2A of the Companies Act 1956. The main purpose of these disclosure requirements is to enable investors to make an *informed decision*.

Under the 2013 Act, Schedule II has been dispensed with. Instead, Section 26 of the Act expressly mentions what must be disclosed,[41] with further disclosure requirements to be prescribed under rules, which are yet to be notified.

Section 56, Companies Act 1956 also discusses the liability for failure to fulfill the requirements laid down. In the event that *any person* fails to comply with disclosure requirements in the prospectus, they will be subject to penal liability.[42] It is submitted that this broad phrasing expands the scope of the provision to cover all the intermediaries who help facilitate the issue of securities. However, there are certain specific circumstances in which directors and other persons who were responsible for the prospectus will not be liable. This includes situations when the person did not have knowledge of

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[40] Part A of The Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009 specifies what disclosures are required in a Prospectus, a Red Herring Prospectus and a Shelf Prospectus. Part B and C list the non-mandatory disclosure requirements. Part D lists out the disclosure requirements for Abridged Prospectuses. Part E lists the disclosure requirements in Letters of Offer, and Part F on abridged letters of offer.

[41] Section 26(1), Companies Act, 2013.

[42] Section 56(3), Companies Act 1956.

the matters that the prospectus failed to disclose, when there was an honest mistake made, or when this contravention or non-compliance by the company is immaterial or can be excused by the court.[43] This position is echoed in common law as well.[44]

Under the Companies Act, 2013, while the broad scope of Section 56, Companies Act, 1956 is retained,[45] the liability of the company is different. Section 26(9) mandates a significantly enhanced fine as well as imprisonment.[46] Furthermore, it does not make any mention of defences available to persons so liable.

Companies may also issue an information memorandum prior to issuing a prospectus. This is done for the purposes of gauging the market. If they choose to do so, they have to issue a red-herring prospectus as well, which together with the information memorandum, is subject to the same mandatory regulations as a prospectus.[47] This implies that the company, its directors and employees, as well as all intermediaries will be as liable for misstatements in the information memorandum as in a prospectus issue. In the event that the final prospectus differs in any way from this red-herring prospectus, all such variations must be intimated to any and all invitees.[48] If there is failure on the part of the company,

[43] Section 56 (4), Companies Act, 1956.
[44] This is discussed below: *infra* Part III(C).
[45] As opposed to referring specifically to directors and other persons as under Section 56, Companies Act, 1956, Section 26, Companies Act, 2013 states that "*every person who is knowingly a party to the issue of such prospectus…*" shall be liable.
[46] Section 26 (9), Companies Act, 2013.
[47] Section 60B(3), Companies Act, 1956.
[48] Section 60B(6), Companies Act, 1956.

the underwriters or bankers to the issue, to adequately inform the invitees, all applicants are entitled to receive a refund. The company will also be liable to pay an interest of 15% from the date of payment till the refund is realized.[49]

In the 2013 act, the concept of information memorandums has been done away with. The process of issuing a red-herring prospectus has also been greatly simplified. Moreover, the requirements and liability under Sections 60(5) to (8) that existed under the Companies Act, 1956 have been removed.[50]

Expert Statements in Prospectuses

When a company releases a prospectus, it may include within it, expert statements. These are statements made in the prospectus by experts in a relevant field which give authority to claims made therein.[51] While such use of experts is permitted, and even encouraged, no person is allowed to make a statement in the prospectus purporting to be an expert on any matter, if he had been, or was at the time of the issue, or at any previous time been connected with the company.[52] Such measures ensure that the public are not misled by any biased or personal opinions, masquerading as

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[49] Section 60B(8), Companies Act, 1956.

[50] Section 32, Companies Act, 2013.

[51] "*Expert*" means anyone who holds himself out to the public as specially qualified in any line by knowledge or skill (*Palmer's Company Precedents*, 123 (16th edn.) *as cited in* A Ramaiyya, GUIDE TO THE COMPANIES ACT, 863 (17th edn., 2010).). The statutory definition as that stated in Section 59(2), Companies Act, 1956 - "*expert" includes engineer, valuer, accountant and any other person whose profession gives authority to a statement made by him*.

[52] As per Section 57, Companies Act, 1956, this connection is understood in the terms of "*engaged or interested in the formation or promotion, or in the management, of the company.*"

authoritative analyses. However, such a "*connection*" with the company does not include any professional engagement, but only personal ones. For instance, a chartered accountant or a solicitor engaged by the company in a professional capacity, for assisting in the preparation of constitutional documents, can act as an expert.[53]

Further, any such expert statement included in the prospectus has to be with the expert's express consent in writing, to both the form and the content. If he withdraws consent prior to issuance, the company cannot use his statements.[54] This section has been adopted from English law.[55] If there is failure to abide by these requirements as to expert statements in the prospectus, the company and every person who was "*party to the issue thereof*" are punishable with fine up to 50,000 rupees.[56] Under the 2013 Act, however, Section 35(1)(e) makes experts liable to pay compensation to every person who relies on and suffers consequent loss due to any misstatements in the prospectus. This is a departure from the position in the Companies Act, 1956 where experts were made expressly liable only to the statement made by them in the prospectus.

Registration of Offer Documents

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[53] This is because only personal or financial interests are presumed to affect any objective assessment that may be done. Mere professional transactions are not presumed to colour any statement that is made in the prospectus. A Ramaiyya, *supra* note 60.

[54] Section 58, Companies Act, 1956.

[55] This provision takes inspiration from Section 40 of the 1948 English Companies act. It is meant to be a "*wholesome rule intended to protect intending investors by making experts liable*". ¶ 59, Company Law Committee Report, 1952, *as cited in* Ramaiyya, *supra* note 60.

[56] This provision pertaining to the consent of experts has been incorporated in the Companies Act, 2013, in Section 26(5).

Prior to issuing a prospectus, all directors or proposed directors must sign and deliver a copy of it to the Registrar of Companies.[57] This copy must be accompanied by the written consent of all experts as per Section 58, as well as endorsed copies of all existing contracts and other statements pertaining to Schedule II disclosures.[58] Such contracts mentioned in the prospectus or other documents cannot be varied unless the company in general meetings grants its approval.[59] Any liability for failure to abide by this provision does not fall within the jurisdiction of a company court, but will be subject matter of a regular court. Ordinary civil courts will have jurisdiction in such cases.[60]

The Registrar will then register this prospectus, after ensuring all the requirements under Sections 56-58 are complied with.[61] He must also ensure that the consent of any person named in the prospectus such as an auditor, attorney, solicitor, banker or broker, have been included as a separate statement.[62] Once this prospectus is registered, it must be issued within 90 days.[63] If it is not issued, then it will be deemed a prospectus for which registration has not been done. A failure to follow any of these stipulated requirements under Section.

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57 Section 60, Companies Act, 1956. This requirement is retained under Section 26(4), Companies Act, 2013,, subject to a few modifications.

58 Under the Companies Act, 2013,, there is no requirement for these endorsed copies of every contract entered into by the company and Schedule II documents.

59 Ramaiyya, *supra* note 60; Section 27, Companies Act, 2013.

60 Poonam Chand Kothari v. Rajasthan Tubes Mfg. Co. Ltd., (1996) 87 Com Cases 842 (Raj).

61 This has been incorporated in Section 26(7), Companies Act, 2013.

62 Section 60(3), Companies Act, 1956.

63 Section 60(4), Companies Act, 1956.

60 of the Companies Act, 1956 will expose the company and every person who has knowingly authorized the issue to a fine extending to Rs. 50,000.[64]

This provision follows Section 41 of the English Companies Act of 1948 and Sections 64-65 of the 1985 Act, which provides for registration of the prospectus. However, the Indian law makes certain departures. Once registered, the prospectus must be issued within 90 days. There is no similar provision in English law. The purpose behind such a restriction on the company and all persons involved is to ensure that the issue is not delayed for a considerable period of time. This is because conditions may be altered and what appears in a prospectus may not necessarily be valid at the end of that period of time.[65] The Companies Act, 2013 incorporates these requirements in Section 26(8). Further, under the Companies Act, 2013, if a prospectus is issued without registration, the liability has been enhanced: the company and any party who knowingly issued the prospectus shall be liable to pay a fine of minimum Rs. 50,000 but which may extend to three lakh rupees; such persons may also be imprisoned up to 3 years.[66]

Section 60, Companies Act, 1956 also mandates the written consent of certain persons named in the prospectus.[67] While this written consent does not expose such persons to liability,[68] it ensures

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64 Section 60(5), Companies Act, 1956.
65 Ramaiyya, *supra* note 60 at 946.
66 Section 26(9), Companies Act, 2013.
67 Section 60(3), Companies Act, 1956.
68 This is only in so far as they are <u>*not*</u> acting as experts. If they are acting as experts, Ss. 58 and 59, Companies Act, 1956 will apply to them.

that they are circumspect in their actions. The public places importance on the inclusion of well-known or respected names in a prospectus, and this ensures that such professionals do not associate themselves with dubious enterprises.[69] Interestingly, however, there is no such requirement under the Companies Act, 2013. Only those who have been named as a director, or proposed director, or their duly authorized attorney need to provide such written consent.[70]

(2) United Kingdom

The prospectus rules are provided in the Financial Conduct Authority Handbook (FCA Handbook). A prospectus can either be a single document or separate documents.[71] If the prospectus is in the form of a single document it needs to have a registration document, a securities note and a summary.[72] However, if the prospectus is in the form of separate documents, it must have a registration document which contains information of the issuer and the securities that are going to be issued.[73]

Under the FSMA, 2000 it is unlawful to deal in transferable securities unless an approved prospectus has been published.[74] Moreover, the mere request to have securities admitted to trading on

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[69] ¶ 60, Report of the Company Law Committee, 1952, *as cited in* Ramaiyya, *supra* note 60, at

[70] Section 26(4), Companies Act, 2013.

[71] Para 2.2.1R, Prospectus Rules, Financial Conduct Authority Handbook, 2013.

[72] Para 2.2.2(1)R, Prospectus Rules, Financial Conduct Authority Handbook, 2013; Further requirements are laid down in Article 25.1, Prospective Directives Regulation.

[73] Para 2.2.2(2)R, Prospectus Rules, Financial Conduct Authority Handbook, 2013; Further requirements are laid down in Article 25.2, Prospective Directives Regulation.

[74] Section 85(1), Financial Services and Markets Act, 2000.

the stock exchange is criminalized unless such an approved prospectus has been made available to the public.[75]

Copies of Form A and the prospectus are the relevant documents for the approval by the competent authority.[76] The competent authority cannot approve a prospectus unless the requirements under section 87A(1) of the FSMA, 2000 are satisfied.[77] Section 87A(1)(b) contains a requirement that all '*necessary information'*, as defined in section 87A(2) of the FSMA, 2000,[78] needs to be provided. The general duty for disclosure is that the investor needs to make an '*informed assessment'*[79] i.e. while preparing the prospectus, the people involved in the drafting must keep in mind the level of information a prospective investor needs to be able to assess the securities being offered. As is evident, the United Kingdom follows a system of mandatory disclosure obligations on issuers. This is to promote confidence in the market and protect investors.[80]

The FSMA, 2000 also permits, in certain circumstances, the omission of required information.[81] However, this is only allowed by application of the issuers of the prospectus. The application must

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75 Section 85(2), Financial Services and Markets Act, 2000. Exemptions to the requirement of issuing a prospectus are laid down in Section 86, Financial Services and Markets Act, 2000.

76 Para 3.1.1R, Prospectus Rules, Financial Conduct Authority Handbook, 2013.

77 Section 87A, Financial Services and Markets Act, 2000.

78 Section 87A(2), Financial Services and Markets Act, 2000.

79 Palmer, *supra* note 23, at 5114.

80 Ellis Ferran, COMPANY LAW AND CORPORATE FINANCE, 582 (1999).

81 Section 87B, Financial Services and Markets Act, 2000.

identify the information that is sought to be omitted, and the reasons under Section 87B(1) for the same.[82]

Additionally, Section 87G provides for a procedure if during the relevant time period,[83] there is a "*a significant new factor, material mistake or inaccuracy relating to the information included in a prospectus approved by the competent authority*".[84] The persons responsible for the prospectus can then provide for the further information in a '*supplementary prospectus'* to the FCA. The issuers of the prospectus do not need to start the procedure for approval of prospectus from scratch. In fact, persons responsible for the prospectus have an obligation to give notice of any new factor, mistake or inaccuracy.[85] The purpose of the supplementary prospectus is to correct any incorrect impression created by the original prospectus.

To ensure that issuers of securities comply with the above requirements, the Financial Conduct Authority has been given certain powers. They can be divided it two parts based on the time at which they are exercised- ex ante controls and ex post controls:

Ex ante Controls

The methods by which the FCA can exercise ex ante control are as follows –

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[82] Para 2.5.3R, Prospectus Rules, Financial Conduct Authority Handbook, 2013.

[83] As per Section 87G(3), Financial Services and Markets Act, 2000, '*relevant time period'* begins when the prospectus is approved and ends either with the closure of the offer of the transferable securities to which the prospectus relate or when trading in those securities on a regulated market begins.

[84] Section 87G(1), Financial Services and Markets Act, 2000.

[85] Section 87G(5), Financial Services and Markets Act, 2000.

1. The FCA can refuse admission to listing where the applicant has not met the listing requirements or any other requirement imposed in relation to application.[86]
2. The FCA does not need to approve a prospectus if it does not contain the required information or other rules are not adhered to.[87]
3. The FCA can suspend offer of securities, even after it has approved the prospectus, if it has reasonable grounds to suspect that Part VI of the FSMA or of the Prospectus Rules or any other provision required by the Prospective Directives has been infringed.[88]
4. If the FCA finds that a provision has been or is likely to be infringed it can require the offer to be withdrawn or the securities to be prohibited from trading.[89]

If there are suspension orders or instances where the FCA refuses to give approval, notice needs to be issued to the applicant stating the reasons for the action.[90] Moreover, of the two powers i.e. to refuse admission to listing and not approving a prospectus, the latter may be more viable. This is because if the FCA cancels listing rights, after securities have been offered to the public, it will result in shareholders holding an illiquid asset.[91]

Ex Post Controls

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86 Section 75(4), Financial Services and Markets Act, 2000.
87 Section 87A, Financial Services and Markets Act, 2000.
88 Section 87K, Financial Services and Markets Act, 2000.
89 Section 87L, Financial Services and Markets Act, 2000.
90 Section 87D, Financial Services and Markets Act, 2000.
91 Gower, *supra* note 3, at 940.

The FCA can also impose penalties on individual members of a corporation. Section 91(1A) of the FSMA, 2000 provides for penalties to be imposed if there has been a breach of Part VI of the FSMA, prospectus rules or listing rules. The FCA may substitute public censure in lieu of imposing a penalty.[92] This liability can also be imposed on individual Directors who were knowingly parties to the contravention.[93]

It is submitted that any law on the liability of issuers of securities should have remedies arising under both general, substantive law and financial regulation. There is a question of which of these two systems are more efficacious.[94] However, the researchers submit that since both laws are based on different presumptions and are aimed at different aspects of the issuance, having both frameworks provides for a more holistic system.[95]

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92 Section 91(3), Financial Services and Markets Act, 2000.

93 Section 91(2), Financial Services and Markets Act, 2000.

94 Palmer, *supra* note 23, at 5009-5010.
On the one hand, financial regulation is concerned with the observance of standard market procedures with a view to support the efficiency of markets. Palmer considers two aspects of general law that result in it being more efficacious than financial regulation. One, is that common law and equity are in constant flux and therefore, better able to adapt to changing situations and second that since the general law is not created by people involved in financial markets, it carries a latent expression of common social morality and of general legal principles.

95 General law is based on principles of general contract law, tort and equity, and is concerned with the good faith issuance of securities. While, financial regulation deals with standard procedures that need to be followed in the market to promote better efficiency in functioning. *See,* Palmer, *supra* note 23, at 5009.

(3) Comparison between UK and India

While the broad principles relating to issue of prospectus are the same in both jurisdictions, there are certain differences in the liability incurred. For instance, liability incurred with respect to registration of prospectus differs. In India, as discussed previously, the prospectus must necessarily be registered with the Registrar of Companies, prior to the issue. Failure to do so will attract a penalty of Rs. 50,000 under the Companies Act, 1956.[96] Under the Companies Act 2013, the penalty has been made harsher. The company and every person who was knowingly a party to the issue will be liable to pay a fine not less than Rs. 50,000, which may extend to three lakh rupees as well. Every person, who was knowingly a party to this, may also be punished with imprisonment for a term up to three years. With respect to English law, a prospectus cannot be circulated without being approved by the FCA. Failure to follow this would result in criminal liability of a term extending to 3 months and/or fine for a summary conviction, and up to 2 years and/or fine for a conviction.[97]

Moreover, under English law, any liability that the company may incur with respect to the prospectus extends to supplementary prospectuses as well.[98] In contrast, the Companies Act, 1956, and other related legislations do not allow for such supplementary prospectuses. If any change has to be made to a prospectus, the entire issuance process must be started *de novo*.

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[96] Section 60, Companies Act, 1956.

[97] Section 8(3), Financial Services and Markets Act, 2000.

[98] Section 90(10), Financial Services and Markets Act, 2000.

Finally, under the Companies Act, 1956, if there is failure to comply with the requirements under Section 60, such as attaching a copy of written consent by an expert, the company and every person who is knowingly a party to the issue, may be liable to pay fine up to Rs. 50,000. A similar, but more enhanced liability exists under Section 26(9) of the Companies Act, 2013 as well. There is no such corresponding provision in the UK under the FSMA.

[C] LIABILITY – CIVIL, CRIMINAL AND COMMON LAW

In addition to imposing sanctions for violations of the rules for the publication of a prospectus, liability also arises in both jurisdictions with respect to false or misleading statements made by persons responsible for the prospectus. This is with a view to protect investors from suffering loss due to misinformation of an investment. This section will examine the liability arising in connection with the issuance of securities in both UK and India, under three heads- civil liability **[A]**, criminal liability **[B]** and common law **[C]**. The researchers have also distinguished the liability regimes in India and the UK under the heads of civil liability and criminal liability. Finally, the researchers will also look at certain specific liabilities that are imposed on intermediaries **[D]**.

(1) Civil Liability

India

Liability on the part of companies and other persons is not limited to that imposed under Section 56.[99] If the prospectus contains any untrue statements, or is fraudulent or engages in misrepresentation, liability may still be imposed. This involves paying compensation to every person who subscribes for shares or debentures based on the strength of these untrue statements contained in the prospectus, who have suffered any loss or damage.[100]

There are four categories of persons who may be so liable:[101]

1. Every director at time of the issue
2. Anyone is named or has authorized himself to be named in the prospectus as a director or has agreed to become a director of the company immediately or after an interval of time.
3. All promoters of the company
4. Anyone else who has authorized the issue of the prospectus

The fourth category is subject to exceptions. It does not include any expert who has given consent under Section 58. It also excludes any "*auditor, legal adviser, attorney, solicitor, banker or broker of the company or intended company*" who has consented

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[99] In fact, Section 56(6), Companies Act, 1956 specifically states: "*Nothing in this section shall limit or diminish any liability which any person may incur under the general law or under this Act apart from this section.*"

[100] Section 62, Companies Act, 1956.

[101] Section 62(1), Companies Act, 1956.

under Section 60(3).[102] Such persons will only be liable to the extent of their own statement in the prospectus.[103]

This liability that is imposed is not absolute in nature. It is subject to certain exceptions. *First*, any person so liable will be exempt if he shows that he withdrew consent to the impugned statement, before the prospectus was issued, and that this issuance was undertaken in without his authority or consent.[104] *Secondly*, liability may also be avoided if the prospectus was issued without that persons' knowledge or consent, and upon becoming aware of the same, he gave reasonable public notice of this absence of knowledge or consent.[105] *Thirdly*, if this person becomes aware of an untrue statement after the prospectus has been issued but before the allotment has occurred, he can withdraw his consent. He must also give reasonable public notice of and reasons for the same.[106] *Finally*, there is no liability if as regards the untrue statement, that person had reasonable ground to believe and did in fact, believe that the statement was true. If this statement was made by an expert or was of official nature, it should have been a fair and correct representation of an extract of, or of the statement itself. In the case of an expert, the person must also have had reasonable ground to believe, and should

[102] Section 60(3), Companies Act, 1956.
[103] Proviso to Section 62(1)(d), Companies Act, 1956.
[104] Section 62(1)(a), Companies Act, 1956.
[105] Section 62(1)(b), Companies Act, 1956.
[106] Section 62(1)(c), Companies Act, 1956.

have believed that the expert had competence to, and did consent to, the statement.[107]

Experts making statements in a prospectus may also be held liable if the statement made by them authorizing the issue of the prospectus is untrue. However, he may be exempt from liability if:[108]

1. He withdraws consent in writing before delivery of the copy of the prospectus
2. After delivery of the copy of the prospectus for registration and prior to allotment, he becomes aware of the untruth, then withdraws consent in writing and gives reasonable public notice with reasons for the withdrawal.
3. He was both competent to make the statement and had reasonable grounds to believe, and did believe that the statement was true

Liability may be imposed upon other directors and other persons authorizing the issue of the prospectus, if the prospectus names people as directors, even though they are not directors; or if the named persons have withdrawn consent from the prospectus; or if the named persons have not authorized or consented to the issue of the prospectus; or where consent is required under Section 58, such consent has either not been given, or has been withdrawn prior to the issue of the prospectus.[109] In such a case, they will be required to indemnify such persons named consequently for all damages, costs

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[107] Section 62(1)(d), Companies Act, 1956.
[108] Section 62(2), Companies Act, 1956.

and expenses that they may incur, as well as any costs arising out legal proceedings instituted against them.[110]

The 2013 Act has made several changes with respect to this civil liability. It retains the broad scope under Section 62, including all four categories previously mentioned.[111] However, significantly, it adds *experts* as a fifth category to the list of persons who are liable. Further, unlike Section 62 of the Companies Act, 1956, Section 35 of the Companies Act, 2013 makes a distinction between innocent and fraudulent misstatements. If the statement made is fraudulent, under Section 35(3), all such persons shall be personally responsible, with unlimited liability, to all those incurring loss or damage due to the untrue statements made. This imposition of unlimited personal liability is not there under Section 62 of the Companies Act, 1956.

Further, Section 35 of the 2013 Act simplifies Section 62 of the Companies Act, 1956 to a large extent. Under sub-section (2), in the case of directors, the director has to prove that he withdrew his consent before the prospectus was issued; in the case of all other persons who may be liable, they have to show that the prospectus was issued without their knowledge or consent, and that on becoming aware, they immediately gave reasonable public notice indicating the same. This is vastly different from Section 62 which provides very similar defences, in a complicated yet repetitive manner, for the different categories of persons who may be liable. This is particularly

[110] *Id.*

[111] By retaining persons who have "*authorized the issue of the prospectus*", it continues to cover intermediaries. Section 35(1)(d), Companies Act, 2013.

true with respect to the liability of "*experts*", which has a much more detailed definition under Section 26(5) of the Companies Act, 2013 that that under Section 59(2) of the Companies Act, 1956.[112] By proceeding on the basis of the definition of an expert as someone unconnected to the company, who has consented in writing and has not withdrawn his consent prior to the issue of the prospectus, the legislature has avoided the complicated approach under Section 62 of the Companies Act, 1956.[113] A similar approach, simplifying matters, can be seen with respect to directors' liability as well.

However, there are certain drawbacks as well to this simplification. Under the Companies Act, 1956, as previously discussed, there were defences available to persons under certain specific circumstances, which have been dispensed with under the Companies Act, 2013.[114]

Finally, the Companies Act, 2013 also allows for class action by virtue of Section 37. A suit may be filed under Section 35, Companies Act, 2013 by any person, group of persons or any

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[112] Experts have been defined in Section 26(5), Companies Act, 2013, as someone "*who is not, and has not been, engaged or interested in the formation or promotion or management, of the company and has given his written consent to the issue of the prospectus and has not withdrawn such consent before the delivery of a copy of the prospectus to the Registrar for registration and a statement to that effect shall be included in the prospectus*".

[113] Under Section 62, Companies Act, 1956, experts who have not given consent, or who have withdrawn consent have been repeatedly exempted in sub-sections (2), (3) and (4). The approach under the Companies Act, 2013, is evidently briefer and less confusing.

[114] These defences included whether the untrue statement was a correct and fair representation, whether there was reasonable ground to believe and the person did believe that the statement made by an expert or an official document was true. These defences, exempting persons from liability have been done away with under the Companies Act, 2013.

association of persons who have been affected by a misleading statement or the inclusion or omission of any matter in the prospectus. Affected shareholders can thus, take joint action.

United Kingdom

Section 90 of the FSMA, 2000 provides for a parallel remedy to those provided for in common law. A statutory remedy for loss suffered due to a misleading statement was necessary because under common law, it was difficult to establish proximity between the maker of the statement and the investor.[115] Moreover, as illustrated in Part I of this paper, the burden was on the plaintiff to establish that the maker of the statement had fraudulent intent. The current statute providing a remedy for false or misleading particulars is the FSMA, 2000. It needs to be emphasized that the FSMA, 2000 is a supplement to the common law remedies.[116] This section will examine the nuances of the civil liability as provided for in sections 90 and 118 of the FSMA, 2000.

Three heads of liability arise from section 90 of the FSMA, 2000: (i) untrue or misleading statements;[117] (ii) omission of material which would otherwise be required by section 80 or 81;[118] and (iii) omission of information about the absence of a particular matter

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[115] *See* Part IIID(2)(ii).

[116] Section 90(6), Financial Services and Markets Act, 2000.

[117] Section 90(1)(b)(i), Financial Services and Markets Act, 2000.

[118] Section 90(1)(b)(ii), Financial Services and Markets Act, 2000. The heads of liability in relation to false or misleading statements or omissions in listing particulars were extended to apply to prospectuses in the same manner by Prospectus Regulations (SI 2005/1433) 2005.

required by the listing particulars.[119] The amount of compensation payable will be determined in the same manner as a claim in tort.[120]

Moreover, in 2010, section 90A was introduced by way of amendment.[121] This section makes issuers of securities liable to pay compensation for a misleading statement or a dishonest omission in certain published information relating to the securities *and* a dishonest delay in publishing such information. With respect to the former, Section 90A extends liability to any information that has been published by a quoted company, through a recognized information services, whether the information is required to be published or not.[122] Additionally, the liability for delay in context of issuance of securities will arise in the situation where bad news is dishonestly delayed, and the claimant purchased the securities in that delay.[123]

To bring a claim under section 90, two things need to be proved by the plaintiff: *first* that some loss has been suffered by them and *second,* that the loss was a result of the untrue or misleading statement or omission.[124] The plaintiff does not necessarily need to be a subscriber; they can also be a purchaser in the secondary market.[125]

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[119] Section 90(3), Financial Services and Markets Act, 2000.

[120] Palmer, *supra* note 23, at 5218.

[121] By the Financial Services and Markets Act 2000 (Liability of Issuers) Regulation, 2010.

[122] Alcock, *supra* note 8, at 7.

[123] Alcock, *supra* note 8, at 7.

[124] Alcock, *supra* note 8, at 7.

[125] Section 90(1)(a), Financial Services and Markets Act, 2000 states that a remedy exists for *'a person who has acquired securities to which the particulars apply'.* 'Acquire' has been defined in Section 90(7) as contracting to acquire securities or having an interest in them.

Persons who can be held liable under section 90 are provided for in Para 5.5, Prospectus Rules.[126] The people responsible in an offer of equity shares are-

1. The issuer
2. The directors of the issuer
3. Each person who has authorized themselves to be named in the prospectus
4. Each person who has accepted responsibility, and is stated to have accepted responsibility, for any part of the prospectus
5. Each person who has authorized the contents of the prospectus or any part of it, and
6. The offerer of the securities or the company seeking admission and its directors where it is not the issuer.[127]

The above liability is subjected to the exceptions under Schedule 10 of the FSMA, 2000.[128] There are four defences that can be availed of -

1. <u>Defendant's belief</u>[129] – there are two limbs to this defence. The first is that the defendant should have believed the statement at the time when the listing particulars, prospectus, supplementary prospectus were submitted for approval.

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126 Para 5.5, Prospectus Rules, Financial Conduct Authority Handbook, 2013 makes a classification between '*equity shares'* and '*all other securities*'.

127 Gower states that this is for secondary offers. However, the offeror will not be liable if the offeror was made in association with the issuer and the issuer took the lead in drawing up the prospectus. Gower, *supra* note 3, at 933.

128 Section 90(2), Financial Services and Markets Act, 2000.

129 Para 1, Schedule 10, Financial Services and Markets Act, 2000.

The second is in relation to the time when the securities were acquired by the plaintiff. One of the four alternatives needs to be present-

a. That the defendant continued in their belief
b. Securities were acquired before it was reasonably practicable to bring to the notice of person the correction
c. Before the acquisition of the securities, the defendant had done all that is reasonable for him to ensure that the correction had been brought to the notice of interested persons.
d. Substantial lapse of time between commencement of business and the claimant's acquisition of securities.

2. Statement by an expert[130] – this defence is not available to the expert but to the person who is incurring liability under section 90(1). This defence is similar to the first one i.e. there are two limbs- *first,* at the time of submitting documents for approval, the defendant's belief should have existed and *second,* subject to the time when the securities are acquired by the plaintiff. The four alternatives in the second limb are also the same as those mentioned above, under (1).
3. Correction[131] – this defence is based upon publication, or the taking of reasonable steps to secure publication of a correction. The defendant needs to establish that before the

[130] Para 2(1), Schedule 10, Financial Services and Markets Act, 2000.
[131] Para 3, Schedule 10, Financial Services and Markets Act, 2000.

securities were acquired, a correction of the fact had been published. *Or,* the defendant needs to establish that they took all reasonable steps to bring it to the notice of the claimant, and they actually believed that this had taken place before the acquisition of securities.

4. Official Statement or Document[132] – the defendant only needs to establish that such statement or document was fairly and accurately reproduced.
5. Claimant's Knowledge- the defendant has to prove that the person claiming compensation had knowledge of the false or misleading particular or omission in the document. The test for '*knowledge*' is whether the claimant would have known if reasonable enquiries had been made.[133]

Market Abuse

Civil liability can also arise under Section 118 of the FSMA, 2000 which defines market abuse generally, which is when persons use '*insider information*'[134] in relation to qualifying investments admitted to trading, or where a request has been made for permission to trade. Section 123 of the FSMA provides that if a person has engaged in market abuse, it can either impose an appropriate penalty[135] or publicly censure the person.[136]

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[132] Para 2(3) & 4, Schedule 10, Financial Services and Markets Act, 2000.
[133] Palmer, *supra* note 23, at 5221.
[134] Section 118C(2) of the FMSA, 2000.
[135] Section 123(1), Financial Services and Markets Act, 2000.
[136] Section 123(3), Financial Services and Markets Act, 2000.

Included in the definition of market abuse is acting on information which is generally not available to the general public, but which would affect the decision of a regular investor;[137] transactions that are conducted which are likely to give a false or misleading impression as to the supply or demand of the qualifying investment;[138] or the dissemination of information by means which gives or is likely to give a false or misleading impression.[139]

Comparison between India and the UK

In India, as discussed previously, there are 4 categories of persons who will liable under the Companies Act, 1956. The Companies Act, 2013 has introduced a fifth category – experts making statements in the prospectus. In English law, on the other hand, civil liability does not extend to experts, but only to persons liable under Section 90, as discussed in the previous sub-section. Such persons also will not be liable for expert statements if they satisfy the exceptions under Schedule 10. Further, the categories of persons liable under Indian law, in both the Companies Act, 1956 and the Companies Act, 2013, do not include the company which is issuing the prospectus. In the UK, on the other hand the issuer of the prospectus is also liable. According to Professor Gower, this "*issuer*" means the company itself.[140]

UK and Indian law also differ on the question of who can sue. A plain reading of Section 56 indicates that only subscribers to securities have

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[137] Section 118(4), Financial Services and Markets Act, 2000.
[138] Section 118(5), Financial Services and Markets Act, 2000.
[139] Section 118(7), Financial Services and Markets Act, 2000.
[140] Gower, *supra* note 3, at 933.

a remedy. In contrast, UK law not only provides remedies for subscribers, but also for purchasers in the secondary market.[141]

Moreover, in UK law, if the claimant had knowledge of the error or misstatement in the prospectus, he cannot claim compensation under Section 90, FSMA, 2000. In India, there is no such statutory defence provided to persons who may otherwise be liable. Additionally, in Indian law, a person will be exempted from liability if he is named in the prospectus as a director, but is not actually a director.[142] There is no corresponding express statutory defence in UK law. This defence is not expressly mentioned in the Companies Act, 2013 either.

(2) <u>Criminal Liability</u>

India

Liability imposed, under the Companies Act, 1956 and the Companies Act, 2013 in the case of untrue statements in prospectuses may also be of penal nature. This is over and above penal sanctions that may be imposed under other statutes, such as the Indian Penal Code, 1872. However, all offences under the companies act may not be taken cognizance of by any court unless the Registrar, shareholder or any person authorized by the Central Government makes a complaint in writing.[143]

Under Section 63 of the Companies Act, 1956, any person authorizing the issue may be subject to two years imprisonment or a

[141] Section 90, Financial Services and Markets Act, 2000.
[142] Section 62, Companies Act, 1956.
[143] Section 621, Companies Act, 1956.

fine extending to Rs. 50,000, or both. However, in the event that the person did have reasonable ground to believe and did believe that the statement was true up to the time of issue, or if the statement was immaterial, there is no liability.[144] Echoing the other related provisions in the Companies Act, 1956, this criminal liability does not extend to persons merely because they have consented under Section 58 or Section 60 (3).[145] Criminal liability also exists under Section 68, when a person fraudulently induces others to invest in the company though shares or debentures.[146]

The company is not permitted to allot shares in its first allotment, unless a minimum subscription, as stated in the prospectus, is received. There are strict regulations as to the procedure to be followed in such cases. For instance, the money collected must be accounted for and deposited in a very specific manner. Moreover, if the minimum subscription is not received within 120 days, all the money received must be returned to the applicants.[147] If this process is not adhered to, every promoter, director and other person responsible for the contravention is liable for fine up to Rs. 50,000.[148] In the specific event that there is failure to return all the monies within 130 days from issue, all directors shall be jointly and severally liable to repay the money at 6% interest from then on.[149]

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[144] Section 63(1), Companies Act, 1956.
[145] Sections 58, 63(2), Companies Act, 1956.
[146] Section 68. Companies Act, 1956.
[147] Section 69(5), Companies Act, 1956.
[148] Section 69(4)(b), Companies Act, 1956.
[149] This liability is on the condition that this default is not because of misconduct or negligence on his part. Proviso to Section 69(5), Companies Act, 1956.

Section 70 of the Companies Act, 1956, also imposes criminal liability. A company that has a share capital but has not issued a prospectus, or which has not yet allotted shares after issuing a prospectus, cannot make a first allotment without registering a statement in lieu of a prospectus 3 days before such allotment. Such a written statement must also comply with disclosure requirements under Schedule II.[150] If this provision is contravened, the company, and every director of the company who willfully authorizes or permits the contravention, shall be punishable with fine which may extend to Rs. 10,000.[151] If this statement contains anything untrue, any person authorizing this statement will be punished with imprisonment extending to two years or with fine up to Rs. 50,000.[152]

All transactions in violation of Sections 69 and 70 are voidable at the option of the applicant.[153] Any willful contravention by a director of Section 69 and 70 exposes him to liability to the extent of the loss, damages or costs that the company or the allottee suffered. When the company allots shares, subsequent to registration of prospectus, it is necessary for it to do so only 5 days after issuance.[154] The purpose behind such a measure is to ensure that all potential shareholders have adequate notice of the issue, and time to seek independent financial advice. Section 72(3) makes any

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[150] Section 70(1), Companies Act, 1956.

[151] Section 70(4), Companies Act, 1956.

[152] Section 70(5), Companies Act, 1956.

[153] Section 71, Companies Act, 1956.

[154] In the event that any person liable under Section 62 issues a public notice excluding, limiting or diminishing his responsibility, the five days begins from the date of the public notice.

transaction in violation of this requirement valid, but exposes the company and every officer of the company who is part of the issuance to a fine extending to Rs. 50,000.

Similar to changes to civil liability, significant changes have been made to the criminal liability imposed on persons under the 2013 Act. Section 34 of the 2013 Act does not incorporate sub-section (2) of Section 63, Companies Act, 1956. That is, although previously experts and other persons named in the prospectus, covered under Section 60(3), Companies Act, 1956, were exempted, they are now criminally liable under the 2013 Act. The defence provided under sub-section (1) of Section 60, Companies Act, 1956 is still available.[155] Additionally, Section 63, Companies Act, 2013, adds a phrase "*or the inclusion or omission was necessary*". This acts as an additional ground of defence to penal liability. Sections 36 to 39 of the Companies Act, 2013 also impose criminal liability.

United Kingdom

a. FSMA

The FSMA, 2000 also imposes criminal liability when securities are offered to the public without a prospectus approved by the competent authority first being circulated.[156] A mere request to trade in securities where an approved prospectus has not been made available is also an offence.[157]

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[155] That is, the person may prove that the statement or omission was immaterial or that he had reasonable grounds to believe and did believe up to the issuance of the prospectus that the statement was true.

[156] Section 85(1), Financial Services and Markets Act, 2000.

[157] Section 85(2), Financial Services and Markets Act, 2000.

If the above two offences are committed, the penalty that can be imposed in a summary conviction is imprisonment not exceeding 3 months and/or a fine.[158] While, if the person is convicted on indictment, the penalty imposed is a term not exceeding 2 years and/or a fine.[159]

However, liability will not be imposed if the offer is made to qualified investors only;[160] where the offer is made to fewer than 150 persons;[161] where the minimum consideration which may be paid by any person for transferable securities offered is at least 50,000 euros;[162] when the transferable securities are denominated in amounts of at least 50,000 euros;[163] or when the total consideration for the securities cannot exceed 100,000 euros.[164] It can be inferred that a person will be exempted from criminal liability when either the offer is made to a small group of targeted investors or they are of such a size that they are beyond the reach of small investors.[165]

The FSMA, 2000 also provides for criminal liability under section 397,[166] for misleading statements and practices. However, the standards of proof required for imposing liability under this section remains vague.[167] For example, it is uncertain what would constitute '*knowledge*' in section 397(1)(a) i.e. it is unclear whether this is actual

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[158] Section 85(3)(a), Financial Services and Markets Act, 2000.
[159] Section 85(3)(b), Financial Services and Markets Act, 2000.
[160] Section 86(1)(a), Financial Services and Markets Act, 2000.
[161] Section 86(1)(b), Financial Services and Markets Act, 2000.
[162] Section 86(1)(c), Financial Services and Markets Act, 2000.
[163] Section 86(1)(d), Financial Services and Markets Act, 2000.
[164] Section 86(1)(e), Financial Services and Markets Act, 2000.
[165] Palmer, *supra* note 23, at 5261.
[166] Section 397 of the Financial Services and Markets Act, 2000.
[167] Palmer, *supra* note 3, at 5266.

or constructive knowledge. Similarly, under section 397(1)(b), the test for 'dishonesty' or actual fraud, on the basis of which liability will be imposed, is if a person failed to operate as an honest person. Contravention of this section will result in summary conviction with imprisonment up to six months and/or a fine; whereas if convicted on indictment, imprisonment will extend up to seven years and/or fine.[168]

b. Theft Act

Since the FSMA, 2000 does not exclude liability under other statutes, the Theft Act, 1968 can also be applied. Section 19 of the Theft Act makes it illegal for an officer of the company to make any statement with the intention of misleading investors or creditors.[169]

Under this Act, the prosecution bears the burden of proving that the officer of the court fraudulently made the statement.[170] The defendant only needs to establish that he was negligent to escape liability. However, judicial interpretation has eased the burden on the prosecution by holding that even if a statement is literally correct, if it creates a misleading impression, it would constitute a false statement.[171]

Comparison between UK Law and Indian Law

UK law provides for summary conviction as well as conviction by indictment, for offences pertaining to issue of securities. With respect to the former, liability extends up to 3 months imprisonment and/or fine; whereas, in the latter, liability extends up

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168 Section 397(8), Financial Services and Markets Act, 2000.
169 Section 19, Theft Act, 1968.
170 Palmer, *supra* note 23, at 5262.
171 R v. Kyslani, [1932] 1 K.B (Court of Criminal Appeal).

to 2 years imprisonment and/or fine.[172] In Indian law, on the other hand, no such distinction is made.

Additionally, UK law exempts criminal liability when either the offer is made to a small group of targeted investors or they are of such a size that they are beyond the reach of small investors.[173] In contrast, criminal liability is exempted in India when there is reasonable grounds for believing the same or if the statement is immaterial.[174]

Apart from these specific distinctions, both jurisdictions preserve criminal liability under multiple other statutes.

(3) <u>Common law</u>

The liability under common law is same for both jurisdictions, as both India and UK are common law countries. Under common law, the liability of persons who have authorized the issue of an offer document is based on the "*golden rule*" as laid down by Kindersley V.C. in *New Brunswick, etc. Co.* v. *Muggeridge.*[175] This rule

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[172] Section 96, Financial Services and Markets Act, 2000.

[173] Section 86(1), Financial Services and Markets Act, 2000.

[174] Section 63(1), Companies Act, 1956.

[175] Kindersley V.C. in New Brunswick, etc. Co. v. Muggeridge, (1860) 30 LJ Ch 242 stated: "*Those who issue a prospectus, holding out to the public the great advantages which will accrue to persons who will take shares in a prosposed undertaking, and inviting them to take shares on the faith of the representations therein contained, are bound to state everything with strict and scrupulous accuracy, and not only to abstain from stating as facts that which is not so, but to omit no one fact within their knowledge the existence of which might in any degree affect the nature, or extent, or quality of the privileges and advantages which the prospectus holds out as inducements to take shares*". This was subsequently expanded upon by Lord Halsbury in Aaron's Reefs v. Twiss, 1896 AC 273 (HL) who said: "*I do not care by what means it is conveyed, by what trick or device or ambiguous language; all those are expedients by which fraudulent people seem to think they can escape the real*

governing the issue of a prospectus, specifically with respect to its content and consequent effect on the public, was upheld in *Henderson* v. *Lacon*.[176] This has been accepted by the Indian Supreme Court.[177]

The principles embodied in the "*golden rule*" have been incorporated in the respective statutes in India and in the UK.[178] Under common law, in the event that the prospectus fails the "*golden rule*" test and there are false or misleading statements present in the prospectus, liability will arise under both tort and contract law.[179] In this regard, three interrelated questions need to be answered: *who is liable*; *who can sue*; and *what remedies do they have?* The researchers have sought to answer these questions in this section by discussing the two main remedies available to aggrieved persons – **[1]** Recission and **[2]** Damages

Rescission

Rescission is considered a good supplement to the right to claim damages because the investor may often merely wish to return

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substance of the transaction. If by a number of statements you intentionally give a false impression and induce a person to act upon it, it is not the less false although if one takes each statement by itself there may be a difficulty in showing that any statement is untrue."

176 Henderson v. Lacon, (1867) LR Ew 249.

177 N Parthasarathy v. Controller of Capital Issues, (1991) 72 Com Cases 651.

178 For instance, the particulars laid out in Schedule II of the Companies Act, 1956 and Section 26 of the Companies Act, 2013 read with the rules that are expected to be issued regarding the same (*see infra* Part II(A)) are supposed to ensure that the disclosures in the prospectus give investors a reasonably fair and clear picture as to the company's financial and other affairs. In the UK, similar disclosure requirements are laid out in the Prospectus Rules.

179 S. Gleeson and H.S. Bloomenthal, *The Public Offer of Securities in the United Kingdom*, 27(3), DENVER JOURNAL OF INTERNATIONAL LAW AND POLICY, 359, 443 (1999).

to the position he had originally occupied.[180] For the purchaser of securities to be entitled to rescission, he will have to prove that the misrepresentation was one of fact, that it was a material representation, and that he had acted upon it.[181]

Not only is this burdensome on the purchaser of securities, this remedy has other shortcomings as well. *First,* under the Misrepresentation Act, 1967, the court has the discretion to substitute a suit for rescission and replace it with an award for damages.[182] *Secondly,* rescission is available only against a contracting party. This implies that if a person purchases shares from a shareholder in the market, or from an issuing house, they would subsequently not be allowed to rescind that contract against the company, because the company was not a contracting party. *Thirdly,* a failure to give information i.e. an omission, will not give rise to a right to rescission. *Fourthly,* the right to rescind expires more quickly than the right to damages. That is, if after the truth is discovered, an investor performs certain acts such as accepting dividends, or attending and voting at meetings, the contract will be understood as ratified.[183] *Finally,* a rescission claim is defeated by the liquidation of the company.[184]

Damages

a. <u>Tort of Deceit</u>

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[180] Gower, *supra* note 3, at 937.
[181] Palmer, *supra* note 23, at 5209.
[182] Section 2(2), Misrepresentation Act, 1967.
[183] Gower states that this is with the view to protect the interests of creditors i.e. the company may have raised credit from third parties who would have acted on the basis of capital already raised by the company, which rescission of the shareholder’s contract would undermine. Gower, *supra* note 3, at 938.
[184] Gower, *supra* note 3, at 938.

Actions against misrepresentations made in prospectuses originally developed out of actions for the tort of deceit. For the tort of deceit to be established, the requirements are: [185]

1. The maker of the statement should have knowingly known it to be false, or should have at least been reckless of the truth,
2. The recipient of the statement should have relied on the false statement, and
3. The maker of the statement should have intended that the other person rely on the statement.

This implies that the maker of the statement can escape liability if he can prove that there was no fraudulent intention, and that they honestly believed in the veracity of the statement made.[186] Persons who can potentially be held liable are the company, directors, experts and agents of the company.[187] The measure of damages that

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[185] Palmer, *supra* note 23, at 5224.

[186] The test for deceit has been held to be a subjective one. In Akerhielm v. De Mare (1959) 3 All ER 485, it was held that the defendant can escape liability if he honestly believed the representation made to be true in the sense that he made it. The court specifically stated–
"*The question is not whether the defendant in any given case honestly believed the representation to be true in the sense assigned to it by the court on an objective consideration of its truth or falsity, but whether he honestly believed the representation to be true in the sense in which he understood it, albeit erroneously when it was made. This general proposition is no doubt subject to limitations. For instance, the meaning placed by the defendant on the representation made may be so far removed from the sense in which it would be understood by any reasonable person as to make it impossible to hold that the defendant honestly understood the representation to bear the meaning claimed by him and honestly believed it in that sense to be true.*"

[187] Palmer, *supra* note 23, at 5224.

can be claimed by any person is appropriate to a claim in tort.[188] The aim is to place the plaintiff in the position they would have been had it not been for the misrepresentation. Therefore, the actual value of the shares is subtracted from the price paid.[189]

b. Tort of Negligent Misrepresentation

A claim for negligence can be made only when the maker of the statement owed some duty of care to the plaintiff. The test for imposing such a duty of care is proximity of relationship, foreseeability of damage, and reasonableness.[190]

An interesting question that arises is to what extent the proximity condition can be stretched. That is, should proximity be

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188 Lord Browne-Wilkinson laid down seven principles to assess the damages that can be claimed in Smith New Court Securities Ltd. v. Scrimgeour Vickers (Asset Management) Ltd., [1996] 4 All E.R. 769:
"*1. The defendant is bound to make reparation for all the damage directly flowing from the transaction;*
2. Although such damage need not have been foreseeable, it must have been directly caused by the transaction;
3. In assessing such damage, the plaintiff is entitled to recover by way of damages the full price paid by him, but he must give credit for any benefits which he has received as a result of the transaction;
4. As a general rule, the benefits received by him include the market value of the property acquired as at the date of acquisition; but such general rule is not to be inflexibly applied where to do so would prevent him obtaining full compensation for the wrong suffered;
5. Although the circumstances in which the general rule should not apply cannot be comprehensively stated, it will normally not apply where either (a) the misrepresentation has continued to operate after the date of the acquisition of the asset so as to induce the plaintiff to retain the asset or (b) the circumstances of the case are such that the plaintiff is, by reason of the fraud, locked into the property.
6. In addition, the plaintiff is entitled to recover consequential losses caused by the transaction;
7. The plaintiff must take all reasonable steps to mitigate his loss once he has discovered the fraud."

189 McConnel v. Wright [1903] 1 Ch. 546.

190 Caparo Industries Plc v. Dickman, [1990] 2 A.C. 605.

recognized only between the maker of the statement and the persons to whom the document is specifically directed to? Or can it be extended to exist between the makers of the statement and the people who relied on the document to purchase shares, but to whom the document was not specifically directed? The courts have been grappling with this question. In *Al-Nakib Investments (Jersey) Ltd. and Another* v. *Longcroft and Others* it was held that this proximity could be established only between the maker of the statement and people to whom shares are allotted.[191] The rationale for this was that

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[191] Al-Nakib Investments (Jersey) Ltd. and Another v. Longcroft and Others, [1990] 1W.L.R. 1390.
Judge Mervyn Davies applied the ratio of Caparo Industries Plc. v. Dickman to the facts of the case before him. In Caparo Industries Plc. v. Dickman, the court looked into the extent a person is liable for a negligent statement made by them. It was held in Caparo Industries that the auditors of a company would be liable for their reports only to shareholders of the particular company and not outside investors. Lord Jauncey was of the opinion that-
"*If the statutory accounts are prepared and distributed for certain limited purposes, can there nevertheless be imposed upon auditors an additional common law duty to individual shareholders who choose to use them for another purpose without the prior knowledge of the auditors? The answer must be no. Use for that other purpose would no longer be use for the 'very transaction' which Denning L.J. in the Candler case [1951] 2 K.B. 164, 183 regarded as determinative of the scope of any duty of care. Only where the auditor was aware that the individual shareholder was likely to rely on the accounts for a particular purpose such as his present or future investment in or lending to the company would a duty of care arise. Such a situation does not obtain in the present case*."
Judge Davies agreed with the ratio of Caparo Industries as he stated that duty of care could not be fastened on a situation when a statement has been made for a particular purpose and that statement is used for another purpose. He held , therefore, that the defendants did not owe the plaintiffs a duty of care for shares bought in the market. This is because the prospectus and the interim reports were addressed to the first plaintiff i.e. Al-Nakib Investments (Jersey) Ltd. with the purpose of convincing the first plaintiff to take up the rights issue. It was not with the purpose for buying shares in the market. Hence, applying the test of proximity between the plaintiff and defendant, the court did not extend prospectus liability to transactions that took place in the secondary market.

the purpose of the prospectus was only to induce people to subscribe to shares, and they would not have considered the trade of shares in the secondary market.

In *Andrews* v. *Mockford,* however, it was held that liability could be extended to the secondary market also since there was a '*continuous fraud'* beginning with the issue of prospectus.[192] Such a similar view was taken by the court in *Possfund Custodian Trustee Ltd. and Another* v. *Diamond and Others Parr and Others v Diamond and Others.*[193] The court recognized the proximity between the people

[192] Andrews v. Mockford, [1896] 1 Q.B. 372.
The defendants contended that even assuming that the statements made in the prospectus were false, the plaintiff bought shares in the market and not at the time of subscription. Therefore, the damage sustained by the plaintiff did not arise from the prospectus. They cited Peek v. Gurney, which held that the purpose of the prospectus was to induce people to whom it is sent to become allottees and after this its effect is exhausted, to argue that the plaintiff had not bought shares relying on the statements made in the prospectus.
However, the court held that there was a '*continuous fraud'* by the defendants i.e. the prospectus' function was not exhausted and it continued to play a role in conjunction with the false telegram. Lord Justice Smith was of the opinion that-
"*There was proof against the defendants a continuous fraud on their part, commencing with the sending of the prospectus to the plaintiff, and culminating in the direct lie told in the telegram, which was intended by the defendants to operate upon the plaintiff's mind as well as on the minds of others, and did so operate to his prejudice, and to the advantage of the defendants.*"
Therefore, the court imposed liability on the defendants even though the plaintiff had bought these shares in the secondary market. However, liability was imposed not because liability extends to market transactions but because there was a '*continuous fraud'* which began with the misleading statements in the prospectus. In effect, the court still applied the test that the plaintiff should have *relied* on the misleading statements in the prospectus to buy shares.

[193] Possfund Custodian Trustee Ltd. and Another v. Diamond and Others Parr and Others v Diamond and Others, [1996] 1 W.L.R. 135.
In relation to the second aspect i.e. *proximity,* the court examined whether the plaintiff's contention that the prospectus must be examined after taking into account the changed market practice on the date of preparation and circulation can be accepted. The plaintiff contended that an additional purpose had evolved

responsible for the contents of the public and the general public, if the prospectus was prepared with the intention of inducing the public to invest in the companies' securities.

Palmer is of the opinion that the decision in *Possfund Custodian Trustee Ltd.* is in line with the principles that the FSMA, 2000 and the listing rules are based on.[194] Section 90 of the FSMA, 2000, for instance, provides a remedy for people who bought securities in the secondary market. In *Possfund Custodian Trustees Ltd.,* the court also recognized that prospectuses are intended to be relied on by the public at large. The researchers submit that since the statutory law has already extended liability to the secondary market, the decision in *Possfund Custodian Trustees Ltd.* is correct. There is no rationale today for common law to limit liability to only the initial allotment of shares.[195]

c. <u>Breach of Contract</u>

The principle is that the misrepresentation present in the prospectus can be incorporated in the subsequent contract of allotment

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for the publication of the prospectus by the issuer i.e. to '*inform and encourage aftermarket purchases*'.

Judge Lightman examined case law and observed that courts have since 1873 recognised a duty of care in relation to prospectuses, when there is a direct connection between those who issue the prospectus and those who rely on it. He cited Lord Chelmsford and Lord Cairns judgments in Peek v. Gurney for the proposition that necessary direct connection between issuers and aftermarket purchasers can be found if there was intention that the aftermarket purchasers continue to rely on the prospectus. This intention the Judge felt could be manifested in whatever manner i.e. by the sale of the prospectus to possible aftermarket purchasers (Scott v. Dixon) or by other means (Andrews v. Mockford). It was held therefore, that the claim could not be struck off and the merits of this matter need to be determined in trial.

[194] Palmer, *supra* note 23, at 5238.

[195] Palmer, *supra* note 23, at 5238.

between the company and the subscriber. However, whether statements made in a prospectus amount to a term of a contract is a contested point of law, as courts are unwilling to regard it as more than mere misrepresentations.[196] Yet, there are certain advantages to viewing this as a contract, as damages can be claimed in a contractual manner.[197] Moreover, applying the doctrine of privity of contract, it would follow that the vendor of the shares can be held liable only to those he entered into the contract with.[198] Therefore, any damages sought for breach of contract will necessarily be available only to the allottees of shares.

[D] LIABILITY OF INTERMEDIARIES

(1) India: Regulation by SEBI

As discussed in the previous sections, the Companies Act, 1956 details the liability of the company, the directors and other persons authorizing the issue of the securities. It is submitted that this includes employees and other officers of the company, as well as *intermediaries* to an issue. In addition to those provisions, the SEBI, which is the primary regulator of the securities market, lays out the function and duties of such intermediaries to an issue.

'*Intermediary'* has been defined in the SEBI (Intermediaries) Regulations, 2008,[199] which defines its scope by referring to the various categories contained in Sections 11 and 12 of the SEBI Act.[200]

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196 S. Gleeson and H.S. Bloomenthal, *supra* note 187, at 444.

197 Jacobs v. Batavia [1924] 2 Ch. 329.

198 Dunlop Pneumatic Tyre Co Ltd v Selfridge & Co Ltd., [1915] UKHL 1.

199 The SEBI (Intermediaries) Regulations, 2008 primarily relates to the registration by these intermediaries with the SEBI

200 Regulation 2(g) of the SEBI (Intermediaries) Regulations, 2008.

These two provisions discuss several intermediaries including stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers, and others.[201] While some of these intermediaries are involved only in the secondary market, many of them perform essential functions in the primary market, particularly in IPOs. The most important of these intermediaries in the issuance of securities is the lead merchant banker.[202]

Under Regulation 5 of the ICDR Regulations, it is mandatory for any issuer of securities to appoint a lead merchant banker to carry out all the obligations relating to the issue. Further, in consultation with this lead merchant banker, other intermediaries may be appointed.[203] Such intermediaries have several obligations imposed on them under the ICDR Regulations, above and beyond the Companies Acts and applicable delegated legislations.[204]

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201 Section 11, SEBI Act, 1992.

202 Merchant banker is defined under Regulation 2 (cb) of the SEBI (Merchant Bankers) Regulations, 1992 as *"...any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant, adviser or rendering corporate advisory service in relation to such issue management."*

203 These intermediaries must necessarily be registered with the SEBI. The SEBI has issued guidelines pertaining to the registration and regulation of each of these kinds of intermediaries. This includes the SEBI (Merchant Bankers) Regulations, 1992; SEBI (Registrars to an Issue and Share Transfer Agents) Regulations, 1993; SEBI (Portfolio Managers) Regulations, 1993; SEBI (Registrars to an Issue and Share Transfer A gents) Regulations, 1993; The SEBI India (Underwriters) Rules, 1993; the SEBI (Bankers to an Issue) Regulations, 1994; and The SEBI (Investment Advisers) Regulations, 2013.

204 Under Section 11A of the SEBI Act, 1992, the Board has the power to issue regulations, general orders and special orders pertaining to the issue of securities, without prejudice to the Companies Act, 1956. For instance, prior to

In addition to the provisions in the Companies Act against untrue statements or fraudulent inducement of investment, there are additional provisions imposing liability on persons under the SEBI Act as well. Section 12A prohibits "*manipulative and deceptive devices, insider trading and substantial acquisition of securities or control*", in relation to securities that are listed or proposed to be listed. The penalties are listed in Chapter VIA of the SEBI Act. Among the provisions relevant to this paper is Section 15HA,[205] which penalizes fraudulent and unfair trade practices, and Section 15HB,[206] which is a penalty for contravening provisions for which separate penalties have not specifically been provided. Section 27, which discusses offences by companies, makes the company and all persons in charge of, and responsible for, the conduct of the business activities of the company, liable for these offences. If any officer of the company was also a party to the offence, he too shall be prosecuted for it. The use of "*every person who was responsible to the*

the registration of any offer document with the registrar such as a prospectus, red-herring prospectus or a shelf prospectus, the lead merchant banker must submit a draft to the SEBI, which will suggest changes or make observations. Regulation 6(2), The Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009.

[205] Section 15HA, SEBI Act, 1992: "*If any person indulges in fraudulent and unfair trade practices relating to securities, he shall be liable to a penalty of twenty-five crore rupees or three times the amount of profits made out of such practices, whichever is higher.*"

[206] Section 15HB, SEBI Act, 1992: "*Whoever fails to comply with any provision of this Act, the rules or the regulations made or directions issued by the Board thereunder for which no separate penalty has been provided, shall be liable to a penalty which may extend to one crore rupees.*"

company for the conduct of business" in Section 27 may be broad enough to include intermediaries.[207]

(2) United Kingdom

Under the Listing Rules, it is a requirement for a company seeking admission to the Official List to have a sponsor.[208] The sponsor is appointed by the FCA,[209] which maintains a list professionals and bodies who are authorized sponsors.[210] The FCA also determines the functions of the sponsor.[211]

With respect to issuance of new securities, the sponsor must, before submitting an application to the FCA on behalf of the applicant, have a '*reasonable opinion*' that the applicant has satisfied all the requirements of the Listing Rules, Prospectus Rules, and that the directors have established procedures which enable the applicant to comply with the listing, disclosure and transparency rules.[212]

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207 Section 27, SEBI Act, 1992.

208 Para 8.2.1R, Listing Rules, Financial Conduct Authority Handbook, 2013.

209 Section 88(2), Financial Services and Markets Act, 2000.

210 Section 88(3)(a), Financial Services and Markets Act, 2000.

211 Section 88(3)(b), Financial Services and Markets Act, 2000.

212 Para 8.4.2, Listing Rules, Financial Conduct Authority Handbook, 2013- "*A sponsor must not submit to the FCA an application on behalf of an applicant, in accordance with LR 3, unless it has come to a reasonable opinion, after having made due and careful enquiry, that:*
(1) the applicant has satisfied all requirements of the listing rules relevant to an application for admission to listing;
(2) the applicant has satisfied all applicable requirements set out in the prospectus rules unless the home Member State of the applicant is not, or will not be, the United Kingdom;
(3) the directors of the applicant have established procedures which enable the applicant to comply with the listing rules and the disclosure rules and transparency rules on an ongoing basis;
(4) the directors of the applicant have established procedures which provide a reasonable basis for them to make proper judgments on an ongoing basis as to the financial position and prospects of the applicant and its group; and

Additionally, the sponsor should also submit documents such as the Sponsor's Declaration on an Application for Listing, a Shareholder Statement or Pricing Statement and should ensure that the prospectus discloses prominently any matters which the FCA would take into account in the application for listing.[213]

With respect to liability, a sponsor is not liable to investors directly. This is because professional advisers who provide assistance on the contents of the listing documents are not regarded as people

(5) the directors of the applicant have a reasonable basis on which to make the working capital statement required by LR 6.1.16R."

[213] Para 8.4.3, Listing Rules, Financial Conduct Authority Handbook, 2013-
"*A sponsor must:*
(1) submit a completed Sponsor's Declaration on an Application for Listing to the FCA either:
(a) on the day the FCA is to consider the application for approval of the prospectus and prior to the time the prospectus is approved; or
(b) at a time agreed with the FCA, if the FCA is not approving the prospectus or if it is determining whether a document is an equivalent document ;
(2) submit a completed Shareholder Statement or Pricing Statement, as applicable, to the FCA by 9 a.m. on the day the FCA is to consider the application;
(3) ensure that all matters known to it which, in its reasonable opinion, should be taken into account by the FCA in considering:
(a) the application for listing; and
(b) whether the admission of the equity shares would be detrimental to investors' interests; have been disclosed with sufficient prominence in the prospectus or equivalent document or otherwise in writing to the FCA; and
(4) submit a letter to the FCA setting out how the applicant satisfies the criteria in LR 2 (Requirements for listing - all securities), LR 6 (Additional requirements for premium listing (commercial company)) and, if applicable, LR 15 or LR 16, no later than when the first draft of the prospectus or listing particulars is submitted (or, if the FCA is not approving a prospectus or if it is determining whether a document is an equivalent document, at a time to be agreed with the FCA)."

who are responsible for the prospectus under Para 5.5 of the Prospectus Rules.[214]

However, even though investors may not have a remedy against the sponsors, the FCA has various modes of monitoring the functioning of the sponsors. Other than regulating the list of sponsors, the FCA can also impose the following sanctions[215] –

1. Public Censure of the sponsor- If the sponsor contravenes any of their obligations as per section 88(3)(c) of the FSMA, 2000, the FCA can publish a statement to that effect.[216]
2. Financial Penalty[217]
3. Suspension, limitation or other restriction[218]

The second and third categories i.e. financial penalty and suspension of sponsors, are newly introduced powers that came into effect only on 1 April, 2013.

(3) Comparison between Indian Law and UK Law

The primary difference between Indian law and UK law with respect to the functioning and regulation of intermediaries is that Indian law discusses intermediaries in great detail, in different statutes and applicable delegated legislations. The FSMA, 2000 and the

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214 Footnote 14, Wai Yee Wan, *Recent Changes to, and Proposals to Enhance Effectiveness of, the Listing Regime in the United Kingdom,* COMPANY LAWYER (2013).

215 As per para 8.7.20, Listing Rules the Enforcement Guide sets out the FCA's policy on when and how it will use its disciplinary powers in relation to a sponsor. A statutory notice may be required under section 88B of the FSMA, 2000.

216 Section 89(1), Financial Services and Markets Act, 2000.

217 Section 88A, Financial Services and Markets Act, 2000.

218 Section 88A, Financial Services and Markets Act, 2000.

delegated legislation passed under it, on the other hand, specifically provides only for sponsors.

Further, sponsors in the UK are analogous to lead merchant bankers in India. The type of liability that the respective regulatory bodies impose upon these two categories of intermediaries is different in both jurisdictions. For instance, while public censure is one form of punishment imposed on sponsors, there is no such corresponding power granted to the SEBI or any other body in India. Other punishments such as penalties and suspension are common to both jurisdictions.

[E] CONCLUSION

This paper has sought to examine the liabilities that may be incurred in the issuance of securities by companies and intermediaries. As discussed, in public issues, the role of the prospectus is paramount. The regulatory structures prevailing in both countries lay down elaborate and comprehensive guidelines to ensure that all necessary information is passed on to potential investors. This is done to prevent investor right violations and to promote market confidence, which will facilitate the further development of the securities market and the economy in general.

The focus of the paper was on comparing the liability regimes in India and in UK. Largely, both jurisdictions impose the same kind of liabilities in that they regulate the issue of prospectus, and in case this prospectus carries untrue or misleading statements, they impose civil and criminal liabilities. Since both India and UK are common law countries, affected parties can avail of common law remedies.

However, there are certain limitations under common law, and there has been a difference in the statutory response of both countries to these limitations. For instance, purchasers in the secondary market have no remedy under common law. While UK has provided a remedy for them under the FSMA against all liable persons, India only recognizes the rights of subscribers. In addition, in India, SEBI has detailed provisions regulating the functioning of intermediaries. In UK, attention has been devoted only to the role and regulation of sponsors. Other differences, as highlighted in the paper, also exist. The researchers submit that these nuanced differences arise due to the indigenous factors present in the respective political economies.

It is also extremely evident that both securities markets are dynamic in nature. In the UK, after the 2008 financial crisis, the regulatory framework for the securities market was extensively revamped. The latest regime came into effect in April, 2013. In India also, after the economic crisis in the 1990s, significant changes were made to the regulatory structure. The securities market was modernized, and regulatory bodies were set up to better monitor it. More recently, the Companies Act, 2013 has been enacted, which has also changed the liability regime that previously existed in light of the vastly changed Indian economy. Clearly, both countries are responding to the changing times.

In conclusion, while there are certain differences in the liability regimes, these are not fundamental in nature. They both appear to be driven by the same principles of equitably balancing market efficiency with the rights of the investor.

SEBI ON TRACK? – AN ANALYSIS OF THE SEBI (RESEARCH ANALYST) REGULATIONS, 2014

Sindoori Sriram [*] and *Srijan Sahay* [#]

The threat of research analysts exploiting loopholes in the legal framework and misrepresenting reports and recommendations in order to make illegal profits for themselves is a very real one. Given the importance placed on these reports by investors in order to make investment decisions, such acts by research analysts can cause a severe information asymmetry in the markets. It was to tackle this problem that SEBI, in 2014 came out with the SEBI (Research Analyst) Regulations. However, inspite being hailed as a godsend by many investors, the regulations do come with their own set of problems which might hamper their effective implementation. The present paper is an analysis of the same.

[A] INTRODUCTION

The Indian securities market has gone through a series of continual changes since its inception to keep pace with the requirements of an unremittingly developing global market. To assist the Indian economy keep abreast with the ever-changing global economy, the Securities and Exchange Board of India (SEBI) was incorporated in 1992 and authorized with statutory powers to undertake the role of becoming the Indian securities market watchdog. Ever since, SEBI has strived to introduce reforms that ensure efficient, fair and transparent market practices; that safeguard

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the interests of investors; and which reduce the incidents of fraud and corruption in the Indian securities arena. A recent development in this area was introduced by SEBI on 1st September, 2014 in the form of a new regulatory framework that proposes to capture research analysts, intermediaries as well as independent entities who are involved in securities research activities that include the formulation of research reports, recommendations, suggestions and opinions regarding securities.[1] The proposed SEBI (Research Analyst) Regulations, 2014 are an effort to ensure that research analysts and entities do not have any leeway to exploit conflicts of interest, thereby resulting in biased research reports that might be used to manipulate market trends.[2] In light of SEBI's recent efforts to protect the Indian securities market from analyst scandals, this essay seeks to evaluate the practicality and efficacy of the proposed SEBI (Research Analyst) Regulations, 2014.

The historical importance of implementing research analyst regulations can be traced all the way back to the 1990's stock market boom.[3] Although it initially caused a surge in the stock market, the boom was short-lived and resulted in the collapse of several large public companies, consequently leading to the complete breakdown of

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1 Sachin P. Mampatta, *SEBI's New Regime for Research Analysts*, BUSINESS STANDARD, (September 11, 2014), http://www.business-standard.com/article/markets/bs-primer-sebi-s-new-regime-for-research-analysts-114091100845_1.html.

2 *Id.*

3 Urban J. Jermann & Vincenzo Quadrini, *Stock Market Boom and the Productivity Gains of the 1990's*, THE WHARTON SCHOOL OF THE UNIVERSITY OF PENNSYLVANIA, available at: http://finance.wharton.upenn.edu/~jermann/FinalPapOct6.pdf (last updated November 20, 2014).

the stock market itself.[4] In an attempt to identify the cause of the stock market fiasco and rectify regulatory failures, the U.S. Securities and Exchange Commission[5] scrutinized market players, only to discover rampant incidents of corruption, accounting discrepancies and instances of corporate delinquency. The SEC further found that several intermediaries, particularly research analysts, had exploited an array of grey areas in the regulatory framework to quickly cut deals for themselves and make money by misrepresenting research reports and recommendations, providing unreliable information, lying about the nature of securities to investors, touting extremely average securities by giving them high ratings and providing biased investment advice to naïve investors.[6] Upon finding evidence of such widespread analyst misdemeanour that was resulting in the dissemination of skewed information on market trends, the US regulators decided to introduce stronger legislations that would effectively address the problem of conflicts of interest and capture all analysts and research-entities that were engaged in unfair securities related activities.[7]

[B] THE ROLE OF RESEARCH ANALYSTS AND THE NEED FOR REGULATIONS

In today's global economy, information is the most vital component of any decision-making process. This is especially true in the case of investment-decisions, for which, there is a significant need

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4 *Id.*

5 Hereinafter referred to as "SEC".

6 Jill E. Fisch, *Fiduciary Duties and the Analyst Scandals*, 55 ALABAMA LAW REVIEW 1083, 1083 – 1085 (2007).

7 *Id.*

for investors to rely upon accurate and timely information about the investment products and the company offering the investment products. However, it is also an arduous task for an investor to understand and decipher the complex and voluminous material available to him before he can come to a conclusion and make an investment decision. In this context, Research Analysts play a vital role in bridging the gap between the investors and the companies offering the investment products. Research analysts are, in essence, the sentinel for the securities market – they study the information that is available on companies, industries, the different types of shares and investment products that are offered, and prepare reports and recommendations that they subsequently deliver to the investors and the public, thereby enabling them to make informed investment decisions.[8]

Their role, however, is not limited to merely compiling reports. Research analysts have to go about their duties in an extremely systematic manner – they have to first, collect information on the subject-matter upon which they seek to base their reports on. Second, they have to study and process the information that has been collected – this requires the research analysts to use their own research as well as publicly available information to explain what the company does and what its prospects are.[9]They are expected to give a

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8 *Id.*

9 Jill Fisch, *Regulatory Responses to Investor Irrationality: The Case of the Research Analyst*, UNIVERSITY OF PENNSYLVANIA LAW SCHOOL, PENN LAW: LEGAL SCHOLARSHIP REPOSITORY 2006, http://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=2055&context=faculty_scholarship (last updated November 28, 2014).

thorough analysis of not only the shares and securities of the company, but also the market within which it operates, the products of its competitors and a general evaluation of the merits and demerits of investing in the company.[10] Third, research analysts are required to give their own opinion about the company, the industry, and the investment products, and are further required to use statistical techniques to provide predictive analysis about the company's performance in the future, especially with respect to its earnings.[11]

There are three different types of research analysts - buy-side analysts, sell-side analysts and independent analysts.[12] Buy-side analysts are typically employed by money managers such as mutual funds, hedge funds, portfolio managers etc. Research reports prepared by these analysts are generally circulated amongst the top management of the employer firms and may contain information as to which securities to buy, sell, or hold. There is a potential for conflict of interest in such a case because the views taken by these research analysts may be influenced by the views of the money manager and the clients that they work for.[13] Sell-side analysts are analysts who usually publish reports in the industries and companies that they cover which contain advice as to holding, selling or buying the securities in question. These reports typically include forecasts made by the sell-

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[10] *Id.*

[11] *Id.*

[12] Jermann & Quadrini, *Supra* n.5.

[13] Report on Analyst Conflicts of Interest, *A Report of the Technical Committee of the International Organization of Securities Commissions*, IOSCO, http://www.iosco.org/library/pubdocs/pdf/IOSCOPD152.pdf (last updated 28November 2014).

side analyst as to the future performance of the securities in question.[14] Hence there is a large potential for conflict of interest in such a scenario as many analysts who publish these reports often work for investment banking firms whose clients are those that the research analyst cover in their reports. Finally, independent analysts are those analysts who are usually employed by research organisations and boutique firms that are separate from full service investment banks.[15] These analysts sell their research reports on a subscription basis. Here, a potential conflict of interest may arise when companies that these research analysts are covering pay a substantial subscription fee for the research report.[16]

A major concern of regulatory authorities with respect to research analysts is the credibility of the research reports and recommendations that they issue to the investors. Sometimes, research reports are made to artificially inflate the price of the securities, thereby causing a negative impact on the market as a whole.[17] This problem arises because, oftentimes, the investment analysis made by a research analyst is highly susceptible to conflicts of interest that may prevent them from providing a neutral opinion on

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[14] *Id.*

[15] *Id.*

[16] Anup Agarwal & Mark A. Chen, *Do Analyst Conflicts Matter? – Evidence From Stock Recommendations*, UNIVERSITY OF ALABAMA AND GEORGIA STATE UNIVERSITY, http://bama.ua.edu/~aagrawal/reco.pdf (last updated November 28, 2014).

[17] *Id.*

the securities in question.[18] These conflicts of interest may interfere with the neutrality of the research report, which subsequently will affect the decisions made by investors.[19]The primary objective of all regulatory authorities in the securities market is investor protection, and in this regard, many regulatory authorities have failed because the degree of their governance over research analysts has proven to be grossly insufficient.[20] However, after having learnt from regulatory failures, most developed economies today have implemented strict norms for research analysts, to avoid the spread of tainted research reports that are detrimental to the interests of investors.[21]

[C] RESEARCH ANALYST REGULATIONS – THE USA APPROACH

Since the 1990's stock market scandal, there has been a global effort to identify and address the potential conflicts of interest arising from the production of securities-related research reports, with many developed market economies, such as the USA, the UK and Hong Kong, having proposed or implemented extremely precise legislations that provide no scope for exploitation or circumvention.[22] Learning from previous regulatory mistakes with respect to research analysts and issues of conflicts of interest, the SEC, in conjunction with the

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[18] Roni Michaely & Kent L. Womack, *Conflict of Interest and the Credibility of Underwriter Analyst Recommendations*, 12(4) THE REVIEW OF FINANCIAL STUDIES 654, 654 (1999).

[19] *Id.*

[20] *Id.*

[21] Fisch, *Supra* n. 8.

[22] Anup Agarwal & Mark A. Chen, *Analyst Conflicts and Research Quality*, 2(2) QUARTERLY JOURNAL OF FINANCE (2012), http://www.bama.ua.edu/~aagrawal/analysts.pdf (last updated on 27 November 2014).

Financial Industrial Regulatory Authority (FINRA) and the New York Stock Exchange (NYSE), negotiated the Global Research Settlement in 2003, an enforcement agreement that sought to completely eradicate issues of conflicts of interest between the investment banking and the research analytics departments of all the investment firms in the United States.[23] The primary objective of this Global Settlement was to stop the flow of information between the research department and the investment banking departments of all firms to ensure that stock recommendations and research reports were not tainted by conflicts of interest.[24] Further, the Global Settlement also prohibited research analysts from receiving compensation for investment banking activities and prevented the investment banking departments from partaking in research activities thereby mandating a complete severing of any nexus between the investment banking and research divisions to guarantee the reliability of research reports and recommendations.[25]

Another regulatory reform that the US adopted to curb unethical research analyst practices was the Sarbanes-Oxley Act of 2002. Although the foremost objective of the Sarbanes-Oxley Act, 2002 was to tackle widespread corporate and accounting scandals, an

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[23] John Heine, *Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking,* SECURITIES AND EXCHANGE COMMISSION (April 28, 2003), http://www.sec.gov/news/press/2003-54.htm.

[24] *Id.*

[25] Ohad Kadan, Rong Wang, Leonardo Madureira & Tzachi Zach, *Conflicts of Interest and Stock Recommendations: The Effects of the Global Settlement and Related Recommendations*, 22(10) REVIEW OF FINANCIAL STUDIES 4189, 4191 (2009).

entire section in the Act was dedicated towards tightening the norms surrounding research analysts as well.[26] A salient feature of the Sarbanes-Oxley Act, 2002 is the provision under Section 501 that mandates the certification and registration of all research analysts and further requires disclosures to be made in special circumstances.[27] This two-pronged regulatory move of mandating registration and disclosure by the Sarbanes-Oxley Act has helped solve several issues of analyst conflicts of interest and capture defaulters in a methodical manner.[28]

The Sarbanes Oxley Act, 2002 and Global Settlement aside, the US regulatory authorities frequently update their regulatory framework with the objective of ensuring that retail investors are aware of the potential for conflict of interest in the preparation of research reports through enhanced disclosure requirements.[29] Measures such as enhancing and strengthening existing 'Chinese walls' between research and business units in a full service investment firm,[30] regulating the ability of the analyst to own and trade securities of the firm they cover as well as regulating the incentive mechanism of research analysts in a full service investment firm have been implemented so as to reduce the likelihood of the production of biased research.[31] The American model of research analyst regulations has,

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26 *Id.*

27 SARBANES- OXLEY ACT, 2002, § 501.

28 John C. Coates, *The Goals and Promise of the Sarbanes-Oxley Act*, 21(1) JOURNAL OF ECONOMIC PERSPECTIVES 91, 97 (2007).

29 *Id.*

30 Fisch, *Supra* n. 11.

31 Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA LAW REVIEW 1035 (2003).

thus far, been a great success in preventing analyst scandals and improving investor confidence by ensuring the dependability of research reports and recommendations.[32]

[D] THE RESEARCH ANALYST REGIME IN INDIA – THE NEED FOR CHANGE

Prior to 2014, there were no specific regulations regarding research analysts in India. However, there were certain mechanisms in place that sought to address potential conflicts of interest, such as the one enshrined in the SEBI (Prohibition of Insider Trading) Regulations, 1992, (hereinafter 'Insider Trading Regulations) which mandated that analysts who were involved in the preparation of research reports for clients must disclose their shareholding in the client's company.[33] The Insider Trading Regulations further prevented analysts from trading in the securities of the company 30 days post the publication of the research report.[34]Another mechanism that sought to address issues of conflicts of interest in the securities market of India was the Code of Corporate Disclosure Practices for the Prevention of Insider Trading, which laid down a series of disclosure requirements.[35] The Code stipulates certain disclosures that companies have to make while dealing with analysts or institutional investors, including the following:

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32 *Id.*

33 Suchismita Bose, *Securities Market Regulations: Lessons from US and Indian Experience*, THE ICRA BULLETIN, MONEY & FINANCE, Vol. 2, No. 20-21, (January 2005), http://icra.in/Files/MoneyFinance/2005-jan-june-suchismita%20bose.pdf.

34 *Id.*

35 *Id.*

i. To prevent misquoting or misrepresentation, at least two authorised company representatives or brokers must be present at meetings with analysts.
ii. Only publicly available information is to be provided to institutional investors and analysts. Alternatively, information given to research analysts must be made public as soon as possible.
iii. Issues raised by analysts during discussions, whose answers may include unpublished price sensitive information, are required to be disclosed to the public before the response is recorded with the analyst.
iv. A company must issue a press release or post relevant information after every meeting with a research analyst.[36]

Even though potential issues of conflicts of interest were being dealt with by SEBI's prescribed code of conduct and the regulations on fraudulent and unfair trade practices and insider trading, there were no self-sufficient set of guidelines or regulations to deal with the conflicts of interest by research analysts and entities that were not captured by SEBI. This absence of a comprehensive and exclusive regulation to deal with the potential conflicts of interest that may arise as a consequence of the work done by research analysts was recently answered by the introduction of the new SEBI (Research Analyst) Regulations, 2014[37] (hereinafter 'Research Analyst Regulations').

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[36] *Id.*

[37] Anuradha Verma, *SEBI Notifies Norms For Research Analysts*, VC CIRCLE, (September 2, 2014), http://www.vccircle.com/news/finance/2014/09/02/sebi-notifies-norms-research-analysts

[E] ANALYSIS OF THE SEBI (RESEARCH ANALYST) REGULATIONS, 2014

The new Research Analyst Regulations are a much needed change in the realm of Indian securities law and governance. They are to come into effect by 1st December, 2014 and from their commencement, all research analysts and research entities in India have to obtain a certificate of registration in accordance with these regulations to be able to discharge the activities of a research analyst.

(1) Taxonomy of Research Units

The regulations have defined three different units that can be engaged in the preparation and dissemination of securities-related research reports: research analyst, research entity and independent research analyst. A research analyst is any person who is primarily responsible for the preparation and publication of the contents of a research report; for making buy/sell/hold recommendations; for giving price targets and for offering opinions.[38] A research entity, on the other hand, is an intermediary that is registered with SEBI which is also engaged in merchant banking or investment banking or brokerage or underwriting services and simultaneously also issues research reports or research analysis in its own name or through individuals employed by it.[39] Finally, an independent research analyst is a person whose only business activity is research analysis or preparation and/or publication of research report.[40]

[38] SEBI (Research Analyst) Regulations, 2014, § 2(1)(u).
[39] *Id.*, § 2(1)(v).
[40] *Id.*, §2(1)(h).

SEBI has created this distinction between the three types of entities that are involved in research activities in order to identify the different types of conflicts of interests and lay down suitable regulations for each entity to ensure the prevention of biased research reports. Apart from the three abovementioned research units, SEBI has also attempted to capture other intermediaries, including investment advisers, credit rating agencies, asset management companies and fund managers by requiring that they strictly comply with the provisions pertaining to management and disclosures under Chapter III of the Regulations in order to be able to issue or circulate research reports in India. However, registration under the Regulations per se, is not required for investment advisers, credit rating agencies, asset management companies and fund managers as long as they comply with Chapter III. Furthermore, SEBI has also brought within its ambit, those persons or entities located outside India which are engaged in the issuance of research reports or research analysis (of securities that are listed or proposed to be listed in India), by mandating that they enter into agreements with a research analyst or a research entity who is already registered under the SEBI (Research Analyst) Regulations, 2014.[41] However, this regulation poses a glaring ambiguity as neither does it provide any clarifications on the nature of such an agreement, nor does it provide any explanation as to its scope.

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[41] *Id.*, § 4.

(2) Eligibility Requirements for Registration

The Research Analyst Regulations have laid down certain eligibility criteria that research analysts and entities must observe in order to be eligible to apply and obtain certification under Section 3 of the said Regulations. Certain qualifications and capital adequacy requirements have been prescribed, which need to be adhered to by all applicants. The qualification requirements include the applicant being a fit and proper person based on the criteria specified in Schedule II of the SEBI (Intermediaries) Regulations, 2008 (hereinafter, 'SEBI Intermediaries Regulations'); professional qualification from a recognized university specified under the regulations; and certification from the National Institute of Securities Market (NISM). Further, before granting a certificate of registration, SEBI also takes note of whether the applicant has the necessary infrastructure to effectively carry out the activities of a research analyst and whether the applicant has had any disciplinary action taken against him or against any person directly or indirectly connected to the applicant by the Board or by any other regulatory authority. Although it has tried to maximize precautions with respect to the granting of certification to research analysts and entities, SEBI has neglected to mention the scope of "*any person directly or indirectly connected with the applicant*". This could pose another significant grey area in terms of its implementation.

The general eligibility criteria aside, SEBI has also prescribed certain capital adequacy requirements that all applicants have to comply with. Section 8 of the regulations require that a research

analyst who is an individual or a partnership firm must have net tangible assets of value not less than one lakh rupees; and that a research analyst who is a body corporate or a limited liability partnership firm must have a net worth of not less than twenty five lakh rupees. With respect to this requirement, SEBI has not yet given an explanation on whether there is any separate capital adequacy/ net worth requirement for a research analyst who works in an entity that undertakes other activities as well, and if so, whether the net worth is to be computed separately for each of such activities. Although instructions on how to calculate the net worth for a body corporate or a limited liability partnership firm have been given by SEBI, no clarification has been provided on how an individual's net tangible assets of value are to be calculated. This is another ambiguity that SEBI needs to provide more information for.

(3) Parameters for Research Reports

The regulations provide an extremely wide, albeit concise definition of what constitutes a "research report". It is wide enough to cover all written and electronic communications which include research analysis, recommendations or opinions concerning any securities or public offer. The definition also includes within its ambit, any comments on general trends in the securities market; discussions on broad-based indices; commentaries on economic, political or market conditions; periodic reports or other communications prepared for the unit holders of mutual funds, alternative investment funds or clients of portfolio managers and investment advisers; statistical summaries of financial data of

companies and technical analysis relating to the demand and supply in a particular sector.[42]

The regulations have also specified certain guidelines regarding the contents of the research report, and have laid down extra requirements for disclosures to be made in it.[43] Section 19 of the regulation mandates that the research analyst or entity disclose all material information about itself including:

i. its business activity
ii. its disciplinary history
iii. complete details of the associates
iv. the terms and conditions on which it offers such report
v. any financial interest it may have in the subject company
vi. any beneficial or actual ownership it may have in the securities of the subject company
vii. any other conflicts of interest it may have at the time of publication of the research report or at the time of public appearance.[44]

Although SEBI has taken a well-calculated move by mandating the disclosure of any financial interest along with the nature of such interest that a research analyst or entity may have in the subject company, it has failed to provide a materiality threshold for

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42 *Id.*, § 2(1)(w).

43 *Guidelines Issued by Securities and Exchange Board of India for Regulating Research Analysts*, ERNST & YOUNG REGULATORY ALERT, (September 9, 2014), http://www.ey.com/Publication/vwLUAssets/EY_Alert_SEBI_Research_Analysts_Regulations/$FILE/EY_Alert_SEBI_Research_Analysts_Regulations.pdf

44 *Supra* n. 40, § 19.

the determination of such financial interest. This provision requires further clarity and explanation to ensure appropriate compliance by research analysts and entities, and to avoid future instances of circumvention.

In addition to the abovementioned disclosures, a research analyst or a research entity is also required to make certain other disclosures with respect to the receipt of compensation. The core concept behind the requirement to mandate compensation-related disclosures is to ensure that there are no side deals or hidden transactions that benefit research analysts to the detriment of the neutrality of research reports and recommendations. Section 19 (ii) requires a research analyst and a research entity to disclose the following:

i. whether it or its associates have received any compensation from the subject company in the past 12 months;[45]
ii. whether it or its associates have managed or co-managed public offering of securities for the subject company in the past 12 months;[46]
iii. whether it or its associates have received any compensation for investment banking or merchant banking or brokerage services from the subject company in the past 12 months;[47]
iv. whether it or its associates have received any compensation for products or services other than investment banking or merchant

[45] *Supra* n. 40, § 19(ii)(a).
[46] *Id.*, § 19(ii)(b).
[47] *Id.*, § 19(ii)(c).

banking or brokerage services from the subject company in the past 12 months;[48]

v. whether it or its associates have received any compensation or other benefits from the subject company or third party in connection with the research report.[49]

(4) <u>Separation of Research Analysts from other Divisions</u>

In a bid to prevent instances of conflicts of interest, SEBI has adopted the US model of research analyst regulations by prohibiting research analysts from participating in business activities that are designed to solicit investment banking, merchant banking or brokerage service businesses. Further precautions in this regard have been taken in the form of a requirement, under Section 18, that the personnel from the investment banking, merchant banking or brokerage services divisions not be permitted to direct the individuals employed as research analysts to engage in sales or marketing activities, or to engage in any communication with current or prospective clients.[50] Moreover, Section 18(8) specifically provides that no research analyst or entity can provide any promise or assurance of a favourable review in its research report to a company or industry or sector or group of companies or business group as consideration to commence or influence a business relationship or for the receipt of compensation or other benefits.[51] The insertion of Section 18(10) has sought to effectively compound the same

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48 *Id.*, § 19(ii)(d).
49 *Id.*, § 19(ii)(e).
50 *Supra* n. 45.
51 *Supra* n. 40, 18(8).

precautions by requiring that the individuals employed as research analysts are separate from other employees who are performing sales trading, dealing, corporate finance advisory or any other activity that may affect the independence of its research report.[52]

SEBI, having realized that conflict of interest with respect to research analysts have to be kept at bay, has installed an additional regulatory restriction on personal trading by analysts. Section 16 has laid down a mechanism that monitors, oversees and records all personal trading activities of individuals employed as research analysts and seeks to put all research analyst trading activities through a formal approval process. Section 16(2) has established that no research analyst or entity shall deal or trade in securities which are the subject of the recommendation or report within 30 days before and 5 days after the publication of the research report.[53] Moreover, section 16(3) requires that research analysts or entities do not deal or trade in any securities that they review in a manner contrary to their given recommendation,[54] while section 16(4) further requires that they do not purchase or receive securities of the issuer before the issuer's initial public offering, if the issuer is principally engaged in the same types of business as companies that they follow or recommend.[55] Therefore, by inserting the requirements under section 16, SEBI has successfully filled any void that research analysts and entities could

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52 *Id.*, § 18(10).
53 *Id.*, § 16(2).
54 *Id.*, § 16(3).
55 *Id.*, § 16(4).

have used to benefit from the research reports or recommendations that they make for investors.

SEBI (RESEARCH ANALYST) REGULATIONS, 2014 – THE ROAD AHEAD

Having understood the importance of credible and unadulterated research reports being available to the investing public, most developed economies today have attempted to permanently solve issues of conflicts of interests by way of narrowly tailored laws that leave no lacuna for research analysts, entities and other intermediaries to exploit. SEBI's adoption of the principles enshrined in the US Global Settlement of 2003 has been an excellent move to keep research reports and recommendations pure and free from the blemish of investment banking-influenced conflicts of interest. Its chief objective in implementing the Research Analyst regulations is two-fold: to ensure the credibility of research reports and recommendations, and to reinstate the research analyst's eminence as the gatekeeper of the securities market. It has, in this regard, once again put forward a set of comprehensive regulatory reforms that seek to uphold investor interests as well as maintain the stability of the Indian securities market. Although its efforts are commendable, there are plenty of difficulties on the implementational front, along with the existence of gaping grey areas in the regulations, that it has yet to close. However, given the nascent stage of the regulations, there is plenty of optimism that SEBI will as always continue to devise amendments to tighten the norms and close any void that the 2014 regulations might have.

Although the costs of complying with the new regulations will be high for most research entities, analysts and intermediaries, the regulations offer a new degree of transparency and availability of credible information on market trends that will provide the investing public with confidence to make the right investment decisions, which will further help the Indian securities market flourish. While it is too early to tell what kind of impact the new SEBI (Research Analyst) Regulations 2014 will have on the Indian securities market, it can be assumed from SEBI's focused effort of mandating independence of research analysis that the above will most definitely help in addressing issues of conflicts of interest and recuperate corporate governance standards in India.

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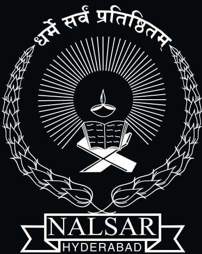

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