Between the lines...

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Highlights

I. SAT rules on SEBI's power to lift corporate veil, dismisses Sahara's appeal

The Securities Appellate Tribunal (**"SAT"**) in the matter of ***Sahara Asset Management Company Private Limited*** (**"Sahara AMC"**) ***and Others vs. Securities and Exchange Board of India*** (**"SEBI"**) (decided on July 28, 2017) held that SEBI has the power to lift corporate veil in the interest of investors.

Mutual fund framework

It is pertinent to take note of the mutual fund framework in India as existing under the SEBI (Mutual Funds) Regulations, 1996 (**"MF Regulations"**) in order to understand the facts of the case in proper perspective. Mutual fund structure consists of: (i) Asset Management Company; (ii) Trust; and (iii) Sponsor. Under the MF Regulations, sponsor applies for a license and if the eligibility criteria under the MF Regulations is met, SEBI grants registration certificate. One of the conditions is that the applicant and the asset management company must be a 'fit and proper person' as defined under the MF Regulations read with the SEBI (Intermediaries) Regulations, 2008 (**"IM Regulations"**). Other conditions include informing SEBI of any material change in the information or particulars previously furnished, which can have a bearing on the approval granted by it. For the definition of 'fit and proper person', we need to look under Schedule II of the IM Regulations, as under:

"Criteria for determining a 'fit and proper person'

For the purpose of determining as to whether an applicant or the intermediary is a 'fit and proper person' the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant or the intermediary, the principal officer and the key management persons by whatever name called –

(a) integrity, reputation and character;

(b) absence of convictions and restraint orders;

(c) competence including financial solvency and networth."

Thus, key managerial persons or key persons who control the affairs of sponsor are also required to be 'fit and proper person'.

Facts

SEBI had passed an order dated June 23, 2011 against Sahara India Real Estate Corporation Limited (**"SIRECL"**) and Sahara Housing Investment Corporation Limited (**"SHICL"**) and some of their directors in relation to refund of sums collected from investors and certain restraint orders were passed. When this matter reached the Supreme Court of India, the apex court directed SIRECL, SHICL and Mr. Subrata Roy Sahara to refund the money of investors.

The orders as mentioned above triggered investigations against other Sahara group entities. The Designated Authority appointed by SEBI for enquiry found that Sahara Mutual Fund (**"SMF"**), Sahara AMC, Sahara India Financial Corporation Limited (**"Sahara Sponsor"**) and the trustees were not 'fit and proper person' to carry on the mutual fund business and recommended cancellation of SMF's registration certificate. Consequent to the findings of the Designated Authority and after considering the reply to show cause notice, etc., SEBI cancelled the certificate of registration of SMF by its order dated July 28, 2015. This order of SEBI was in appeal before SAT.

Arguments

Appellants argued that SEBI was wrong in piercing the corporate veil in this matter by disregarding the corporate identity of Sahara Sponsor and Sahara AMC to look at their shareholders/promoters. According to the Appellants, Sahara Sponsor and Sahara AMC were to be 'fit and proper person' and not its promoters and directors. It was further argued that the requirement of 'fit and proper person' was applicable to Sahara Sponsor only for the purposes of making the application for registration and the role of a sponsor of mutual fund is limited after the asset management company and trust are setup.

Appellants pointed out that Mr. Subrata Roy Sahara was only a non-executive director of Sahara Sponsor and his role in the day to day management of Sahara AMC, Sahara Sponsor and SMF was negligible. In relation to the observations of the Supreme Court of India in the case involving SIRECL and SHICL with respect to the offence of Mr. Subrata Roy Sahara, Appellants contended before SAT that they were not parties to these cases and therefore, involvement of Mr. Sahara in SIRECL and SHICL could not be transfixed to the appellant companies in this case. Appellants submitted, *"In any case there is no order against Mr. Sahara finding him to be guilty of any offence involving moral turpitude or any economic offence. His detention order by the Hon'ble Supreme Court is only in relation to the issue of non-refund of the amounts ordered to be repaid by SIRECL and SHICL having no bearing in the present matter."*

According to Respondent SEBI, the order of the Supreme Court against Mr. Sahara clearly made a dent on his integrity, reputation and character. The counsel for SEBI then pointed out that the shareholding of Mr. Subrata Roy

Sahara and his wife in Sahara Sponsor was more than 87%(eighty seven percent). Therefore, as Mr. Sahara was in absolute position to control Sahara Sponsor by virtue of his shareholding and as he was not a 'fit and proper person' consequent to Supreme Court orders against him, it was submitted that consequently the Sahara Sponsor also was no longer a 'fit and proper person'.

With respect to the argument of Appellants on the limited liability of a sponsor after registration of mutual fund, SEBI countered by submitting that the liability of a sponsor is continuous as sponsor has to keep on fulfilling certain responsibilities under the MF Regulations even after the registration of the mutual fund.

With regard to lifting of the corporate veil, SEBI's counsel contended that SEBI, as a guardian of investor interests, is statutorily empowered to lift the corporate veil in cases where it is required to establish real corporate identity in terms of ownership and control.

Observations of SAT

SAT noted that under various provisions of the MF Regulations, the obligations of a sponsor are continuous and the obligations of a sponsor are not limited only to the stage of registration. SAT pointed out several provisions of the MF Regulations which supported its view like the provision under the MF Regulations requiring disclosures to be made by a sponsor to SEBI from time to time, continuous liability of a sponsor for compensating the affected investors, etc.

SAT made a reference to the observations of the Supreme Court of India in its order dated May 6, 2014, in which, the apex court had observed that Mr. Subrata Roy Sahara was in absolute charge of all the group companies and nothing in the companies of Sahara group moved without Mr. Sahara's active involvement. Noting these findings of the apex court, SAT took the view that he had absolute control over the affairs of Sahara Sponsor in which he also held a majority stake.

SAT made certain important observations regarding lifting of corporate veil by SEBI. Appellants had cited several judgments before SAT to support their argument that corporate veil cannot be lifted except in matters where the incorporation of the company itself is to perpetuate fraud or to carry out a fraudulent objective. However, SAT distinguished such judgments cited by Appellants on facts. SAT noted that no judgments cited by the Appellants were issued in the context of the securities market wherein the SEBI Act, 1992 and regulations thereunder were examined.

SAT took the view that SEBI is empowered to take actions in investor interest under the SEBI Act, 1992 and for that purpose, SEBI can lift the corporate veil to identify the persons who control an entity. SAT observed that without such a power, SEBI will be a mute spectator to many of the corporate misdeeds which may jeopardize the interests of investors. Lastly, SAT noted that the Reserve Bank of India ("RBI") had cancelled the registration certificate of Sahara Sponsor to carry on activities of a Non-Banking Financial Company and winding up steps were initiated under the RBI Act, 1934.

Decision

SAT dismissed the appeal. A stay on the operation of the order was granted for 6 weeks on the oral prayer of Appellants to enable them to prefer an appeal in the Supreme Court.

VA View

This order of SAT is an important pronouncement on SEBI's powers to lift the corporate veil. In SAT's view, SEBI can look beyond an entity to look at the persons who are in control of it. In cases where SEBI has to determine whether an entity is a'fit and proper person' to carry on a particular business in the securities market, it might also look at the 'fit and proper person' status of persons who control such an entity. SAT has opined that the purpose of such power is to protect the interest of investor community.

This is a deviation from the general view that corporate veil can be lifted only in respect of matters where the incorporation of the company itself is to perpetuate fraud or to carry out a fraudulent objective. SAT has held that such judgments are not in the sphere of securities market, indicating that lifting of corporate veil by SEBI in the securities market is the need in certain cases to safeguard investor interest.

II *"The Moratorium has no application on the properties beyond the ownership of the Corporate Debtor":* NCLT

The National Company Law Tribunal, Mumbai Bench (**"NCLT"**) in the matter of ***M/s Schweitzer Systemtek India Private Limited vs. Phoenix ARC Private Limited*** (decided on July 3, 2017) observed that properties which are not owned by Corporate Debtor are not within the scope of the moratorium.

Facts

Application was filed before NCLT in this case to initiate the Corporate Insolvency Resolution Process under Section 10 of the Insolvency and Bankruptcy Code, 2016 (**"Code"**). Section 10 of the Code is reproduced hereunder.

"10. *(1) Where a corporate debtor has committed a default, a corporate applicant thereof may file an application for initiating corporate insolvency resolution process with the Adjudicating Authority.*

(2) The application under sub-section (1) shall be filed in such form, containing such particulars and in such manner and accompanied with such fee as may be prescribed.

(3) The corporate applicant shall, along with the application furnish the information relating to—

(a) its books of account and such other documents relating to such period as may be specified; and

(b) the resolution professional proposed to be appointed as an interim resolution professional.

(4) The Adjudicating Authority shall, within a period of fourteen days of the receipt of the application, by an order—

(a) admit the application, if it is complete; or

(b) reject the application, if it is incomplete:

Provided that Adjudicating Authority shall, before rejecting an application, give a notice to the applicant to rectify the defects in his application within seven days from the date of receipt of such notice from the Adjudicating Authority.

(5) The corporate insolvency resolution process shall commence from the date of admission of the application under sub-section (4) of this section."

Applicant had raised debt from Dhanlaxmi Bank and Standard Chartered Bank. Dhanlaxmi Bank had later assigned and transferred the outstanding debt to the Respondent Phoenix ARC Private Limited through an Assignment Agreement. With such assignment, the properties earlier mortgaged with Dhanlaxmi Bank stood mortgaged to the Respondent. It is to be noted that the personal properties of the promoters of Applicant were given as security to Dhanlaxmi Bank, which later stood mortgaged with the Respondent.

Arguments

The counsel for Applicant mentioned that there was an order of the Chief Metropolitan Magistrate, Esplanade, Mumbai through which a Court Commissioner had been appointed to take over the possession of certain secured assets. Applicant submitted that there was a bar on taking over the possession of such secured assets till the Corporate Insolvency Resolution Process is concluded, as once the application in this case was admitted by NCLT, the moratorium was to commence.

Respondent, on the other hand, argued that the application was filed with malafide intention to frustrate the recovery of debt.

Observations of NCLT

With respect to the Balance Sheet and Profit/Loss Account furnished before NCLT by Applicant, it was observed that there was lack of clarity as to the heads of the account under which the impugned debt was reflected. NCLT, therefore, took the view that the application should be admitted as it was necessary to streamline the debt position of Applicant which was possible only after proper examination of accounts.

Certain sundry creditors were also reflected in the Balance Sheet of Applicant and NCLT noted that the fate of such creditors was not clear. NCLT observed that there was need for appointing a Professional under the Code to examine the position of such sundry creditors. NCLT further supported its view in favour of admission of the application by giving other reasons such as safeguarding the interest of stakeholders, etc.

With regard to the important question as to whether properties not owned by the Corporate Debtor could come within the ambit of the moratorium (which was to commence once the application was admitted), NCLT noted the relevant provision under the Code, as under.

*"**14.** (1) Subject to provisions of sub-sections (2) and (3), on the insolvency commencement date, the Adjudicating Authority shall by order declare moratorium for prohibiting all of the following, namely:—*

(a) the institution of suits or continuation of pending suits or proceedings against the corporate debtor including execution of any judgment, decree or order in any court of law, tribunal, arbitration panel or other authority;

(b) transferring, encumbering, alienating or disposing of by the corporate debtor any of its assets or any legal right or beneficial interest therein;

(c) any action to foreclose, recover or enforce any security interest created by the corporate debtor in respect of its property including any action under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002;

(d) the recovery of any property by an owner or lessor where such property is occupied by or in the possession of the corporate debtor.

(2) XXXX

(3) XXXX

(4) The order of moratorium shall have effect from the date of such order till the completion of the corporate insolvency resolution process:

XXXX"

NCLT emphasized on the term "its" used in Section 14(1)(c)and observed that "its" referred to the property which was owned by the Corporate Debtor and any other property was not within the scope of the moratorium. Therefore, NCLT held that the order of the Chief Metropolitan Magistrate, Esplanade, Mumbai through which Court Commissioner was appointed to take over the possession of the certain secured assets was not within the scope of the moratorium as these assets were not owned by the Corporate Debtor but by the promoters of the Corporate Debtor.

Decision

NCLT admitted the application and moratorium came into operation (subject to exception captured above). Further, the name of Interim Resolution Professional was approved and consequential directions were issued by NCLT.

VA View

NCLT observed that moratorium is an effective tool which is sometimes used by debtors to thwart or frustrate recovery proceedings initiated by lenders. NCLT has clearly laid down that the properties of the promoters which are given as security can be proceeded against by the creditors and moratorium under the Code does not save such properties of the promoters from being proceeded against in recovery of the debt.

This order of NCLT comes as a respite for the creditors as in several cases promoters pledge their personal assets in respect of borrowings of their companies. With NCLT ruling that moratorium has no effect on such pledged properties, creditors will be free to sell and realise value from such assets during the pendency of the Corporate Insolvency Resolution Process.

III. SAT stays SEBI action on suspected shell companies

The Securities Appellate Tribunal, Mumbai (**"SAT"**) decided two appeals ***(J. Kumar Infraprojects Limited vs. Securities and Exchange Board of India and Others; and Prakash Industries Limited vs. Bombay Stock Exchange Limited and Others)*** on August 10, 2017 related to a communication issued by the Securities and Exchange Board of India (**"SEBI"**) to stock exchanges on suspected shell companies.

Facts

SEBI had issued a communication on August 7, 2017 to three stock exchanges, through which, it had asked exchanges to take certain measures with respect to certain suspected shell companies. The Ministry of Corporate Affairs (**"MCA"**) had identified 331 companies as suspected shell companies for action as per SEBI framework. SEBI had, vide its said communication, directed three exchanges to identify companies out of such list of MCA listed on their exchange and take certain measures against them such as restrictions on trading and transfer of securities, verification of credentials of such companies by independent auditor appointed by the exchanges, etc. Further, compulsory delisting was to be initiated against such companies if appropriate credentials proving their existence were not found on verification.

Appellants challenged this communication of SEBI and the orders passed by two stock exchanges on the same day as per said communication of SEBI before SAT.

Arguments

Appellants submitted before SAT that SEBI had not granted them opportunity of hearing and hence, the action of SEBI was arbitrary. Appellants objected to them being considered as shell companies by SEBI as their argument was that none of the ten criteria as prescribed by the Ministry of Finance for considering a company as shell company were satisfied. Argument was also raised with regard to the absence of any investigation in this regard by stock exchanges before taking action against Appellants.

Appellants mentioned that they had impeccable track record and their annual turnover in last three years was in excess of INR 10 billion (Indian Rupees ten billion) and they had paid more than INR 1 billion (Indian Rupees one billion) as income tax/ excise duty in the last three years. Appellants submitted that such action by SEBI and stock exchanges, considering them as shell companies, has put a dent on their market reputation.

Citing a Supreme Court decision, SEBI raised a preliminary objection on the maintainability of the two appeals, contending that SEBI communication was an administrative decision and therefore, SAT had no jurisdiction under Section 15T of the SEBI Act, 1992 to entertain such appeals. Further, on the jurisdiction aspect, it was submitted by SEBI that the communication was issued by the Chief General Manager of SEBI and therefore was not appealable under Section 15T of SEBI Act, 1992. SEBI also contended that Appellants should have challenged MCA decision before the appropriate forum, and not SEBI's action, as SEBI had only implemented MCA's decision.

Observations of SAT

SAT rejected the preliminary objection raised by SEBI as to the maintainability of appeals by observing that the communication was not just a general administrative direction given by SEBI but was rather a specific direction issued with respect to specific number of companies. SAT noted that SEBI communication could not be considered as an administrative order (but was a quasi-judicial order) given the fact that Appellants, its promoters and directors were prejudicially affected. SAT further noted in this regard that Whole Time Member of SEBI, on July 28, 2017, had approved the action which was decided to be taken vide the communication.

SAT held that SEBI had taken action without proper investigation and observed, *"Even if the letter of MCA dated June 9, 2017 was considered by SEBI to be a direction given for implementation without investigation, very fact that SEBI took nearly two months to comply with the directions given by the MCA clearly shows that there was no urgency in issuing the impugned communication without even investigating the credentials/ fundamentals of those companies."*

Decision

SEBI communication was stayed qua the two Appellants in this case and action taken with respect to both Appellants by stock exchanges was directed to be reversed.

VA View

There is no definition for shell companies under any law. Such companies are often confused with the term 'dormant company' but the two concepts are different. However, possibility that a dormant company can be used as a shell company cannot be ruled out. In recent times, shell companies used for money laundering and tax evasion have been on the radar of the Central Government agencies for stringent action.

SAT rightly pointed out that SEBI, on its own, had not investigated into the fundamentals of the companies which MCA had suspected to be shell companies. Further, SAT clearly laid down that such actions of SEBI cannot be taken as its administrative decisions but are quasi-judicial in nature and therefore, subject to appeal before SAT.

Subsequent to this order of SAT, six other suspected shell companies were also granted relief by SAT and stock exchanges were directed to lift the trading restrictions imposed on them.

This order of SAT is just an interim relief for companies which are suspected as being shell companies. We will have to wait for ruling of the Whole Time Member of SEBI in this regard.

IV. SC uses its extra-ordinary powers to allow parties to withdraw insolvency application after admission

The Supreme Court of India in the case ***of Lokhandwala Kataria Construction Private Limited vs. Nisus Finance and Investment Managers LLP*** (decided on July 24, 2017) ruled on the question whether, in view of Rule 8 of the Insolvency and Bankruptcy (Application to Adjudicating Authority) Rules, 2016 (**"AA Rules"**), the National Company Law Appellate Tribunal (**"NCLAT"**) could utilize the inherent power recognized by Rule 11 of the National Company Law Appellate Tribunal Rules, 2016 (**"NCLAT Rules"**) to allow a compromise before it by the parties after admission of the matter.

Facts

Vista Homes Private Limited (**"Vista"**), group company of Appellant/Corporate Debtor subscribed to debentures to which Appellant stood as guarantor. Respondent, the Financial Creditor, was responsible for pooling money from various persons and was the facility agent to ensure returns reach the debenture holders. A Debenture Trust Deed was entered into in 2015 for governing the rights and obligations. Vista failed to repay the agreed amount and Respondent filed the present casein the National Company Law Tribunal, Mumbai (**"NCLT"**) against Appellant.

NCLT had admitted the application to initiate Corporate Insolvency Resolution Process and appointed an Interim Insolvency Professional. Through its order, NCLT also laid down directions as required under Insolvency and Bankruptcy Code, 2016 (**"Code"**).

Interestingly, though NCLT had admitted the case, the parties later on settled the matter mutually and part amount was paid. This settlement would have permitted the withdrawal of case from NCLT had the Rule 8 was not framed under the AA Rules which bars withdrawal of application after admission. Rule 8 lays down as under.

"8. Withdrawal of Application – The Adjudicating Authority may permit withdrawal of the application made under Rules 4, 6 or 7, as the case may be, on a request made by the applicant before its admission."

Parties approached NCLAT which refused to allow parties to withdraw the application. The case then came before the apex court of the country.

Arguments

Before NCLAT, parties informed it of the settlement and asked NCLAT to allow withdrawal of application.

Appellant had requested NCLAT to use its inherent powers under Rule 11 of NCLAT Rules which reads as under.

"11. Inherent powers - Nothing in these rules shall be deemed to limit or otherwise affect the inherent powers of the Appellate Tribunal to make such orders or give such directions as may be necessary for meeting the ends of justice or to prevent abuse of the process of the Appellate Tribunal."

This request was denied by NCLAT basis the reasoning that the said Rule 11 had not been adopted for the purpose of the Code. The parties then approached the Supreme Court of India.

Observations of the Supreme Court and decision

Agreeing with NCLAT on the non-applicability of Rule 11 as mentioned above, the Supreme Court invoked its special powers under Article 142 of the Constitution of India to put a quietus to the matter. The Court took the consent terms on record and also recorded the undertaking of Appellant to abide by consent terms.

VA View

Under Article 142 of the Constitution of India, the Supreme Court can pass any decree or order as is necessary for doing complete justice in any cause or matter pending before it to fill a lacuna in law. These powers are used in rare cases, that is, rulings under Article 142 are exceptions and not the norm.

This is a welcome decision by the Supreme Court in ensuring that once the creditor is paid off, there is no necessity to continue with the Corporate Insolvency Resolution Process. However, the NCLT and the NCLAT have in various judgments taken a stance that Rule 11 of the NCLT Rules and NCLAT Rules is not applicable to the Code. In the absence of Rule 11 of the NCLT Rules and NCLAT Rules being made applicable, healthy companies may have to go through the entire Corporate Insolvency Resolution Process even though they settle with their creditors after admission of the petition.

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