ACCOUNTABILITY OF CORPORATE MANAGERS: ROLE OF CRIMINAL SANCTIONS

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By

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Certificate

This is to certify that this thesis titled **"Accountability of Corporate Managers: Role of Criminal Sanctions"** submitted by Mrs.**Preetha S,** for the Degree of Doctor of Philosophy is the record of bonafide research carried out under my guidance and supervision in School of Legal Studies, Cochin University of Science and Technology. This thesis or any part thereof, has not been submitted elsewhere for any other degree.

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Certificate

This is to certify that the important research findings included in the thesis **"Accountability of Corporate Managers : Role of Criminal Sanctions"** has been presented in a research seminar held at the School of Legal studies, Cochin University of Science and Technology on 2/2/2012.

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Declaration

I do hereby declare that this work titled **"Accountability of Corporate Managers : Role of Criminal Sanctions"** is the record of original research work carried out by me under the guidance and supervision of **Dr. A. M. Varkey**, Professor (Rtd.), School of Legal Studies, Cochin University of Science & Technology. The thesis has not been submitted either in part, or in whole, for any degree at any university.

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Preface

Crimes committed by corporations and crimes committed within the corporation cause great harm to the people and the economy. Irresponsible conduct by managers results in gross human rights violations. Investor confidence in the capital market gets eroded. The social and financial harm caused by the corporate crime is much larger than that caused by the traditional crimes. Even though law enforcement agencies have started giving serious attention to corporate crime, the enforcement strategy adopted to regulate corporate crime is focusing more on entity liability. The perpetrators of corporate crime either go unpunished or receive lenient punishments.

There is an ever increasing demand from the public that the perpetrators of corporate crime should be prosecuted and punished. The study examines the role of criminal sanctions in making corporate managers accountable for their acts and omissions. It tries to identify the issues involved in imposition of criminal sanctions on corporate managers and directors. It also attempts to assess the efficacy of criminal sanctions in disciplining corporate managers. The major obstacles in holding corporate managers accountable for their acts are identified. The research questions are framed based on the issues identified. The objective of the research is to help the policy makers in framing a better policy in imposing criminal sanctions against corporate managers.

The present study is both doctrinal and explorative in nature. The doctrinal part examines the theoretical basis of imposition of criminal liability of corporate officers. The present law on imposition of criminal liability on corporate officers for corporate crimes is analysed in detail

and the problems therein are defined. The explorative part examines the need for use of criminal sanctions against corporate officers. It critically discusses the legal provisions and identifies the flaws in it. The study is mainly a collection and analysis of statutory provisions and case laws relating to attribution of criminal responsibility on corporate managers. Books, articles and committee reports pertaining to the field of study are also relied upon. The method of citation followed is the one suggested by Enid Campbell *et.al,* in *Legal Research Materials and Methods*, The Law books Company Ltd., Melbourne (1979).

The thesis is divided into eight chapters. The introductory chapter gives an overview of various mechanisms that are employed to ensure accountability of corporate managers. It traces the history of the use of criminal sanctions against corporate managers and directors.

The second chapter on corporate criminal liability discusses the legal issues involved in imposing criminal liability on corporations and gives an insight into the difficulties encountered in prosecuting and convicting corporate entities. It also analyses how the sanctions imposed on corporations fail in achieving the deterrent and preventive objective of punishment. It finally establishes the need for fixing responsibility on individuals.

The third chapter deals with the theoretical justifications for imposing criminal liability on corporate managers and directors. There have been a lot of criticisms relating to use of criminal sanctions to regulate corporate managers. Many theories were developed for increased use of criminal sanctions. Assessment of the views for and against use of criminal sanctions is an area which requires a detailed

study. Law imposes various duties on corporate directors. The non-observance of such duties is made punishable with criminal sanctions. The basis of the liability is variously termed as 'direct' liability, 'vicarious' liability, 'strict' liability, 'liability for criminal omission' or as 'liability for negligence'. Judiciary has failed to make a theoretical exposition of the nature of criminal liability imposed on directors and officers of the company. The conflicting views taken by courts in this regard call for an in depth analysis. The ways in which corporate managers and directors escape liability are also discussed. Depending on the nature of punishment prescribed for an offence, courts have taken divergent views regarding the liability of the company. When the company is acquitted of the charges there is a tendency for courts to relieve its officers also from liability.

The fourth chapter addresses the issues involved in identifying the corporate officer who is to be made responsible for corporate crime. The statutory attribution of liability and increased use of no- fault liability has been subjected to wide criticisms. Statutes fail to make proper distinctions as to who is to be held liable for non-compliance of the law. This seems to violate the fundamental principle of criminal law that no individual shall be held criminally liable under a statutory provision unless the statute specifies with reasonable certainty that he is one of those individuals to whom the prohibition applies. How the courts have struck a balance in finding the person responsible for the violation requires a critical analysis.

An analysis of the application of criminal sanctions in various potential areas is made in subsequent chapters. Investors and creditors are the main stakeholders of the company. Hence the prominent areas identified for study are use of criminal sanctions for investor protection

and creditor protection. The use of criminal sanctions for enforcement of disclosure regulations, prevention of unfair practices in securities transactions and prevention of fraudulent trading are selected to examine its utility in disciplining corporate managers.

The fifth chapter analyses how far criminal sanctions are used to ensure compliance with disclosure regulations. Disclosure regulations are aimed at enabling investors to make rational and informed decisions. There should be an effective mechanism to ensure compliance with disclosure regulations, failing which the regulations will remain as a mere paper tiger.

The scope of criminal sanctions to regulate corporate managerial misconduct in securities transactions are examined in the sixth chapter. Insider trading, price manipulation, market rigging and circular trading are some of the evils prevailing in the capital market. The chapter examines how far each of these unfair practices are regulated by the use of criminal sanctions.

The role of criminal sanctions in controlling fraudulent trading is another area examined in the study. Prohibition on fraudulent trading aims at protecting the creditors of the company. It prevents managers from excessive risk taking and from the abuse of limited liability principle. Directors are duty bound to consider the interests of creditors in times of financial distress and should restrain themselves from unreasonable gambling with the money of the creditors.

The concluding chapter summarises the issues discussed in the study and makes recommendations and suggestions that would help in developing a better legal framework for ensuring accountability of corporate managers.

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204) *White Constructions (ACT) Pty Ltd.*, v. *White,* (2004) 49 A.C.S.R.220 (S.C.).

205) *Williams* v. *Natural Life Health Foods Limited and Mistlin,* [1997]1 B.C.L.C.131 (C.A).

206) *Williams* v. *Natural Life Health Foods Ltd* [1998] 1 W.L.R.830 (H.L.).

207) *Wimco Ltd.* v. *Union of India,* 1995 (70) F.L.R.429 (Gau.)

208) *Winkworth* v. *Edward Baron development Co. Ltd.,* [1987] 1 All E.R.114 (H.L.).

209) *Z. Kotasek* v. *State of Bihar,* 1989 Cri.L.J.683.(Pat.)

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Abbreviations

A.C.	Appeal Cases
A.C.S.R	Australian Corporations and Securities Reports
A.I.R.	All India Reporter
A.L.J.	Australian Law Journal
A.P.	Andhra Pradesh
ACLC	Australian Corporate Law Cases
Adelaide L.R.	Adelaide Law Review
All E.R.	All England Reporter
Am.Crim.L.R.	American Criminal Law Review
Arizona.L.R.	Arizona Law Review
Aus.L.J.	Australian Law Journal
B.C.C.	British Company Cases
B.C.L.C.	Butterworths Company Law Cases
Bom.	Bombay
Bom.L.R.	Bombay Law Reports
Bond L.R.	Bond Law Review
Brit.J.Crim.	British Journal of Criminology
C.A.	Court of Appeal
C.L.C.	Corporate Law Cases
C.U.L.R.	Cochin University Law Review
Cal.	Calcutta
Calif.L.R.	California Law Review
Camb.L.J.	Cambridge Law Journal
Ch.D -	Chancery Division
cl.	Clause
Colum.L.R.	Columbia Law Review
Com.Cas.	Company Cases
Comp. L.J.	Company Law Journal
Cri.L.J.	Criminal Law Journal

Crim.L.Rev.	Criminal Law Review
D.L.T.	Delhi Law Times
Del.	Delhi
DePaul L.R.	DePaul Law Review
Duke L.J.	Duke Law Journal
E.B.O.R.	European Business Organisation Law Review
E.C.L.R.	European Competition Law Review
Ed.	Editor
Exe.Ch.Sec.	Executive Chartered Secretary
F.B.	Full Bench
F.C.	Federal Court
F.L.R.	Indian Factories and Labour Reports
Florida State Uni.L.R.	Floida State University Law Review
G.L.R.	Gujarat Law Reports
Gau.	Gauhati
Griffith L.R.	Griffith Law Review
H.L.	House of Lords
H.P.	Himachal Pradesh
Harv.L.R.	Harvard Law Review
I.C.L.Q.	International and Comparative Law Quarterly
Insolv.L.J.	Insolvency Law Journal
Iowa L.R.	Iowa Law Review
J. F.C.	Journal of Financial Crime
J.B.L.	Journal of Business Law
J.Crim.L.Criminology	Journal of Criminal Law and Criminology
J.Pol.Econ.	Journal of Political Science and Economics
Jo.C.L.	Journal of Criminal Law
J.T.	Judgments Today
K.B.	Kings Bench
K.L.T.	Kerala Law Times
Ker.	Kerala

L.Contem.Probs.	Law and Contemporary Problems
L.L.J.	Labour Law Journal
L.L.R.	Labour Law Reports
L.Q.R.	Law Quarterly Review
Ltd.	Limited
MANU	Manupatra
M.L.R.	Modern Law Review
Mich.L.R.	Michigan Law Review
Mys.	Mysore
n.	Note
N.L.J.	New Law Journal
N.Z.L.R.	New Zealand Law Reports
O.J.L.S.	Oxford Journal of Legal Studies
p.	Page
pp.	Pages
P.&H.	Punjab and Haryana
Q.B.	Queens Bench
Raj.	Rajasthan
s.	Section
S.C.	Supreme Court
S.C.C.	Supreme Court Cases
S.C.R	Supreme Court Reports
ss.	Sections
Stanf.L.R.	Stanford Law Review
U.Chi.L.R.	University of Chicago Law Review
U.S.	United States
v.	Versus
Vand.L.R.	Vanderbuilt Law Review
Virg.L.R.	Virginia Law Review
W.L.R.	Weekly Law Reports
Yale L.J.	Yale Law Journal

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Chapter 1
INTRODUCTION

The modern era witnessed the burgeoning growth of corporations of great size and dimensions. Large enterprises administered by salaried managers replaced the small traditional family firm as the primary instrument for managing production and distribution.[1] The rise and growth of giant corporations have been a socio-economic phenomenon.[2] These corporations have tremendous power and enormous resources at their command. Nowadays the bulk of economic activity takes place through corporations. Slowly people started realizing the threats posed by corporations to the national economy. The corporations hold monopoly over the market. The giant corporations formed the nucleus of economic power. They swallowed the smallss industrial units. They created artificial scarcity enabling them to dictate the market price. So the state had to intervene to control the massive power of corporate giants and to regulate the restrictive business practices adopted by them.

Corporate crime has assumed significant dimensions. The general public is growing intolerant of corporate crime. Corporations are being found guilty for a wide variety of offences such as financial manipulations, unfair labour practices, restrictive trade practices, infringement of patents, trade-marks and copyrights, false advertisements and fraud. The legal form

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1 Alfred D Chandler, Jr, *The Visible Hand: The Managerial Revolution in American Business*, Harvard University Press, England (1977), p.1.

2 Tom Hadden, *Company Law and Capitalism,* Weidenfeld and Nicholson, London (1972), p.24.

of corporation is used as a vehicle for carrying out criminal activity. Corporate crimes such as environmental offences, tax evasion and violation of health and safety regulations involve abuse of corporate power. Natural resources are being increasingly destroyed and polluted.[3] The life support system has been overburdened as a result of plundering of the planet. Corporate crime has many victims which include the employees, the consumers, other companies, the government, the public and the environment. There is also another category of offences wherein crime is committed against the corporation by its own executives and directors. Offences involving manipulation of prices and expropriation of profits are examples where the company itself becomes the victim of corporate crime.

Many multinational companies have become the worst perpetrators of human rights abuses throughout the world.[4] The *Saro-Wiwa* case[5] illustrates the extent to which the multinational companies may go in their pursuit for maximization of profits. A false charge of murder was

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3 See David Korten, *When Corporations Rule the World*, Kumarian Press, USA (2001), p.34.

4 Sarah Joseph, *Corporations and Transnational Human Rights Litigation*, Hart Publishing, Oxford (2004), p.2; *Access to Justice: Human Rights Abuses Involving Corporations in India*, A Project of the International Commission of Jurists, 2011, Geneva, available at www.indianet.nl/pdf/AccessToJustice.pdf accessed on 12/11/2011 The Coco Cola plant in Plachimada, Kerala extracted large quantities of underground water through bore wells and the communities living in the area are facing acute scarcity of drinking water. The Perumatti Panchayat (local body) cancelled the license in 2003 and the matter is now pending before the Supreme Court.

5 The Nigerian activist Ken Saro-Wiwa founded the Movement for the Survival of the Ogoni Peoples (MOSOP) in 1990s to protest against the damage done to the Niger delta communities to make way for pipelines. They organized movements against the government and the oil companies. Four prominent Ogoni leaders were murdered by a mob of youths. Saro-Wiwa and eight other Ogoni activists were charged with the murder. Despite lack of credible evidence to connect them to the deaths they were hanged to death in 1995. The executions were said to be the result of collusion between the companies now known as Royal Dutch Shell and the military government. Detailed discussion is available at www.en.wikipedia.org/wiki/Ken_Saro-Wiwa.

built up against an activist and he was prosecuted and hanged to death. *Unocal* case [6] is another example of abuse of corporate power. The US District Court held that corporations could be held accountable for human rights abuses committed overseas.[7] The case was finally settled in 2005.[8] Ford Motor Company was prosecuted for manufacturing unsafe automobiles and for reckless homicide.[9] They produced and marketed a hazardous product wilfully disregarding the safety of its consumers. They failed to rectify the situation because of cost considerations. Warren Anderson, the chief executive officer of Union Carbide Company alleged to be responsible for the Bhopal Gas tragedy in India is still enjoying his life freely in his homeland while thousands of victims are suffering the trauma and pain.[10]

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6 Unocal, a California-based oil company was sued for complicity in forced labour, rape and murder. According to the claim filed in the US under the Alien Tort Claims Act, 1789 Unocal hired the Burmese army units that used forced relocations, forced labour, rape, torture and murder to secure the route of an oil pipeline through Burma for the American oil company. The case set a precedent for all future cases of corporate accountability when a US Federal District Court concluded that Unocal executives could be held legally responsible for violation of international human rights norms in countries outside the US, and that the US court system has the authority to adjudicate such claims. Data is available at www.earthrights.org/legal/doe-v-unocal-case-history.

7 *National Coalition Government of Burma* v. *Unocal Inc*., 176 F.R.D. 329 (C.D.Cal.1997).

8 Earth Rights International, Final Settlement Reached *in Doe* v *Unocal*, March 21, 2005, available at www.earthrights.org/legalfeature/final_settlement_reached_in_doe_v._unocal.html accessed on 12/1/2008.

9 Sally Simpson, *Corporate Crime, Law and Social Control*, Cambridge University Press, Cambridge (2002), p.49.

10 The leakage of MIC gas at the pesticide plant of UCIL ,Bhopal resulted in the death of around 3000 people and about two lakh people suffered permanent injuries. Another 8000 people have since died from gas related diseases. In June 2010, seven ex-employees, including the former UCIL chairman, were convicted for causing death by negligence and sentenced to two years imprisonment and a fine of about $2,000 each. However the CEO of UCC at the time of disaster was released on bail on the very day of arrest and flown out of the country. He was later declared a fugitive from justice by the Chief Judicial Magistrate, Bhopal, in 1992. Data available at en.wikipedia.org/wiki/Bhopal_disaster accessed on 10/11/2010.

Financial mismanagement and fudging of accounts has taken a heavy toll ruining the lives of thousands of people. Embezzlement of corporate funds, termed as criminal misappropriation in the legal parlance is a bane to the Indian capital market.[11] The *Dalmia* affairs of the mid-fifties was the earliest case of corporate fraud in India involving embezzlement of Rs. 2 crores.[12] The infamous *Mundhra* affairs caused huge losses to the Life Insurance Corporation of India. The *Harshad Mehta* scam dealt a severe blow to the Indian stock market.[13] The *Satyam* episode was investigated by the Serious Fraud Investigation Office.[14] The Central Bureau of Investigation has filed a charge sheet under various provisions of the Indian Penal Code, 1860 against the managers

[11] V Gopalan, "Corporate Scams in India: Lessons to be Learnt", (2009)1 Comp. L.J.73 (J).

[12] Mundhra, the chairman and director of Dalmia Airways misappropriated funds after acquiring control over a number of companies including a banking company and an insurance company. Funds of one company were transferred to another to cover up the real financial position and used for the personal use of the individuals involved. LIC purchased shares of some companies promoted by Mundhra. Those companies were found to be loss making companies and the shares were found to have been forged. The investment committee was informed of the transaction only after the whole transaction was over. Mundra was finally sentenced to imprisonment for defrauding LIC. For a discussion see MC Setalvad, *My Life- Law and Other Things*, N M Tripathi Private Ltd., Bombay (1971), chapter 9: The Mundra Scandal , pp.266-296.

[13] Notes, "Securities Scam: The Systemic Origins", 27 *Economic and Political Weekly* 1981(1992).

[14] Satyam Computer Services Limited was a leading information technology services company incorporated in India. Its securities are listed on the Bombay Stock Exchange and the National Stock Exchange and on the NewYork Stock Exchange. In January 2009, the Chairman of the company confessed to having falsified the financial statements of the company by showing fictitious cash assets of over US$ 1 billion on its books. It also revealed that the proposed Maytas buy-outs were just illusory transactions intended to manipulate the balance sheet of Satyam. Data available at http://netindian.in/content/govt-extends-satyam-probe-sfio-maytas-firms accessed on 8/1/2011.

for allegedly indulging in siphoning off money, forging board resolutions and unauthorisedly obtaining loans and preparing fake invoices.[15] These scams present an urgent need to make the laws more deterrent. Richness of a few cannot be at the cost of depriving others of their due. There must be clear principles of accountability when such losses take place.

However the role played by corporations in the development of the economy cannot be belittled. It is not suggested that all companies violate the law. A reputed company will obey the laws of the land. But it is the unruly and recalcitrant companies that cause all havoc. Various mechanisms were adopted to regulate corporate crime and one method of regulation followed was to regulate the conduct of corporate managers. Corporate managers and officers who work behind the corporate veil are the real perpetrators of corporate crime. The growth of large corporations was accompanied by an increasing separation between those who own the shares and those who control their operations. Another striking development is the dispersal of shareholdings in large quoted companies resulting in loss of shareholder control over companies. The changing balance in power from control by capitalists to control by managers substantially increased the authority and power of corporate managers.[16] Corporate managers enjoy enormous powers and they handle the money belonging to the public contributed towards shares, deposits and debentures. Abuse and misuse of power by the corporate managers affects not only the shareholders but also the employees, depositors, consumers and the society. Hence it is essential that the managers be

[15] 'Satyam scam is of over Rs.14,000 crore: CBI', available at www.indiaenews.com/pdf /233587.pdf accessed on 16/5/2011.

[16] *Supra* n.2 at p.81.

made accountable for the abuse and misuse of power. There are different ways is which directors and managers of companies are held accountable for their acts. The corporate managers and directors are vulnerable to greed and self interest. There are many situations where a conflict between the personal interests of the directors and the interests of the company can arise.[17] In such situations, the fiduciary law is invoked to regulate the conduct of corporate managers and directors. Criminal sanctions are provided for breach of fiduciary obligations by directors.[18]

This study examines the role of criminal sanctions in ensuring accountability of corporate managers. It also analyses how far criminal sanctions are used in preventing abuse and misuse of power by the corporate managers. In the recent years almost all jurisdictions like the US, the UK and Australia are extensively using criminal sanctions against corporate managers.[19] In this context it is necessary to analyse the theoretical basis of criminal liability of directors, officers and employees of the companies for their acts, failures and omissions.

Evolution of the Law on Managerial Accountability

An analysis of the development of company law would reveal that the law has evolved through the process of incorporation of more and more provisions to regulate corporate activities thereby restricting the freedom of corporate managers. The Joint Stock Companies Act, 1844 was the first statute enacted for the regulation of joint stock enterprise in

[17] Conflict of interests can arise in situations where a director competes with the company or contracts with the company and in case of fixing remuneration payable to managers and directors.

[18] For eg., criminal liability is provided for insider trading.

[19] *Supra* n.9 at p.18.

the United Kingdom. It provided for incorporation of companies by registration on fulfilling the statutory conditions. Full personal responsibility of shareholders was thought to discourage men from investing in enterprises and hence to encourage wider investment limited liability was introduced in 1855.[20] This legislative intervention finally established companies as a major instrument in economic development.[21] The Companies Act, 1862 was a comprehensive piece of legislation and contained detailed provisions on winding up. The Act imposed absolute prohibition on alteration of objects clause in the memorandum of association. Thus all companies registered under the Act became subject to the doctrine of ultravires.[22]

A step by step study of the various amendments to the Act reveals greater and greater intervention and control by State and this control was in direct proportion to the abuse of the economic power wielded by the corporate sector. The Board of Trade in England appointed departmental committees at intervals of every 20 years to review company law. The provisions relating to the contents of prospectus, compulsory audit of company's accounts and registration of charges with the registrar were incorporated by the Companies Act, 1900. The Companies Act, 1907 made provision for incorporating private companies. The Amendment Acts of 1908, 1929, 1948 and 1985 consolidated the company law and substantially modernized it with a view to safeguard the market for

[20] For arguments advanced for and against the introduction of limited liability principle, see Farrar and Hannigan, *Farrar's Company Law*, Butterworths, London (1998), p.20.

[21] Janet Dine, *The Governance of Corporate Groups*, Cambridge University Press, Cambridge (2000), p. 6.

[22] Horrwitz, "Historical Development of Company Law", 62 L.Q.R. 375 at p.377 (1946).

investment capital.[23] More and more restraints were imposed on the freedom and discretion of corporate directors. All major corporate activities such as issue of capital, reduction of capital, declaration of dividend, appointment of directors and winding up of companies became strictly regulated. Significant changes were brought by the Companies Act, 2006 which for the first time codified the duties of corporate directors in UK.[24]

The major developments in company law were not entirely statutory. Many of the fundamental principles of company law were evolved by courts. Based on the foundation of partnership law, the courts worked out a coherent and comprehensive body of company law. The ultravires doctrine, the capital maintenance doctrine and the concept of separate legal personality are exclusive creations of the judiciary. Many

[23] At present the company law in England is found in the Companies Act, 2006; the Insolvency Act , 1986; the Company Directors Disqualification Act ,1986; the Criminal Justice Act ,1993 (Part V) and the Financial Services and Markets Act,2000. The Financial Services and Markets Act, 2000 constituted the Financial Service Authority as the regulator of banking, insurance and investment business.

[24] Main changes are the following: The Act significantly changes the requirements in respect of entering into substantial property transactions with directors. It abolishes the prohibition on loans and quasi-loans to directors and credit transactions with directors, and replaces it with a requirement for member approval. The criminal penalty for breach has also been abolished and the affirmation of loan is now permitted. A new two-stage statutory procedure has been introduced for derivative actions. A company must not make a political donation to a political party or other political organisation, or incur any political expenditure unless the donation or expenditure is authorised by a resolution of the members of the company, and in certain cases, also its holding company. A new exemption for donations to trade unions has been introduced. Several changes are introduced that are aimed at increasing accountability of auditors. The capital maintenance rules for private companies are significantly relaxed .The rules prohibiting a private company from giving financial assistance for the purchase of its own shares are abolished.

of these principles were later incorporated into the statute with necessary modifications to suit the exigencies of the time.

The history of Indian company law is closely linked with the origin and development of company law in England.[25] Following the enactment of the Joint Stock Companies Act, 1844 in England, the Joint Stock Companies Act, 1850 was brought into force in India. It was the first legislative measure to regulate the companies in India. The Act provided for registration of companies through the High Courts of Bombay, Calcutta and Madras. Unlike the English Act, the Indian Act did not make registration compulsory.[26] The Act conferred some privileges on the companies registered under the Act and imposed some restrictions on the management of such companies. The Act required the accounts of the company to be audited by two or more auditors. The balance sheet, profit and loss account and the auditor's report were required to be filed in court. The Act also provided for half yearly meetings of shareholders.

The 1850 Act was amended in 1857, 1860 and 1913. The 1857 Act recognized the concept of limited liability of shareholders of the company. The Act required companies to state the objects for which the company is proposed to be established in its memorandum of association.[27] The Act provided for the alteration of capital clause in the memorandum of association and no other clause could be altered. The Joint Stock Companies Act, 1860 permitted banking and insurance

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[25] P B Menon, "Evolution of Indian Company Law", (1982) 1 Comp.L.J.52 at p. 57.

[26] R. S. Rungta, "Indian Company Law Problems in 1850", 6 *The American Journal of Legal History* 298 at p.300 (1962).

[27] P. S. Sangal, "Ultra Vires and Companies: The Indian Experience", 12 I.C.L.Q. 967 at p.968 (1963).

companies to be established with limited liability of shareholders. The Joint Stock Companies Act, 1866 repealed all the previous acts and incorporated provisions governing the registration, regulation and winding up of companies.

The Indian Companies Act, 1913 was a fairly comprehensive measure incorporating the changes effected by the amendments in the English company law. The Act rearranged the sections in a chronological order as to maintain a sequence in the formation, growth and decay of companies.

The Companies Act, 1956 was enacted pursuant to the recommendations of the Bhabha Committee appointed by the Government of India. The Act is mainly based on the Companies Act, 1948 (UK) and the case laws. The 1956 Act was a significant landmark in the development of company law in India. The Act contained provisions for ensuring democratic decision making, reduction in concentration of economic power and for checking activities prejudicial to public interest. Disproportionate voting rights were abolished. It imposed restrictions on the powers of directors and managers and required them to obtain approval of shareholders on important matters affecting the company. The Act contains numerous provisions imposing penal sanctions on the corporate managers and directors for their acts and omissions.

The Companies (Amendment) Act, 1960 introduced many provisions to prohibit unfair practices and to enable better government control over companies. The Act prohibited appointment of different categories of managerial personnel simultaneously. It empowered government to conduct

special audits of the company accounts.[28] The Act made provisions for annual reports on government companies. Fraudulent preferences affected within a period of one year prior to winding up of company were declared void.[29] The Act imposed restrictions on the power of companies to make political contributions.[30]

The Companies (Amendment) Act, 1963 empowered the central government to remove managerial personnel from office. Such removal can be made on recommendations of the company law tribunal to be established to enquire into cases of fraud, misfeasance and other malpractices in the management of companies.[31] The Companies (Amendment) Act, 1965 vastly increased the Governmental control over private companies. The provisions relating to investigation into the affairs of the company were strengthened with a view to ensure due and proper administration of the funds of the company. The Companies (Amendment) Act, 1969 abolished the offices of the managing agents, secretaries and treasurers. The Monopolies Enquiry Commission had found that the managing agency system had resulted in concentration of economic power in India. Companies were banned from making contributions to political parties.

The Companies (Amendment) Act, 1974 introduced provisions to regulate acceptance of deposits by companies. Criminal sanctions were provided for the company as well as the officer in default for acceptance

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[28] The Companies Act, 1956, ss. 233 A, 240 A.

[29] *Id.*, s. 531A.

[30] *Id.*, s. 293 A.

[31] Experience of the functioning of the tribunal was found unsatisfactory and the tribunal was abolished by the Companies Tribunal (Abolition) Act, 1967.

of deposits in contravention of the conditions prescribed. The Act also introduced restrictions on transfer on shares with a view to check the trend towards takeover of well established companies by individuals or groups. The Companies (Amendment) Act, 1988 empowered the Company Law Board to exercise the judicial and quasi-judicial functions performed by the courts and the central government. It also provided for compounding of offences punishable with fine.[32]

The post 1990 reforms in the field of company law in India were introduced to keep pace with the developments in international trade and commerce. The Companies (Amendment) Act, 1999 introduced a number of changes in the company law to keep pace with the prevailing economic policy of liberalization and deregulation. Buyback of shares was legalized, provisions relating to loans and investments were rationalized and the requirement of government approval on investment decisions was dispensed with. Buyback of shares in contravention of the provisions of the Act and rules is punishable with imprisonment and fine.[33] It provided for the establishment of Investor Education and Protection Fund. The companies were empowered to make inter-corporate investments and loans without seeking prior approval of the central government.

The Companies (Amendment) Act, 2000 introduced various measures to ensure shareholder democracy in the working of companies.[34] It introduced postal ballot and provided for direct appointment of auditors

[32] The Companies Act, 1956, s.621 A.

[33] *Id.*, s. 77.

[34] S D Israni and K Sethuraman, "The Companies (Amendment) Act, 2000-A Critical Analysis" 2000 *Chartered Secretary* 1651.

in government companies by the Comptroller and Auditor General of India. The Act introduced minimum capital requirement for private companies and public companies.[35] It required the directors to submit a directors responsibility statement along with the board's report. The amendment enhanced the amount of fines provided for various offences under the Act.

The Companies Bill, 2009 was introduced to simplify the procedural laws relating to registration, management and winding up companies in India.[36] The bill has lapsed and is replaced by the Companies Bill, 2011 which is now before the parliament for consideration.

Measures for Ensuring Corporate Accountability

The corporate directors and managers should be made accountable for their acts and omissions because they deal with the money of the shareholders and their acts have wide impact on the well being of the society. Shareholders appoint directors to manage the affairs of the company. Shareholders of large corporations have little control over their

[35] Private companies should have a minimum capital of Rs 1 lakh and public companies should have a minimum capital of Rs 5 lakhs.

[36] The Bill aims at simplifying company law by segregating the procedural law from the substantive law. The main features are as follows: Provisions relating to minimum paid up capital are omitted. The bill puts emphasis on the role and responsibilities of key managerial personnel. It proposes changes in provision relating to transactions of the company with related parties. It proposes substitution of government based regime with the shareholder approval and disclosure based approval for related party transactions. It proposes prohibition of giving loans to directors of the company. Bill provides simpler and faster process of mergers and facilitates cross border mergers. Bill provides that the powers of winding up shall rest with the Tribunal. Bill proposes strict action against erring companies and regular defaulters. For detailed discussion of the changes proposed in the bill see Vijay Singh, "An Analysis of New clauses in the Companies Bill, 2009",(2010) 1 Comp. L.J. 25 (J); Gopalan, "The Companies Bill, 2009: An Appraisal of Some Important Proposals", (2009)3 Comp.L.J.193 (J).

directors and managers.[37] Major corporate decisions are taken by the board of directors and not by the shareholders. Shareholders do not have the power to direct the board of directors to follow a particular policy of action. The shareholders cannot impose its will upon the directors when the articles of association have conferred the control of the company's affairs on the directors nor can they usurp the powers vested in the directors.[38] The voting power of shareholders is limited only to those instances where in shareholder approval is mandated by the statute.[39] Shareholder passivity and the legal rules governing voting makes shareholder monitoring harder.[40] Control of corporate directors by the shareholders is a myth.[41] The only way in which the shareholders can bring about a change in corporate policy is by replacing the existing board. However shareholders have very limited power to replace the directors.[42] Even if the directors pursue an environment offensive or labour offensive policy, the shareholders may not be in a position to obtain sufficient support to remove them. Hence there exists the need for

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[37] Stephen M. Bainbridge, "Director Primacy and Shareholder Disempowerment", 119 Harv.L.R.1735 (2006).

[38] *John Shaw & Sons Ltd.*,v *Peter Shaw & John Shaw,* [1935] All E.R.456 (C.A.); *Scott* v *Scott,* [1943]1 All E.R. 582(Ch.D) ; *M.P.& Works* v *Muruka,* A.I.R.1961 Cal. 251; *Suburban Bank Ltd.,* v *Thariath,* A.I.R.1968 Ker. 206.

[39] The Companies Act, 1956, s.293 mandates that the powers provided thereunder can be exercised by the board only with the consent of the company in general meeting. This includes sale or lease of company's undertaking ,borrowing of money beyond paid up capital, investment of compensation received on compulsory acquisition in securities ,contributions to any charitable institutions beyond fifty thousand rupees.

[40] Bernard S. Black , "Shareholder Passivity Re-examined", 89 Mich.L.R.520 at p. 527(1990)

[41] Adolph A. Berle, Jr. & Gardiner C. Means, *The Modern Corporation and Private Property* , Brace & World Inc, New York (1932), p. 277.

[42] Lucian Arye Bebchuk, "The Case for Increasing Shareholder Power", 118 Harv.L.R.833 at p. 856 (2005).

regulatory measures to ensure accountability of corporate directors and managers.

The term accountability is used here in the sense of being answerable for what one has done. The trend towards responsibility and accountability can be noticed from the very beginning of the evolution of company law. Accountability of corporate managers is achieved through administrative controls, disclosure requirements, accounting and auditing, doctrine of ultravires, doctrine of capital maintenance, shareholder controls and by imposing civil and criminal sanctions on the officers of the company for breach of their duties to the company. These measures are aimed at controlling corporate behaviour and ensuring accountability of corporate managers in general.

Various strategies aimed at controlling corporate crime have been put forward. Different schools of thought offer divergent views as to the best way to regulate corporate illegality. Some scholars are of the view that since corporations are engaged in socially productive activities, they should be persuaded, educated and allowed to self regulate corporate crime. Prosecution should be adopted as a last resort. [43] Some others argue for the increased use of criminal law because it remains the most powerful expression of moral disapproval of harmful activities.[44]

The following are the main mechanisms employed to ensure corporate accountability:

[43] Gray, "The Regulation of Corporate Violations", 46 Brit.J.Crim.875 (2006)

[44] *Ibid*.

Disclosure Regulations

The rule requiring disclosure by companies of basic data during registration was introduced in the Companies Act, 1844 (UK).[45] It required the publication of the details of the organization and membership of all newly incorporated companies, 'so that the public would have the means of knowing with whom they were dealing'.[46] Full publicity was regarded as the most potent safeguard against fraud. In the early nineteenth century, financial disclosures and preparation of accounts were perceived as domestic matters to be determined by the company's shareholders. As the inequalities of information between parties and manipulation of data became apparent, there was a change in the non-interventionist philosophy. Provision was made for holding of periodic meetings and auditing of accounts in order to discourage mismanagement and abuse of trust in the conduct of company's affairs. The principal additions to the disclosure rules were made in 1907 and all public companies were required to disclose their annual balance sheets. The distinction between public and private companies was made in 1907. The private companies were exempt from the full disclosure requirements. The Companies Act, 1929 required the balance sheet and profit and loss account to be laid before the company meetings every year. The requirement of disclosure of accounts were extended to all

[45] The Joint Stock Companies Act, 1844 provided for the institution of the Office of the Registrar of Joint Stock Companies. It required documentary information relating to companies to be kept for public inspection .The Act provided for preparation and delivery of "full and fair" audited balance sheets and the auditors reports thereon to all shareholders, the reading thereof and of the report of the directors at the annual meetings of companies, and the filing of the balance sheets and auditors reports at the office of the Registrar.

[46] *Supra* n.2 at p.19.

limited companies regardless of their status in 1967 on the ground that the privilege of limited liability should be granted only if certain basic information on the company's finances is regularly disclosed. Larger companies with a turnover of more than $250,000 were required to give additional information on director's fees, emoluments of highly paid executives, number and average pay of employees, turnover and exports. All companies were required to maintain registers of current shareholdings of their directors and officers, their share dealings and of any charges or mortgages on the company property.

In India, the Companies Act, 1956 mandates disclosure of all important financial and non-financial information regarding the company. The annual reports, balance sheet, profit and loss account and various other registers are to be filed before the Registrar of Companies. MCA-21 project launched in 2006 has extinguished physical filing of forms and returns with the ROC. The project facilitates e-filing of all forms and records before the Registrar of Companies. It provides for online verification, registration and centralized database management of company records.

Accounting

Accounting was introduced as a device to provide the shareholders with maximum information about the affairs of the company. The most significant objective of accounting is to reveal the past financial performance of the company.[47] Under the English law and the Indian law every company is required to keep proper books of account. The books of account are open to inspection by any director during the business

[47] Nafees Baig, "Accounting for Future", 15 *Chartered Secretary* 643 (1985)

hours. The information disclosed in the accounts of companies varies widely. There is an apprehension that disclosure of particulars in the accounts of a company may give secret information to a competitor thereby affecting the interest of the company prejudicially. The recent trend all over the world is to give more and more information to the investors.

Auditing

Auditing of accounts is an essential part of disclosure regulations. Statutory audit was introduced in England in 1900. It is meaningless to increase the range of information to be disclosed unless it is certified that the data provided is accurate. Auditors perform the function of verifying the accuracy of the accounts. Auditors have right to access the books, accounts and vouchers of the company. Auditors are appointed at the annual general meeting and owe duty to the creditors and shareholders of the company. Professional qualification was made mandatory for the auditors of public and private company under the Companies Act, 1948 (UK). The auditor has to submit a report on the accounts of the company to the members of the company. The report should state whether the accounts have been prepared in accordance with provisions of the law and whether the accounts give a true and fair view of the state of affairs of the company. The significance of auditor's report was the main issue for consideration in *Caparo Industries plc.* v. *Dickman,*[48] wherein Lord Oliver said:

> " It is the auditor's function to ensure, so far as possible , that the financial information as to the company's affairs prepared by the directors accurately reflects the company's position in

[48] (1990)1 All E.R.568 (H.L.).

> order first, to protect the company itself from consequences of undetected errors or, possibly, wrongdoing (by for instance declaring dividends out of capital) and secondly, to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the company's affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided." [49]

The Companies (Audit, Investigations and Community Enterprise) Act, 2004 (UK) was enacted as part of the government strategy to restore investor confidence in the wake of major corporate scandals. The Act strengthened the power of auditors to obtain information from directors and other employees of the company.

In India the auditors are appointed at each annual general meeting of the company.[50] Every auditor has free and complete access to the books, accounts and vouchers of the company.[51]Auditors are required to report on the accounts, balance sheet and profit and loss account of the company.[52]

Ultravires Doctrine

The conception of the company as separate entity and as the exclusive owner of the property leads to another basic doctrine that the legal capacity of the company shall be determined by the list of objects and powers in its memorandum of association. Any activity which is not

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[49] *Id.*, p.583.

[50] The Companies Act, 1956, s.224.

[51] *Id.*, s.227.

[52] *Ibid.*

expressly or impliedly authorized by the statute or by the list of objects in the objects clause is ultravires or beyond the powers of the company. The legal capacity of the company is restricted to the objects in the objects clause and matters incidental thereto. If unlimited freedom is given to companies to change its activities, that would hamper the interests of the shareholders and the creditors. The avowed object of the doctrine was to protect the shareholders so that they may know the purposes for which their money is utilised.[53] The doctrine protects creditors by ensuring that the company's funds to which they must look for payment are not dissipated in unauthorised activities. The doctrine prevents the wrongful application of company's assets in activities likely to result in the insolvency of the company. The doctrine ensures accountability of corporate managers and directors by preventing the directors of a company from deviating from the objects for which it was formed and thus puts a check over the activities of the directors. [54]

The legal effect of the doctrine is that any ultravires contract or activity entered into by the company is void and any rights arising under it shall be unenforceable. The effect of the doctrine was that an innocent creditor may be left without any remedy. Gower has pointed out that the doctrine has outlived its purpose and advocated for its removal.[55] To mitigate the effect of the doctrine, the Companies Act, 1985 provided that a transaction decided on by the directors of the company and entered into in good faith by a third party should not be held to be invalid on the ground that it was outside the powers of the company or its directors,

[53] *Ashbury Railway Carriage and Iron Co*. v. *Ritche*, (1875) L.R.7 H.L.653.

[54] Horrwitz, "Company Law Reform and the Ultravires Doctrine", 62 L.Q.R.66 (1946).

[55] L.C.B.Gower, *Principles of Modern Company Law*, Sweet and Maxwell, London (1992), p.167.

unless the third party was aware of the fact.[56] The validity of an act done by a company cannot be called into question on the ground of lack of capacity by reason of anything in the company's memorandum.[57] The Companies Act, 2006 has virtually abolished the applicability of the doctrine.[58]

In India the doctrine of *ultravires* is strictly applied.[59] An *ultra vires* act or transaction cannot be enforced by the company or by the third party. Both the third party and company can plead against each other that the transaction was *ultravires.* The doctrine of *ultravires* was recognized by the Supreme Court of India in *A. Lakshmanaswami Mudaliar* v. *Life Insurance Corporation of India*.[60] It has been suggested by several commentators that a developing country like India cannot afford to abolish the doctrine[61]. A company is looked upon as a socio economic institution. Hence the business undertaken by a company cannot be treated as a matter of domestic concern of itself.[62] The courts have been developing some principles to reduce the rigours of the doctrine. In *Sivashanmugham* v. *Butterfly Marketing Private Ltd.*,[63] the Madras High Court held that that the third party may not take advantage of this doctrine in order to avoid the performance of the

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56 The Companies Act, 1989, s. 35.

57 *Ibid.*

58 The Companies Act, 2006, ss.31(1) and 39(1) reads, "Unless a company´s articles specifically restrict the objects of the company, its objects are unrestricted."

"The validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company´s constitution."

59 C R Dutta, *The Company Law*, Orient Law House, Allahabad (1982), p. 538

60 A.I.R.1963 S.C.1185.

61 L C Dhingra, "Doctrine of Ultravires in Company Law", 1992 Comp.L.J.17 at p. 27(J).

62 *Ibid.*

63 (2001) 105 Com.Cas.763 (Mad).

obligations voluntarily undertaken with full opportunity to know the extent of the company's power before entering into the transaction.

Doctrine of Capital Maintenance

The issued share capital is the funds to which the creditors of the company look for payment of their funds. It is a fundamental principle of company law that the issued share capital has to be maintained for the benefit of the creditors. No shares shall be issued for a consideration less than the nominal value of the shares. Issue of shares at a discount is ultravires.[64] The allottees are liable to pay for the shares in full.[65] However shares can be issued at a premium.[66]

A company cannot return its capital to the shareholders. Unauthorised return of capital is ultravires and cannot be validated by shareholder ratification or approval. The principle of capital maintenance was developed by the courts and it has three limbs.[67] The first rule is that the company shall not purchase its own shares. Secondly, a company shall not give any kind of financial assistance to any person for the acquisition of its own share. Thirdly, dividends shall be paid to the shareholders only out of distributable profits. The efficacy of the rules as a means of protecting creditors has been questioned. In the context of economic liberalization the doctrine has been subject to many dilutions by way of carving out exceptions to the rule.[68]

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64 *Ooregum Gold Mining Co of India* v. *Rooper*, [1982] A.C. 125.

65 *Ibid*.

66 Issue of shares at a premium means issue of shares for a value higher than the nominal value.

67 Farrar and Hannigan, *Farrar's Company Law*, Butterworths, London (1998), p.182.

68 The companies are allowed to issue redeemable preference shares and buy back of shares are legalised.

Administrative Controls

The Companies Act, 1956 provides a variety of powers to the central government to monitor, regulate and control the affairs of the companies. For proper accountability relating to financial matters, maintenance of proper books of account is very essential. The Act mandates compulsory maintenance of books of account by limited liability companies.[69] The Act empowers central government to inspect books of account and other documents of companies.[70] The inspection can be carried out during the office hours by the Registrar of Companies or such other person authorized by the government. The Registrar is authorized to call for any information with respect to any document submitted to him.[71] The inspections are intended to find out whether the companies are conducting their affairs in accordance with the provisions of the Act. Inspection can also be carried out to see whether any unfair practices prejudicial to the public interest are being resorted to by the company and to examine whether there is any mismanagement which may adversely affect the interests of the shareholders, creditors employees and others. If the inspection discloses a prima facie case of fraud or cheating the same may be referred to the investigative authorities for initiating corrective action. Periodical inspection by government authorities would bring to light corporate abuses and errors and enable the public machinery to ensure that

[69] The Companies Act, 1956, s.209.

[70] *Id.*, s.209A

[71] *Id.*, s.234.

national capital which is collected from individual savings is not wiped off and national resources are utilised for the best interest of the nation. [72]

To ensure better management of companies, the central government accords approval for the appointment of persons as managing directors, whole time directors, and manager of a public companies and private companies which is a subsidiary of a public company.[73] No approval shall be granted unless the government is satisfied that the proposed appointee is in its opinion a fit and proper person to be appointed as such and that the appointment is not against the public interest. The central government may appoint directors for a company in order to prevent the affairs of the company from being conducted in a manner prejudicial to the interests of the company or to the public interest.[74] The central government may direct special audit to be conducted if it is of the opinion that the affairs of the company are not being managed in accordance with sound business principles or that the company is being managed in a manner likely to cause serious injury or damage to the interests of trade and business or that the financial position of the company is such as to endanger its solvency. [75]

The Act empowers the central government to order investigation into the affairs of the company where the business of the company is conducted to defraud its creditors or for unlawful purposes. Investigation

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[72] R Santhanam, "Control of Companies by Company Law Board Through Inspection and Investigation", (1989)1 Comp.L.J.3 (J).

[73] The Companies Act, 1956, s.269.

[74] *Id.*, s.408.

[75] *Id.*, s. 233 A.

can be ordered if the business of the company is conducted in a manner oppressive to any of its members.[76]

Every public company and a private company which is a subsidiary of the public company should obtain previous approval of the central government before giving loan to the directors, relatives of directors or to a firm in which the directors of the company are interested.[77] Prior approval of the central government is necessary for entering into any contract in which the directors of the company are interested. [78] Prior approval is mandatory for making inter-corporate loans and inter-corporate investments in excess of the prescribed limits.[79] Thus it can be seen that the central government has been given wide powers to regulate the affairs of the company.

Self Regulation

This method of regulation seeks to put in place a system of internal controls that prevent aberrant behavior. The concept of enforced self regulation was developed in response to the problems associated with government regulation of businesses.[80] Under this method each company is required to formulate a set of rules tailored to its transaction contingencies. These internally developed rules will be evaluated and approved by the relevant regulatory agency. Each company has to establish its own independent compliance group which has the duty to

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[76] *Id.*, ss. 235 and 237.

[77] *Id.*, s. 295.

[78] *Id.*, s. 297.

[79] *Id.*, ss. 370 and 372.

[80] Braithwaite, " Enforced Self –Regulation: A New Strategy For Corporate Crime Control", 80 Mich.L.R.1466 at p.1470.(1981)

monitor compliance with the internal rules. The compliance officer reports to the regulatory agency which initiates prosecution aganist companies which continually and irresponsibly violate compliance group recommendations. Braithwaite asserts that private policing would be more effective than policing by the state.[81] The criticism leveled against this method is that the ethical codes may be drafted in such a way as to circumvent the very purpose of regulation.

Civil Liability

The company can act only through living persons. Hence it appoints directors as its agents. The directors have a duty to act in the best interests of the company. The law imposes certain duties upon the directors to reduce the chances for abuse of their strategic position in the company. Directors are fiduciary agents of the company and are under an obligation to act honestly.[82] Any breach of fiduciary liability would make the director liable for breach of trust. Courts have used fiduciary duties to prevent abuse of position by individuals who run the company.[83] It follows that the director shall not exploit corporate opportunities for his own benefit[84]. A director who diverts corporate opportunities for his own personal benefit is liable to account for the profits derived out of the transaction. Directors owe a duty of care and skill and has to attend the work assigned to him with due diligence. A director who fails to perform his functions with reasonable care may be held liable for negligence.

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81 *Ibid.*

82 Michael Christie, "The Director's Fiduciary Duty Not to Compete", 55 M.L.R.506 (1992).

83 *Supra* n.41 at p.238.

84 *Cooks* v. *Deeks*, [1916] 1 A.C.554.

However the standard of care expected from the directors at common law has traditionally been light.[85] Courts are reluctant to impose liability for mere imprudence or error of judgment. [86] Directors were held liable only in cases of gross negligence. The extent of duty expected from directors depends on the nature of the company, the director's position within the company, the distribution of work within the company, and the director's knowledge and experience.[87] The great size and complexity of the company and the exigencies of business necessitates some degree of delegation of responsibility. Where the distribution of work within the company is reasonable and not inconsistent with the articles of association, delegation of responsibility is treated as a valid ground for absolving the liability of the directors.

The use of civil sanctions as a method to control corporate crime is based on the assumption that civil law deters by imposing a price for illegal acts. The courts follow different standards in imposing civil liability on directors.[88] Civil liability can be imposed when the directors have actively participated in the offence or when they have procured the commission of the offence or in cases where the company has been used as a cloak to commit fraud or any illegality. The injured has the freedom to proceed against the corporation, against the director individually, or against both the individual actor and the corporation.

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85 Riley, "The Company Director's Duty of Care and Skill: The Case for an Onerous but Subjective Standard", 62 M.L.R.697 (1999).

86 See *Re City Equitable Fire Insurance Co. Ltd.,* [1925] Ch.407.

87 *Id.*, p. 427.

88 Ross Grantham, "Company Director's Personal Liability in Tort", 62 Camb.L.J.15 (2003).

Tortious liability cannot be imposed on a corporate director merely on account of the fact of his directorship.[89] The director of a company who has authorized, directed and procured the commission of a tort by his company may be personally liable for the tort.[90] In order to impose tortious liability on directors, some additional factor beyond the bare commission of the tortious act by the company is necessary. The directors and officers can be held liable to for negligent supervision and management.[91] There exists a division of judicial opinion as to the basis of tortious liability of a director. Three tests have been evolved to deal with tort liability of directors.

In 'make the tort his/her own' test it is the personal involvement of the director that determines whether tortious liability should be imposed on directors. [92] When the director acts deliberately or recklessly so as to make it his own as distinct from the act of the company, he should be held personally responsible. In *King* v. *Milpurrurru*[93], the Federal Court of Australia adopted this test in determing personal liability of directors for breach of copy right. The company was held to have infringed copy right in respect of some art works. However the Court held that failure on part of the managing director and other directors to investigate the true state of affairs was not sufficient to make the tortious act their own so as to fix personal liability on them.

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89 CM Schmitthoff, *Palmer's Company Law*, Stevens and Sons, London (1980), p. 972.

90 *Ibid.*

91 Martin Petrin, "The Curious Case of Directors' and Officers' Liability for Supervision and Management: Exploring the Intersection of Corporate and Tort Law," 59 *American University Law Review* 16 (2010).

92 Farrar, "The Personal Liability of Directors for Corporate Torts", 9 Bond L.R.102 (1997).

93 (1996)136 A.L.R.327.

The 'direct and procure' test was followed in *Performing Right Society Ltd.*, v. *Ciryl Theatrical Syndicate Ltd.*[94] It was a copyright infringement case wherin Atkin J. held that the managing director of the lessee company cannot be held liable for permitting the theatre to be used for performance in public because it was neither proved nor contended that he was privy to the commission of the act. As per the 'direct and procure' test the directors would be liable if they had directed or procured the commission of the act.[95]

The 'assumption of responsibility' test was adopted in *Trevor Ivory Ltd*. v. *Anderson.*[96] According to this principle, the directors or officers of the company can be personally made liable upon his assumption of duty of care. Assumption of responsibility can arise where a director or an officer exercises control over a particular operation or activity.[97] Personal liability can be imposed on directors for the torts of negligent supervision and management on the basis of assumption of responsibility.[98] In *Williams* v.

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94 [1924] 1 K.B.1.

95 *Mancettor Developments Ltd*., v. *Garmanson Ltd*, [1986] 1 All E.R.449 (C.A.); *C Evans& Sons Ltd* v. *Spritebrand Ltd*., [1985] 2 All E.R.415 (C.A.).

96 [1992] 2 N.Z.L.R.517 as cited in Borrowdale, "Liability of Directors in Torts-Developments in New Zealand", [1998] J.B.L.96. The facts of the case were that the plaintiff contracted with Mr Ivory, the principal officer of Trevor Ivory Ltd for expert advice on the management of a raspberry orchard. Ivory gave negligent advice on the spraying of the orchard resulting in the destruction of the raspberry plants. The plaintiffs sued the company and Mr. Ivory.

97 *Ibid.*

98 Ross Grantham, "Company Directors and Tortious Liability", 56 Camb.L.J.259 (1997); Barker, "Unreliable Assumptions in the Modern Law of Negligence", [1993] 109 L.Q.R. 461; Ross Grantham and Charles Rickett, "Directors' 'Tortious' Liability: Contract, Tort or Company Law", 62 M.L.R. 133 (1999).

Natural Life Health Foods Limited and Mistlin, [99] the Court of Appeal held the director liable for negligent advise on the principle of assumption of responsibility. But the House of Lords absolved the director from liability on the ground that there was no evidence to show that the respondents believed that Mr. Mistlin was undertaking personal responsibility to them.[100]

Tortious liability cannot be imposed on directors merely because he is occupying the position of a director. The presence of some additional factor needs to be proved to make them personally liable. The courts of law accept the proposition that the director should be held responsible for his own tort. But when it comes to reality the court carves out some way to preclude director's liability. Sometimes court finds lack of evidence to establish assumption of responsibility as was done in the *Ivory* case.

Use of Criminal Sanctions: An Overview

The policy of holding the directors and officers of the company criminally liable was well established ever since corporations came to be recognized as separate entities. The Bubbles Act, 1720 provided for imposition of criminal sanctions on all those who were members of

[99] [1997]1 B.C.L.C.131 (C.A). The case arose out of a franchise agreement under which the plaintiff set up a health food shop in Rugby. The franchisor was the defendant company, formed by Mr. Mistlin, who had successfully run a similar shop on his own account. Central to the plaintiffs' decision to proceed with the venture were income projections provided by the defendant company. These projections showed favourable income streams with substantial profits after two years. The projections proved to be inaccurate and the plaintiffs were forced to close their shop with substantial losses after eighteen months of trading. The plaintiffs alleged that the projections were negligently prepared and sought damages from Mistlin the founder and Managing Director of the company on the ground that he owed a personal duty of care in respect of the projections.

[100] *Williams* v. *Natural Life Health Foods Ltd.,* [1998] 1 W.L.R.830 (H.L.).

illegal corporate bodies.[101] Whenever a duty was placed on a corporate enterprise, the corporation as well as corporate officers was punishable for non-observance of such duty. The Sherman Act, 1890 (US) provided for jail terms for those individuals involved in price fixing.[102] The Anglo-American precedents show that liability of the corporate officers was founded upon their supervisory responsibility for the corporation's management.[103] Criminal liability was imposed in cases where there was a failure to oversee that the company complied with the rules and the standards prescribed by law.[104] The corporate officers owing responsibility for the management and operation of the affairs of the company cannot plead ignorance of what is going on in the company. Where failure on the part of an officer to instruct and supervise his subordinates results in a crime, the officer becomes liable for his own omission.

[101] Section 19 of the Bubble's Act provided that all those who participated in the illegal and void corporate bodies and their stock shall be subject to "such fines, penalties and punishments, whereunto persons convicted for common and public nuisances ... and moreover shall incur and sustain any further pains, penalties, forfeitures as were ordained and provided by the statute of provision and prÆmunire16 made in the sixteenth year reign of King Henry the Second". As cited in Jean J. Du Plessis, "Corporate Law and Corporate Governance Lessons From the Past: Ebbs and Flows, But Far From the End of History." 2009 *Company Lawyer* 43.

[102] David Eckert, "Sherman Act Sentencing: An Empirical Study, 1971-1979", 71 J.Crim.L.Criminology 244 (1980)

[103] Lee, "Corporate Criminal Liability", 28 Colum.L.R.1 at p.20 (1928)

[104] *Rex* v. *Medley,* 6 Car. & Payne 292 (1834) as cited *id.,* p.18. The facts of the case were that the general superintendent and engineer of a company were fined for public nuisance of causing water pollution. The imperfections in the machinery caused untreated effluents to flow into the river. The general superintendent and engineer were held liable on the ground that they were entrusted with the general management of the works.

The increased reliance on the strategy of criminalization became evident in the 1980's.[105] Many securities frauds, health care frauds and environmental violations were uncovered during this period. Corporate crime became more costly than conventional crime which necessitated harsher response by the law makers. A number of environmental statutes were criminalized and the punishment became more severe.

In India also there had been attempts to impose criminal sanctions on corporate officers for violation of various regulatory Acts. The Companies Act, 1956 provides the legal framework for corporate governance in India. All defaults and lapses by companies are penalised. While some offences under the Act are punishable with fine, some others are punishable with imprisonment and fine. The Act imposes a continuing obligation on companies to conduct the affairs of the company in accordance with the requirements of the Act. Annual meetings are to be held every year.[106] Audited annual accounts must be laid before the annual general meeting.[107] Proper books of account have to be maintained.[108] Failure to comply with the obligations renders the company as well as the officers liable for criminal prosecution.[109]

The offences under the Companies Act, 1956 are to be prosecuted in trial courts. The prolonged process of prosecution has resulted in the

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105 *Supra* n. 9.

106 The Companies Act, 1956, s. 166.

107 *Id*., ss. 210 & 217.

108 *Id*., s. 209.

109 *Id*., ss.168 &220

dilution of the deterrent effect of the penal provisions.[110] The number of pending cases has been growing every year. Almost 80% of the total number of prosecution cases filed has been on account of non-filing of annual returns and balance sheets. The Vaish Committee recommended that cases which do not involve public interest should either be withdrawn or allowed to be liberally compounded.[111] The J.J.Irani Committee recommended that there should be an in-house structure for dealing with cases of technical defaults involving imposition of monetary penalties.[112] This would enable courts to concentrate their attention on the disposal of cases relating to frauds, scams and embezzlement of funds which adversely affects the interest of investors and other stakeholders. The number of default and nature of offences committed by companies are provided in the annual report.[113] There is a decline in the number of prosecutions initiated and in the number of convictions secured during 2010-2011.[114] The cases in which punishment by way of imprisonment has been awarded is negligible.[115]

The Ministry of Corporate Affairs had been implementing fast track default settlement schemes very often.[116] The Serious Fraud Investigation

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110 The Report of the Expert Group on Streamlining Prosecution Mechanism under the Companies Act, 1956, (The report is popularly known as the Vaish Committee Report, 2005). For full text of the report see (2006) 2 Comp.L.J.37 (J).

111 *Ibid.*

112 The J.J. Irani Committee Report on New Company Law, 2005.

113 See 55th Annual Report on the Working and Administration of the Companies Act, 1956 (2010-2011), Ministry of Corporate Affairs, table 5.4.and 5.5. To view the table see appendix-I, table 1 and 2.

114 *Id.*, table 5.6. To view the table see appendix-I, table 3.

115 *Supra* n.110.

116 The Simplified Exit Scheme (SES) was launched in 2000, 2003 and 2005 for quick and effective closure of dormant and defunct companies with minimum

Office was set up in 2003 to investigate cases of corporate fraud. [117] The investigation is entrusted to SFIO where the size of the alleged fraud is Rs 50 crore or more or where the paid up capital of the company is Rs 5 crore or where the alleged fraud involves widespread public concern or where the investigation requires specialized skills. During the period 2010-2011, 31 cases were referred to SFIO for investigation.[118]

Criminal liability is imposed on corporate managers by attributing responsibility on persons in charge of the affairs of the company. Almost all regulatory statutes in India contain a standard provision that where an offence has been committed by the company, the company as well as every officer in charge of the conduct of business of the company shall be punishable for the offence.[119] The legal system has always faced the dilemma as to whether the corporation or the officer in charge has to be made responsible for the offence. The law makers adopted the policy that both the corporation and the officer in charge has to be made responsible for the offences committed by the corporation. But on the enforcement side, it can be found that the rate of prosecution and conviction of corporate managers is very low. The regulatory agencies have very limited resources to detect, investigate and prosecute crimes. Conviction

formalities. The Company Law Simplified Settlement Scheme, 2005 provided for filing of pending documents on payment of lump sum amount based on the number of documents and period of delay. About 50 per cent of the defaulting companies availed the benefit of the scheme.

117 Serious Fraud Investigation Office (SFIO) consists of experts from banking sector, capital market, company law, forensic audit, taxation and information technology.

118 *Supra* n.113.

119 The Negotiable Instruments Act, 1881, s.141; the Water (Prevention and Control of Pollution) Act, 1974, s. 47; the Air (Prevention and Control of Pollution) Act, 1981, s.40; the Environment (Protection) Act, 1986, s.16; the Drugs and Cosmetics Act, 1940, s. 34 ; the Food Adulteration Act, 1954, s.17.

rate is very low and most often both the corporation and the officers in charge of the company evades liability.[120]

Attribution of Criminal Responsibility on Corporate Managers

The Companies Act, 1956 provides that the company as well as the 'officer-in-default' shall be liable for contravention of the provisions of the Act. Prior to the Companies (Amendment) Act 1988, the term 'officer-in default' was given a narrow definition. The term officer-in-default was defined as 'any officer of a company who was knowingly guilty of the default, non-compliance, failure, refusal or contravention mentioned in any provision of the Act, or who knowingly and willingly authorized or permitted such default, non compliance, failure, refusal or contravention'.[121] '*Mensrea*' was an essential requirement that had to be established before an officer of the company could be made liable as an officer in default.

The intention of the legislature was to punish only those persons who actually caused the offence by way of any failure, default, non-compliance or contravention on their part. It was the duty of the Department of Company Affairs, the prosecuting authority to pinpoint and identify the persons responsible for commission of the offence. This often created difficulties for the prosecuting authorities.

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[120] For detailed discussion see *infra* chapter 2 and 3.

[121] The Companies Act,1956, s.5 (prior to the Amendment Act 1988) read, "For the purpose of any provision in this Act which enacts that an officer of the company who is in default shall be liable to any punishment or penalty, whether by way of imprisonment, fine or otherwise, the expression "officer who is in default" means any officer of the company who is knowingly guilty of the default, non-compliance, failure, refusal or contravention mentioned in that provision, or who knowingly and wilfully authorises or permits such default, non-compliance, failure, refusal or contravention ".

In *Gopal Khaitan* v. *State*,[122] the Calcutta High Court widely construed the mensrea element so as to rope in ordinary directors within the definition of officer-in-default. The court held that the directors of a company cannot take a defence that the managing director alone was responsible for non-compliance with the requirements of the statute. The court observed that negligence, blameful inadvertence or failure to supervise can be designated as mensrea. If the officer had knowledge of the default and permitted the defaults to take place by not taking any step to have the requirements under the Companies Act, 1956 complied with, then he can be said to have the requisite mensrea for the offence. The court relied on another decision of the Calcutta High Court in *Bhagirath Chandra Das* v. *Emperor*,[123] where Lodge J. observed:

> "It is clearly the duty of all the directors to see that the particular returns, the list and summary under Section 32 and the copies of the balance sheet and profit and loss account are submitted under Section 134. If directors who are responsible for the management of a company and who presumably know the duty imposed upon them by law, make no attempt to see that those duties are carried out, there is justification for holding, in my opinion, that they have wilfully and knowingly permitted the company to fail to carry out those duties. The suggestion that these various directors were mere figureheads not taking any active part in the control of the company, is in my opinion not worthy of serious consideration."[124]

[122] A.I.R. 1969 Cal.132.

[123] A.I.R.1948 Cal.42.

[124] *Id.*, p.43.

The court upheld the order of conviction against the directors of the company for failure to submit the annual return of the company and made the following observations on the object underlying the provisions of the Companies Act:

> "The definite duties imposed on all "officers" as defined in the Act, are not without their purpose. The Act has been enacted to prevent, amongst others, the snowballing of finance as also the formation of bubbles and the consequent effect thereof upon the economy of a Welfare State. The provisions of the Act are indeed like sentinels on duty at the threshold or graver offences under other Acts and the continued defaults and nondisclosures under the Act are, in many cases, but attempts to draw a red-herring 'across the trail for preventing the detection of more serious offences".[125]

The net effect of the decision was that each and every officer of the company could be tagged in the category of officer-in-default to suffer the penal consequence for failure to properly supervise and monitor the company.

A totally different approach was taken in later years wherein courts gave a narrow interpretation to the term officer-in-default. In *V.M. Thomas* v. *Registrar of Companies*,[126] the company, its managing director and the directors were prosecuted for not filing annual returns of the company. The company and the managing directors pleaded guilty. The issue was whether the petitioner who was a director during the material time could be treated

[125] *Supra* n.122 at p.136.

[126] (1980) 50 Com.Cas.247 (Ker.).

as an officer in default. To be treated as an officer in default he ought to have been one who was knowingly guilty of the default. There was nothing to show that the petitioner had known that annual return should have been filed with the signature of the managing director or the secretary and that it had not been filed in time. So the Kerala High Court held that the petitioner could not be treated as an officer in default.

There had been many cases where directors escaped liability on the ground that the prosecution failed to prove that the offences were committed by them knowingly and willingly. In *Ramacant Ltd* v. *Asst. Registrar of Companies,*[127] the director was not held liable to be convicted for failure to file balance sheet and profit and loss account due to the absence of clear evidence that the director had knowingly or wilfully permitted the default. The learned judge said:

> "When the directors fail to perform their statutory duties, they bring themselves within the mischief of the penal provision of the law. In order to sustain the conviction of an "officer of the company" it has to be proved that the particular officer knowingly and willingly, authorized or permitted these defaults. The offence is complete only if the officer of the company knew of the defaults and permitted the same".[128]

A similar approach was taken by the Bombay High Court in *Consolidated Pneumatic Tool Co. (I) Ltd.,* v. *Addl. Registrar of Companies.*[129] The court held that every director of the company could

[127] (1987) 3 Comp.L.J.242 (Cal.).

[128] *Id.*, p. 245.

[129] (1989) 65 Com.Cas.259 (Bom.)

not be made liable for defaults committed by the company. The director must have authorised the said default knowingly or wilfully. The court quashed the proceedings initiated aganist the directors of the company for failing to make payment of the dividend. The court observed:

> "the prosecution must establish, though not necessarily by direct evidence but at least inferentially supported by enough material, that the default has been done knowingly or the default has been authorised knowingly or wilfully. In other words the bare fact of default or contravention does not make an officer of the company suffer penal consequence but to incur that disqualification, he must have knowledge and that for the second part, he must also have the intention." [130]

Thus the prosecuting authorities faced a heavy burden in identifying the officers responsible for the default and also in producing evidence to show that the offence was committed knowingly and willfully.

The Companies (Amendment) Act, 1988 specified seven categories of officers who can be made liable for punishment irrespective of the fact whether they have contributed to the commission of the offence of default.[131] Thus under the new provision mensrea is not at all an essential

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[130] *Id*., p. 270.

[131] The Companies Act, 1956, s.5 reads, " For the purpose of any provision in this Act which enacts that an officer of the company who is in default shall be liable to any punishment or penalty, whether by way of imprisonment, fine or otherwise, the expression "officer who is in default" means all the following officers of the company, namely:-

(a) the managing director or managing directors;

(b) the whole-time director or whole-time directors;

(c) the manager;

requirement that had to be established before an officer of the company could be made liable. The amendment considerably reduced the difficulties faced by the prosecuting agencies in identifying the officer responsible for the offence.

Managerial Accountability and Use of Criminal Sanctions: Issues Involved

Corporations are run by directors and managers. These men are vulnerable to greed and profit motive. Various mechanisms are employed to curb abuse and misuse of corporate power by corporate managers and directors. Almost all mechanisms are backed by criminal sanctions. The imposition of criminal sanctions on managers poses many theoretical questions. Whether the existing law on imposition of criminal liability on corporation is sufficient to ensure individual accountability is the fundamental issue to be addressed.

Whether accountability can be ensured by imposing criminal liability on corporate managers is another issue to be addressed. The theories of culpability in criminal law explain the conditions to be fulfilled to impose criminal liability. Fixing criminal liability on corporate managers without

(d) the secretary;

(e) any person in accordance with whose directions or instructions the Board of directors of the company is accustomed to act;

(f) any person charged by the Board with the responsibility of complying with that provision: Provided that the person so charged has given his consent in this behalf to the Board;

(g) where any company does not have any of the officers specified in clauses (a) to (c), any director or directors who may be specified by the Board in this behalf or where no director is so specified, all the directors:

Provided that where the Board exercises any power under clause (f) or clause (g), it shall, within thirty days of the exercise of such powers, file with the Registrar a return in the prescribed form".

sacrificing the traditional norms of criminal law is a major concern. There is an emerging trend towards expanding individual liability for corporate crime. The basis for liability of corporate managers can be an omission, knowledge or acquiescence resulting in a crime. The need for an expansive standard of criminal liability is to be explored in this context.

The problem of unwanted criminal prosecution of corporate managers and directors is another potential problem facing the legal system. The legal system has to provide adequate safeguards to protect innocent directors and managers from being prosecuted and dragged into criminal courts. Developing a proper criminal liability framework without dampening the decision making power and discretion of corporate managers is a challenging task. If the directors become overcautious it can hamper corporate growth. The circumstances in which corporate managers and directors may be granted relief from criminal liability require detailed analysis.

Individual accountability cannot be achieved without identifying the officer responsible for the crime. Persons responsible for crime are identified on the basis of principle of attribution. Whether the rules of attribution are broad enough to catch the senior officers of the company even though they are not directly involved in the crime needs to be examined.

There is an increasing trend in the use of criminal sanctions for violation of fiduciary obligations of directors. Director's duty not to commit insider trading and fraudulent trading is an extension of his duty towards shareholders and creditors respectively. It is essential to find out

how the law has been structured to fasten criminal liability for breach of director's fiduciary duties.

This study aims to evaluate these issues.

Conclusion

The forgoing discussion shows that there are many areas which call for a critical study. The theoretical exposition of the basis of imposition of criminal liability on the corporate officers and identification of the flaws in the approach would help to make suitable changes in the legislation so as to make the provisions more meaningful. This may also aid the judiciary in availing the interpretative techniques to impose liability on corporate officers in appropriate cases.

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Chapter 2

JURISPRUDENTIAL PROBLEMS IN IMPOSING CRIMINAL LIABILITY ON CORPORATIONS

Today in many jurisdictions, criminal sanctions are widely used as a method of regulating corporate misconduct. The focus of criminal law can be on the entity or on the directors who manage the affairs of the corporation. The need for prosecuting and punishing corporate managers and directors along with corporations is the main focus of the study. Imposing criminal liability on corporations alone is not sufficient to regulate corporate misbehavior. For appreciating the need for imposing criminal liability on corporate officers it is necessary to understand the problems associated with the imposition of criminal liability on corporations. The difficulties involved in attributing mensrea and in securing convictions are to be analysed.

There are different models of corporate criminal liability. There are many flaws in the current system which should be corrected so that criminal law can play an active part in preventing *Enron*[1] like situations of corporate criminality in future. Individual liability should play an

[1] The Enron scandal was the first in the series of corporate accounting scandals that emerged recently in the Unites States. The company was engaged in natural gas business. The financial statements of the company were manipulated to hide its huge debt and failed deals. Asset values were inflated. Finally Enron filed a bankruptcy application in 2001.The US Securities Exchange Commission ordered an investigation. It was found that Arthur Anderson, the auditors of the company was involved in the manipulation. Criminal charges were filed against the executive directors of the company for money laundering, insider trading, conspiracy and fraud. Data available at en.wikipedia.org/wiki/Enron_scandal accessed on 22/3/2009.

extensive role in regulating corporate crime. Corporate criminal liability has its own inadequacies and deficiencies which can be overcome by allocating responsibility on the individuals responsible for the corporate crime. A detailed examination of the law relating to imposition of criminal sanctions on corporations is essential to show the inadequacies of the law in this respect.

Infliction of penal sanction on corporations gave rise to many jurisprudential and procedural difficulties.[2] Attributing juristic personality to the corporation was the main obstacle in the way of imposing criminal liability on corporations. Eighteenth century courts and legal thinkers approached corporate liability with an obsessive focus on the theories of corporate personality. The second obstacle was that the legal thinkers did not believe that corporation could possess the moral blameworthiness necessary for crimes of intent. The third obstacle was the *ultravires* doctrine, under which courts would not hold corporation accountable for crimes that were not provided for in their charters. Finally the fourth obstacle was courts literal understanding of criminal procedure. For example the accused had to be brought physically before the court for trial. Different theories of corporate criminal liability were developed to overcome these hurdles.

In this context it is necessary to examine different models of corporate criminal liability and the problems associated with corporate sanctions. It is also essential to examine whether imposing criminal liability on corporation catalyses internal accountability. The question of

[2] VS Khanna,"Corporate Criminal Liability: What Purpose Does it Serve?", 109 Harv.L.R.1477 at p.1480 (1996); K.Balakrishnan, "Corporate Criminal Liability-Evolution of the Concept", [1998] C.U.L.R.255.

how the legal system has structured the liability of the corporation for the acts of its wayward agents is also analysed.

Problems in Detection and Prosecution of Corporate Crime

The probability of detection has a significant role in determining the deterrent effect of criminal sanctions on corporations.[3] Corporate offenders are less at risk and they have a variety of means to resist enforcement strategies. Corporate crimes are harder to detect, investigate and prosecute.[4] Regulatory agencies are understaffed. Company directors, accountants and auditors who are likely to make initial detection of corporate crime are not consistently vigilant and often cover up the crime. It is stated that the prosecution had to incur a cost $ 1 million to prosecute P&O Company following the Herald of Free Enterprise Tragedy in England. But the corporate and individual defendants were able to employ the combined services of fourteen defence counsel.[5] These facts demonstrate the difficulties which corporate liability presents for the criminal justice system.

Many corporate crimes-such as securities fraud, health care fraud, banking crimes and environmental crimes cannot be easily detected by the government. These crimes are done in greater privacy and are often complicated and covered up with falsified records.[6] Most of the

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3 John Byam, "The Economic Inefficiency of Corporate Criminal Liability", 73 J.Crim.L.Criminology 582 (1982); Gary Becker, "Crime and Punishment: An Economic Approach", 76 J.Pol.Econ.169 (1968).

4 Darryl K. Brown, "The Problematic and Faintly Promising Dynamics of Corporate Crime Enforcement", 1 *Ohio State Journal of Criminal Law* 521 at p.527 (2004).

5 Celia Wells, *Corporations and Criminal Responsibility*, Clarendon Press, Oxford (1993), p.40.

6 *Ibid.*

documents are often protected by legal privileges. Even if they are accessible, the volume and complexity of such financial records makes them hard to search effectively. Corporations are better positioned to detect such crimes and determine which agents committed them. The problem of corporate crime detection has been solved to some extend by the whistle blower protection laws.[7] The Sarbanes Oxley Act, 2002 (US) extends protection to all employees of public companies who reports corporate misconduct to public authorities. The Public Interest Disclosure Act, 1998 (UK) provides protection to employees in the public and private sectors. India does not have a law to protect whistle blowers.

Once the crime is detected, determining the responsible agent often require use of corporate information. The safeguards including the presumption of innocence provided by the anglo-american legal system to the criminal defendants make the prosecution and conviction of corporations all the more difficult. The safeguards which are meant for individuals are made available to corporations also.[8]

The barriers encountered in effective investigation and prosecution prompts the prosecutors to enter into non-prosecution or leniency agreements.[9] Prosecutors frequently resort to deferred prosecution

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[7] Whistle blower is an employee, member of an organisation, especially business or government agency who reports misconduct to authorities having power to take corrective action. The Whistle Blower (Protection in Public Interest Disclosures) Bill, 2006 is pending in the Indian Parliament.

[8] Leo Davids, "Penology and Corporate Crime", 58 *Journal of Criminal Law, Criminology, and Police Science* 524 at p.530 (1967).

[9] The US Department of Justice (DOJ), the principal investigator of corporate prosecutions in the US follows the Principles of Federal Prosecution of Business Organizations which specifies the factors that prosecutors must consider before deciding whether to charge a corporation. The Principles is otherwise known as the 'Filip Memorandum' it can be found at Chapter 9-28 of the DOJ's US Attorney's Manual.

agreements to resolve corporate criminal investigations.[10] In the Unites States, the *Mc Nulty* memo issued by the Department of Justice in 2006 gives guidance for prosecutors faced with the decision whether or not to prosecute a corporation.[11]

The current regime gives too much discretion to the prosecutors. Corporations have enormous power and corporate defendants often exert power on the prosecutors to grant concessions in the form of no prosecution agreements and deferred prosecution agreements.

Models of Corporate Criminal Liability

Corporate criminal liability is not an accepted feature of all modern legal systems.[12] Some countries like Brazil, Bulgaria, Luxemburg and the Slovak Republic do not recognise any form of corporate criminal liability.[13] In countries like France and Germany, the principle of *societas delinquere non potest*[14] prevented imposition of criminal liability on artificial entities.

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[10] Deferred prosecution agreements take two forms. In the first type, no charges are filed, and the government reserves the right to prosecute if the conditions of the agreement are not met. In the other, a complaint or indictment is filed, along with a simultaneous agreement deferring prosecution of the charges for a fixed period of time, after which the charges are dismissed if the company has complied with the conditions of the agreement.

[11] Memorandum from Paul J. McNulty, U.S. Deputy Attorney General., to Heads of Department Components and U.S. Attorneys (Dec. 12, 2006), *available at* http://www.usdoj.gov/dag/speech/2006/mcnulty_memo.pdf accessed on 2/5/2008.

[12] Several commentators have raised doubts as to whether corporate criminal prosecutions are socially desirable. For eg see Jill Fisch, "Criminalization of Corporate Law: The Impact on Shareholders and Other Constituents", 2 *Journal of Business & Technology Law* 91 (2007).

[13] Allens Arthur Robins, Report on "*Corporate Culture' as a basis for the Criminal Liability of Corporations",* available at http://198.170.85.29/Allens-Arthur-Robinson-Corporate-Culture-paper-for-Ruggie-Feb-2008.pdf accessed on 10/3/2009.

[14] This principle means that a legal entity cannot be blameworthy.

Basically three models of corporate criminal liability are found in modern legal systems to determine culpability of a corporation. The first model puts forward the view that the corporation can be identified with its policy making officials and hence it can be held liable for their acts and intent. The second model advocates that the principal is responsible for the acts of his agents on the basis of the doctrine of *repondeat superior.* A corporation is vicariously liable for the criminal acts of its agents. The third theory model proposes that criminal liability of corporations is based on its internal process. Culpability of the corporation depends on the overall reasonableness of corporate practises and procedures designed to avert crime.

Identification Model of Corporate Criminal Liability

Recognition of corporations as a distinct legal person provided the foundation for accepting corporate criminal liability. Earlier courts did not consider it logical to prosecute corporations. Lord Holt said that:

> "a corporation is not indictable, but the particular members of it are."[15]

However at the turn of 19th century courts started recognizing corporate criminal liability. The doctrine of liability expanded from offenses of omission to include offenses of active behavior.[16] Initially corporations were held liable for acts of non-feasance. In *R* v. *Birmingham & Gloucester Railway Co*.,[17] a corporation was fined for failing to fulfill a statutory duty. The common law principle that master

[15] Anonymous Case (No. 935), (1518) K.B. 1701.

[16] *Supra* n.5 at p.97.

[17] (1842) 3 Q.B.223.

is liable for the acts of the servant facilitated the development of civil and criminal liability of corporations. Liability of the corporation was based on the principle of vicarious liability and the corporations were held liable only for statutory offences where mensrea was not an essential ingredient. In *Queen* v. *The Great North of England Railway Company,*[18] criminal liability was extended in the case of misfeasance.

In a landmark decision in *Lennard's Carrying Co Ltd.* v. *Asiatic Petroleum Company Ltd.,* [19] the House of Lords evolved the doctrine of identification to establish corporate liability. Viscount Haldane J. held:

> "A corporation is an abstraction. It has no mind of its own any more than it has a body of its own; its active mind and directing will must consequently be sought in the person of somebody who for some purposes may be called an agent, but who is really the directing mind and will of the corporation, the very ego and centre of the personality of the corporation. That person may be under the direction of the shareholders in general meeting; that person may be the board of directors itself, or it may be, and in some companies it is so, that person has authority to co-ordinate with the board of directors given to him under the Articles of Association and is appointed in

[18] (1846) 9 Q.B.315.

[19] [1915] A.C.705. The issue involved in the case was whether a corporate ship owner could be liable for loss of cargo due to negligent navigation of one of its ships. Under the Merchant Shipping Act, 1894 the owner could be exonerated from losses arising without his actual fault. The House of Lords held that the company cannot rely on the defence since the fault of the appropriate organ such as the board of directors or managing director would be attributed to the company.

general meeting of the company and can only be removed by the general meeting of the Company."[20]

Under the identification doctrine a corporation is identified with its controlling officers and the mind and will of the natural persons who manage and control the affairs of the corporation are attributed to the corporation. Certain persons are identified as the alter ego of the company and their acts and knowledge are attributed to the company.

Three cases decided in the year 1944 established the principle that the act and state of mind of the controlling officers could be attributed to the company to make the company criminally liable. These cases established the criminal liability of corporations for common law offences involving mensrea.[21] In *D.P.P.* v. *Kent & Sussex Contractors Ltd.*,[22] the company was held liable for furnishing false returns with 'intend to deceive'. It was held that the criminal intention of an agent of the company acting within the scope of his authority could be imputed to the company. In *R* v. *ICR Haulage Ltd.*,[23] the appellant company, its managing director and nine others were charged with conspiracy to defraud. Fraud of the managing director was held to be that of the company and the company was found guilty of conspiracy to defraud. In *Moore* v. *Bresler Ltd.*,[24] the general manager and sales manager of a company sold certain goods of the company with the object of defrauding the company and made certain false returns with intent to

[20] *Id.*, p.713.

[21] R S Welsh, "The Criminal Liability of Shareholders", 62 L.Q.R.345 (1946).

[22] [1944]1 All E.R.119 (K.B.)

[23] [1944] 1 All E.R.691 (CA.).

[24] [1944] 2 All E.R.515 (K.B.).

deceive. The company was held liable for the act of its controlling officer even though the act was done with the intention of deceiving the company itself. It was held that a corporation may be convicted even though it is a victim of the fraud, provided that the offence was committed by a person identified with the corporation and acting within the scope of his office.

Thus the identification doctrine, also known as the alter ego doctrine was developed as a means to render corporations liable for offences involving mensrea.

Identification Model: 1950's to Tesco

The identification theory proceeds on the basis that the person who acts for the company acts as the company. In *Bolton (Engineering) Co.Ltd.* v. *T.J. Graham & Sons Ltd*.,[25] Lord Denning evolved the 'organic theory' of corporate liability. The organic theory treats certain officials as the organ of the company, for whose action the company is to be liable just as a natural person is for the action of his limbs. His Lordship likened a company to a human body and said:

> "A company may in many ways be likened to a human body. It 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. Some of the people in the company are mere servants and agents who are nothing more than hands to do the work and cannot be said to represent the mind or will. Others are directors and managers who represent the directing mind and will of the company, and control what it

[25] [1957] 1Q.B.159

> does. The state of mind of these managers is the state of mind of the company and is treated by the law as such.[26]

The state of mind of the managers who control the company is treated as the state of mind of the company. But there existed lack of clarity as to which officers and employees were said to act as the company.

Tesco Supermarkets Ltd. v. *Nattrass,*[27] was decided in an atmosphere of liberal thinking concerning criminal liability of employers. In this case the House of Lords clarified that corporations would be directly liable only for wrongdoing committed by persons sufficiently senior in the corporate hierarchy to constitute the corporation's 'directing mind and will'. The actions and culpable mindset of such individuals were the actions and mindset of the company itself. The majority took the view that a rational and fair system of justice required that a company be criminally made liable only for defaults committed by those forming its directing mind. Managers down the ladder of management cannot be treated as 'directing minds'. Directing mind is said to reside in persons who are the company's very ego and centre of personality and its higher and general management distinct from relatively subordinate posts.

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[26] *Id.*, p.172.

[27] [1971] 2 All E.R.27 (H.L.). The facts of the case were that a large and reputed company operating about eight hundred supermarkets was convicted for a breach of the Trade Descriptions Act. A shop assistant in one of the supermarkets displayed misleading price information by failing to keep up the stock of a discount item. The manager of the supermarket failed to adequately check the situation. On appeal, the House of Lords reversed the conviction on the ground that the supermarket manager was not part of the directing mind and will of the company and the company cannot be criminally liable for his defaults.

Identification Model: Developments after the Tesco case

In the cases that followed the *Tesco* case there has been some shift in the scope of the class of persons considered as a corporation's 'directing mind and will'.[28] The public outcry for a strict regulatory regime for companies prompted courts to adopt a broad approach.[29]

In *El Ajou* v. *Dollar Land Holdings plc.*,[30] the Court of Appeal held that the directing mind concept applies to a person who has the ultimate responsibility for a particular transaction. He may not have responsibility for the whole project or business decisions. The directing mind need not always be found in the top level of management. The directing mind could be found in different persons for different purposes. In this case, the chairman, a non-executive director having *defacto* control over the investment project was held to be the directing mind of the company for the limited purpose of obtaining funds. The chairman was acting under the general instruction of other executive directors and had little discretion in performance of his duties. But the Court of appeal regarded these matters as irrelevant. This radical shift in approach reversing the emphasis given in *Lennard's* case and *Tesco* case led to a situation where a group of middle level managers became the directing mind of the company.[31]

In *Meridian Global Funds Management Asia Ltd.* v. *Security Commission*,[32] the House of Lords relied on the primary and secondary

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[28] R J Wickins and Ong, "Confusion Worse Confounded: The End of the Directing Mind Theory", 1997 J.B.L.524.

[29] David Burles, "The Criminal Liability of Corporations", 141 N.L.J. 609 (1991).

[30] [1994] 2 All E.R.685(C.A.)

[31] *Supra* n. 28 at p.544.

[32] [1995] 3 All E.R.918 (H.L.) The question was whether the company was in breach of the securities law requiring disclosure of substantial shareholdings knowingly

rules of attribution to determine persons constituting the directing mind and will of a company. The primary rules of attribution were to be found in the company's constitution and its articles of association.[33] These rules are supplemented by general rules relating to agency and estoppel. Whose actions are to be counted as the act of the company depends on rules of attribution. Even when the general rules of agency exclude attribution, individual actions might still be attributed by virtue of special attribution rule. The question 'whose act or state of mind shall bind the company' is to be determined by way of statutory interpretation. Emphasizing the need for a flexible approach, Lord Hoffman observed that, in the case of statutory offences, the language of the provisions, their content and policy served to indicate the persons whose state of mind would constitute the state of mind of the corporation. Accordingly, in order to identify these persons, it is necessary to engage in a rather circular inquiry into whether they have 'the status or authority in law to make their acts the acts of the company'. It is the nature of the functions performed by the individual officer that is crucial in deciding whether his acts could be attributed to the company.

In the later years, courts expressed no sympathy for the policy aspects of the *Tesco* decision. After the decision in the *Meridian* case, acts of officers with operational autonomy were attributed to the

held by an investor. The investment manager had full responsibility for buying and selling of shares and was not under any direct supervision. The investment manager was held to be the directing mind and will in respect of transactions relating to buying and selling of shares. The investment managers who were not even members of the company's board were held to be the company's directing mind and will.

[33] *Id.*, at p.923.

company.[34] The concept of directing mind and will theory has been widened to include the junior officers of the company by the application of special rules of attribution. The demise of the directing mind theory seems to have occurred as a result of the public outcry for strict regulatory regime against financial disasters in the corporate field.[35] Application of special rule of attribution resulted in imposition of guilt on the company on a vicarious basis.[36]

The identification doctrine acts as a barrier to corporate liability for manslaughter. In *R* v. *P& O European Ferries Ltd.*,[37] the corporation and seven of its employees were prosecuted for the manslaughter of 193 passengers and crew. Turner J., held that a company could be held liable for manslaughter. But the prosecution failed to identify an individual within the organization who was guilty of gross negligence and who was sufficiently senior to be said to represent the directing mind of the corporation. Turner J. and Rose L.J. rejected the possibility of aggregation of the state of mind of its controlling officers. Despite overwhelming evidence that there were errors on the part of senior officers in issuing and enforcing orders to ensure that the bow doors of the vessel were closed while sailing, the corporation and its officers were acquitted. The sheen inquiry had found that all concerned in the

[34] Ross Grantaham, "Corporate Knowledge: Identification or Attribution", 59 M.L.R. 732 (1996)

[35] *Supra* n.28 at p.554.

[36] Ellis Ferran, "Corporate Attribution and the Directing Mind and Will", 127 L.Q.R.239 at p.245 (2011).

[37] [1991] Crim.L.Rev.695.

company's management shared responsibility for the failure of the safety system.[38]

In *R* v. *H M Coroner,*[39] Bingham L., observed that both the *mensrea* and *actus reus* of manslaughter should be established against those who can be identified as the embodiment of the company to hold a company criminally liable for manslaughter.

The orthodox position of law was re-established by the Court of Appeal in *A G's Reference* (No: 2 of 1999).[40] The defendant company was charged with manslaughter following a rail accident in which seven people died. The issue for consideration was whether the company could be convicted for manslaughter by gross negligence in the absence of evidence establishing the guilt of an identified human individual for the same crime. The court answered the question in the negative stating that the concept of identification is not dead or moribund in relation to common law offences. Rose L.J. observed that in fashioning the special rule of attribution in the *Meridian* case, Lord Hoffman was not departing from the identification theory but was reaffirming its existence.[41] The court rejected the concept of aggregation of mental state and held that unless an identified individual conduct, characterisable as gross criminal negligence can be attributed to the company, the company is not liable for manslaughter.

Thus to indict the company for common law offences, the doctrine of identification still continues to be the rule.

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[38] See Celia Wells, "Corporate Killing", 147 N.L.J.1467 at p.1468 (1997).

[39] (1987) 88 Cr.App.R.10.

[40] [2000] 3 All E.R.182 (C.A.)

[41] *Id.*, at p.192.

France also follows the identification model of corporate criminal liability. Ever since the Napoleon Code, French law rejected the idea that companies may be held liable before criminal courts.[42] The concept of corporate criminal liability entered the French criminal system with the adoption of the new penal code in 1992. The French model is based on the directing mind concept.[43] Corporations can be held liable only when one of the legal representatives or organs of the corporation has acted. Violation of the supervisorial duties can also be a ground for corporate criminal liability. However the application of corporate criminal liability is confined to a limited number of offences by the requirement that each crime needs to mention specifically that a corporation can be punished for the same.[44] Statutes pertaining to the field of public welfare such as those concerning tax fraud, price fixing and safety at work permit the imposition of criminal liability on corporations.[45] Under the safety at work legislation, personal liability is the general rule and the corporation can be convicted where the fault cannot be imputed to a natural person.[46]

In Australia, the judiciary has largely followed the identification approach developed in the U.K. in 1940's. The Federal Criminal Code provides for organisational liability in relation to federal offences. Under

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[42] Christina Mauro, "France", in Helen Anderson (Ed.), *Directors Personal Liability for Corporate Fault*, Wolters Kluwer, Netherlands (2008), p.144.

[43] Guy Stessens, "Corporate Criminal Liability: A Comparitive Perspective", 43 I.C.L.Q. 496 (1994).

[44] The French Nouveau Code Penal, 1992, article 121-2. For more discussion see, Roland Hefendehl, "Corporate Criminal Liability: Model Penal Code Section 2.07 and the Development in Western Legal Systems" 4 *Buffalo Criminal Law Review* 283 (2000).

[45] L H Leigh, "The Criminal Liability of Corporations and Other Groups: A Comparitive View", 80 Mich.L.R.1508 at p.1520 (1982).

[46] *Ibid.*

the Criminal Code Act, 1995 criminal liability can be attributed to the corporation, where an employee, agent or officer of a body corporate, acting within the actual or apparent scope of their employment, or within their actual or apparent authority, commits the physical element of an offence.[47] Intention to commit the offence can be attributed to the corporation if that body corporate expressly, tacitly or impliedly authorised or permitted the commission of the offence. Authorisation or permission for the commission of an offence can be established if a high managerial agent of the body corporate intentionally, knowingly or recklessly engaged in the relevant conduct. Statutory attribution is possible if a corporate culture existed within the body corporate that directed, encouraged, tolerated or led to non-compliance and the body corporate failed to create and maintain a corporate culture that required compliance.[48] Acts of an employee, agent or officer can be attributed to the corporation. Thus there is a departure from the identification approach as applied in *Tesco* case.[49] Corporate criminal liability can also be based on deficiencies in the corporate culture.[50]

Corporate Blameworthiness Model

The corporate blameworthiness model proposes that a corporation is blameworthy when its practices and procedures are inadequate to protect the public from corporate crimes.[51] Corporate blame worthiness

[47] The Criminal Code Act, 1995, (Australia), s. 12.

[48] *Id.*, s. 12.3(2).

[49] Jennifer Hill, "Corporate Criminal Liability in Australia", 2003 J.B.L.1 at p.15.

[50] *Ibid.* 'Corporate culture' is defined as attitudes, policies, rules and so on existing within the body corporate generally in which the relevant activities takes place.

[51] Notes, "Developments in the Law: Corporate Crime: Regulating Corporate Behavior Through Criminal Sanctions" 92 Harv.L.R.1227 at p. 1243 (1979).

depends upon the overall reasonableness of corporate practices and procedures designed to prevent crime. This theory recognizes that criminal acts of a corporation result not from the isolated activity of a single agent, but from the complex interactions of many agents in a bureaucratic setting.[52] Illegal conduct by a corporation is the consequence of corporate processes such as standard operating procedures and hierarchical decision making.

The Corporate Manslaughter and Corporate Homicide Act, 2007, (U.K.) was enacted in the light of the recommendations of the Law Commission for the creation of a new offence of corporate killing.[53] The Act follows corporate blameworthiness model for fixing liability on corporations. The Act provides that an organisation will be guilty of the offence if the way in which its activities are managed or organised causes a death and amounts to a gross breach of a duty of care to the deceased.[54]

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[52] *Ibid.*

[53] The Law Commission Report, UK, "Legislating the Criminal Code: Involuntary Manslaughter", (Report No: 237). The commission recommended that death should be regarded as having been caused by the conduct of a corporation if it was caused by a failure in the way which the corporation's activities are managed or organized. The offence can be said to be committed only where the defendant's conduct in causing death fell far below what could reasonably be expected. The report is available at http://www.lawcom.gov.uk/files/Ic237.pdf accessed on 25/6/2008.

[54] The Corporate Manslaughter and Corporate Homicide Act, 2007, s.1 (1) reads, "A corporation is guilty of corporate killing if- (a) a management failure is the cause or one of the causes of a persons death; and (b) that failure constitutes conduct falling far below what can reasonably be expected of the corporation in the circumstances.

(2) For the purposes of subsection (1) above- (a) there is a management failure by a corporation if the way in which its activities are managed or organized fails to ensure the health and safety of persons employed in or affected those activities; and (b) such a failure may be regarded as a cause of a person's death notwithstanding that the immediate cause is the act or omission of an individual.

(3) A corporation guilty of an offense under this section is liable on conviction on indictment for a fine."

The liability of the corporation will depend on how the fatal activity was managed or organised throughout the organisation, including any systems and processes for managing safety and how these were operated in practice. A substantial part of the failure within the organisation must have been at a senior level. An organisation guilty of the offence will be liable to an unlimited fine. The courts can also impose a publicity order, requiring the organisation to publicise details of its conviction and fine. Corporate managers and directors cannot be prosecuted under the Act.

The Act seeks to overcome the difficulty of identifying the top level officer responsible for the crime. Senior management consists of the persons having a significant role in the decision-making and management of the organisation.[55] The organization is said to be grossly negligent where the breach falls below what can reasonably be expected of the organisation in the circumstances.[56] An objective standard is adopted to assess gross negligence.

Respondeat Superior Model

The Industrial Revolution brought drastic changes in the role of large corporations in American society emphasising the need for developing new mechanisms to punish corporate malfeasance. In a landmark decision in *New York Central & Hudson River Railroad* v. *United States*,[57] the U.S. Supreme Court adopted the civil law doctrine of *respondeat superior* to impose criminal liability on corporations. The court held that a corporation could be convicted for a crime when one of its agents has committed a criminal act within the scope of his employment and for the benefit of the

[55] *Id.*, s.1 (4) c.

[56] *Id.*, s.1 (4)b.

[57] 212 U.S.481 (1909).

corporation. Corporations will become liable if the individual commits an offence in the course of pursuing objectives of the corporation or undertaking tasks which are authorised or required by virtue of his position. The scope of employment includes any act that 'occurred while the offending employee was carrying out a job-related activity.'[58]

The terms 'agent' and the 'intent to benefit' test have been read expansively by courts.[59] The requirement that the individual's actions should be intended to benefit the corporation is said to be satisfied if the benefit to the company is one of the motivation of the individual's conduct.[60] To meet this standard the employee need not act with the exclusive purpose of benefiting the corporation and the corporation need not actually receive the benefit.[61]

Courts have found that a low-level employee is acting 'within the scope of his employment'even when he is acting in a manner expressly forbidden by the company's own internal policies.[62] Corporations can be held criminally liable whether or not management was aware of the conduct in question.

The fact that a superior officer has given express instructions that the individual should not engage in the conduct constituting an offence does not prevent that conduct from being within the scope of the

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58 *Supra* n.51 at p.1250.

59 Edward B. Diskant, "Comparative Corporate Criminal Liability: Exploring the Uniquely American Doctrine Through Comparative Criminal Procedure", 118 Yale L.J.126 (2008).

60 *US* v. *Sun- Diamond Growers of California*, 138 F 3d 961 (DC Cir, 1998).

61 *Supra* n.51 at p.1251.

62 *United States* v. *Automated Med. Labs., Inc.*, 770 F.2d 399, 407 (4th Cir. 1985).

individual's duties.[63] In *US* v. *Potter*[64], the general manager paid bribe to the Speaker of the Rhodes Island House of Representatives. The president of the company had considered the proposed course of action and ordered him not to proceed. The Court of Appeal observed:

> "For obvious practical reasons, the scope of employment test does not require specific directives from the board or president for every corporate action; it is enough that the type of conduct (making contracts, driving the delivery truck) is authorized. The principal is held liable for acts done on his account by a general agent which are incidental to or customarily a part of a transaction which the agent has been authorized to perform. And this is the case, even though it is established fact that the act was forbidden by the principal.…despite the instructions (the individual in question) remained the high-ranking official centrally responsible for lobbying efforts and his misdeeds in that effort made the corporation liable even if he overstepped those instructions".[65]

Aggregation Model of Corporate Liability

The aggregation model is a new approach developed for imposing criminal liability on legal bodies. The aggregation model allows linking the thoughts of different agents of the legal body and thus creating the

[63] Kevin B. Huff, "The Role of Corporate Compliance Programs in Determining Corporate Criminal Liability: A Suggested Approach", 96 Colum.L.R.1252 (1996)

[64] 463 F 3d 9 (1st Cir, 2006).

[65] *Id.*, at p.42

required mental element. [66] The behaviour of one agent can be joined to the knowledge of another to establish a criminal offense. In *United States* v. *Bank of New England* [67] the Court of Appeals adopted the aggregation approach in convicting the bank and held:

> "Corporations compartmentalize knowledge, subdividing the elements of specific duties and operations into smaller components. The aggregate of those components constitutes the corporation's knowledge of a particular operation. It is irrelevant whether employees administrating one component of an operation know of the specific activities of employees administrating another aspect of the operation."[68]

Thus in the U.S. *mensrea* of different employees and agents can be combined and attributed to the corporate entity.

A Critique of Corporate Criminal Liability Models

The identification model has been criticized on the ground that criminal liability on companies is imposed vicariously under the guise of the directing mind and will theory.[69] Imposing vicarious criminal liability on company is arbitrary and unjust. The identification approach is too narrow and enables large companies to avoid liability.[70] In large

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[66] Eli Lederman, "Models for Imposing Corporate Criminal Liability: From Adaptation and Imitation Toward Aggregation and the Search for Self-Identity", 4 *Buffallo Criminal Law Review* 640 (2000).

[67] 821 F.2d 844 (1st Cir. 1987)

[68] *Id*.,at p.856

[69] *Supra* n.28 at p.533.

[70] *Supra* n.5 at p.132; Smith & Hogan, *Criminal Law*, Butterworths, London (1992), p.180; Simon Parsons, "The Doctrine of Identification, Causation and Corporate Liability For Manslaughter", 67 Jo.C.L.69 (2003); Gobert, "Corporate Criminality:

companies it is unlikely that senior managers would commit the actus reus of an offence. The identification approach is notorious for failing to secure convictions in relation to large corporations, even in high profile cases.[71] The identification approach is of no help in situations where a crime has been caused not by wrongful acts of its agents but from the policies and operational procedures of a company.[72] Systemic failures cannot be attributed to any specific individual.

The identification doctrine does not allow aggregation of the acts and state of mind of two or more controlling officers. In corporations, decisions are taken not by a single controlling officer but by a number of them. The identification approach requires a member of senior management to actually commit the offence for which the corporation is charged. Thus the exposure of the corporation to corporate criminal liability is very less.

The corporate blameworthiness model imposes a duty based liability on the corporation. Corporations are supposed to adopt policing measures, preventive measures and follow up actions to ensure that there is no law breaking by its agents. If no institutional procedure is available to detect and prevent crime, corporations are held liable for failing in its duty to prevent crime.

New Crimes for the Times", [1994] Crim.L.Rev.722; Fisse, "Consumer Protection and Corporate Criminal Liability: A Critique of *Tesco Supermarkets Ltd.*, v. *Nattrass*", 4 Adelaide L.R.113 (1971).

[71] *Supra* n.29 at p. 611.

[72] Gerry Johnstone and Tony Ward, *Law & Crime*, Sage Publications, London (2003), p.124.

The corporate blameworthiness model and the *respondeat superior* model is broader in its approach in attributing criminal responsibility on the corporation. It is easier to establish corporate guilt. But the common law jurisdictions are reluctant to accept the *respondeat superior* doctrine as it may lead to sacrificing the noble ideals cherished by the criminal justice system.

Corporate Criminal Liability in India

The theoretical basis for corporate criminal liability in India has not been clearly expounded by courts. Courts in India have applied both the English model and the American model while imposing liability on corporations. For determining liability of companies for statutory offences, courts have followed the *respondeat superior* doctrine and for common law offences, courts have applied the identification model of corporate criminal liability. A corporation is covered under the definition of person under the Indian Penal Code and is liable to be punished for any offence under the code.[73]

In *Anath Bandhu* v. *Corporation of Calcutta,* [74] a limited company was prosecuted for breach of Calcutta Municipal Act, 1923 committed by the director of the company. The offence charged did not involve any mensrea. Hence the Calcutta High Court repelled the contention that the company could not be indicted for the offence. However the decision did not consider the question of whether the mensrea of the servants or agents of the company could be attributed to the company.

[73] The Indian Penal Code, 1860, s.11 reads, "person" includes any company or association, or body of persons, whether incorporated or not".

[74] A.I.R.1952 Cal.759.

In *State of Maharashtra* v. *Syndicate Transport Co. Ltd.,*[75] the Bombay High Court held that a corporate body is indictable for acts or omissions of its directors and authorised agents. However the agents must have acted under authority of the corporate body or in pursuance of the aims or objects of the corporate body. The question whether a corporate body should be made liable depends on the nature of the offence committed, the relative position of the officer in the corporate hierarchy and the other relevant facts and circumstances which could show that the corporate body meant or intended to commit that act. A company cannot be indictable for offences like bigamy, perjury, rape etc which can only be committed by a human individual or for offences punishable with imprisonment or corporal punishment. Barring these exceptions, a corporate body can be punished for criminal acts or omissions of its directors, or authorized agents or servants, whether they involve mens rea or not. The decision upheld the principle that corporations are indictable for offenses involving mensrea.[76]

In *Keshub Mahindra* v. *State of Madhya Pradesh,*[77] the Union Carbide Corporation and its officers were prosecuted for culpable homicide not amounting to murder following the Bhopal gas tragedy. Without referring to either the alter ego doctrine or the *respondeat superior* doctrine or the principle of aggregation, the Supreme Court held that the corporation and its controlling officers could not be said to have the requisite *mensrea* to cause death intentionally. The court really missed a golden opportunity to enunciate the jurisprudential basis of corporate

[75] A.I.R.1964 Bom.195.

[76] Also see *A.K. Khosla* v. *T.S. Venkatesan,* 1992 Cri.L.J.1448; *Kalpanath Rai* v. *State,* (1997) 8 S.C.C.732.

[77] (1996) 4 Comp.L.J.441(S.C.).

criminal liability in India. The U.S. and the U.K. courts have applied the concept of negligent manslaughter and reckless homicide to establish corporate guilt where breach of duty and negligence on the part of the agents of the corporation has resulted in serious harm to the public or its employees. The Indian Judiciary made no such attempt in developing a proper liability regime to regulate and control corporate criminality.

In *Assistant Commissioner, Assessment-II* v. *Velliappa Textiles Ltd.,*[78] the question for consideration was whether mensrea of the agents can be attributed to the company. Rajendra Babu J., who delivered the majority judgment agreed that the common law doctrine of alter ego and the identification approach is applicable under the Indian law. But the court refused to attribute the element of mensrea to the corporation. This approach is paradoxical because accepting the doctrine of alter ego without accepting the purpose and aim of the doctrine is an anomalous position to take.[79]

As of now there is lack of clarity regarding the theoretical basis, the nature and scope of corporate criminal liability in India. Unless the same is clarified by the legislature or the court the deviant corporations might get away with the offence.

Corporate Liability for Offences Punishable with Imprisonment

It was doubted whether a company could be prosecuted for an offence for which the only punishment prescribed was a mandatory

[78] A.I.R.2004 S.C.86.

[79] The case was overruled in *Standard Chartered Bank* v. *Directorate of Enforcement,* A.I.R.2005 S.C.2622. The court did not address the question of attribution of mensrea to the company. The overruling was on the issue of sentence to be awarded to a company in case the offence charged is punishable with imprisonment.

sentence of imprisonment. There is no dilemma when fine is the only punishment prescribed for the offence and when the statute confers judicial discretion to impose fine or imprisonment. The problem arises when a statute prescribes imprisonment as mandatory part of the sentence. To get over this difficulty the Law Commission in its 41st report and 47th report recommended that section 62 of the Indian Penal Code may be amended by adding the following words:

> "In every case in which the offence is only punishable with imprisonment or with imprisonment and fine and the offender is a company or a body corporate or an association of individuals, it shall be competent for the court to sentence such offender to fine only."[80]

These recommendations were not acted upon and the Indian Penal Code (Amendment) Bill, 1972 proposed to give effect to the report of the Law commission also lapsed.

There was a difference of opinion among high courts on the issue of whether a company could be prosecuted and punished in a case where the offence was punishable with imprisonment or imprisonment along with fine. Some of the High Courts were of the opinion that a company cannot be prosecuted for offences which entail a mandatory sentence of imprisonment.[81] It would only result in the court stultifying itself by

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[80] The Law Commission of India, 41st report on The Code of Criminal Procedure 1898, (1969) para 24.7; the Law Commission of India, 47th report on the Trial & Punishment of Social and Economic Offenses, 1972, (para 8.3).

[81] *State of Maharasthra* v. *Syndicate Transport,* A.I.R.1964 Bom.195; *Badsha* v. *Income Tax Officer,* 1987 (1) K.L.T.112; *P.V.Pai* v. *R.L. Rinawma, Dy. Commissioner, Income Tax,* (1993) 2 Comp. L.J.314 (Kar.)

embarking on a trial in which no effective order by way of sentence can be made.

A contrary view was taken in a series of other decisions.[82] The Supreme Court settled this controversy in *Asst. Comm., Assessment-II* v. *Velliappa Textiles Ltd.*[83] The court held that since a company is incapable of suffering corporal punishment, it may not be prosecuted and punished in respect of offences for which imprisonment is mandatory part of the sentence. The majority was of the view that the legislative mandate is to prohibit the courts from deviating from the minimum mandatory punishment prescribed by the statute and that while interpreting a penal statute, if more than one view is possible, the court is obliged to lean in favour of the construction which exempts a citizen from penalty than the one which imposes the penalty. The court relied on the decision in *State of Maharashtra* v. *Jugamander Lal,*[84] wherein it was held that where the expression used is 'imprisonment and fine', the court is bound to award sentence of imprisonment as well as fine and that there is no discretion on the part of the court to impose fine alone. The court upheld the view that a statutory provision cannot be interpreted purposively so as to supply a lacuna in a statute.

But the minority view of G .P. Mathur J., in *Velliappa's* case is worth mentioning.

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[82] *Municipal Corporation of Delhi* v. *J. B. Bolting Company,* 1975 Cri.L.J.1148 (Del.)(F.B); *Oswal Vanaspati & Allied Industries* v. *State of Uttar Pradesh,* (1993) 1 Comp.L.J.72 (All.).

[83] *Supra* n.78.

[84] [1966] 3 S.C.R.1

> "Courts would be shirking their responsibility of imparting justice by holding that prosecution of a company is unsustainable merely on the ground that being a juristic person it cannot be sent to jail to undergo the sentence. Companies are growing in size and have huge resources and finances at their command. In the course of their business activity they may sometimes commit breach of the law of the land or endanger other's lives. More than four thousand people lost their lives and thousands of others suffered permanent impairment in Bhopal on account of gross criminal act of a multinational corporation. It will be wholly wrong to allow a company to go scot free without even being prosecuted in the event of commission of a crime only on the ground that it cannot be made to suffer part of the mandatory punishment."[85]

The *Velliappa* case was overruled in *Standard Chartered Bank* v. *Directorate of Enforcement.*[86] The Supreme Court held that no immunity can be given to the companies on the ground that the prosecution is in respect of an offence for which the punishment prescribed is mandatory imprisonment and fine. As the company cannot be sentenced to imprisonment, the court cannot impose that punishment, but when imprisonment and fine is the prescribed punishment the court can impose the punishment of fine. Such discretion is to be read into the section.[87] The court used the mischief rule of statutory interpretation to arrive at a just result. K.G. Balakrishnan J. as he then was, opined that it would be

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[85] *Supra* n.78 at p.105.

[86] A.I.R 2005 S.C.2622.

[87] *Id.*, 2638.

sheer violence to commonsense that the legislature intended to punish the corporate bodies for minor and silly offences and extended immunity of prosecution to major and grave economic crimes.

The principle of strict interpretation of penal statutes should not be widened to such an extent as to enable companies to go scot free. In *Balram Kumawat* v. *Union of India,*[88] the Supreme Court had observed that even in relation to a penal statute any narrow, pedantic, literal and lexical construction may not always be given effect to. The law should be interpreted having regard to the subject-matter of the offence and the object of the law it seeks to achieve. The purpose of the law is not to allow the offender to sneak out of the meshes of law.

In the absence of any action on the part of legislature to fill in the lacuna, the court would be justified in applying the mischief rule of interpretation and the principle of purposive construction to prosecute and punish companies for offences where imprisonment is the only punishment prescribed.

The law as it stands today is that a company can be punished for offences punishable with imprisonment and fine. But the company cannot be prosecuted or punished for an offence where the only punishment prescribed is imprisonment. Hence there is an urgent need for legislative amendments in this respect.

Problem of Sanctions

None of the sanctions which are presently imposed on corporations are capable of attaining the deterrent or preventive objective of

[88] A.I.R.2003 S.C.3268.

punishment. Being an artificial entity, there is a limitation on the kind of sanctions that can be imposed on a company.

The conventional method of punishing corporate entities has been to impose fines. In many cases fines may not be an appropriate remedy. Fines may have no effect on the company. A fine on the corporation can be absorbed as a cost of doing business.[89] Fines have a limited preventive effect. The fines imposed by courts are extremely low.[90] Fines imposed are not sufficient enough to extract illegal profits derived out of the criminal activity.[91] As presently administered, the criminal fine deprives the corporation of a small portion of its bounty, but permits it to retain the 'lions share'.[92] If crime is to be deterred corporations should be deprived of the fruits of its illegal activity.

In the leading case of *Tesco Supermarkets Ltd* v. *Nattrass,*[93] the fine imposed by the trial court was £25. In *Alphacell Ltd.* v. *Woodwar,*[94] the corporate defendant was fined only £24 for having polluted a river. To be effective, the fine must be sufficiently onerous to have an impact on the company. Fines have to be large enough to have a deterrent effect on the corporation, and small enough so as not to imperil the earnings of employees.[95]

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89 Michael Jefferson, "Corporate Criminal Liability: The Problem of Sanctions", 65 Jo.C.L.235 (2001).

90 John C. Coffee, "'No Soul to Damn: No Body to Kick': An Unscandalized Inquiry into the Problem of Corporate Punishment", 79 Mich.L.R.386 at 413 (1980).

91 Note, "Increasing Community Control Over Corporate Crime-A Problem in the Law of Sanctions", 71 Yale.L.J.280 (1961).

92 *Ibid*.

93 *Supra* n.27.

94 [1972] 2 All E.R.475 (H.L.).

95 *Supra* n.90 at p.400.

The criticism most often made of fines is their 'spill-over' effect.[96] The ultimate burden of fine will fall on innocent parties. Fining a company can lead to reduction in dividends, reduction in wages and increase in price of goods thereby adversely affecting the interests of shareholders, employees and consumers.

Judges need options so that they can pick and choose the most appropriate sanction according to the facts of the case. Innovative proposals are being made in developed countries to introduce different variety of sanctions apart from mere imposition of fines. The US Sentencing Commission's Guidelines for Organisational Defendants provide for various forms of punishment that can be used in combination within the sentencing court's discretion.[97]

Equity Fine

An ingenious solution to the spill-over problem advanced by Professor Coffee is to make companies issue equity fines to the victim compensation fund.[98] It would induce corporations to institute controls to reduce incidence of corporate wrongdoing.[99] The number of shares issued has to be equal to the cash fine. No money would be taken from the company's liquid assets and there would be no spill over into consumers and employees.

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[96] *Ibid.*

[97] US Sentencing Commissions Guidelines for Organisational Defendants, 2005, available at www.ussc.gov/...and.../Guidelines.../Organizational_Guidelines.cfm. Punishment for organizations can include restitution, remedial orders, community service, public notice and apologies, disgorgement and probation. The Guidelines also provide for a corporate death penalty for the 'worst offenders' by imposing fines large enough to divest a corporation of all of its net assets. Corporate death penalty can be imposed only where the organization is found to exist for a criminal purpose.

[98] *Supra* n.90 at p.413.

[99] *Ibid.*

The problem with equity fine is that it would adversely affect the shareholders interests. The value of their stock would be reduced. The company would become more vulnerable to a hostile take-over.

Corporate Probation

In the U.S., courts are allowed to impose any condition that is reasonably related to the nature and circumstances of the offence.[100] The company can be directed to comply with certain undertakings and it is subjected to a period of supervision. If the company breaches the conditions imposed, it is brought back for re-sentencing. The dominant impact of such probation would be interference with managerial power and prestige.[101] Probationary conditions could be used to direct corporate defendants to report on the disciplinary action taken in response to being found liable.[102] The probation order can include community service or other reasonable conditions such as changes in personnel, implementation of corporate information systems, monitoring of workforce and establishment of new posts to reduce misconduct.[103]

The advantage of corporate probation is that it has no direct spill over effects. However the company would have to incur significant costs in carrying out the directions. They would result in the spill over effect.

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[100] Christopher A. Wray, "Corporate Probation under the New Organizational Sentencing Guidelines", 101 Yale L.J.2017 (1992).

[101] Fisse and Braithwaite, *Corporations, Crime and Responsibility,* Cambridge University Press, Cambridge (1993), p.43.

[102] *Ibid*.

[103] Bergman D, "Corporate Sanctions and Corporate Probation", 142 N.L.J.1312 (1992).

Community Service

A community service order provides an opportunity for a company to make amends for its crime. A company which pollutes the environment can be ordered to clean up the damage. In *United States* v. *Danilow Pastry Corporation,*[104] directions were issued to the bakeries to supply fresh baked goods without charge to needy organisations for a twelve month period. Such orders would not necessarily result in compensation or restitution to the victims of the offence. They are designed to supplement, rather than displace, compensation and restitution orders.

The main defect of a community service order is that it does not oblige the company to change its organizational structures. Another disadvantage is that the company may gain favourable publicity as a result of the community service programme.

Adverse Publicity

Adverse publicity is necessary to fasten stigma to a convicted company. Adverse publicity will lead to loss of corporate prestige. In the US, courts may order a company to publicise the nature of the offence committed, the fact of conviction, the nature of the punishment imposed and the steps taken to prevent the recurrence of similar offences.[105]

The Law Commission of India in its 47th report had recommended the need for some procedure like a judgment of condemnation analogous

[104] (1983) 563 F. Supp.1159 (SDNY).

[105] United States Sentencing Commission, *Federal Sentencing Guidelines* (2006). Publicity is undertaken at the company's expense and in the format and media specified by the court.

to the punishment of public censure proposed for individuals.[106] Some of the statutes in India also provide for publication of conviction of a company at their own cost. [107]

Advertisements would alert the society to the kinds of wrongdoing committed by the company. The bad publicity created may affect the corporation's goodwill, its ability to do business with the public and to raise capital on public markets. Senior personnel in the company are also likely to suffer a loss of reputation and may thus implement procedures to prevent the offence from happening again.[108] Adverse publicity can result in a decline in sales and ultimately in closure of the factories and the liquidation of the company.

Adverse publicity also is not free from spill over effect. If companies are forced out of business, innocent parties such as shareholders, workers, distributers and suppliers will be affected adversely.

Corporate Dissolution

Dissolution of the corporation is the equivalent of capital punishment. Companies engaged in persistent illegal acts should not be allowed to continue their business. Penal statutes could be amended to incapacitate erring corporations by compelling their dissolution. Even if the erring corporation is dissolved, its promoters would find other ways to continue in business. They may get incorporated in a new name.

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[106] The Law Commission of India, 47th Report on the Trial & Punishment of Social and Economic Offenses (1972), para 8.1.

[107] The Essential Commodities Act, 1955, s.10B; the Standard of Weights and Measures Act, 1976, s.74; the Drugs and Cosmetics Act, 1940, s.35.

[108] *Supra* n.89 at p. 240.

To address the problem of repeated misconduct on the part of corporations, Professor Ramirez [109] proposes a new regime of corporate death penalty. It seeks to minimize harm to innocent shareholders and employees associated with errant corporations. As per the scheme, if a corporation is convicted for repeated offences the appropriate government would dissolve the corporation by revoking its charter. A receiver or trustee would be appointed to oversee the dissolution of the corporation. Even though dissolution would end the corporate existence, the trustee could liquidate the business or negotiate the sale of the business on behalf of the stakeholders. The main advantage of this novel sanction is that dissolution simply means that assets are sold for the highest price possible and the factories and jobs are generally transferred intact.[110]

Different novel sanctions have been proposed and introduced to improve the deterrent effect of corporate criminal liability. However, each of the alterative sanction proposed has got its own drawbacks. None of them can ensure corporate deterrence. The ultimate burden of the sanctions is borne by shareholders, workers and consumers.

Duality of Corporate and Individual Criminal Liability

Corporate criminal liability has its own limitations in achieving deterrence. But is it not wise to abolish corporate criminal liability. Both individual criminal liability and corporate criminal liability should co-

[109] Mary Kreiner Ramirez, "The Science Fiction of Corporate Criminal Liability: Containing the Machine Through the Corporate Death Penalty", 47 Arizona.L.R.932 (2005). If a corporation has been convicted for a substantial violation of law for the third time, corporate death penalty can be imposed. It would be imposed upon corporations with a history of serious wrongdoing or upon corporations involved in multiple acts of criminality. The precise contours of what constitute a substantial violation of law is a policy issue for the legislature to decide.

[110] *Ibid.*

exist in the legal system. There are many justifications as to why corporate criminal liability should be retained. The main rationale is that corporate crimes are perpetrated for increasing profits. The working environment may pressurise the directors and managers to deviate from accepted standards of behaviour. Feelings of loyalty and fear of dismissal prompt managers to succumb to the pressures. The profits derived from the crime flow into the coffers of the corporation. Corporate negligence and corporate recklessness can also result in crime. Hence corporations should bear the responsibility for such crimes.

There are equally good justifications for ensuring individual accountability. Theoretically corporate criminal liability is supposed to catalyse individual accountability. But the reality is that the persons responsible for the crime remain elusive. There is no due allocation of responsibility. The conviction of a corporation is not followed by internal disciplinary actions against erring officials.[111] Corporations are rather reluctant to initiate actions against errant officers and to embarrass its managers. The problem of non-prosecution of corporate managers is rampant.

Conclusion

Corporate criminal liability is widely regarded as a necessary part of the legal system to regulate corporate conduct. But it has failed to achieve its purpose of deterring and preventing corporate crime. A perusal of the case law indicates that convictions against corporations are difficult to achieve. The procedural rules associated with the criminal law, the heavier burden of proof and strict construction of statutes are

[111] *Supra* n.101 at p.8.

some of the main impediments to the successful prosecution against corporations. These barriers are equally applicable to all criminal prosecutions. Along with the above factors, there are other ingredients peculiar to the present system of corporate criminal liability. The principles of attribution of mensrea, identification of the officer in default are some of them. Once the prosecution succeeds in obtaining a conviction, imposing proper punishment to fit the crime is also a problem.

In the absence of any significant improvement in the law relating corporate criminal liability, there would be no justification for imposing criminal liability on corporations. The law as it exists today in most of the countries is more or less the same that the liability of the corporation cannot be established unless the individual offender is identified. Criminal law and its tools have to rise up to the occasion to devise new means to establish corporate guilt. Unless the same is done mere acknowledgement of the corporate criminal liability regime in its legal system would be of no use.

Legislative reforms are necessary to facilitate easier corporate convictions. Under the existing regime it is extremely difficult to establish corporate guilt and to secure conviction. Hence there arises the need to focus on the individual managers to ensure accountability for corporate crime. There is an urgent need to reconsider alternative liability regimes to distribute responsibility between the corporation and the individuals who work behind the corporate veil.

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Chapter 3

LAW RELATING TO IMPOSITION OF CRIMINAL LIABILITY ON CORPORATE MANAGERS

As a matter of public policy it is of vital importance that companies comply with the laws of the land. Imposing criminal sanction is one method of regulating corporate misconduct. Whether compliance can be secured by placing criminal liability on the company alone or by imposing liability on the directors and managers of the company is a fundamental question that has perplexed the legal system world wide. Most of the regulatory statutes prescribe criminal sanctions for both the company and the person in charge of the company. But in reality individual accountability is displaced by corporate accountability.

Criminal liability can be imposed on corporate managers and officers in different situations. They can be held liable for acts and actions done in their capacity as agent or trustee of the company. Here statutory liability is cast on the officer in charge of the affairs of the company. The failure to file statutory reports, violation of environmental standards, violation of consumer standards and violation food safety norms falls in this category.

In the second category of offences like criminal misappropriation, insider trading and fraudulent trading, the company as an entity is being used as a mechanism to perpetrate crime. Money subscribed by the shareholders are looted by way of illegal distributions or diversification of funds resulting in corporate bankruptcy. Here the crime is committed

against the corporation and the society at large. The company is not at all a beneficiary of such a crime and in fact it is a crime against the company. It is perpetrated by the officer for his own personal benefit.

In the third category of cases, a strict demarcation as to whether the crime is committed in an individual capacity or while acting as an agent of the company is not possible. When a corporate officer bribes a government official, the company as well as the officer could be beneficiary of the act. The company may succeed in getting some license or contract in its favour. The benefit accruing to the officer is higher prospects for promotion and improvement in his standing in the company.

Directors and managers are subjected to criminal liability under various legislations pertaining to environment protection, labour safety and food safety. The managers and directors of the company are held accountable for the crimes of omission and commission. But there is a lack of clarity as to the nature of the criminal liability imposed on the directors and officers of the company. This has led to confusions as to what should be the threshold of criminal liability for corporate managers. The nature of the liability is sometimes termed as 'direct liability', or as 'vicarious liability' or as 'strict liability.' The divergent views taken by the court with regard to the issue of personal liability for crimes committed in their official capacity call for an in depth analysis. Various doctrines evolved in the western jurisdictions in this respect are also to be analysed.

The chapter mainly covers the following aspects. Firstly, the need for fixing liability on managers is analysed. It is followed by the

arguments for and against the use of criminal sanctions against corporate managers. The practical implications of creating a broad criminal net for corporate managers are examined. The extent of the use of criminal sanctions in India and the problem of non-prosecution of corporate managers are also examined. Finally the legal nature of criminal liability imposed on corporate managers is analysed. The thrust of the chapter is that individual liability should have a concurrent role alongside corporate liability. The suggestion is not to abolish corporate liability. Both the liability models should play an important role in allocating responsibility for corporate crime.

Justifications for Imposition of Criminal Liability

Scholars have different opinion on whether sanctions should be directed against company or its managers.[1] Critical criminologists advocate prosecution of perpetrators of corporate crime. [2] The need to impose criminal liability on corporate managers arises because corporate criminal liability has failed to achieve the preventive, deterrent and retributive objectives of punishment. Corporate criminal liability is deficient and inadequate in many ways. The damage caused by the

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[1] E. Lederman, "Criminal Law, Perpetrator and Corporation: Rethinking a Complex Triangle", 76 J. Crim.L.Criminology 285 (1985); John Scholz, "Enforcement Policy and Corporate Misconduct: The changing Perspective of Deterrence Theory", 60 L.Contem.Probs.253 (1997); V.S.Khanna, "Corporate Criminal Liability: What Purpose Does It Serve?", 109 Harv.L.R.1477 (1996); Notes, "Corporate Crime: Regulating Corporate Crime Through Criminal Sanctions", 92 Harv.L.R.1227 (1979).

[2] Gerry Johnstone & Tony Ward, *Law & Crime*: *Key Approaches to Criminology*, Sage Publications, London (2010), p.118.

corporate officers in not repaying the trust placed on them necessitates severe punishment.[3]

The Company Law Review Steering Group (U.K.) supported the continued use of criminal sanctions in company law stating that such penalties help to reduce the adverse effects of directors' conflicts of interest.[4] The threat of criminal sanctions influences directors' behaviour directly. Without the threat of such sanctions, it would be difficult to persuade certain directors to avoid transactions of dubious legality.[5] The Cooney Committee of Australia recommended the implementation of strategic regulation theory.[6] According to this theory sanctions should escalate as contraventions of the law become more serious. The committee recommended that criminal liability shall apply where conduct is genuinely criminal in nature and where directors had acted fraudulently or dishonestly.

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[3] Alex Steel, "Hard Labour to *Spies* v. *The Queen*: Prosecuting Corporate Officers under the Crimes Act", 2001 Aus.L.J.479 at p.480.

[4] "Modern Company Law For a Competitive Economy: The Strategic Framework", Company Law Streeing Group, Department of Trade and Industry, (2000) available at www.bis.gov.uk/files/file23279.pdf accessed on 12/5/2008.

[5] A U.K. study addresses professional advisors' reactions to criminal penalties for directors. Based on background interviews with legal practitioners, the study suggests that the possibility of criminal sanctions induce directors to act in the proper manner. The study concludes that though direct evidence is not available, criminal sanctions have a significant influence on managerial behavior. *See* Simon Deakin & Alan Hughes, "Directors' Duties: Empirical Findings-Report to Law Commission, (1999)", *available at* http://www.lawcom.gov.uk/docs/study.pdf accessed on 3/11/2010.

[6] The Senate Standing Committee on Legal and Constitutional Affairs, *Company Directors' Duties: Report on the Social and Fiduciary Duties and Obligations of Company Director*s, The Cooney Committee, Canberra, (1989) available at www.treasury.gov.au/documents/283/PDF/full.pdf accessed on 15/5/2009.

In the opinion of Woodrow Wilson the best way to control corporations was to give the law direct access to the individuals who control the business. He observed:

> "You cannot punish corporations. Fines fall upon the wrong persons ; more heavily upon the innocent than upon the guilty; as much upon those who knew nothing whatever of the transactions for which the fine is imposed as upon those who originated and carried them through- upon the stockholders and the customers rather than upon the men who direct the policy of the business. If you dissolve the offending corporation, you throw great undertakings out of gear. You merely drive what you are seeking to check into other forms or temporarily disorganize some important business altogether, to the infinite loss of thousands of entirely innocent persons and to the great inconvenience of society as a whole. Law can never accomplish its objects in that way. It can never bring peace or command respect by such futilities."[7]

The imposition of criminal sanctions on corporate managers is justified on the basis of the following theories of punishment.

The Retributive Theory

According to the retributive theory of punishment, every man should be held responsible for his own acts. The punishment which he should suffer shall be corresponding to the harm which he has inflicted

[7] Woodraw Wilson, "The Lawyer and the Community," Address to the 33rd Annual Meeting of the American Bar Association, as cited in Christopher D Stone, *Where the Law Ends*, Harper & Row Publishers, London (1975), p.58.

on others.[8] The retributionists are least concerned about the consequences of punishment. It is the nature of the harm caused that decides the quantum of punishment to be inflicted.

Even though the term 'corporate crime' is generally used, a corporation can do no wrong. It is the individuals who perpetuate crime. Law recognizes innumerable situations when the corporate veil can be lifted.[9] Whenever a crime is committed by the corporation, the veil should be lifted and punishment should be inflicted on those responsible for it. The individual who has committed a prohibited act should bear the punishment for the offence. The company should not be allowed to be used as a mere cloak or sham for committing crimes. The human agents through whom the crime was committed should not be absolved from liability. The retributive object of punishment can be achieved only when persons responsible for the crime are punished.

It is the individuals who intend, plan and decide things and hence individuals should be held responsible for the same. Retribution demands punishment of individuals and not corporate entities.

The Deterrence Theory

The deterrence theory, also known as the utilitarian theory of punishment provides that suffering is pain and any kind of suffering or punishment can be justified only if it leads to prevention and reduction of

[8] B. Sharon Byrd, "Kant's Theory of Punishment: Deterrence in Its Threat, Retribution in Its Execution", 8 *Law and Philosophy* 151 (1989),

[9] See John P. Lowry, "Lifting of Corporate Veil",1993 J.B.L.41; M.A.Pickering, "Company as a Separate Legal Person", 31 M.L.R.481 (1968)

future crime.[10] Punishment is used as a mechanism for maximizing utility. The capacity of punishment to deter offenders from committing criminal acts in future is referred as special deterrence. The tendency of punishment of one person to deter others from committing crime is referred as general deterrence. Corporate fine do not advance the goal of deterrence.[11] However significant the fines may be, the corporations will find ways to transfer the burden of fine to the consumers by raising prices for their products and services.[12]

Directors and managers are not sufficiently deterred by imposing liability on the corporate entity.[13] Punishment is more likely to have a deterrent effect when an individual such as a corporate officer is held responsible for violating the law. Undergoing the trial and imprisonment are professionally damaging and personally humiliating experiences for the corporate officers. Businessmen are reluctant to do business with managers who have a past record of conviction.[14] Threat of incarceration gives an incentive for directors to abstain from committing crimes. The deterrence of officials is best achieved through imprisonment because

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[10] Anthony Ellis, "A Deterrence Theory of Punishment", 53 *The Philosophical Quarterly* 337(2003).

[11] John T Byam, "The Economic Inefficiency of Corporate Criminal Liability", 73 J.Crim.L. Criminology 582(1982).

[12] Spurgeon and Fagon, "Criminal liability for Life endangering Corporate Misconduct", 72 J.Crim.L. Criminology 400 (1981).

[13] B. H. Kabayashi, "Antitrust, Agency and Amnesty-An Economic Analysis of the Criminal Enforcement of the Antitrust Laws Against the Corporation", 69 *George Washington Law Review* 715 (2001).

[14] David Charney, "Non-Legal Sanctions in Commercial Relationships", 104 Harv. L.R.373 (1990).

they carry a very strong moral message.[15] The cost of imprisonment cannot be passed on to the consumer or shareholder. Deterrence works best when corporate executives responsible for the corporate crime are prosecuted and punished.[16] No regulation can be effective unless it is backed by appropriate sanctions. The threat of criminal sanctions offers greater deterrence for corporate managers than any other control mechanisms.[17]

The Preventive Theory

The preventive theory justifies punishment as a mechanism to prevent future crimes. Incarceration incapacitates men from committing crimes. Punishing a corporation would not serve the preventive aim of punishment. Various studies have shown that sanctions against the corporations seldom result in due allocation of responsibility on managerial personnel.[18] There is no guarantee that the corporation would take action disciplinary or otherwise against those responsible for the crime. The corporations are reluctant to embarrass their managerial personnel and walks away paying whatever may be the fine

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[15] P.H.Rosochawincz, "The Appropriateness of Criminal Sanctions in the Enforcement of Competition Law", 2004 E.C.L.R. 752.

[16] See Coffee, "Corporate Crime and Punishment: A Non-Chicago View of the Economics of Criminal Sanctions", 17 Am.Crim.L.R. 419(1980); Wheeler, "Antitrust Treble –Damage Actions: Do they Work?", 61 Cal.L.Rev.1319(1973); *John C. Coffee, Jr.*, "Reforming the Securities Class Action: An Essay on Deterrence and its Implementation", 106 Colum.L.R.1534 (2006); Martin Dermott, "Occupational Disqualification of Corporate Executives: An Innovative Condition of Probation",73 J.Crim.L.Criminology 604 (1982).

[17] Hazel Croall, "Combating Financial Crime: Regulatory Versus Crime Control Approaches", 2003 J.F.C.45.

[18] Fisse and Braithwaite, *Corporations, Crime & Accountability*, Cambridge University Press, Cambridge (1993), p.8.

that is imposed.[19] The offenders continue in their position. The persons responsible would continue to cause more harm to the society unless they are incapacitated and thereby prevented from causing crimes. Officers responsible for corporate crime should be punished and substituted with men of responsibility and accountability.

The Reformative theory

The reformists consider punishment as a method of reforming and rehabilitating the offender with a view to alter the character of the person so that he no longer desires to commit offences in future.[20] There is no such thing as a 'good' or a 'bad' or a 'moral' or an 'immoral' corporation. Attributing anthropomorphic qualities to a corporation is an absurdity. Only the individuals who man the corporation can be reformed. It is the individual who require rehabilitation, education and reformation.

There is a real difficulty in establishing the validity of the above arguments because of lack of concrete data as to the efficacy of imposition of criminal sanctions on corporate managers in preventing corporate crime.[21] One can only draw conclusions based on certain assumptions.

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[19] *Ibid.*

[20] Albert W. Alschuler, "The Changing Purposes of Criminal Punishment: A Retrospective on the Past Century and Some Thoughts about the Next", 70 U.Chi.L.R.1 at p.12 (2003)

[21] There is a dearth of empirical research on the merits of deterrent strategy of criminal sanctions.

Use of Criminal Sanctions Against Corporate Managers: Concerns Raised

There is a strong argument that criminal sanctions should not be used against corporate managers. The following are the main arguments raised by them.

Risk Aversion

The use of criminal sanctions to regulate business activities is widely perceived as an overreaction that is likely to discourage directors from taking the risk that is necessary to run the business. Liability should not be so onerous that manager's behaviour becomes too cautious.[22] Risk aversion can be damaging to the company and society if directors and managers are deterred from undertaking activities that might bring a net positive benefit in future.[23] Directors' attention would be diverted to compliance issues rather than on wealth creation for shareholders. It can lead to inefficiency in management.[24] If the directors are overburdened with responsibility, they would feel that their decision making power is seriously constrained.[25]

A survey of Australia's top directors has found that 70% of them have declined board positions primarily because of concerns about

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[22] "Personal liability For Corporate Fault", Corporations and Markets Advisory Committee (CAMAC), Discussion Paper, May 2005, Australia, available at http:// www.camac.gov.au accessed on 10/2/2008.

[23] R Baldwin, "The New Punitive Regulation", 67 M.L.R.351 (2004)

[24] Ronald Daniels, "Must Boards go Overboard? An Economic Analysis of the Effects of Burgeoning Statutory Liability on the Role of Directors in Corporate Governance", 24 *Canadian Business Law Journal* 229 at p.249 (1994).

[25] *Ibid*.

personal liability.[26] Majority of the respondents surveyed opined that the risk of personal liability forced them to take an overly cautious approach in decision making.

Prosecution of Middle Level Officers

Corporations view middle level managers as fungible commodities that can be sacrificed as scapegoats.[27] The risk involved in prosecuting corporate managers is that persons low in the corporate hierarchy may be put up as a "scapegoat" for the fault of those higher in the hierarchy.[28] A lower grade officer may be punished for the fault of a senior executive. Fixing liability on middle level managers and lower level officers may lead to harsh and unjust results. The corporate culture and environment in which the officers work might force the corporate managers to deviate law. The corporate managers are always under pressure to perform up to the expectations. The pressure, opportunity and predisposition lead to corporate illegalities.[29] Sometimes the corporate crime may be a result of organizational failure. In such situations, it would not be appropriate to punish corporate officers.

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[26] Data available from www.smartcompany.com.aus/laedership/personalliabilitylawsscare off directors .html accessed on 28/3/2008.

[27] Paul Lansing and Donald Hatfield, "Corporate Control through the Criminal System: An Alternative Proposal", 4 *Journal of Business Ethics* 409 at p. 411(1985); Coffee, "No Soul to Damn, No Body to Kick": An Unscandalised Inquiry Into the Problem of Corporate Punishment", 76 Mich.L.R.386 (1981).

[28] Michael Jefferson, "Recent Developments in Corporate Criminal Responsibility", 16 *Company Lawyer* 146 at p.148 (1995).

[29] Melissa S. Baucus and Janet P. Near, "Can Illegal Corporate Behaviour be Predicted? An Event History Analysis", 34 *Academy of Management Journal* 9 at p.17 (1991)

Arbitrary Use of Criminal Law

It is argued that punishing managers for regulatory offences is arbitrary.[30] Regulatory offences are not regarded as 'criminal' in their strict sense.[31] Use of criminal sanctions would unfairly penalise managers for errors of judgment. Individual freedom cannot be sacrificed in the name of greater good. Critics of the expansion of criminal law argue that criminal law should be used to regulate inherently wrongful violations and shall not be applied to regulatory offences.[32] The Australian Law Reform Commission cautioned against extending the criminal law regime into the arena of regulatory offences. If the criminal law is made the default regime, the stigma associated with it will be weakened over time. [33]

Inspite of the arguments raised above, use of criminal sanctions continue to be a widely employed strategy to discipline corporate managers.

Use of Criminal Sanctions: Global Trends

Unlike in other jurisdictions, a clear shift towards the use of the criminal law with its emphasis on punishment and stigmatization is noticeable in the United States.[34] In the US, criminal sanctions are

[30] David A. Barker, "Environmental Crimes, Prosecutorial Discretion, and the Civil/Criminal Line", 88 Virg.L.R.1387 (2002).

[31] Wright J. introduced the distinction between regulatory and truly criminal offences in *Sherras* v. *De Rutzen*, [1895] 1 Q.B. 918.

[32] Erik Luna, "The Over-Criminalization Phenomenon", 54 Am.U.L.R.703 (2005); Harry V.Ballt & Lawrence M. Friedman, "The Use of Criminal Sanctions in the. Enforcement of Economic Legislation: A. Sociological View", 17 Stanf.L.R.197 (1965).

[33] The Report on Federal and Civil Administrative Penalties, Australian Law Reform Commission, 2002.

[34] Jeffrey M. Bellamy, "Putting the Boss Behind Bars: Using Criminal Sanctions Against Executives Who Pollute - What China Could Learn From the United States," 13 *Indiana International and Comparative Law Review* 579 (2003).

widely used for the enforcement of economic legislations.[35] Experience has shown that criminal sanctions are very effective in regulating anti-competitive cartel activities.[36] Criminal sanctions have been used in a number of high profile cases in US. Most recently, former *Enron* boss was convicted for falsifying accounts, lying to shareholders and plundering the corporate funds for their personal enrichment.[37] The most important enactment in this respect is the Sarbanes-Oxley Act, 2002 which provides criminal sanctions for chief executive officers, chief financial officers, and other senior officers of the corporation for certifying financial documents of the company containing false statements. The shift towards individual liability is noticeable in European nations and in Australia. Anti-competition activities, environmental offences and health and safety offences are penalised and they carry criminal liability for the individuals responsible for the violation.[38]

The prosecutorial policy followed by the regulatory agencies addresses the concern of over regulation of business activities. The regulatory statutes confer wide discretion on the prosecutors in deciding

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[35] *Supra* n.32.

[36] W Kolasky, "Criminalising Cartel Activity: Lessons from the United States Experience",12 *Competition and Consumer Law Journal* 207 (2004).

[37] He was sentenced to twenty-four years imprisonment and ordered to forfeit $45 million of illegal profits gained during his time at Enron. Data available at www.highbeam.com/doc.html accessed on 12/10/2009.

[38] Eleanor J. Morgan, "Criminal Cartel Sanctions Under the UK Enterprise Act: An Assessment", 17 *International Journal of the Economics of Business*, 67(2010); Brent Fisse, "The Australian Cartel Criminalisation Proposals: An Overview and Critique", 4 *Competition Law Review* 51(2007).

whether to prosecute a particular case or to use the civil justice system.[39] In the US, corporate executives are prosecuted only in cases which have a reasonable probability of conviction.[40] Deferred prosecutions are very common in the US with respect to corporate crimes.[41] Even if the prosecution concludes that there is sufficient evidence to bring a case against a corporate entity, different options are available to prosecutors. They may enter into a plea agreement with the company or decline to prosecute the company on public-policy grounds or enter into a deferred prosecution agreement with the company. The exercise of the discretion is dependent on the presence of the degree of technical fault, prospects of success and availability of evidence.[42] In most cases the prosecutors prefer negotiation and compromise. Criminal sanctions are provided under the Occupational Safety and Health Act, 1970 (U.K.) were the offence is committed wilfully.[43] The enforcement authority under the Act

[39] G.E.Lynch, "The Role of Criminal Law in Policing Corporate Misconduct", 60 L.Contem.Prob.23 (1997). The widely held view is that prosecutorial discretion is crucial and that it would not be practical to employ criminal prosecution in each occasion, as it would produce draconian consequences to the individual and the business entity.

[40] Kathleen F. Brickey, "The Rhetoric of Environmental Crime: Culpability, Discretion, and Structural Reform", 84 Iowa L.Rev.115 (1998); Devaney Earl E, "The Evolution of Environmental Crimes Enforcement at the United States Environmental Protection Agency", Third International Conference on Environmental Enforcement, Washington, available at www.inece.org/ 3rdvol1/ pdf/devaney.pdf.

[41] Benjamin M. Greenblum, "What Happens to a Prosecution Deferred? Judicial Oversight of Corporate Deferred Prosecution Agreements?", 105 Colum.L.R.1863 (2005).

[42] *Ibid.*

[43] Note, "A Proposal to Restructure Sanctions Under the Occupational Safety and Health Act: The Limitations of Punishment and Culpability", 91Yale.L.J.1446 (1982).

adopts a compliance strategy to achieve its primary objective of preventing harm to the workers.[44]

The budget allocation for antitrust investigations, environmental crime investigations and financial fraud investigations in the US has been increasing since 1990's.[45] The number of prosecutions has also increased and there is an increased emphasis on the criminal prosecution of business managers. The judges are also sensitive to corporate crime and in many cases business leaders were sentenced to prison.[46]

The developed nations rely more on criminal sanctions in regulating corporate crime. They have evolved a clear policy on prosecuting corporate managers which mitigates the apprehension of overregulation of businesses. But at the same time, prosecutions are initiated in deserving cases.

Corporate Managerial Accountability in India

Corporate managerial accountability has become an exception in India. It is not because of dearth of statutory provisions, but because the regulators and prosecutors are reluctant to initiate criminal proceedings against corporate managers.

The principal environmental legislations in India envisage criminal sanctions for ensuring its effective enforcement. A study conducted on

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[44] Edwin Mujith, "Reform of the Law on Corporate Killing: a Toughening or Softening of the Law?" 29 *Company Lawyer* 76 (2008); Clarkson, "Corporate Manslaughter: Yet More Government Proposals" [2005] Crim.L.R.677.

[45] Kitty Calavita, Henry N. Pontell, "State Theory, Myths of Policing, and Responses to Crime", 68 *Law and Society Review* 297 at p.302 (1994); Geraldine Szott Moohr, "On the Prospects of Deterring Corporate Law", 2 *Journal of Business & Technology Law* 25 at p.32 (2007).

[46] *Ibid.*

the rate of prosecutions and convictions secured under various environmental protection legislations shows that the Pollution Control Board has not been able to effectively use its prosecution strategy against delinquent polluters.[47] The board was able to secure conviction in very few cases.[48] The punishment under the Water Act, 1974 may go upto seven years of imprisonment and fine. The highest number of prosecutions was reported from the state of Gujarat. Out of 1813 prosecutions launched, decision was rendered only in 459 cases. But only 216 cases went in favour of the board. Surprisingly fine was imposed only in 8 cases and imprisonment was awarded only in a single case. This is indicative of the fact that the courts are reluctant to pass adverse orders against industrial giants and its officers.

Very few prosecutions have been initiated under the Factories Act, 1948 and the environmental statutes.[49] Unfortunately the regulatory agencies are not maintaining any record on the number of prosecutions initiated under different statutes.[50]

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[47] Kailash Thakur, *Environmental Protection Law and Policy in India*, Deep& Deep Publications, New Delhi (1997), p.385.

[48] *Ibid.* The data regarding prosecutions launched, and convictions secured under Water (Control and Prevention of Pollution) Act, 1974 and the Air(Control and Prevention of Pollution) Act, 1981 upto February 1994 were collected by the author. The study concludes that the Board has miserably failed in detecting violations and in prosecuting the offenders.

[49] B.Bowonder and S.S.Arvind, "Environmental Regulations and Litigation in India, Project Appraisal", 182-196, Centre for Energy, Environment and Technology, Administrative Staff College of India, Hyderabad (1989) available at http://dx.doi.org/10.1080/02688867.1989.9726733 accessed on 12/4/2009.

[50] Information was sought from the Kerala State Pollution Control Board under the Right to Information Act. It was found that there is no practice of compiling data as to the total number of prosecutions launched in a year, or the number of cases wherein corporate officers were convicted or fined. Information collected from the Kerala State

If the regulators continue a policy of leniency towards corporate managers the law would fall into disrepute. Corporate crimes are deliberately committed either to maximize corporate profits or to reduce production costs. A belief that the crime would never be detected and that the offenders would never be caught would nullify the deterrent effect of criminal sanctions. Risk of apprehension plays a significant role in deterring people from violating law. A pro-active enforcement policy is the need of the hour.

Prosecution of Company *a sine qua non* for Prosecuting Corporate Managers

A practical difficulty in prosecuting and punishing corporate officials arises on account of the rule that directors cannot be prosecuted unless the company is also prosecuted for the offence. Initially there was a difference of opinion among the courts of law as to whether directors of a company could be prosecuted without prosecuting the company for an offence. In some cases it was held that persons in charge of the company could not be prosecuted if the company was not prosecuted for the offence.[51] But in some other cases it was held that prosecution proceedings against corporate directors are maintainable inspite of the company not being proceeded against as an accused.[52]

Pollution Control Board under the Right to Information Act, 2005 shows that not even a single case was initiated aganist a corporate manager for causing pollution. See Appendix 11 and 12.

[51] *Krishnan Bai* v. *Arti Press*, (1996) 1 Comp.L.J.540 (Mad.); *Ram Bhushan* v. *State of West Bengal*, 1983 Cri.L.J.39 (Cal.); *Ajit Kumar* v. *R.O.C.,* (1979) 49 Com.Cas.909 (Cal.); *V.B. Shivalingam Chettiar* v. Labour Officer, (1986) 3 Comp.L.J.118 (A.P.).

[52] *Alex* v. *Vijayan*, (1996) 1 Comp.L.J.544 (Ker); *Rama Bhushan* v. *R.O.C.*, (2002) 3 Comp.L.J.385 (A.P.)

In *Sheoratan Agarwal* v. *State of M.P.*,[53] the Supreme Court held that there was no statutory compulsion that person in charge of the company shall not be prosecuted unless he is prosecuted along with the company. The corporate officer can be prosecuted alone. However before the person in charge is held guilty, it should be established that an offence has been committed by the company. In *Anil Hada* v. *Indian Acrylic Ltd.*,[54] the Supreme Court reiterated this view and held that prosecution of the company is not a *sine qua non* for prosecution of director or manager of company. But a finding that the offence was committed by the company is essential for convicting the officers. The officers cannot escape penal liability on the ground that the company is not prosecuted.

But in *R. Kalyani* v. *Janak C. Mehta*,[55] the Supreme Court held that a corporate officer cannot be prosecuted unless the company is arrayed as an accused in the offense. The law as it stands now provides that the prosecution of the company is a must for prosecuting the individual officers of the company.

Hence if the company is also not arrayed as an accused, the officers may ultimately escape liability on this technical ground.

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[53] A.I.R.1984 S.C.1824.

[54] A.I.R.2000 S.C.145. The court held that when the company is the drawer of the cheque, the company is the principal offender. Every person who in charge of and responsible for the business of the company is also punishable by virtue of the legal fiction created by the legislature. Instead of prosecuting the company the payee can prosecute the persons in charge of the company. The payee can succeed if he proves that the offence was committed by the company and that the accused was in charge of the company during the relevant period.

[55] (2009)1 S.C.C.516.

Legal Nature of Criminal Liability of Corporate Managers

For the purpose of examining the legal nature of criminal liability imposed on corporate managers a classification is made between crimes committed by managers in their individual capacity for their own personal benefit and crimes committed by managers in their capacity as an agent of the company. The offences such as criminal misappropriation, insider trading and fraudulent trading falls in the former category. Violation of environmental standards, violation of consumer standards, violation of food safety norms and tax evasion fall in the latter category. At times the distinction between the two gets blurred because the company as well as the corporate manager might have benefitted from the crime. The nature of criminal liability imposed on corporate managers can be termed as 'direct' or 'vicarious' depending on the nature of the offence committed.

Nature of Liability for Common Law Offences

The source of criminal liability for a common law offence can be an act, omission or a breach of duty. Corporate managers cannot be punished for common law offences without proof of knowledge. Criminal responsibility cannot be fastened on directors and officers of the corporation merely on the ground that they are holding the position of director of the company. The persons managing the affairs of a company cannot use the corporate entity as a shield to commit crimes. There are many instances where the promoters form a bogus company with the sole object of making wrongful gain. In this process the public becomes victim of the evil design of the promoters who enrich themselves by dishonest means. If those in charge of the affairs of the company commit offences like cheating, criminal breach of trust or criminal misappropriation, they can be held liable under the Indian Penal

Code, 1860. However the intention to commit the offence has to be proved. The director can take the defences available under the penal code to prove his innocence.

The Indian Penal Code, 1860 does not contain any provision like deemed criminal liability clause available in modern regulatory statutes under which the officer in charge of and responsible to the company for the conduct of the business of the company is made liable for the offence committed by the company. There is no provision in the IPC which provides for deemed criminal liability of a person in charge of the affairs of the company.

In *Kalyani* v. *Janak C. Mehta*[56] the Honourable Supreme Court held that unless the officers of a company are proved to be involved in the offence in their individual capacity, they cannot be prosecuted for a common law offence. Vicarious liability can be fastened only by reason of a provision of a statute and not otherwise. Unless a legal fiction is created the corporate officers cannot be held liable for a common law offence on a vicarious basis.[57]

This does not mean that a director or an employee can never be made an accused in a crime. If the prosecution wants to make the director or an employee of a company liable for a crime, then it will have

[56] *Supra* n.55. Here prosecution was launched against high ranking officers of M/s. Shares and Securities Ltd., a company dealing in shares. The third respondent was alleged to have committed forgery and misappropriated money due to the complainant. The demat fixed accounts of the complainant were operated without his consent. The respondents were sought to be proceeded against for cheating on the premise that they are vicariously liable for the affairs of the company.

[57] Also see *Sesa Goa Limited and Ors.* v. *State of Maharashtra,* (2008)111 Bom.L.R.261.

to make out a case against such person in his or her individual capacity.[58] The precise role of the persons concerned in the actions of the company which led to the offence will have to be proved.

In *Radhey Shyam* v. *State of Bihar,*[59] the Supreme Court held that even though there is a specific legislation pertaining to company affairs, a prosecution can be launched under the penal code if the circumstances of the case indicated the dishonest intention to defraud the investors. If it is established that the primary object of the incorporation and existence of the company is to defraud public, the promoters and persons in charge of the affairs of the company can be prosecuted.[60] But while taking

[58] *Avnish Bajaj* v. *State*, 150 D.L.T.69 (2008).

[59] (1993) 2 Comp.L.J.155 (S.C.). The managing director and directors of a company were prosecuted for breach of trust committed by conversion of share application money for their own benefit. The appellants issued prospectus inviting public subscriptions. The application made to the Stock Exchange for enlisting shares of the company was rejected. In spite of the rejection, the share money collected from the investors was not repaid. The money lying in the bank on account of share applications were transferred to another account of the company. The Supreme court held that the officers are not immune from the provisions of the penal code.

[60] *A G. Abraham* v. *State of Kerala*, (1987) 3 Comp.L.J.211 (Ker.). In this case public deposits were collected by the financiers purportedly as bankers. When the depositors asked for the return of their money, the company found it impossible to repay the account. The question before the court was whether the petitioner who had engaged in the business of banking without being legally entitled to do so could be punished for criminal breach of trust. The petitioners were not legally entitled to do banking business. However they described themselves as bankers. Public deposited large amounts with them on the basis of the representation made by the financiers. The depositors handed over the money to the accused and parted with possession on condition that they would be returned on demand. The petitions are not in a position to return the money. So the court held that the prosecution for criminal breach of trust is maintainable. The court took notice of the evil of financiers collecting huge public deposits purportedly as banker. After collecting deposits from the innocent public, they closed down their business. Also see *Sampat Lal Lodha* v. *State of Rajasthan,* 1987 (3) Comp.L.J.12 (Raj).

cognizance of alleged offences in connection with the registration, issuance of prospectus, collection of money from investors and the misappropriation of the fund collected from the shareholders, the court must be satisfied that a prima facie case has been disclosed on the materials produced before the court. The dishonest intention of the directors can be proved by direct evidence or from the circumstances of the case.[61]

In *S.K.Alagh* v. *State of U.P.*,[62] the managing director and general manager of the company were prosecuted for criminal breach of trust. There was a dealership agreement between M/s. Akash Traders and the company. The dealership was cancelled and two demand drafts were issued in favour of the company for the supply of goods. A compliant was filed against the appellants alleging that the company with mala fide intention neither sent the goods, nor returned the money. The Supreme Court observed that the Indian Penal Code, except some provisions specifically providing therefore, does not contemplate any vicarious liability on the part of a party who is not charged directly for commission of an offence. As the drafts were drawn in the name of the company, its managing director, cannot be said to have committed an offence. In the absence of any provision laid down under the statute, a director of a company or an employee cannot be held vicariously liable for any offence committed by the company.[63]

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[61] *Ibid.*

[62] A.I.R.2008 S.C.1731.

[63] Also see *Maksud Saiyed* v. *State of Gujarat*, (2008)5 S.C.C. 668. Here the Supreme Court upheld the decision of the High Court in quashing the prosecution launched against the former chairman and managing director of Dena Bank for causing loss of reputation of the appellant on the ground that the Penal code does not contain any provision for attaching vicarious liability on the managing director of a company.

The judicial response to the infamous gas tragedy needs special discussion in this context. In *Keshub Mahindra & Others* v. *State of Madhya Pradesh,*[64] the officers of Union Carbide of India Ltd. were prosecuted for committing culpable homicide not amounting to murder following the Bhopal gas tragedy. The Honourable High Court of Madhya Pradesh held that the material relied on by the prosecution was sufficient to proceed with the charges. The Supreme Court reversed the judgment stating that the materials relied on does not indicate that on that fateful night, the plant was run by the accused with the knowledge that such running of the plant was likely to cause deaths of human beings. The court observed that even assuming that it was a defective plant and it was dealing with a very toxic and hazardous substance like MIC, the mere act of storing such a material by an accused would not prima facie suggest that the accused had knowledge that they were likely to cause death. However court held that the accused could be charged for causing death by negligence because the accident occurred on account of negligence in operating the plant. The court failed to take into account the fact that the accused shared common criminal knowledge about the potential damages of escape of the lethal gas both on account of defective plant and also on account of the operational shortcomings detected by the Vardarajan Committee, the expert committee appointed by the Government of India to examine the causes of the

[64] (1996) 4 Comp.L.J.441 (S.C.) There were 12 accused in the case which included the chairman of Union Carbide Company, the chairman of Union Carbide of India Ltd, the managing director of UCIL, the Vice-President and in charge of A.P division of UCIL, the works manager of Bhopal Plant, assistant works manager at Bhopal, Production Manger of Bhopal, Plant Superintendent and Production Assistant at the Bhopal Plant.

accident.[65] The case reveals the laxity with which judiciary dealt with a matter involving death of thousands of people. The evidence produced by the prosecution prima facie indicated that the accused at the helm of affairs knew the shortcomings of the working of the plant, its structural and operational defects. The negligent and rash way in which they dealt with highly dangerous and toxic poison shows their scant care for the life and property of the people. If the above evidence would not be sufficient, what else would have satisfied the judiciary is a wonder. After a long legal battle, the accused were sentenced to two years of imprisonment and fine.[66] Warren Anderson, the former Chairman of UCC still remains an absconder.

The Indian judiciary followed a very sensitive approach towards the plight of innocent people in *Sushil Ansal* v. *State through C.B.I.*[67] Here

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[65] The investigation conducted by the CBI revealed that the design of the plant was defective, the refrigeration system provided was inadequate. The temperatures of MIC tanks were not maintained at the preferred temperature etc. The evidence collected during the investigation revealed that the accused had the knowledge that by the various acts of commission or omission in the design and running of the MIC plant, death and injury would be caused to large number of human beings and animals. The experts from United States had conducted an operational safety survey at Bhopal and various deficiencies were pointed out in the report. No remedial steps were taken.

[66] *State of MP through C.B.I.* v. *Warren Anderson*, Cr.Case No: 8460/1996. The Chief Judicial Magistrate, Bhopal delivered the judgment on 7th June 2010 and is available at www.countercurrents.org/UCIL.pdf accessed on 8/2/2011.

[67] 2002 Cri.L.J.1369 (Del.). Charges were framed under sections 304-A, 337, 338 read with section 36 of Indian Penal Code and Section 14 of Cinematograph Act, 1952. The facts leading to the case were that a fire in a transformer emitted thick smoke and toxic gases, which asphyxiated 59 people to death and injured over 100 in the balcony of the cinema. The oil started leaking from the transformer and spread towards the nearby open area where vehicles were being parked unauthorisedly. The vehicles which caught fire, produced dense smoke. The toxic gases entered the cinema building primarily on account of the fact that an unauthorised wall had been raised near this open space. This wall obstructed the flow of the smoke and gases into the open. It was also alleged that the

charges were framed against the managing director and other officers of Uphaar Cinema theatre following the death of many people in a fire in the cinema hall. The prosecution alleged that the managing director was guilty of gross negligence in the matter of compliance of rules and regulations relating to the safety of the patrons. It was during his tenure that the high voltage transformer was put up in the building knowing fully well that its presence in the complex was hazardous. It was also alleged that various permissions and renewals of license of the cinema year after year were on account of collusion between some public servants and management. Various acts of omission and commission on the part of these two resulted in the incident. The tragedy was thus a conjoint and cumulative effect of all these factors. The court held:

> "Those who establish and run public places are expected to exercise a very high degree of care for the safety of those who visit such places believing that everything required to be done for their safety and protection is in place. It is absolutely criminal to take any chance in the matter of public safety and betray the trust and confidence of unsuspecting innocent public. Foreseeability of the risk is always a relevant factor to be considered. The cinema management ought to have foreseen that in the event of some untoward incident the patrons in the balcony had no adequate facilities for safe and

other transformer which was supplying electricity to the cinema was switched off as a result of which there was total darkness in the balcony. The people were unable to find their way out as the emergency lights were not working, public address system was not operational, required gangways leading to exit doors were not available. One stair-case was full of smoke and the other had obstructions which made it impossible for the patrons to escape. No help came from the theatre staff or management.

> quick escape. It would be too liberal an approach for this court to say that the negligence on the part of the cinema management and others was not so gross as to hold it "not culpable" especially at this initial stage of trial."[68]

The court presumed knowledge on the part of the accused that the people would have no rapid escape facilities in case a fire took place in the cinema hall. Those who were looking after the management of cinema had the knowledge that their acts of omission and commission were highly dangerous in nature and posed a substantial threat to the lives of those, who were visiting the cinema hall for watching movies**.** The court found that the negligence on the part of the accused was of "gross character". Accordingly the managing director was sentenced to imprisonment.

Officers of the company often file petitions to quash criminal proceedings filed against them. The grounds taken by them are that they are not officers in charge of the business of the company or that there exists no sufficient grounds for proceeding against them. The consistent view taken by the court is that if there exists a prima facie case, then criminal proceedings against the officer of the company can be continued.[69] Thus the corporate officers can be held liable for common law offences only if the intention to commit the offence is proved.

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[68] *Id.*, p.1378.

[69] *Naganna* v. *Veeranna,* A.I.R.1976 S.C.1947. At the stage of issuing process the magistrate is mainly concerned with the allegations made in the complaint or the evidence led in support of the same. He has only to be prima facie satisfied that there are sufficient grounds for proceeding against the accused. The magistrate need not enter into a detailed discussion of the merits or demerits of the case. The scope of the enquiry under Section 202 is extremely limited. In coming to a

Nature of Liability for Regulatory Offences

In India most of the regulatory statutes provide criminal sanctions for corporate managers and directors. Some of the regulatory laws create strict liability offences.[70] But some others particularly, the penal provisions of the environmental statutes are attracted only if the prohibited act is committed 'knowingly'.

When a company commits an offence, criminal liability can be fastened on different officers in the corporate hierarchy. The person who commits the act, the officer charged with the responsibility of overseeing the activities of a particular division, the manager, the managing director of the company and finally directors of the company are the persons liable to be charged for the offence. The hierarchy of officers may vary according to the structure and size of the company.

Pollution caused as a result of discharge of untreated trade effluents into the stream may be taken as an example. The persons liable to be charged can include the employee who opened the pipe, the plant supervisor, the manager of the plant, the managing director of the company and finally the members of the board of directors of the

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decision as to whether process should be issued the Magistrate can take into consideration the inherent probabilities appearing on the face of the complaint or in the evidence led by the complainant. The line of demarcation between a probability of conviction of the accused and establishment of a prima facie care against him is very thin. Once the magistrate has exercised his direction, it is not for the High Court or even the Supreme Court to substitute its own discretion for that of magistrate to examine the case on merits with a view to find out whether or not the allegation in the complaint if proved, would ultimately end in conviction of the accused.

[70] For eg., the Food Adulteration Act, 1954; the Standards of Weight and Measures Act, 1976.

company responsible for decision making of the company. The basis of liability of each individual may be analysed in detail.

a) Liability of Persons Knowingly Committing the Illegal Act

Criminal law seeks to regulate the conduct of individuals by creating offences of commission and omission and prescribing punishments for the same. The commission of a criminal act and a wrongful intent is necessary to constitute a crime.[71]

In the illustration given above, the *actus reus* forming part of the crime was committed by the employee who opened the pipe. But he can be held liable only if he was aware of the fact that the matter being discharged is untreated effluents. Thus the mensrea part would be missing if the case is that the employee was unaware that the matter being discharged is untreated effluents. If we presume that the employee is aware of the fact that he is committing an act proscribed by the statute, then some other circumstances also require consideration in fixing responsibility on him. He might be acting under instruction from his superior officer. If he refuses to discharge the untreated effluents, his dismissal from service might perhaps be the result.

Thus theoretically we find a problem in fixing criminal responsibility on the low level employees who have no say in the activities of the company but are very much under pressure to act as directed by his superiors. When it comes to entering false data in the company records or manipulation of accounts, same is the position of clerical officers and low level employees. Whether they are duty bound

[71] Glanville Williams, *Text Book of Criminal Law,* Stevens and Sons, London (1978), p.29.

to refuse the manipulation of accounts is a different matter. The deterrent objective of punishment cannot be achieved by imposing criminal responsibility on such low level employees.

This philosophy is well appreciated in almost all regulatory statutes which provides that where an offence has been committed by a company, the company as well as every person who at the time the offence was committed was in charge of and was responsible to the company for the conduct of the business of the company shall be deemed to be guilty of the offence. It is the officer in charge of and was responsible to the company for the conduct of the business of the company who is liable to be punished and not the employee who commits the prohibited act. Any other manager or officer can he held liable only if it is proved that the offence was committed by his consent or connivance or is attributable to any neglect on his part.[72] Thus any officer can be made liable if it is proved that he had consented to the commission of the offence or is attributable to his connivance or neglect. Consent, connivance and negligence on the part of the officer is an additional requirement to be looked into to fix criminal responsibility on subordinate officers of the company. Consent to the commission of an offence requires the knowledge on the part of the accused.

b) Liability of Managerial Personnel

Regulatory statutes contain provisions fixing criminal liability on both the company and officers in charge of the company. Most of them are strict liability offences wherein mensrea is not an essential ingredient of the offence. For eg: the offences under the Factories Act, 1948 are

[72] *Ibid.*

strict liability offences and the occupiers of the factory are guilty of offences under the Act. The nature of liability of a director or manager under the Act can be termed as 'strict liability'. It is the development of strict liability that has enabled the imposition of criminal liability on corporate managers for regulatory offences committed by the company. The fundamental rule of criminal jurisprudence is that 'an act does not constitute guilt without guilty mind'.[73] The object is to punish only those acts which are coupled with a guilty mind. Although the general rule is that there must be a mind at fault before there can be a crime, it is not an inflexible rule. A statute my relate to such a subject matter and may be so framed as to make an act a 'crime' irrespective of whether there has been an intention to break the law or not.

Strict liability imposes liability regardless of the offender's knowledge, intent or state of mind. The case for and against strict liability is complex and has been investigated in depth.[74] The disregard of the concept of mensrea and the resort to the concept of 'strict liability' rule is in public interest. The courts have in their interpretation of various statutes foreclosed the considerations of *mensrea* for certain acts which are prohibited in public interest.[75] Several cases decided by the Supreme

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[73] See Smith & Hogan, *Criminal Law*, Butterworths, London (2002), p.119.

[74] L.Leigh, *Strict and Vicarious Liability, A Study in Administrative Criminal Law*, Sweet and Maxwell, London (1982); Horder, "Strict Liability Statutory Construction & the Sprit of Liberty", 118 L.Q.R.458 (2002); Jackson Storkain, "A Case Study in Strict Liability and Self Regulation",[1991] Crim.L.R.892; M Smith & A Pearson, "The Value of Strict Liability",[1969] Crim.L.R.5.

[75] In *Sherraz* v. *De Rutzen*,(1895)1Q.B. 918. Justice Wright held that there is a presumption that *mensrea* is an essential ingredient in every offence. But the presumption is liable to be displaced either by words creating the offence or by the subject matter with which it deals and both must be considered.

Court of India are also based on the same analogy.[76] Strict liability is essential in regulating corporate activities and ensuring that corporate officers and directors discharge their duties with due diligence to prevent harm to the public.

The nature of criminal liability is termed as 'vicarious' when the accused is held liable for the act or fault of another. Personal responsibility is the general rule of criminal law. But a statute can create vicarious criminal liability.[77] Invoking the principle of vicarious liability into criminal law is justified on the ground that it would induce persons to keep themselves and their organizations law abiding. [78]

The courts in India have always regarded the nature of criminal liability of corporate managers under regulatory statutes as 'vicarious liability'.[79] In *Sabitha Ramamurthy* v. *R.B.S. Channabasavaradhya*[80] the liability of the managing director for dishonor of a cheque issued by the company was termed as vicarious. In *Nicosulf Industries & Exports Pvt. Ltd.,* v. *State of Gujarat,*[81] the liability of the directors of the company for discharging untreated trade effluents into the stream was held as

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[76] See *Nathulal* v. *State of M.P.,* A.I.R.1966 S.C.43; *State of Maharashtra* v. *M H George,* A.I.R. 1965 S.C. 631; *Sarjoo Prasad* v. *State of UP,* A.I.R.1961 S.C.631

[77] *Vane* v. *Yiannopoullas,* [1965] A.C.486; *Linnett* v. *Metropolitan Police Commissioner,* [1946]1 All E.R.380 (K.B.).

[78] *Reynollds* v. *G. H. Austin & Sons, Ltd.,* [1951] 1 All E.R.606 (K.B.)

[79] See *Maksud Saiyed* v. *State of Gujrat,* (2008)5 S.C.C.668 ; *Pannalal Sunderlal Choksi,* v. *State of Maharashtra,* 2000 Cri.L.J.4442; *State of Haryana* v. *Brij Lal Mittal,* (1998) Comp.L.J.1 (S .C.); *M V Arunachalam* v. *T Karthikeyan,* (1991)2 Comp.L.J.125 (Mad); *NC Sippy* v. *Premkumar* (1987) Comp.L.J.91 (Del).

[80] A.I.R.2006 S.C.308.

[81] (2002) 2 G.L.R.1580.

'vicarious'. For imposing liability on corporate officers, the focus of enquiry is whether the accused is the person in charge of the company. The case laws prove that that it is the active participation of the accused in the business of the company at the time of commission of the offence that determines his liability.[82]

It is doubted whether the liability of corporate manager can be termed as 'vicarious' because going by the identification theory the senior managers of the corporation constitute the directing mind and will of the company. The manager is punished for his own fault and not for the fault of the company which can act only through his instrumentality. A company can be made vicariously liable for the criminal acts of its employees or its directors. But is the reverse position possible? The question is whether a corporate manager can be said to be vicariously liable for the acts of the company. In the corporate world, the company is the master and officers are its agents. Where the manager is punished for discharge of trade effluents or dishonor of cheque, his liability is direct because he is the person who has committed/authorized the prohibited act. Where the directors are punished for their failure to monitor and oversee company affairs, it would be wrong to term the liability of the director as 'vicarious'. It may be right to term the liability of a senior manager as vicarious when he is made responsible for a default committed his subordinate officer and not otherwise. Thus in the corporate context, the real vicarious criminal liability can arise only when a company is held criminally liable for the crimes committed by its managers or directors and not in the reverse kind of relationship.

[82] *Supra* n.79.

It would be better to term nature of liability of a corporate manager as 'omission based liability'. All systems of criminal law recognize offences of omission. In everyday life we find a great variety of duty and non duty situations. Omissions are culpable when there is a duty to act.[83] However the penalties provided for active wrong doing should not be automatically applied to corresponding omissions.[84] Negligent monitoring, negligent handling and negligent manufacturing can threaten the life and property of the citizens. Criminal liability can be imposed for failure to take proper care and precautions in operating the plant. The officers in charge of the company can be held liable for failure to take proper action in preventing the commission of the offence. But no person should be held responsible for a failure to do something that is impossible.[85]

The penal system is designed to protect public order by directing its commands to individuals and threatening them with punishment in case of violation. It should strive to achieve its goal in a similar manner where human activity within the framework of corporate bodies is concerned. Taking into account the moral wrongfulness of the action and the harm caused to the society, there is every justification for imposing criminal liability on corporate managers. To take the illustration, a single act of discharge of untreated effluents into the river by a company may not be treated as morally wrong. But considering the irreversible damage

[83] See Andrew Ashworth, "The Scope of Criminal liability for Omissions", 105 L.Q.R. 424 at p.432(1989)

[84] Glanville Williams, "Criminal Omissions-The Conventional View", 107 L.Q.R. 86 (1991).

[85] Ann Smart, "Criminal Responsibility for Failure to do the Impossible", 103 L.Q.R. 532 (1987); Otto Kircheimer, "Criminal Omissions", 55 Harv.L.R.615 (1942).

caused to the environment and the ecosystem one may not feel fettered to apply punitive sanctions on those responsible for the conduct of business of the company. The same reasoning may be extended in cases of corporate fraud, price fixing and workplace fatalities. The Law Commission of India in its 47th report suggested that in order to prevent contravention of regulatory offences a presumption should be inserted that the offence was committed with the consent or connivance of the chairman or managing director if he has signed the application for license or permission to carry on a regulated activity.[86] It was also recommended that even where the application has not been signed by the managing director, he should be deemed to have signed it in cases where the application has been signed by a lower officer. This clearly reveals that the Law Commission intended the person in ultimate control of the affairs to be personally made accountable for offences committed by the company.

If negligence based liability and omission based liability is recognized, it would indirectly impose a positive duty on corporate officers to act. This would help in making corporate officers more vigilant and force them to take active steps to prevent harm to the public.

Attribution of Criminal Responsibility in the US

In the United States individual corporate officers are held liable in two situations. Any corporate officer who knowingly participates in an illegal act is subject to criminal liability. Corporate officers may be held criminally liable for directing or authorizing violations of the law.

[86] The 47th Report on the Trial and Punishment of Socio- Economic Offences, Law Commission of India (1972), para 8.14 & 8.18.

However proving actual knowledge of the violation is difficult. Hence the legal system uses the responsible corporate officer doctrine and willful blindness doctrine to attribute criminal responsibility.

a) Responsible Corporate Officer Doctrine.

The genesis of responsible corporate officer doctrine [87] can be traced back to two U.S. Supreme court cases. In *U.S.* v. *Dotterweich* [88] the president and general manager of a company was convicted for misbranding and shipping adulterated drugs under the Federal Foods Drugs and Cosmetics Act, 1938. D was the manager of the company that purchased drugs from manufacturers, repacked them and distributed them under its own label. D argued that he had no knowledge of the shipments. The US Supreme Court upheld the conviction despite the absence of culpable conduct. The court observed that it is better to place the burden of preventing the harm upon the corporate officials who are in a superior position to prevent such harm. The liability would extend to those individuals who had a "responsible share" in the furtherance of the transaction which the statute outlaws. The *dotterweich* case established the legitimacy and constitutionality of the RCO doctrine.

The degree of involvement required to hold an officer liable for a violation was explained by the US Supreme Court in *U.S.* v. *Park*[89].

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87 Hereinafter referred to as the RCO doctrine.

88 320 U.S. 277 (1943)

89 421 U.S.658 (1975). The facts of the case were as follows: Park was the president of a retail food company. The company's warehouses were affected with rodent infection. The reprehensible condition existed for a prolonged period of time without any detection and the advice of FDA was completely ignored. Park was convicted for his failure to oversee and devise measures necessary to ensure compliance with the Act. In his defense Park argued that as the head of a large

Where a person occupies a position of authority that would allow him to prevent, detect and correct the violation, that person can be held liable for failing to do so. As a responsible corporate officer, Park was responsible for seeing that the corporation had a system to attend to sanitation works. The court reasoned that it was the omission or the failure to act that established a sufficient basis for corporate officers' liability.

Responsible corporate officer liability could be imposed on a strict liability basis even though the underlying substantive offence requires a culpable state. To be held criminally liable, a responsible corporate officer would not have to 'willfully or negligently cause a violation.[90] The willfulness or negligence of the actor would be imputed to the responsible corporate officer by virtue of that officer's position of responsibility.

RCO doctrine creates an affirmative duty for the corporate officer to act. The regulatory statute is the source of the duty. The breach or omission to fulfill that duty acts as the basis for criminal liability. RCO doctrine permits a court to impose criminal sanctions upon a corporate officer regardless of the amount or degree of participation, provided he is in a position of power either to prevent or correct the violation. The prosecution must prove that the defendant was a corporate officer who had failed to use his authority to assure that the corporation complied with the regulation. The doctrine substitutes the breach of duty to act for

corporation, he could not manage the day today operations of the corporation. Court upheld the conviction by recognizing that a corporate officer's act, default or omission could be the basis for liability.

90 *U.S.* v. *Brittain*, 93 1 F.2D.1413 (10th Cir.1991)

the conventional *actus reus* requirement.[91] The doctrine serves to satisfy the conventional knowledge requirement of criminal jurisprudence by inferring guilty knowledge based on a corporate officer's position of responsibility.

b) Wilful Blindness Doctrine

The wilful blindness doctrine is another principle invoked to fasten criminal liability on corporate officers. The doctrine was developed by English courts to denote deliberate ignorance and deliberate indifference.[92] A corporate officer may become criminally liable by intentionally shielding himself from knowledge of facts.[93] In *United States* v. *MacDonald & Watson Waste Oil Co*[94] the First Circuit upheld the use of the willful blindness doctrine to impose penal sanctions on a corporate director under the Resource Conservation and Recovery Act, 1976. The Act was enacted in US in response to the serious threat to human health and the environment posed by hazardous waste products dumped on the ground. A person could be convicted under the Act only if the violation was committed "knowingly". There was considerable uncertainty as to what constituted a knowing mental state sufficient to convict a person under the Act. The court observed that the defendant cannot deliberately close his eyes to what otherwise would have been obvious.

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[91] Todd S Aggard, "A Fresh Look At the Responsible Relation Doctrine",19 J.Crim.L.Criminology.1245 (2006)

[92] Ira P. Robbins, "The Ostrich Instruction: Deliberate Ignorance as a Criminal Mens Rea", 81 J.Crim.L.Criminology 191 (1990).

[93] Stefan A. Noe, "Willful Blindness: A Better Doctrine for Holding Corporate Officers Criminally Responsible for RCRA Violations", 42 DePaul L.R.1461(1993).

[94] 933 F.2d 35 (1st Cir. 1991).

Thus the US legal system resorts to the above doctrines to fix criminal liability on corporate managers and directors. These doctrines can be adopted by the Indian legal system to impose liability on corporate managers in appropriate situations, especially in circumstances where it finds it difficult to prove intention and knowledge on the part of the corporate managers.

Defenses Available to Corporate Directors

The fear that imposing strict liability on corporate managers would lead to harsh results is unfounded. The harshness of strict liability is mitigated by the defenses provided to safeguard innocent and honest directors.[95] Similar to the defenses provided under the penal code the Companies Act, 1956 and other regulatory statutes recognise various grounds under which directors can be exempted from liability. The defenses are provided to protect innocent directors.[96]

Exemptions from Liability under Company Law

The provision empowering courts to grant relief to directors has a long history. It was first introduced in England in 1907.[97] The Company Law Amendment Committee, 1906 appointed to undertake a review of company legislation found a diminution in company registrations between 1900 and 1905. It was identified that the Companies Act, 1900 had increased the liabilities of the promoters and directors with respect to the contents of prospectus. This led to shortage of individuals to assume

[95] S.Krishnamurthy, *Impact of Social Legislations on the Criminal Law in India,* R.R.Publishers, Bangalore (1983), p.290.

[96] Edmunds and Lowry, "The Continuing Value of Relief For Director's Breach of Duty", 66 M.L.R.195 (2003)

[97] *Id.*, p.198.

the office of directors. The committee stressed the need to provide adequate safeguards to directors so that the new legislation does not lead to oppression of honest men.[98] The committee recommended for introducing a relief provision for directors. The original English provision was confined to granting relief from liability for violation of common law duties of care and skill and did not extend to liability under statute law. The relief can be claimed if it is proved that the director had acted honestly and reasonably. In 1929 it was extended to cover liability for violation of statutory duties also.[99] The Companies Act, 1948 also incorporated the relief provision.[100]

In interpreting the scope of the provision in *Re Barry and Staines' Linoleum Ltd.*, [101] the Chancery Court held that the jurisdiction ought to be exercised with great care. An objective standard is applied to test the reasonableness of the conduct. The court granted relief from criminal penalties for failure to obtain the necessary qualification shares. Even though the court found that there was some negligence in continuing as directors when they were no longer qualified, it was taken as a purely technical defect which they would have rectified had they realized it at the proper time.

In R*e Duomatic Ltd.*, [102], Buckley J. held that relief can be granted where three circumstances are shown to exist. First of all, the person to be excused must be shown to have acted honestly. Secondly, he must be

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98 *Ibid.*

99 The Companies Act, 1929 (U.K.), s.372.

100 The Companies Act, 1948 (U.K.), s .448.

101 [1934] 1 Ch. 227.

102 [1969] 1 All E.R.161(Ch.D).

shown to have acted reasonably. And thirdly, it must be shown that, having regard to all the circumstances of the case, he ought fairly to be excused. The learned judge dealt with the question of reasonableness of action thus :

> "A man would be shown to have acted reasonably if he was acting in the way in which a man of affairs dealing with his own affairs with reasonable care and circumspection could reasonably be expected to act in such a case, for, such an imaginary character would take pains to find out all the relevant circumstances."[103]

The relief could be claimed only in respect of proceedings against a director for breach of the Companies Act, 1948.[104] The Companies Act,1985 (UK) provided that where proceedings for negligence, default, breach of duty or breach of trust are brought against a director, the court may relieve him from liability if it considers that he has acted honestly and reasonably and that considering all the circumstances of the case, he ought fairly to be excused.[105] The claimant has to prove honesty, reasonableness and fairness in action to satisfy the court that he is entitled to relief. In *R* v. *Ghosh*,[106] dishonesty was objectively assessed by reference to the ordinary standards of reasonable people.

An objective test is applied to determine honesty in action.[107] In *Bairstow* v. *Queens Moats Houses Ltd.*, [108] the directors were prosecuted

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[103] *Id.*, p.164.

[104] *Customs and Excise Commissioners* v. *Hedon Alpha Ltd.*, 1981 (2) All E.R 697(C.A.).

[105] The Companies Act, 1985, s. 727.

[106] [1982] Q.B.1053.

[107] *Supra* n.96 at p.205.

for paying dividends in excess of the distributable reserves in breach of the provision of Companies Act, 1985. The directors had unlawfully paid dividends acting on the 1991 accounts of the company that showed inflated profits. The Court of Appeal held that the directors were not honest in authorizing the dividend payments and had failed to act honestly and reasonably in preparing the accounts.

The provision has mainly been used to provide relief from civil liability and orders granting relief from criminal liability had been very few in the course of its statutory lifetime.[109] The Companies Act, 2006 also restates the same provision.[110]

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[108] [2001]2 B.C.L.C.531 (C.A.).

[109] S*upra* n. 96 at p.221.

[110] The Companies Act, 2006, s.1157 reads, "Power of court to grant relief in certain cases:(1) If in proceedings for negligence, default, breach of duty or breach of trust against

(a) an officer of a company, or

(b) a person employed by a company as auditor (whether he is or is not an officer of the company),

it appears to the court hearing the case that the officer or person is or may be liable but that he acted honestly and reasonably, and that having regard to all the circumstances of the case (including those connected with his appointment) he ought fairly to be excused, the court may relieve him, either wholly or in part, from his liability on such terms as it thinks fit.

(2) If any such officer or person has reason to apprehend that a claim will or might be made against him in respect of negligence, default, breach of duty or breach of trust

(a) he may apply to the court for relief, and

(b) the court has the same power to relieve him as it would have had if it had been a court before which proceedings against him for negligence, default, breach of duty or breach of trust had been brought.

(3) Where a case to which subsection (1) applies is being tried by a judge with a jury, the judge, after hearing the evidence, may, if he is satisfied that the defendant (in Scotland, the defender) ought in pursuance of that subsection to be relieved either

In Australia, the Corporations Act, 2001 empowers court to grant relief to directors if it is satisfied that he has acted honestly.[111] The provision applies only to civil proceedings against a person for negligence, default, breach of trust or breach of duty.[112] Petitions filed under the provision have rarely been successful.[113] It is opined that the provision fails to provide adequate protection to the directors and officers of the corporation.[114] The relief from liability cannot be claimed in respect of criminal liability.[115]

Exemptions from Liability under the Companies Act, 1956

In India the courts power to grant relief to directors was introduced in the Companies Act, 1913.[116] The relief could be claimed by directors,

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in whole or in part from the liability sought to be enforced against him, withdraw the case from the jury and forthwith direct judgment to be entered for the defendant (in Scotland, grant decree of absolvitor) on such terms as to costs (in Scotland, expenses) or otherwise as the judge may think proper."

[111] The Corporations Act, 2001, s.1317.

[112] *Ibid.*

[113] Jason Harris, "Relief From Liability for Company Directors: Recent Developments and their Implications", available at: http://ssrn.com/abstract=1399191.

[114] *Ibid.*

[115] *Deputy Commissioner of Taxation* v. *Dick*, (2007) 64 A.C.S.R.61.

[116] The Companies Act, 1913, s.281 reads, "Power of Court to grant relief in certain cases:

(1) if in any proceedings for negligence, default, breach of duty or breach of trust against a person to whom this Section applies, it appears to the Court hearing the case that that person is or may be liable in respect of the negligence, default, breach of duty or breach of trust, but that he has acted honestly and reasonably, and that having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused for the negligence, default, breach of duty or breach of trust, that Court may relieve him, either wholly or partly, from his liability on such terms as the Court may think fit.

(2) Where any person to whom this section applies has reason to apprehend that any claim will or might be made against him in respect of any negligence, default breach of duty or breach of trust, he may apply to the Court for relief, and the Court on any

managers, officers and auditors of the company.[117] The relief provision under the Companies Act, 1956 provides that in any proceeding for negligence, default, breach of duty, misfeasance or breach of trust against an officer of a company, the court may relieve him from liability if it is satisfied that he has acted honestly and reasonably, and that he ought to be excused having regard to all the circumstances of the case, including those connected with his appointment.[118] The onus is on the

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such application shall have the same power to relieve him as under this Section it would have had if it had been a Court before which proceedings against that person for negligence, default, breach of duty or breach of trust had been brought.

(3) The persons to whom this section applies are the following :

(a) directors of a company.

(b) managers and managing agents of a company;

(c) officers of a company;

(d) persons employed by a company as auditors whether they are or are not officers of the company."

[117] *Ibid.*

[118] The Companies Act, 1956, s.633 reads, (1)"If in any proceeding for negligence, default, breach of duty, misfeasance or breach of trust against an Officer of a Company, it appears to the Court hearing the case that he is or may be liable in respect of the negligence, default, breach of duty, misfeasance or breach of trust, but that he has acted honestly and reasonably, and that having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused, the Court may relieve him, either wholly or partly, from his liability on such terms as it may think fit:

Provided that in a criminal proceeding under this sub-section, the Court shall have no power to grant relief from any civil liability which may attach to an Officer in respect of such negligence, default, breach of duty, misfeasance or breach of trust.

(2) Where any such officer has reason to apprehend that any proceeding will or might be brought against him in respect of any negligence, default, breach of duty, misfeasance or breach of trust, he may apply to the High Court for relief and the High Court on such application shall have the same power to relieve him as it would have had if it had been a Court before which a proceeding against that Officer for negligence, default, breach of duty, misfeasance or breach of trust had been brought under sub-section (1).

officer accused of the offence to prove that he has acted honestly and reasonably. If the court is convinced that a person has acted reasonably and honestly, discretionary power can be exercised. This satisfaction is not a mere ritual and it is not to be met by mechanical averments in the petition.[119] Such satisfaction must be reached after serious and careful consideration of the whole question whether the officer has acted honestly and reasonably.

The object of the provision is to avoid hardship to officers of the company in deserving cases. It intends to relieve directors of their liability in cases where they are technically guilty, but are able to convince the court that they had been acting honesty and reasonably and that having regard to the circumstances of the case, they ought to be excused from the charge or charges made against them.[120] The object is to see that the directors are not unduly harassed for offences for which they may not have any knowledge at all. There had been umpteen number of cases wherein corporate directors and managers were absolved of all liabilities in respect of the alleged offence.[121]

(3) No Court shall grant any relief to any Officer under sub-section (2) unless it has, by notice served in the manner specified by it, required by the Registrar and such other person, if any, as it thinks necessary, to show cause why such relief should not be granted".

[119] *Hemal A. Kanuga* v. *The Registrar of Companies*, [2008]143 Com.Cas.8(Guj.).

[120] *Prestolite of India Ltd.in re*, (1995) 2 Comp.L.J.152 (P.&H.).

[121] *Bhagwati Foods P. Ltd. and Basudeo Gupta* v. *Registrar of Companies*, (1989) 65 Comp.Cas.553(Bom.); *Deba Prasad Roy* v. *Regional Director, Department of Company Affairs*, (2008) 1Comp.L.J.416 (Cal.); *S.B.I. Home Finance Ltd.,* v. *Regional Director, Dept. of Company Affairs*, (2007) 3Comp.L.J.338 (Cal.).

Relief can be sought in cases where the petitioner reasonably apprehends criminal or civil proceedings.[122] Before granting relief to any officer notice shall be send to the Registrar of companies to show cause as to why such relief should not be granted. The court has to hold an enquiry to arrive at a decision whether the persons accused of the offence has acted honestly and reasonably.[123] The court should not exercise the power in a casual manner and a decision should not be arrived at solely relying upon the averments made in the application and the written objection filed thereto. The courts finding has to be based on evidence adduced through examination of documents/ witnesses.[124] In order to grant relief to a person, it is not necessary that he should confess or admit his guilt or that the court must find him guilty.[125] It is sufficient if it appears to the court that he is or may be liable.

The benefit of the provision can be availed only in respect of offences under the Companies Act, 1956. In *Rabindra Chamaria* v. *Registrar of Companies,*[126] relief was sought against prosecution initiated for default in payment of provident fund dues under the Employees Provident Fund Act, 1952. The Supreme Court held that the provision for relief cannot be extended in respect of liability under any Act other than the Companies Act, 1956. The court observed that if the provision is widely interpreted the consequences will be disastrous. The penal provision of all other enactments would be rendered ineffective.

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[122] *S.P. Punj* v. *R.O.C., Delhi*,(1991) 1 Comp. L.J. 167(Del.)

[123] *Sanatan Ganguly* v. *State*, (1984) 56 Com.Cas 93 (Cal.)

[124] *Ibid.*

[125] *M.O. Varghese* v. *Thomas Stephen Co. Ltd.*, (1970) 40 Com.Cas.1131 (Ker).

[126] A.I.R.1992 S.C.398.

The court has to be satisfied that the director has acted honestly and reasonably. The meaning of the phrase 'to act honestly and reasonably' have been considered in many decisions.[127] It is difficult to formulate a general test to prove honesty. A finding of honesty can only be based on an objective assessment of facts. If the accused knew that he had violated the law or if the intention to defraud is proved he cannot be said to have acted honestly. Honesty can be inferred where the director has acted without carelessness and has taken all measures to make up the consequences of the violation.

The case laws in India interpreting the relief provisions show that courts have not followed a consistent approach in awarding reliefs to corporate officers. This is because there is no objective standard for assessing whether the director had acted honestly and reasonably. This creates uncertainties and risks for directors and managers.

The cases reviewed herein for the purpose of examining the efficacy and scope of the relief provision indicates that the likelihood of the criminal sanctions being used to harass innocent directors is very minimal. The common grounds upon which the relief is claimed are the following.

Financial Difficulties

While in some cases financial difficulties were taken as a valid and proper reason for granting relief from liability, in some others courts were not ready to accept it as a valid reason for committing any default or non-compliance with the law.

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[127] *In Re Tri-sure India Ltd* v. *Registrar of Companies,* (1983) 54 Com. Cas.197 (Bom); *Re Tolaram Jalan and In re Filmistan P.Ltd.,* A.I.R.1959 Bom.245; *Re East India Hotels Ltd.* MANU/WB/0144/1978; *Official Liquidator, Supreme Bank Ltd.,* v. *P. A. Tendolkar,* A.I.R.1973 S.C.1104.

In *J.P.Jhalani* v. *Reg.Providend Fund Commissioner,*[128] the petitioners sought to be excused from prosecution for non-deposit of statutory dues under the Employees State Insurance Act, 1948 on the ground that the petitioners had acted honestly and reasonably. The directors contended that the company was facing financial crisis because of recession, high prices of steel and inadequate subsidy from government. The court found that there was nothing on record to show that the financial position on of the company was bad. The contributions to the provident fund were used by the company for its own business purposes. The Court observed that financial difficulty is not an excuse for non-compliance with the statutory obligation. The contribution deducted from the wages was diverted for purposes of the company. If the petitioners were honest they would have deposited the dues from time to time. The court held that the petitioners who had acted deliberately were not entitled to relief.

But in *Raj Kumar* v. *Registrar of Companies,*[129] financial constraints were taken as a valid explanation for non-compliance of statutory obligations. In this case compliant was filed against the directors of the company for non-payment of dividend amount. The accused admitted the delay in distributing the amount but stated that the delay occurred due to tight financial market and the failure to collect its receivables. Further a scheme submitted by the petitioner company was approved by the Company Law Board. This also caused some delay in disbursing the dividend warrant. The delay was held to be not wilful and the petitioners were held to have acted honestly and reasonably.

[128] (1987) 2 Comp.L.J.151 (Del.).

[129] MANU/TN/1378/2004.

Impossibility of Compliance

Courts generally grant relief to directors if it is satisfied that there was an impossibility to comply with the statutory obligations.

In *S.Pattabhiraman* v. *Registrar of Companies,*[130] the directors of the company had committed default in filing the accounts and balance sheet of the company. The accused contended that he was unable to comply with the law due to a dispute between directors of the company. The company was having only two directors, viz., the petitioner and Mr. S. Venkataramanan. All the books and papers of the company were kept in the registered office, which was the residence of the Mr. S. Venkataramanan. The petitioner had no access to the books, records and papers of the company. The petitioner had filed petition before the Company Law Board against the other director and the matter was pending before the Court. In these categorical factual position, the court held that the petitioner had acted honestly and reasonably and the petitioner ought to be excused in respect of statutory obligations relating to filing of annual returns. The inability to perform the statutory obligations was established and hence he was granted relief from being prosecuted.

The directors are granted relief from liability if it is proved that they had acted with due diligence to secure compliance with statutory obligations.

In *Kenji Tamiya in Re,*[131] the petitioners were the directors of the Japanese company nominated on the board of Indian Company. The statutory auditors noted some defects in the annual accounts for the

[130] (2009)148 Com.Cas.705 (Mad.)

[131] (1990) 2 Comp.L.J.260 (Bom.).

relevant year. The petitioners advised other directors to appoint auditors of international reputation to investigate the affairs of the company. Having found that the other directors of the company have failed to comply with the statutory requirements, the petitioners tendered their resignation as directors and filed the petition to be relieved from intended prosecution. Here the petitioners took reasonable precautions to prevent the commission of the offence. It was held that they were entitled to be relived from any intended prosecution.

The directors are entitled to rely upon the skill and integrity of the managing director or other principal officers of a company exercising supervisory functions.[132] The directors should be satisfied about the honesty and general competence of the appointee before appointing them as the managing director or other principal officer of the company. If circumstances come to their notice which raise reasonable doubt or suspicion about either the integrity and competence of the person placed in charge of the company, it shall be their duty to take such steps as may be reasonable in the circumstances. If these men are of such a character that no man with any degree of prudence acting on his own behalf would have omitted to take corrective action, it is not open to the directors to say that they continued to rely on the honesty and integrity of the managing director. In such situations the directors would not be justified in contending that they had discharged the duty honestly.

Bonafide Belief

Courts usually grant relief to directors if it is satisfied that the directors had acted bonafide without any intention to defraud.

[132] *Re Supreme Bank of India Ltd.*, (1964) 34 Com.Cas.34 (Mys.)

In *Progressive Aluminium Ltd.,* v. *R.O.C.,*[133] it was alleged that untrue statements had been made in the prospectus issued by the company. The impugned statement was that the company was engaged in construction activity for two and a half decades. The statement was not wholly untrue. It only suffered from want of clarification. A partnership firm engaged in construction activity was taken over by the company. Taking into account the experience of the promoters of the company, the statement was given on the belief that experience of body corporate is always that of persons running it. The statement was not incorporated with any malafide intention of practicing fraud upon the subscribers. On these facts, it was held that petitioner was entitled to relief from liability.

In *R.K. Mahapatra* v. *Secretary to Government,*[134] it was alleged that the surplus funds of the company were invested in non- banking financial institutions and these investments were shown in the balance sheet under the head 'inter- corporate loans and advances' instead of 'investment'. The question before the court was whether the petitioners had acted honesty and reasonably in the deployment of funds as short-term deposits. It was found that the company had not incurred any loss and the petitioners had not secured any personal gain as a result of the act. The officers were held entitled to be relieved from liability for non-disclosure of investments in the balance sheet.

In *Madhavan Nambiar* v. *R.O.C.,*[135] the director was prosecuted for non-disclosure of contingent liabilities in the balance sheet submitted by the company. Though the amount was not shown under the respective

[133] (1997) 4 Comp.L.J.215 (A.P.).

[134] (1998) 92 Com.Cas.809 (A.P.).

[135] (2002)108 Com.Cas.1(Mad.)

head of contingent liabilities, it was shown under the notes on accounts. There was no material defect or concealment and it was not a deliberate or wilful act. The court relieved the director from the legal proceedings after taking into consideration the totality of the circumstances and the bona fide conduct of the director. There was no deliberate inaction, wilful omission or commission on the part of the petitioner. The court opined that mere technicalities should not be allowed to prevail in launching criminal prosecutions.[136]

Trivial Mistakes

There is a tendency to grant relief in cases where the court considers the violation as a trivial offense, not worthy of prosecution.

In *Hemal A. Kanuga* v. *Registrar of Companies,*[137] the allegations made against the directors were that the company had entered into some transactions in which the directors were interested and that the same was

[136] Also see *Hafez Rustom Dalal* v. *Registrar of Companies,* (2005) 128 Com.Cas.883 (Guj.) The allegation against the directors were that various statements and forecasts made in the prospectus were false, deceptive and misleading. The petitioner gave a detailed reply that IFCI has issued a Project Completion Certificate and that the final disbursement of the loan was made only after the project was completed. It was submitted that the Company had achieved what was projected in the prospectus and sometimes it even exceeded the projections so far as sales are concerned. Sanctioning of loan by the financial institutions, granting licenses by the respective authorities, furnishing returns and statements before the statutory authorities under the excise and other laws are sufficient to reveal that the company had made all attempts to adhere to the assurances and promises given in the prospectus. The court observed that if something is lacking somewhere, no motive can be attributed to that so as to prosecute the directors for misrepresentation in prospectus. The Court relieved the directors from liability on being satisfied that the applicants have acted bonafide and there was no deliberate intention on their part to defraud the public and that there was no false or deliberate statement in the prospectus.

[137] (2008) 143 Com.Cas.8(Guj.)

not duly entered in the register. Mandatory disclosures required in the balance sheet had not been made and many mistakes had crept in the accounts submitted. The petitioners pleaded that they had acted honestly and reasonably. No prejudice had been suffered by any person by reason of such alleged default. No pecuniary or other benefit had been obtained by the petitioners by reason of such default. It was also submitted that the petitioners had exercised due diligence in preparing the company's accounts. They had acted with due care and caution. The company and the petitioners had been guided by the company's reputed auditors. None of the shareholders had complained with regard to such violations. The court granted relief on the ground that the petitioners had taken all due care and caution in complying with the provisions of the Act and that no person had suffered any loss on account of the violation. The court observed that prosecution of the company's highest ranking officers for such minor lapses and defaults of technical nature was not just and proper.

The law mandates disclosure of related party transactions. Non-disclosure of the same in the company register is penalised. If the court considers the non-disclosure as a trivial one, it would send a wrong message to the society. The purpose behind mandating compliance with those provisions would be defeated if the violation of the same are treated as minor lapses.

But a contrary view was taken in *Farouk Irani* v. *Registrar of Companies,*[138] where the Madras High Court refused to grant relief to the managing director and the company secretary from liability for

[138] (2009)1 Comp.L.J.112 (Mad.).

nondisclosure in the books of account and registers of the company. The petitioners pleaded that when the defects were noticed, a revised return was placed and the correct particulars were given to the registrar of companies. The court held that it was not a fit case for exercising discretionary power in favour of the petitioners because the violation of mandatory provisions could not be taken as "mistakes crept in."

Establishing a rigorous regulatory framework is essential to maintain investor confidence in the capital market. Too much regulation can make corporate managers over cautious. The courts' power to grant relief can be used to address the concern of over-regulation. The paucity of successful applications in foreign countries evidences the strict interpretation given to the relief provision. But in India the relief order has been granted in so many cases. The liberal approach of the Indian judiciary in granting relief gives a wrong message to the corporate world. The larger interests of the company and the well being of the economy demands that those guilty of negligence, mismanagement and maladministration be dealt with strictly. The prosecution and punishment of offences should be strengthened. The cumulative effect of a technical breach of duty may be the failure of the company and loss of hard earned savings of hundreds of people. Once a legislative policy has been taken to criminalise a violation, the judiciary should exercise self restraint in awarding relief from prosecution.

Exemption from Liability under Regulatory Statutes

Most of the regulatory statutes provide that directors can be exempted from liability if it is proved that the offence was committed without their

knowledge or that they had acted diligently to prevent the commission of such offence.[139]

The directors can escape liability under the following circumstances.

Without Knowledge

The accused person can take the defense that the offence was committed without his consent, knowledge or connivance and that he was not negligent in ensuring that the laws are obeyed.

But it shall also to be seen whether proper arrangements for treatment of effluents were made and the system was in working condition.

In *State of Maharashtra* v. *Joseph Anthony Pareira,*[140] the director and chief chemist of a company was convicted under the Drugs and Cosmetics Act, 1940 on the ground that the pharmaceutical tablets

[131] For example The Air (Control and Prevention of Pollution) Act, 1981, s.40 reads, (1) "Where an offence under this Act has been committed by a company, every person who at the time the offence was committed, was in charge of, and was responsible to the company for the conduct of the business of the company, as well as the company shall be deemed to be guilty of the offence and shall be liable to be proceeded against and punished accordingly;

Provided that nothing contained in this sub-section shall render any such person liable to any punishment provided in this Act, if he proves that the offence was committed without his knowledge or that he exercised all due diligence to prevent the commisssion of such offence.

(2) Notwithstanding anything contained in Sub-section (1), where any offence under this Act has been committed by a company and it is proved that the offence has been committed with the consent or connivance of, or is attributable to, any neglect on the part of, any director, manager, secretary or other officer of the company, such director, manager, secretary or other officer shall also be deemed to be guilty of that offence and shall be liable to be proceeded against and punished accordingly."

[140] 1972 Cri.L.J.274 (Bom.)

manufactured in their laboratory did not conform to the standard prescribed by law. The accused contended that he trusted his purchase officer and sales representative and he had been deceived or cheated by them either by substituting a different sample on the way to laboratory or by substituting the whole powder in the laboratory in collusion with the production manager. But the court observed that whatever was being done in the laboratory is ultimately his responsibility. If he had allowed such production to be undertaken without his knowledge, his conduct amounted to negligence. The facts and circumstances of the case revealed that accused was negligent. He had not taken sufficient measures to satisfy that the tablets which were being produced in the laboratory were up-to the pharmaceutical standards. The High court upheld the conviction for committing the offence by negligence.

It is the duty of the director to exercise control over what is going on in the company. The low level officers are likely to be encouraged in breaking the law if they feel that the directors are lax in the supervision of the company. The officers may be inclined to consent to the commission of the offence if they find that the directors are not properly supervising the functioning of the company. The neglect of the directors to monitor company affairs can lead to the commission of the offence. It is the duty of the director to supervise the running of the company and there should be mechanisms for feedback and co-ordination. Merely giving instructions will not suffice.

Acted Diligently

The accused director can escape liability if he had acted diligently to prevent the commission of the offence. Due diligence defence is recognized by almost all legislation imposing liability on directors. The

director can escape liability by showing that he had taken all necessary steps to prevent the commission of the offence. Due diligence means such diligence as is expected from a person in charge of the affairs of the business of the company.[141]

To establish that the director had acted diligently, he has to prove that necessary precautions were taken to prevent violation of law. What precautions will satisfy the defense will depend on the trade and business in which the company is engaged. There should be a system of checks and necessary follow up action and monitoring is necessary.

The existence of the defense of due diligence ensures that 'moral fault' is not completely ignored by the law in action.[142] The defense provides a practical means for the innocent directors to avoid criminal penalties. The case laws reveal that in India the relief provision is functioning as a loophole through which the reckless, careless and the indifferent directors are escaping from liability.

Conclusion

The widespread impact and harm caused by corporate abuses demand the use of criminal sanctions to combat them. Public notions regarding wrongfulness of an action keep changing. Once the legislature has decided to penalise an act, it shall not be treated as a case of over-criminalization but as a measure for the protection of the society at large. When corporations are used as a shield to perpetuate crime, effective

[141] *Shamsunder Agarwal* v. *State of Rajasthan,* 2007 Cri.L.J.749 at p.752 (Raj.).

[142] W.G.Carson, "Some Sociological Aspects of Strict Liability and the Enforcement of Factory Legislation", 83 M.L.R.369 (1970).

regulation may be possible only by fixing criminal liability on the individuals operating behind it.

Various doctrines and theories are invoked in imposing criminal liability on corporate managers. The vicarious liability principle is invoked to attribute the acts of subordinate officers to senior managers and thereby satisfy the *actus reus* required to be established for the offence. The strict liability principle is invoked to overcome the element of *mensrea* essential to be proved for convicting a person. Liability can also be fixed for negligent monitoring on the part of corporate managers. The line of cases decided in India with respect to the scope of the due diligence defense shows that the judiciary has taken a considerate view to ensure that innocent directors are not harshly dealt with criminal sanctions. Relief has been granted in every deserving case. One may also form a view that the courts are giving undue favour to corporate officers. It can rightly be concluded that the possibility of the penal law being used to harass innocent corporate directors is very minimal.

The prosecuting authorities should follow the spirit of the law. Whenever any violation of law is noticed they should not show any reluctance in using penal sanctions against corporate managers. The Indian judiciary should either develop new doctrines or follow the principles evolved in foreign jurisdictions rather than being carried away by the traditional criminal law doctrines emphasizing on individual liberty because the harm caused by corporate crime is many times severe than the traditional crimes.

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Chapter **4**

IDENTIFICATION OF PERSON RESPONSIBLE FOR CORPORATE CRIME

The main difficulty faced by the legal system in imposing criminal liability on corporate managers is that of identifying the person responsible for the criminal act. Identification of the person responsible for the crime is crucial because punishment cannot be imposed on each and every officer of the company. Criminal liability can be imposed only on the person who has committed the offence by way of commission or omission. Identification of the perpetrator of crime becomes difficult mostly on account of the organisational structure of the corporation. The real culprits and the perpetrators of the crime may escape from liability because of the defect in properly identifying and charging the person responsible for the crime. There are many statutory provisions and judicial decisions that help in identifying the person responsible for the crime.

The legislature has tried to overcome the difficulty of identification of the person responsible for the corporate crime by attributing responsibility on certain officers of the company. It is necessary to analyse whether the legislative scheme seeks to encompass all directors as persons punishable for violation of various provisions of the Act or whether the legislative intention is to make only the 'persons responsible for the conduct of business of the company' liable under different penalty provisions of the Act. For analyzing the legal framework for identification of 'the person responsible for the corporate crime' a discussion on the different classes of directors, executive officers and other employees of the company is

necessary. A brief account of the governance structure of corporations, the various categories of directors and their role in the governance structure would help to better understand the legislative scheme of attribution of responsibility. A consolidation of the attribution rule and the interpretations given by the judiciary would help to improve the application of criminal sanctions on persons responsible for corporate crimes.

Governance Structure of Corporations

Corporations have a unique organizational structure which makes it difficult to identify the person responsible for the corporate crime. Corporations have a hierarchy of executive officers and responsibility is diffused among them.

Hierarchy of Officers

The most striking characteristic of contemporary business enterprise is that it is managed by a hierarchy of salaried executives. A company is a federation of autonomous units engaged in buying, production, pricing and marketing policies.[1] The organizational structure of the corporation depends on the size of the corporation. In multinational companies and large public companies there will be top level executives, divisional executives, sub-divisional executives, managers, lower-level managers and supervisors. A case study on the managerial revolution in American business points out that most of the big enterprises are managerial enterprises noted by a sharp separation of ownership and management.[2] The owners and those persons having

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1 Alfred D Chandler, Jr, *The Visible Hand: The Managerial Revolution in American Business*, Harvard University Press, UK (1977), p.7.

2 *Id.*, p.451.

substantial stake in the company are no longer part of the management. These companies are successfully managed by professional salaried managers who take significant decisions. When the entrepreneurs found it difficult to carry on the multitudinous activities involved in undertaking mass production and mass distribution, they started recruiting managers to administer and coordinate the activities of various units.[3] The success of an enterprise depended on the caliber of its managerial hierarchy. With the rapid growth in the size of corporate units and increasing complexities of modern business, the board of directors had to confine themselves to matters of general business policy and overall supervision of management. The day to day conduct of business and management was left to the managerial personnel.

Diffusion of Responsibility

The complexity of the corporate structure and the diffusion of responsibility within the structure complicate the task of finding responsible individuals.[4] Management of the organization may be carefully controlled at the top or may be largely decentralized so that significant power is held at lower-levels in the organization.[5] Small companies will have a simple structure with a great deal of authority vested in one person. Some companies may have a divisional structure vesting extensive power in divisional managers. The relationship between the top and middle management is not well defined in most of

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3 *Id.*, p.381.

4 Ann Forschler, "Corporate Criminal Intent: Towards a Better Understanding of Corporate Misconduct", 78 Calif.L.R.1287 at p.1288 (1990).

5 James Jackson, "The Liability of Executive Officers under the Corporation Law", 3 Bond L.R.275 at p.277 (1991).

the companies.[6] In some cases the top managers may be actively involved in supervising and co-coordinating the day-to-day operations. In some others the top managers may have only a vague idea of the activities of the operating units. The structure of the corporation has a great impact on the degree of power exercised by each officer. The power and duties of each corporate personnel will be defined by the internal rules of the company.

Group-Decision Making

Most of the corporate decisions are group decisions. This creates problems in identifying the decision maker. Companies are likened to miniature democratic states with similar governance structures.[7] Like the legislative bodies, the board of directors lay down the policy and it is the executive managers who execute the policies and administer the company. High level corporate officers spend most of their time on financial matters and on long range policy planning. [8] Their concerns are confined to making policies and reviewing proposals arising from middle and lower levels of corporate structure. The primary function of middle level managers is to provide direction to the staff officials and to serve as a connecting link between them and senior management.[9] The day today

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6 *Supra* n.1at p. 454.

7 Christopher Ryan, *Company Directors- Liabilities, Rights and Duties*, C.E.H. Editions Ltd., Oxfordshire (1987), p.104. In a democracy the adult citizens elect their representatives to the Parliament. In companies the shareholders appoint a board of directors which is presided over by the chairman of directors. The board has collective responsibility for the running of the company. Similarly the board of directors are accountable to the shareholders in general meeting.

8 Richard Henderson and W.W. Suojanen, *The Operating Manager*, Prentice Hall International, California (1974), p.18.

9 *Id.*, p.22.

administration of policies laid down by the executives is carried out by the subordinate managers. Where tasks are frequently fragmented among multiple actors and responsibility is shared, confusion arises as to who is to be held responsible. Some authors feel that corporate wrong doing is often the result of actions or the inactions by top managers of the organization.[10] Tall hierarchies, intensive specialization and organizational complexity make the organization more difficult to control and thus facilitate the commission of illegal acts.[11] Sometimes violations by companies occur without the knowledge or direct participation of higher corporate officials. These officers will often be ignorant of the day today operational activities of the company. In some other cases a series of incidental acts by several people result in commission of a criminal act. The contribution of each of the officer towards the act may be insignificant resulting in acquittal on an individual basis.[12] These violations can be traced to improper instructions to employees, failure to supervise work or failure to employ qualified personnel.

In this background it is necessary to examine the statutory scheme for identification of person responsible for corporate crime.

Statutory Scheme for Attribution of Criminal Responsibility

Identifying the person responsible for the corporate crime is the main difficulty faced by the legal system in imposing criminal liability

[10] A.J. Da Bauh, "Top Management Team Characteristics and Corporate Illegal Activity", 20 *Academy of Management Review* 138 at p.140 (1995).

[11] *Ibid.*

[12] Not only the perpetrator, but all those persons who aided, abetted and procured the offence are punishable under law.

on corporate managers.[13] Under the Companies Act, 1956 the identification of the offending officer is achieved by attributing responsibility on the 'officer in default'. The Act specifies seven categories of officials who can be made liable in case of contravention of the statute.[14]

Various social-welfare legislations provide criminal sanctions for persons designated as 'persons in charge of and responsible to the company for the conduct of business'.[15] Here also identification of the person responsible is achieved by attribution of responsibility. "Every person who was in charge of the business of the company at the time the offence was committed" is liable for offenses committed by companies.[16] However such a person can defend himself by showing that the offence was committed without his knowledge or that he had exercised due diligence to prevent the offence from being committed. Even if a person is not in charge of the company affairs, but is occupying the position of a director, manager, secretary or other officer he would be liable if it can be shown that the offence was committed with his consent or connivance or is attributable to any neglect on his part.[17]

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[13] Stephen Yoder, "Criminal Sanction for Corporate Illegality",69 J.Crim.L. Criminology 40 at p.49 (1978)

[14] The Companies Act, 1956, s.5.

[15] The Negotiable Instruments Act, 1881, s.141; the Water (Prevention and Control of Pollution) Act, 1974, s.47; the Air (Prevention and Control of Pollution) Act, 1981, s.40; the Environment (Protection) Act, 1986, s.16; the Drugs and Cosmetics Act, 1940, s.34; the Food Adulteration Act, 1954, s.17.

[16] *Ibid.*

[17] *Ibid.*

Concept of Officer-in-Default under the Companies Act, 1956

The Companies Act, 1956 contains around 200 provisions imposing criminal liability on the company and its officers.[18] We can also find some provisions where the officers alone are held liable.[19] Various provisions of the Act provide that in case of contravention of the provisions of the Act the company as well as the 'officer in default' shall be liable. Thus liability is to be imposed only on those particular officers who are in default and not on all directors. Understanding who an officer in default is will enable us to determine who can be held accountable in a particular situation and who ought to be proceeded against.

The policy issue to be addressed here is whether the person in charge of the day today working of the company, designated as managing director or the executive director alone is to be held liable or whether both the managing director and the members of the board of directors are to be held responsible for an offence committed by the company. The choice of policy is crucial because unless the liability issue is settled, the uncertainities regarding the functions and duties of officers and directors would ultimately affect the corporate governance paradigm. The statutory provisions and the response of the judiciary in this respect will be examined here.[20]

The Companies (Amendment) Act, 1988 specified seven categories of officers who can be made liable for punishment irrespective of the fact

[18] The Companies Act, 1956, s.2 (30) reads, "officer" includes any director, manager or secretary or any person in accordance with whose directions or instructions the Board of directors or any one or more of the directors is or are accustomed to act".

[19] For eg: the Companies Act, 1956, ss.63, 68 and 70.

[20] For a discussion on the statutory position prior to the 1988 amendment see chapter 1.

whether they have contributed to the commission of the offence of default.[21] Under the amended provision *mensrea* is not an essential requirement to be established before an officer of the company could be made liable. It has been widely criticized that the amendment is apparently unfair and that it is intended to dispense with the obligation of the Department of Company Affairs to identify the persons who had committed the offence.[22] It is feared that company administration would become a source of tyranny to everyone connected with the affairs of the company and that it would result in the indiscriminate launching of

[21] The Companies Act,1956, s.5 reads, " For the purpose of any provision in this Act which enacts that an officer of the company who is in default shall be liable to any punishment or penalty, whether by way of imprisonment, fine or otherwise, the expression "officer who is in default" means all the following officers of the company, namely:-

(a) the managing director or managing directors;

(b) the whole-time director or whole-time directors;

(c) the manager;

(d) the secretary;

(e) any person in accordance with whose directions or instructions the Board of directors of the company is accustomed to act;

(f) any person charged by the Board with the responsibility of complying with that provision: Provided that the person so charged has given his consent in this behalf to the Board;

(g) where any company does not have any of the officers specified in clauses (a) to (c), any director or directors who may be specified by the Board in this behalf or where no director is so specified, all the directors:

Provided that where the Board exercises any power under clause (f) or clause (g), it shall, within thirty days of the exercise of such powers, file with the Registrar a return in the prescribed form."

[22] R. Santhanam, "Officer-in-Default: Concept and Its Implication", (1987) 3 Comp.L.J.92 (J).

prosecution against all officers resulting in harassment and hardship to innocent, honest and bonafide corporate executives and directors.[23]

The rationale of the amendment as explained in the notes appended to amendment bill was that the officers and directors who are in-charge of the management or who have been charged with the responsibility of complying with the provisions of the Act ought to be held responsible for any contravention of the Act.[24] The philosophy underlying attribution of responsibility seems to be that those who exercise power must be made liable for violations made by the corporation.[25] The duties of director are fiduciary in nature. His duty extends to not merely ensuring that he does not commit any default. The director should ensure that a suitable degree of control is maintained so that there is no scope for anyone to commit any default. If persons are allowed to escape liability on the ground that they had not committed the default, the entire purpose of having a director to oversee management of the company would become ineffective. It will also encourage irresponsibility and carelessness.[26]

The concept of officer who is in default as defined in the Indian law seems to be more focused in approach than its counterpart in the United Kingdom. In the UK, officer in default is defined as one who authorises or permits, participates in, or fails to take all reasonable steps to prevent, the commission of the offence.[27] Thus in UK the onus is on the prosecution to establish that the offence was authorized or permitted by the officer.

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[23] *Ibid.*

[24] See the Companies (Amendment) Bill, 1987, (1987) 3 Comp.L.J.1at p.3 (St.).

[25] Nalini Puri, "Officer-in-Default - A Study", (2003) Comp.L.J.18 (J)

[26] *Ibid.*

[27] The Companies Act, 2006 (UK), s.1121 reads, (1) " This section has effect for the purposes of any provision of the Companies Acts to the effect that, in the event of

Statutory Attribution under Regulatory Statutes

Most of the regulatory statutes contain a provision under the heading "Offences by Companies".[28] These provisions are in *pari materia* with one another.[29] Where any offence has been committed by a company, the primary liability for the offence falls on the company itself. Along with the company 'every person who at the time the offence was committed was in charge of and was responsible to the company for the

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contravention of an enactment in relation to a company, an offence is committed by every officer of the company who is in default.

(2) For this purpose "officer" includes

(a) any director, manager or secretary, and

(b) any person who is to be treated as an officer of the company for the purposes of the provision in question.

(3) An officer is "in default" for the purposes of the provision if he authorises or permits, participates in, or fails to take all reasonable steps to prevent, the contravention."

[28] *Supra* n.15.

[29] For example see the Air (Prevention and Control of Pollution) Act, 1981, s.40 reads, (1) "Where an offence under this Act has been committed by a company, every person who at the time the offence was committed, was in charge of, and was responsible to the company for the conduct of the business of the company, as well as the company shall be deemed to be guilty of the offence and shall be liable to be proceeded against and punished accordingly;

Provided that nothing contained in this sub-section shall render any such person liable to any punishment provided in this Act, if he proves that the offence was committed without his knowledge or that he exercised all due diligence to prevent the commission of such offence.

(2) Notwithstanding anything contained in Sub-section (1), where any offence under this Act has been committed by a company and it is proved that the offence has been committed with the consent or connivance of, or is attributable to, any neglect on the part of, any director, manager, secretary or other officer of the company, such director, manager, secretary or other officer shall also be deemed to be guilty of that offence and shall be liable to be proceeded against and punished accordingly".

conduct of the business of the company' is also deemed to be guilty of the offence. However such a person on whom liability has been imposed may escape from the liability if he proves that the offence was committed without his knowledge or that he had exercised all due diligence to prevent commission of such offence.

The statutory provisions under the head 'offences by companies' also contains a subsection which provides that where an offence has been committed by a company and it is proved that the offence has been committed with the consent or connivance or is attributable to any neglect on the part of any director, manager, secretary or other officer, then such director, manager, secretary shall also be liable to be proceeded against and punished accordingly.[30] This subsection is wider in scope because its application is not confined to persons in charge of the company. It applies to every officer of the company. The only condition for fixing liability under the section is that the connivance or neglect of such officer has to be proved. Actual participation in the offence is not required. This subsection is envisaged to widen the net of vicarious liability and to bring within its sweep not only officer in charge of and responsible to the company but also other officers whose consent, connivance or neglect has resulted in the offence.[31]

Once it is established that an offence has been committed by a company then by virtue of a deeming provision the officer in charge and responsible to the company is also liable to be punished. Thus it is necessary to determine who is or who are in actual control of the affairs

[30] *Ibid.*

[31] L.M. Sharma, "Offences by Companies", (1994) 3 Comp.L.J.1at p.5 (J).

of the company. The answer to this question may vary from company to company depending on its organizational structure. The initial burden is on the prosecution to identify the person in charge of the company. Then the burden shifts to the delinquent officer who has to prove that he had no knowledge of the offence or that he had exercised all due diligence to prevent the commission of the offence.

Thus unlike the Companies Act, 1956 which attributes liability on the managing director, whole time director, manager and such other officers specified in the provision, the terminology used in other regulatory statutes is the 'person who at the time the offence was committed was in charge of and was responsible to the company for the conduct of the business of the company'. Hence the interpretation of the term 'person who at the time the offence was committed was in charge of and was responsible to the company for the conduct of the business of the company' attains significance. Interestingly the judiciary has interpreted the term to mean the person in overall control of the day-today business of the company or firm. The Supreme Court emphasized the need for strictly construing the expression 'a person in charge of and responsible to the company for the conduct of the affairs of the company' in *Girdhari Lal Gupta* v. *D.N. Mehta.*[32] The court held that 'a person in

[32] A.I.R. 1971 S.C.2162. The appellant, the proprietor of the firm was charged under section 23C of the FERA Act, 1947. He agued that he was not physically present in Calcutta at the time of the commission of the offence and the prosecution evidence showed that Jagdish Prasad was the manager of the firm. The appellant was abroad at the time of contravention and it is possible that the contravention took place without his knowledge or because of lack of diligence. The appellant himself had stated in the affidavit that he alone looked after the affairs of the firm. Hence the prosecution of the appellant as the person in charge of the business of the firm was held to be proper even though there was a manager working under him.

charge' shall include only persons who are in overall control of the day-today business of the company. Cases decided under half a dozen of regulatory statutes under the provision 'offences by companies' are examined to see whether courts have followed a consistent stand in fixing liability on corporate managers and directors. Whether the expression 'a person in charge of and responsible to the company for the conduct of the affairs of the company' should be construed strictly to include only the person in charge of day today business of the firm and whether non-executive directors should be brought within the purview of the expression is a fundamental question to be examined. The conditions that are to be satisfied to punish a non-executive director for an offence committed by the company is also looked into. The consequences of nominating an officer as person responsible for compliance of statutory provisions are also analysed.

Companies may have a mixed composition of board members. It may consist of a combination of managing directors, executive directors, non-executive directors, nominee directors and independent directors. The categorization of officers punishable as 'officer in default' has not put an end to the issue of identification of the officer-in-default. Much confusion and complication still surrounds the concept of 'officer-in-default'. The judicial pronouncements in this area have cleared some of the confusions existing in the field. The liability of each of the officers specified above will be examined in detail.

Managing Directors

The managing director is the first person designated as officer in default. A managing director is defined as a person who is entrusted with substantial powers of management by virtue of an agreement with the

company or resolution of the company or by virtue of its memorandum or articles of association.[33] A managing director can exercise only such powers as have been entrusted or delegated to him. The managing director is considered as an employee of the company.[34] The managing director falls within the category of executive director because he is actively involved in the administration of the affairs of the company.[35] The managing director plays the dual role of being a member of the board of directors and a member of the management team.[36] The practice prevailing among the company managements is to appoint the person proposed to be appointed as managing director, as a director in general meeting in the first instance and then to appoint him as the managing director.[37]

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[33] The Companies Act, 1956, s.2 (26) reads, "managing director means a director who, by virtue of an agreement with the company or of a resolution passed by the company in general meeting or by its Board of directors, or by virtue of its memorandum or articles of association, is entrusted with any powers of management which would not otherwise be exercisable by him, and includes a director occupying the position of managing director, by whatever name called".

[34] *ESI* v. *Apex Engg. Ltd*., (1998) 1Comp.L.J.10 (S.C.).

[35] The Companies Act, 1956, s. 269 provides that every public company and its subsidiaries whether public or private having a paid up share capital of such sum as may be prescribed by the central government shall have a managing director or a whole time director or a manager. The sum of rupees five crores has been prescribed for this purpose. The Companies Act, 1956, s. 197-A provides that no company shall appoint more than one managerial personnel namely managing director and manager at the same time. Thus if the directors do not choose to manage the affairs of the company by themselves, they may appoint either a managing director or a manager for the purpose.

[36] R S Gae, "Highlights on the Whole-time Director vis-a-vis the Managing Director", (1986) 3 Comp.L.J.61(J).

[37] S.M. Shah, *Lectures on Company Law*, N.M. Tripathi Pvt. Ltd, Bombay (1990), p. 253.

With respect to the issue of liability of managing director courts have taken a consistent view that persons occupying the position of managing director are liable to be punished for violation of provisions of the Companies Act, 1956 as 'officer-in-default'.[38] Such directors can claim relief from penal sanctions if it is proved they have acted honestly, diligently and that they had taken all reasonable steps to avoid the commission of the offence. [39]

Managing directors, executive directors and managers hold similar powers and responsibilities. The difference lies only in the nomenclature used for giving designation to different officers of the company. In *Ravindra Narayan* v. *R.O.C.*, [40] the Rajasthan High Court upheld the prosecution of the managing director for failing to file the balance sheet before the registrar of companies. A different view was taken by the Bombay High Court in *Umesh Sharma* v. *S.G. Bhakta.*[41] The court held that there cannot be a presumption that the managing director was in charge of and responsible to the company for the conduct of the business of the company. In the absence of specific averment that managing

[38] See *H.H. Marthanda Varma* v. *Registrar of Companies*, [1988] 64 Com.Cas.125 (Kar.)

[39] For detailed discussion on conditions to be satisfied by the officers for claiming relief see chapter 3.

[40] (1994) 3 Comp.L.J.416 (Raj.)

[41] 2002 Cri.L.J.4843 (Bom.). In this case the company, its managing director and directors of the company were charged under Drugs & Cosmetics Act for sale of spurious drugs. The petitioner's contention was that they were not in charge of the business of the company and responsible to the company for the conduct of the business. They argued that the manufacturing chemist, and the Assistant Manager, Quality Control were the persons who had control over the manufacture and composition of various ingredients in the drug. Petitioners as directors had no control over the manufacturing activities. Nowhere is the complaint it was averred that the petitioners were in charge of the business of company.

director was in charge of manufacture of drugs he would not be liable for prosecution. It is the function and duties of a managing director that determines whether he is in charge of and responsible to the company or not.[42] The court observed that as the managing director, he may be having control over policy decisions of the company, but not on the production or manufacture of the objectionable drug. In the absence of specific averments that he was in charge of and responsible to the conduct of the company, so far as it related to manufacture of the drug, he would not be liable for prosecution along with company. It is responsibility of the prosecution to prove that objectionable drug was manufactured with the consent or in connivance of the managing director or that the production of the said drug is attributable to any neglect on the part of the managing director. While the manager by virtue of his office has the management of whole or substantially whole of the affairs of the company, the managing director has to be entrusted with such powers of the management. The powers of management are required to be delegated upon the managing director, either by an agreement with the company or by a resolution passed by the board of directors in its general meeting or by virtue of its memorandum or article of association. The prosecution did not produce any agreement or resolution passed by the board of directors by which substantial powers of management are conferred upon accused. The prosecution had no case that the objectionable drug was manufactured with the consent or in connivance of the managing director. Hence the managing director was not liable to be prosecuted along with the company. However court opined that if additional evidence is adduced before the trial court, cognizance can be taken at appropriate time.

[42] *Id.*, p. 4850.

In *S.M.S. Pharmaceuticals Ltd.* v. *Neeta Bhalla*,[43] the Supreme Court while dealing with the issue of liability of managing director for dishonor of cheque issued by the company observed:

> "….There is no magic as such in a particular word, be it director, manager or secretary. It all depends upon the respective roles assigned to the officers in a company. A company may have managers or secretaries for different departments, which means, it may have more than one manager or secretary. The liability arises from being in charge of and responsible for conduct of business of the company at the relevant time when the offence was committed and not on the basis of merely holding a designation or office in a company. Conversely, a person not holding any office or designation in a company may be liable if he satisfies the main requirement of being in charge of and responsible for conduct of business of a company at the relevant time. Liability depends on the role one plays in the affairs of a company and not on designation or status. If being a director or manager or secretary was enough to cast criminal liability, the section would have said so. Instead of "every person" the section would have said "every director, manager or secretary in a company is liable"....etc. The legislature is aware that it is a case of criminal liability, which means serious consequences so far as the person sought to be made liable is concerned. Therefore, only persons who can be said to be connected with

[43] A.I.R.2005 S.C.3512.

the commission of a crime at the relevant time have been subjected to action."[44]

The court observed that persons holding the position of the managing director or joint managing director would be admittedly in charge of the company and responsible to the company for conduct of its business. Therefore even in the absence of clear averment that managing director is in charge of and responsible to the company for conduct of its business, he can be prosecuted and held responsible for the dishonour of cheque.[45]

Whether the joint managing director of a company could be prosecuted and punished for discharge of untreated trade effluents into the stream was considered in *U.P. Pollution Control Board* v. *Dr. Bhupendra Kumar Modi.*[46] The Supreme Court found that joint managing director was having significant control over the decision making process of the company. It was specifically averred in the compliant that the joint managing director and the secretaries are the brain and nerve centre of the company. Hence the Supreme Court held that proceedings initiated against the joint managing director were proper and valid.[47]

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[44] *Id.*, pp.3516-3517.

[45] *Id.*, p.3532.

[46] (2009) 2 S.C.C.147.

[47] Also see *Vardhman Stamping Pvt. Ltd.*, v. *Imp. Power Ltd.*, 2007 (2) G.L.R.1629 (Guj.). The Court has held that the managing director and joint managing directors can be said to be in charge of and responsible for the conduct of the business of the company by virtue of their office they hold. The court found that they were actively associated with the company in its administration and held that they can be prosecuted for dishonor of cheque issued by the company.

In the case of managing directors, the view taken by the judiciary is that from the very nature of his duties, it can be inferred that they are in control of the affairs of the company.[48] A specific averment as to active participation in the offence is not essential to make them criminally liable. It is generally assumed that the managing director or manager or executive director exercise overall control over the company. In some cases the presumption is extended to joint managing director. But there are cases where the managing director is not held to be a person in overall control of the company. Thus there still exists confusion as to who is to be held responsible for an offence committed by the company. A long legal battle with new petitions and appeals are sought to find the person in control of the business of the company. Hence there is a need for unification in designating officers in the company. The regulatory statutes should cast responsibility on such designated officers. It would be helpful in solving the difficulties faced by the prosecution in identifying the officer responsible for the offense.

Whole-time Director

Whole time director means a person who is in the whole-time employment of the company.[49] The definition indicates the role a whole-time director has to play in the management of the company. A whole time director occupies a dual capacity of being a director as well

[48] See *State of Haryana* v. *Brij Lal Mittal*, J.T.1998 (3) S.C.584; *R. Banerjee* v. *H.D.Dubey*, (1992) 2 S.C.C.552; *Perfetti India Ltd.*, v. Food Inspector, MANU/ KE/0906/1998.

[49] The Companies Act, 1956, Explanation to s.269 reads, "In this section "appointment" includes re-appointment and "whole-time director" includes a director in the whole-time employment of the company."

as an employee of the company.[50] He is supposed to devote all his time and attention to the management of the company and to the carrying on of such affairs of the company as may be assigned to him by the board of directors. The whole-time director is appointed by the board of directors and in the corporate hierarchy he works under the managing director.

A wholetime director does not necessarily perform managerial functions. He may be entrusted primarily with administrative duties. Many big companies appoint whole time director to assist the managing director in the performance of his duties. A whole time director can also be entrusted with managerial functions. A whole time director is liable to be prosecuted and punished as an officer-in-default.

Manager

The manager is liable to be punished as officer-in-default for defaults committed by the company.[51] A 'manager' means an individual who has the management of the whole or substantially the whole of the affairs of a company. He is subject to superintendence of the board of directors.[52]

A manager is not a mere agent or a servant who is to obey orders, but a person who is entrusted with the power to transact the affairs of the

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[50] *Supra* n.36 at p.63.

[51] The Companies Act, 1956, s. 5(c).

[52] *Id.*, s.2(24) reads, "manager means an individual (not being the managing agent) who, subject to the superintendence, control and direction of the Board of directors, has the management of the whole, or substantially the whole, of the affairs of a company and includes a director or any other person occupying the position of a manger, by whatever name called, and whether under a contract of service or not".

company.[53] Both the managing director and the manager have the management of the whole or substantially the whole of the affairs of the company. But the difference between their position is that a managing director is a part of board of directors and not subordinate to it. A manager on the other hand is a paid executive of the company and is subject to the superintendence, control and directions of the board of directors. Only an individual can act as manager. A firm, body corporate or association cannot be appointed as the manager of a company.[54]

In *Municipal Corporation of Delhi* v. *Ram Kishan Rohtagi,*[55] the liability of the manager of the company for manufacturing adulterated toffees was the issue for consideration. The Supreme Court held that from the very nature of his duties as a manager, it is manifest that he must be in the knowledge about the affairs of the sale and manufacture of the disputed sample. The proceedings against the manager were held maintainable.[56]

The manager of the company cannot make a contention that he did not have any hand in the management of the company.[57] But in *Ashok Thorat* v. *Jalandar,*[58] the Bombay High Court held that the prosecution against the manager cannot be sustained unless it is alleged that the manager has consented to or connived in the commission of the offence or that the offence was caused as a result of his neglect.

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53 *Gibson* v. *Baston,* (1875) 10 Q.B.329.

54 The Companies Act, 1956, s.384.

55 A.I.R.1983 S.C.67.

56 Also see *Z. Kotasek* v. *State of Bihar,* 1989 Cri.L.J. 683.(Pat.)

57 *K K Nandi* v. *Amitabh Banerjee,* 1983 Cri.L. J.1479 (Cal.)

58 1991 Cri.L.J.1718 (Bom.)

The Supreme Court considered the liability of deputy general manager for dishonour of cheque in *K.K. Ahuja* v. *V.K. Vora*.[59] The complaint did not contain any averments relating to consent, connivance or negligence. The court observed that to be vicariously liable, a person should fulfill the 'legal requirement' of being a person in law responsible to the company for the conduct of the business of the company and also fulfill the 'factual requirement' of being a person in charge of the business of the company. The court held that if the accused is the managing director or a joint managing director, it is not necessary to make an averment in the complaint that he is in charge of, and is responsible to the company, for the conduct of the business of the company. This is because the prefix `managing' to the word `director' makes it clear that they were in charge of and are responsible to the company for the conduct of the business of the company. The very fact that the dishonoured cheque was signed by the managing director on behalf of the company, would give rise to responsibility.

The court raised a concern that if a mere reproduction of the wordings of the charging section in the complaint is sufficient to make a person liable for prosecution, virtually every officer/employee of a company without exception could be impleaded as accused by merely making necessary averments. That would be absurd and was not intended under the Act. The deputy general manager is not a person who is responsible to the company for the conduct of the business of the company. He does not fall under any of the category of officer-in-default. Therefore he cannot be made vicariously liable for dishonor of the cheque. If he has to be made liable then the necessary averments

[59] (2009)10 S.C.C.48.

relating to consent, connivance or negligence should be made. In the present case, no such averments were made. Hence the court held that prosecution of the deputy general manger was bad in law.

Company Secretary

The secretary of a company is punishable as an officer-in-default for acts committed by the company.[60] A company secretary is appointed to perform ministerial and administrative duties.[61] Any company having a paid up share capital of Rs 50 lakhs or more should have a whole time secretary.[62] A secretary of the company is not a mere clerk but an officer of the company with executive duties and responsibilities.[63] The company secretary plays a dynamic role and is vested with the duty of appraising the top management, directors and shareholders about the legislative provisions, compliance to be done and the consequences of non-compliance.[64]

Statutory declarations of compliance under various provisions of the Companies Act, 1956 are required to be certified by practising company secretaries. The e-filing regime introduced in India in 2006 has brought in a dramatic change in the role of company secretaries. It

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[60] The Companies Act, 1956, s. 5(d).

[61] *Id.*, s.2 (45) reads, "Secretary means a company secretary within the meaning of Sec 2(1) (c) of the Company Secretaries Act, 1980 and includes any other individual possessing prescribed qualification and appointed to perform the duties which may be performed by a Secretary under the Act and any other ministerial or administrative duties".

[62] *Id.*, s.383 A.

[63] *Panorama Development* v. *Fidelis Fabrics*, (1971) 3 All E.R.16 (C.A.).

[64] G S Bajpai, "Role of Company Secretaries in Government Companies," (1988)3 Comp.L.J.72.at p.76 (J).

requires several forms to be certified by them. Being a qualified professional providing corporate advice, company secretaries can be held liable if they have not advised against violations of law.

For fastening criminal liability on a company secretary for regulatory offences, it has to be specifically averred that he was in charge of and was responsible to the company for the conduct of the business of the company. The compliant should either disclose the precise role played by the officer role in the commission of the offense or the consent, connivance or negligence on his part.[65]

Shadow Directors

Any person in accordance with whose directions or instructions the board of directors of the company is accustomed to act is also covered under the definition of 'officer who is default'.[66] This provision is intended to cover shadow directors. A person acting behind the shield cannot escape liability for wrongs committed by the company. Imposition of liability on the shadow director will serve to suppress wrongdoing. A shadow director may have the ability to monitor and prevent wrongdoing by the company.

Under English law, a shadow director is defined as a person in accordance with whose directions or instructions the direction of the company are accustomed to act.[67] Shadow directors control the working of the company. They are the controlling mind of the company and the other directors of the company carries out their duties as instructed by the

[65] *Supra* n.59 at p.58.

[66] The Companies Act, 1956, s.5 (e).

[67] The Companies Act, 1985 (U.K.), s.741.

shadow director. The shadow director may be a parent company, a major shareholder or a bank.

Compliance Officer

Any person charged by the board with the responsibility of complying with the statutory provision comes under the definition of 'officer who is in default'.[68] Consent of the person should be obtained before appointing him as the compliance officer.[69] The board of directors shall also pass a resolution charging the officer with the responsibility of compliance with the provisions. The intention behind incorporating such a provision seems to be that it is better to catch someone rather than be at a loss to identify any officer at fault. There is every possibility that such compliance officers may become scapegoats for wrongs committed by the company. It is doubted whether submission of compliance certificate by various unit heads would exonerate the officer from liability especially when the offence is committed by an officer down the line without director's knowledge.[70] Charging a person with the responsibility of compliance with the provisions of the Act should not render the managing director immune from the liability for non-compliance.[71] It is high time that the provision be reconsidered.

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[68] The Companies Act, 1956, s.5(f).

[69] The consent shall be given by the person concerned in Form 1B and a return shall be filed with the registrar in Form 1AA prescribed under the Companies (Central Government's) General Rules and Forms, 1956 vide notification GSR No: 782(e)dated 13/7/1988. For the text see (1988)3 Comp.L.J.1(J).

[70] T Ramappa, "Certificate of Compliance and Director's Liability", (1996) 4 Comp. L.J.105(J).

[71] K R Chandratre, "Section 5 of the Companies Act: Charging a person with the Responsibility of Compliance", (1988)3 Comp. L.J.1at p.2 (J).

Director as Compliance Officer

Where a company does not have a managing director, whole time director or a manager, the board of directors can designate one of its director as 'officer in default.'[72] This clause is also liable to be misused because the real culprits may escape from liability and the director designated as officer- in -default will bear the whole responsibility for offences committed by the company. However it is better to appoint one of its directors as the compliance officer rather than appointing an outsider as its compliance officer.

Most of the regulatory statutes impose various obligations on individuals and entities coming within its purview and the violation of the obligations are penalized. These statutes enable the company to nominate a person as the one responsible for securing compliance with its provisions.[73] The issue that arises here is whether such person alone can be made liable for violation of the Act or whether the directors of the company can also be held liable for the same.

The Factories Act, 1948 imposes many obligations on the occupiers or managers with a view to protect workers' health and safety. The Act provides that both the manager and the occupier of the factory shall be guilty of offences under the Act.[74] Liability may also be cast on the owner of the premises.[75] Occupier is defined as the person who has the

[72] The Companies Act, 1956, s. 5(g).

[73] The Factories Act, 1948 and the Food Safety and Standards Act, 2006 contains provision for such nomination.

[74] The Factories Act, 1948, s.92.

[75] *Id.*, s.93.

ultimate control over the affairs of the factory.[76] In the case of a company, any one of the directors shall be deemed to be the occupier. [77] However the Act enabled a company to nominate a director, who is resident within India to be the occupier of the factory for the purpose of prosecution and punishment under the Act.[78] Earlier there was no

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[76] *Id.*, s.2(n) reads, "occupier' of a factory means the person who has ultimate control over the affairs of the factory and where the said affairs are entrusted to a managing agent, such agent shall be deemed to be the occupier of the factory: provided that in the case of a ship which is being repaired or on which maintenance work is being carried out in a dry dock which is available for hire."

Provided that (i) in the case of a firm or other association of individuals, any one of the individual partners or members thereof shall be deemed to be the occupier;

(ii) in the case of a company, any one of the directors shall be deemed to be the occupier;

(iii) in the case of a factory owned or controlled by the Central Government or any State Government, or any local authority, the person or persons appointed to manage the affairs of the factory by the Central Government, the State Government or the local authority, as the case may be, shall be deemed to be the occupier."

[77] *Ibid.*

[78] *Id.*, s.100 reads, (1) "Where the occupier of a factory is a firm or other association of individuals, any one of the individual partners or members thereof may be prosecuted and punished under this Chapter for any offence for which the occupier of the factory is punishable:

Provided that the firm or association may give notice to the Inspector that it has nominated one of its members residing within India to be the occupier of the factory for the purposes of this chapter, and such individual shall, so long as he is so resident, be deemed to be the occupier of the factory for the purposes of this chapter, until further notice cancelling his nomination is received by the Inspector or until he ceases to be a partner or member of the firm or association.

(2) Where the occupier of a factory is a company, any one of the directors thereof may be prosecuted and punished under this Chapter for any offence for which the occupier of the factory is punishable. Provided that the company may give notice to the Inspector that it has nominated (a director, who is resident within India) to be the occupier of the factory for the purposes of this Chapter, and (such director) shall so long as he is so resident, be deemed to be the occupier of the factory for

compulsion that only a director should be nominated as an occupier. The employers always found this provision as an escape route to shift their responsibilities on some officer. Many companies used to nominate an officer as the occupier of the factory. Whenever any violation of the Act was committed, it was the officer who was subjected to punishment. Thus, by nominating an employee or an officer as the occupier, the directors of the company were able to escape prosecution and punishment even if they were found to be negligent or indifferent to the welfare of the workmen or had failed to provide adequate and proper safety measures in the factory.

In *M.C.Mehta* v. *Union of India*,[79] the Supreme Court noticed the "escape route" carved out by the directors by nominating an employee or an officer as the occupier of the factory. The court opined that if there was negligence in looking after the safety requirements, the chairman, the managing director and the board of directors must be held liable even when they are not the actual offenders. This alone could ensure reduction of risk and hazard to workmen.

Following the concerns raised by the Supreme Court, Parliament amended the definition of 'occupier'. The material part of the definition for occupier remained unaltered even after the amendment.[80] There was a

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the purposes of this Chapter, until further notice cancelling his nomination is received by the Inspector or until he (ceases to be a director)".

[79] (1986) 2 S.C.C.325.

[80] The Factories Act, 1948, s.2 (n) reads, "occupier of a factory means the person who has ultimate control over the affairs of the factory provided that (i) in the case of a firm or other association of individuals any one of the individual partners or members thereof shall be deemed to be the occupier;

divergence of opinion between various High Courts with regard to the interpretation of the term 'occupier'. The main controversy was whether an occupier should necessarily be a director of the company. In some cases it had been held that a company which runs a factory can nominate a person other than a director of the company to be an occupier of the factory.[81] But in some others it had been held that only a director of the company can be nominated as the occupier of the factory.[82]

Finally the Supreme Court in *J.K.Industries Ltd.,* v. *C.I. of Factories and Boilers,*[83] held that only a director of the company can be nominated as the occupier of the factory for the purposes of the Act. Where the company fails to nominate one of its directors as the occupier of the factory, the Inspector of Factories will be at liberty to proceed against any one of the directors of the company, treating him as the deemed occupier of the factory. Making one of the directors of the company responsible for proper implementation of the provisions of the

(ii) in the case of a company, any one of the directors shall be deemed to be the occupier;

(iii) in the case of a factory owned or controlled by the Central Government or any State Government or any local authority, the person or persons appointed to manage the affairs of the factory of the Central Government, the State Government or the local authority, as the case may be, shall be deemed to be the occupier".

[81] *W.S.Industries Ltd. and another* v. *Inspector of Factories,* (1991)11 L.L.J.480 (Kar.); *Kirloskar Pneumatic Company Ltd.,* v. *A. More,*1992 (65) F.L.R.790 (Bom.); *Wimco Ltd. and others* v. *Union of India* , 1995 (70) F.L.R.429(Gau.); *ION Exchange India Ltd.,* v. *Deputy Chief Inspector of Factories,* 1995 L.L.R.756 (Mad.)

[82] *Bhatia Metal Containers Ltd.,* v. *The State of U.P.,* (1990)11 L.L.J. 534 (All.); *Jaipur Syntex Ltd.,* v. *State of Rajasthan,* 1991 L.L.R.380 (Raj.)

[83] 1996 (74) F.L.R.2608 (S.C.)

Act will ensure that various safety measures prescribed in the Act for the health, welfare and safety of the workers are not neglected. The Act provides adequate protection to "innocent" directors and enables the occupier or the manager of the factory to extricate himself from punishment by establishing that the actual offender is someone else. The director can escape liability by establishing that he had used due diligence to enforce the execution of the Act and that some other person had committed the offence without his knowledge, consent or connivance.[84]

It is not necessary that the occupier and manager should always be jointly prosecuted.[85] In some situations both the manager and the occupier may be responsible for the offence and both of them can be held guilty. Even if they are separately prosecuted, it shall not be open to the other to contend that the real culprit is already convicted or held responsible. In spite of fixing of the criminal responsibility on the manager, the prosecution is free to prosecute the occupier. The prosecution cannot be said to be bad merely because it is launched against the occupier or the manager alone.[86]

No prosecution shall lie against the directors of the company, if a person has duly been nominated to ensure compliance with the law.[87] In

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[84] The Factories Act, 1948, s.101.

[85] *State of Maharashtra* v. *V.S. Raghavan*, (1989)11 L.L.J.427 (Bom.)

[86] *Ibid.*

[87] *R. Banerje* v. *H.D.Dubey*, (1992) 2 Comp.L.J.195 (S.C.). In this case complaints were filed against the company, its director and other officers under Prevention of Food Adulteration Act, 1954. Question arose for determination whether it was permissible to launch prosecution against the directors notwithstanding the nomination made by the company.

State v. *I.K Nangia,* [88] the issue for consideration was whether apart from the nominated person, the sales manager can also be prosecuted for offence under the Food Adulteration Act, 1954. The Supreme Court held that not withstanding the nomination of a person as the person responsible, any director, manager, or other officer can be prosecuted if it is proved that the offence has been committed with the consent, connivance or neglect on the part of the officer. The Supreme Court held that if the nomination form nominating the persons concerned were received and acknowledged by the authority competent to receive and acknowledge the same, the proceedings against the directors are liable to be dropped.

Thus where an Act provides for nominating a person as the officer responsible for prosecution and punishment under the Act, he alone can be prosecuted for the offence. The ordinary directors cannot be held responsible for the same. This questions the very need for having the executive directors and a board of directors to monitor the activities of the company. The directors should not be absolved of all their responsibilities on the ground that an officer has been nominated to ensure compliance with law.

Chairman of Board of Directors

The chairman presides over the meetings of the board and at general meetings.[89] The chairman of the company can be prosecuted only if his

[88] A.I.R.1979 S.C.1977. In the instant case, the company had nominated Mr.Khan, the Quality Control Manager to be the person responsible under the Act. Hence he is the only person liable to be proceeded against. The prosecution of the respondents failed because the prosecution did not have a case that the offence was committed with the consent or connivance or neglect on the part of the sales manager.

[89] For a discussion on role of chairman, See Pramod S Shah, " Role and Function of Chairman under the Companies Act with Special reference to Case- Laws", (1983) 1 Comp.L.J.101(J).

role in the incriminating act is proved. In *G. A. Atherton &Co.(Pvt.)Ltd.* v. *Corporation of Calcutta,*[90] proceedings initiated against the chairman for manufacturing adulterated food was quashed because the prosecution failed to prove that he was in charge of the affairs of the company. The court held that the prosecution cannot be sustained unless the nexus of the accused with adulteration of the article is proved.

In *N.A.Palkivala* v. *Madhya Pradesh Pradushan Niwaran Mandal, Bhopal,*[91] the prosecution of the chairman and deputy chairman of a company was quashed on the ground that they are not persons directly in-charge of and responsible to the company for the conduct of its business. There was nothing on record to connect them directly with the business of the company. The facts of the case involved non-compliance of condition of permission granted to the general manager under the Air Act, 1981. There was nothing on record to point that the said violation was even remotely connected with any policy matter. Hence the prosecution of the petitioners for the alleged violation of the Act was held not in accordance with law.

The court distinguished *B.K. Bhargava* v. *State of M.P.,*[92] wherein the same court had refused to interfere with the prosecution of the chairman of company for selling the purchased oil seed in contravention of the provision of the Essential Commodities Act, 1976. It appeared that the store of oil seed was linked directly with the expansion of plant for which machineries were to be imported. This was taken to be a matter involving policy decision. The Court felt that the possibility of chairman being involved in it could not be ruled out. It therefore, refused to quash

[90] 1979 Cri.L.J.85 (Cal.).

[91] 1990 Cri.L.J.1856 (M.P.).

[92] Cr.Case No. 3172 of 1989 decided on 6-12-1989 as cited *id.,* p.1860.

the prosecution of the chairman of the company. Thus it follows that the chairman of a company can be prosecuted for an offence committed by the company provided the act in question is directly linked with a policy decision taken by the board of directors.

In *Herdilia Unimers Ltd* v. *Renu Jain,*[93] the Rajasthan High Court held that the chairman and vice-chairman cannot be held vicariously liable for the act of the company by virtue of the offices held by them. The chairman of the company was prosecuted for failure to issue share certificate. The question was whether the chairman can be prosecuted when there was a managing director and manager in charge of affairs of the company. The court observed that it is a question of fact as to whether the managing director or the whole time director exists so as to exclude the directors of the company from being considered as officer in default. The chairman can be held responsible as an 'officer in default' only if it is so proved that the company does not have a managing director or a manager.

Directors of the Company

Where no director is appointed as the compliance officer of the company, all the directors are liable as officers in default.[94] The doctrine of collective responsibility is applied to fasten liability on each and every member of the board of directors.

The Act provides an inclusive definition for the term "director".[95] A director includes any person occupying the position of director by whatever name called. The test which determines whether a person is a

[93] (1995) 4 Comp.L.J.45 (Raj.).

[94] The Companies Act, 1956, s. 5(g).

[95] *Id.*, s.2(13)

director or not, is one of function and not one of name. The designation given to the officer in the company is immaterial. If the person acts as a director he will be deemed to be a director. The role of an individual director in a company is a question of fact depending on the peculiar facts in each case. There is no universal rule which suggests that simply by being a director in a company, he is supposed to discharge particular functions on behalf of a company. It happens that a person may be a director in a company, but he may not know anything about the day-to-day functioning of the company. As a director he may be attending meetings of the board of directors of the company where usually they decide policy matters and guide the course of business of a company. The company may have some non-executive directors on its board. Non-executive directors have no connection with the running of business of the company except as a member of the board. Persons possessing knowledge, expertise and special skills are appointed as non executive directors in the hope that their name and status will add to the reputation of the company.[96]

The question remains whether it is proper to rope in all directors as officers in default for each and every default connected with the company. The circular issued by the Department of Company Affairs provides that where penal provisions of the Companies Act, 1956 provide for punishment of officers in default, prosecution is to be filed against managing director, whole-time director, manager, secretary and the company. Prosecution is to be initiated against the directors only when there is no other managerial personnel.[97]

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[96] E.I.Jacobs , "Non-Executive Director", 1987 J.B.L.269

[97] Circular No: 6/94F.No.3/41/93-CL-V dated 24th June 1994, For full text see (1994)3 Comp.L.J.191 (St.).

The courts of law have taken divergent views with respect to the issue of liability of members of the board of directors. Initially it was believed that it is the collective responsibility of the board to ensure compliance with the law.

In *Registrar of Companies* v. *Orissa Paper Industries Ltd.,* [98] the directors of the company were convicted for failing to file the balance sheet and profit and loss account before the registrar of companies. The Orissa High Court upheld the conviction and observed:

> "Punishment for omission to discharge a duty is provided in a statute not only to compel a person to perform his duty, but also as a warning to others similarly situated that in case of their neglect or omission, they would be liable to similar punishment. Directorship of a company is accepted by choice. When an individual has chosen to be a director, he knows the duties he is to perform. In case he tolerates the wrongs done by others with whom he is associated and does not discard such wrong doers, he invites the liability. It is no excuse to say that the wrong doers are not within his control. Persons entrusted with the duty to deal with the wrongs should be alert and should not look into those wrongs casually".[99]

In the later cases, the judiciary took a view that the members of the corporate board cannot be prosecuted unless it is proved that they were

[98] (1986) 2 Comp.L.J.213 (Ori.) Also see *Assistant Registrar of Companies* v. *Southern Machinery Works Ltd.,* (1986) 2 Comp.L.J. 196 (Mad.).

[99] *Id.,* p.216.

directly involved in the day-to-day affairs of the company.[100] The ordinary directors of the company will become officer-in-default only when the company does not have a managing director, whole time director or a manager.[101] An alternate director cannot be regarded as an officer -in -default.[102]

Direct involvement of any director, manager, secretary or other officer of a company in the commission of an offence can invite criminal liability. If it is proved that the offence has been committed with the consent or connivance or is attributable to any neglect on the part of any director, manager, secretary or other officer, then such director, manager, secretary shall also be liable to be proceeded against and punished accordingly. Thus apart from the person in charge of the company every

[100] *H.Nanjudiah* v. *ROC* (1997) Comp.L.J.214 (Bom.) The petitioner, a director of the company was prosecuted for making borrowings in excess of prescribed limits. He was neither the managing director nor a full time director nor a shareholder of the company. He was not concerned with the day to day management of the company. There was nothing to show that the petitioner had knowingly subscribed to the borrowings. The prosecution could not point out a single act to satisfy the fact that he had willfully authorized or permitted someone to borrow monies in excess of limits. Hence he was held not liable on the ground that Registrar of companies has not discharged the onus of proving that he was involved in the day today affairs of the company.

[101] *Vijay Kumar Gupta* v. *ROC*, 2003 C.L.C.277 (H.P.); *S.C. Bhatia* v. *P.C. Wadhwa*, (1995) 1 Comp.L.J.529 (P.&H.).

[102] *Atul B Munim* v. *R.O.C*, (2000) 102 Bom.L.R.288. The facts of the case were that prosecution was lodged against the director for non-refund of share application money. The petitioner was appointed as alternate director to Mr. F. Hartmann who himself was not a whole-time or Executive Director of the Company. The Bombay High Court quashed the proceedings against the alternate director on the ground that he cannot be considered as an officer in default.

other officer of the company can be made liable if the connivance or consent or neglect of such officer is proved.[103]

The proceedings initiated against the directors were held to be improper in *Municipal Corporation of Delhi* v. *Ram Kishan Rohtagi.*[104] The Supreme Court upheld the prosecution launched against the manager as proper and valid. But the proceedings against the directors were held improper. This case established the principle that persons not directly in charge of and responsible for the business of the company can be prosecuted for the offence committed by the company only if there is some material on record from which it could be reasonably inferred that they were in charge of and responsible for company's business.

In *State of Haryana* v. *Brij Lal Mittal*, [105] the Supreme Court quashed the proceedings initiated against the directors of the company for selling misbranded and adulterated drugs. Except a bold statement in the complaint that the respondents were directors, there was no allegation that they were in charge of the company and also responsible to the company for the conduct of its business. There was no allegation that the offence was committed with their consent, connivance or negligence. Director can be made vicariously liable if he was in charge of and was also responsible for the conduct of business of the company. The court

[103] *Municipal Corporation of Delhi* v. *Purushotam Dass Jhunjunwala,* A.I.R.1983 S.C.158. The Chairman, Managing director and other directors of Hindustan Sugar Mills Ltd were prosecuted manufacturing adulterated milk toffee. The averments in the complaint gave complete details of the role played by the Chairman, Managing Director and each of the directors. Hence the court upheld that the proceedings initiated against the respondents.

[104] A.I.R.1983 S.C.67.

[105] 1998 Cri. L.J.3287 (S.C.).

observed that being a director of the company does not mean that he fulfills both the above requirements so as to make him liable. Conversely without being a director a person can be in charge of and responsible to the company for the conduct of its business.[106] The onus is on the prosecution to prove that the director was in charge of the company for the conduct of its business.[107]

In *U.P. Pollution Control Board* v. *Mohan Meakins Ltd.,*[108] the company, its manager and directors were prosecuted for discharging noxious trade effluents into the river. It was clearly stated in the complaint that the chairman, managing director and directors of the company were the persons responsible for constructing the plant for treatment of trade effluents. The accused persons deliberately failed to abide by the provisions of the Water Act, 1974. In the light of factual averments in the complaint, the Supreme Court held that the directors and managing directors of the company were liable to be proceeded against according to law.

The above cases may be contrasted with the decision in *Col.B.S.Sarao* v. *Securities and Exchange Board of India.*[109] In this case criminal complaints were filed against several plantation companies for failing to refund the money deposited. The petitioners contended that the complaints were filed in a mechanical manner with bold allegations

[106] Also see *Secunderabad Health Care Ltd.,* v. *Secunderabad Hospitals (P) Ltd.,* (1999) 4 Comp.L.J.171 (A.P.); *Moosa Raza* v. *State of Gujarat,* (2009)3 G.L.R.2053.

[107] *Pannalal Sunderlal Choksi,* v. *State of Maharashtra,* 2000 Cri.L.J.4442 (Bom.)

[108] (2000) 3 Comp.L.J.408 (S.C.).

[109] (2008) 3 Comp.L.J.242 (Del).

against all directors of the company. It was argued that no precise role had been assigned to directors arraigned as co-accused in the offence. The allegations in the complaint were that the accused were the directors of the company and were in charge of the affairs of the company when the two dishonoured cheques were issued by the company. The Delhi High Court held that nothing further is required to be averred at that stage and declined to quash the criminal proceedings.

Thus criminal liability cannot be saddled merely by virtue of the position held by a person as the director of the company. It is the active participation in the affairs of the company which is the determining factor. It cannot be assumed that because of their office, the directors were in charge of and responsible for the conduct of business of the company.

As the position stands today it is now open for the directors to plead not guilty by merely stating that they were not in charge of the day today affairs of the company. If directors who are responsible for the management of the company make no attempt to see that the duties are carried out, there is no justification for not holding them liable for the same. Where an offence is obvious, the very participation in the decision making process is enough to establish culpability. Non-attendance from board meeting shall never be a ground for exempting directors from the liability of exceeding fixed deposit limits.[110] The relevant provisions of the Act have been enacted to protect the general public and they impose definite duties on the directors. When the directors fail to perform their statutory duty, they bring themselves within the mischief of the penal provisions.

[110] Dileep Goswami, "Directors Liability for Exceeding Fixed Deposit Limits- Can Non-attendance from Board Meeting be an Excuse?", (1987)1Comp.L.J.186 (J).

Other Categories of Directors in Vogue

Apart from managing directors, whole-time directors and shadow directors included in the definition of officer in default under the Act, there exists some other categories of directors which include the following:

Nominee Directors

Nominee directors are appointed to represent somebody, generally a large shareholder or creditor. Nominee directors have the same legal duties, obligations and liabilities of the other directors. Nominee directors may be appointed by financial institutions which grant loans to companies.[111] The articles of association may provide that every shareholder of a particular value of shares shall have right to nominate a director on the board. Lending institutions insist on appointing nominees for protecting their interest. The nominee director is expected to provide adequate feedback to the financial institutions on the affairs and operation of the company.

The question is whether nominee directors are to be treated on par with other directors of the company for the purpose of imposing penal liability for offences committed by companies. The Negotiable Instruments Act, 1881 exempts nominee directors from prosecution for

[111] B.B. Virmani, "Role of a Nominee Director; Some Reflections" 1990 *Chartered Secretary* 170. Almost all financial institutions like L.I.C., G.I.C., I.D.B.I., I.F.C.I., while granting finance to companies stipulate appointment of their nominees as directors on the board of such companies. The appointment, functions and duties of the nominee directors are governed by the respective Acts relating to different financial institutions such as LIC, IDBI and GIC. Nominee directors are not subject to the control by the shareholders.

dishonour of cheques.[112] Nominee directors are not entitled to immunity from prosecution. The onus is on the prosecution to prove that the nominee director was actually in charge of the affairs of the company.[113] If it is proved that the nominee director is a party to the offence he can be punished.

In *Re Beejay Engineers Pvt. Ltd.*,[114] the Delhi High Court held that no distinction can be drawn amongst the directors on the consideration that a person is on the board purely by virtue of his technical skill or because he represents certain special interests and there are other directors who are in effective control of the management of the affairs of the company. The court dissented from the earlier decision in *Om Prakash Khaitan* v. *Shree Keshariya Investments Ltd.*,[115] wherein H.L. Anand J. observed that a distinction has to be made between the directors who are on the board by virtue of the technical skill and those who are in effective control of the management affairs of company.

Whether a person is a solicitor, an advocate or a businessman, he is obliged to comply with the law as long as he is a director of a company. The circumstance of a person being on the board on account of his

[112] Proviso to the Section 141(1) brought in by the Negotiable Instruments (Amendment & Miscellaneous Provisions) Act, 2002.

[113] K R Chandratre, "Nominee Directors Liability for Company Offences", (1989)3 Comp.L.J.52 (J).

[114] (1983) 53 Com.Cas.918 (Del.).

[115] (1978) 48 Com.Cas.85 (Del). The petitioner, a solicitor by profession was appointed as director of the company by virtue of his being a legal adviser of the company. He was exonerated from liability on account of the fact that he was only a nominee director.

special skill or expertise shall not be a ground for exonerating such a director from liability.[116]

In *Geethanjali Mills Ltd.,* v. *Thiru Vengadathan,*[117] prosecution was launched against the company and its nominee director for certain offences under the Indian Penal Code, 1860 for obtaining concessions under the Income-tax Act, 1961 on the strength of bogus vouchers. The Madras High Court held that immunity from prosecution in case of nominee director is a matter of evidence. The court observed that whether the accused was in charge of and responsible to the company for the conduct of its business is to be decided on the basis of evidence adduced. Hence the court refused to grant immunity from prosecution. The court rejected the argument that the nominee directors are mere figure heads who do not participate or take any active part in the control of the company.

But in *J.P Jhalani* v. *Regional Provident Fund Commissioner,*[118] the nominee directors were granted relief from prosecution for non-deposit of statutory dues under the Employees Provident Fund Act, 1952 on the ground that they were not responsible for the conduct of the affairs of the company.

A circular issued by the Ministry of Corporate Affairs directs Registrar of Companies not the prosecute nominee directors for any act or omission by the company which occurred without his knowledge

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[116] Dr. V Gauri Shankar,"Laibilities of Officers and Directors of Companies", (1986)3 Comp.L.J.127(J).

[117] (1989) 1 Comp.L.J.232 (Mad.).

[118] (1987) 2 Comp.L.J.151 (Del.) Also see *S K Sharma* v. *A K Mahajan,* [2005]126 Com.Cas.222 (P&H). *Skyline Aquatech Exports Ltd.,* v. *Sachima Agro Industries Pvt. Ltd.,* 2008(2) Bom.C.R.267.

attributable through board process and without his consent or connivance or where he has acted diligently in the board process.[119] It also directs the registrar of companies to verify certain compliances before taking penal action against such directors.[120]

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[119] General Circular No.2/13/2003/CL dated No:8/2011 issued by Government of India, Ministry of Corporate Affairs to all Regional Directors, Registrars of Companies and Official Liquidators. It provides: "No such Directors as indicated above shall be held liable for any act of omission or commission by the company or by any officers of the company which constitute a breach or violation of any provision of the Companies Act, 1956, and which occurred without his knowledge attributable through Board process and without his consent or connivance or where he has acted diligently in the Board process.

The Board process includes meeting of any committee of the Board and any information which the Director was authorised to receive as Director of the Board as per the decision of the Board".

[120] *Id*., "It is further clarified that before taking penal action under the Companies Act, 1956 against the Directors the following compliances should be verified by Registrar of Companies: -

(a) A director resigns and the company does not file Form 32 as required in terms of Section 302(2) of the Act. In case, the director concerned has informed/endorsed a copy of his resignation to the Registrar of Companies, the Registrar should enquire into such cases and try to find out whether such director has actually resigned or not.

(b) In case the status of a director, i.e. whether he is a nominee director or not, is not reflected in the Annual Return or other documents of the company, available with Registrar, the same should be cross checked with the Annual Report filed by the company;

(c) The timing of the commission of offence is also material to identify the director's responsibility; and Form 1AB should also be checked in case any person has been charged by the Board under Section 5(f) with the responsibility of complying with some particular provision or in case any director has been specified by the Board under Section 5(g) of the Act.

(d) Special Directors appointed by BIFR under section 16 (6)(b) of SICA 1985, shall not incur any obligation or liability for anything done or omitted to be done in good faith and in discharge of duties. Hence they shall be excluded in the list of officers in default".

Independent Directors

Independent directors are perceived as an essential part of the corporate governance reforms introduced worldwide. It is contemplated that directors who are independent of the management would serve as an effective check on the management.[121] The Cadbury committee report stressed the need for board independence in promoting good governance.[122] In India also there has been many committee reports recommending inclusion of independent directors on corporate boards.[123]

The concept of independent director has been implemented in India through clause 49 of the listing agreement.[124] The expression 'independent directors' means directors who apart from receiving director's remuneration, do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in judgment of the board may affect independence of judgment of the directors.[125]

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[121] Victor Brudney, "The Independent Director-Heavenly City or Potemkin Village?", 95 Harv.L.R.597 (1982).

[122] The Report of the Committee on the Financial Aspects of Corporate Governance,1992 (U.K.). For text see (1997) 3 Comp.L.J.58 (J).

[123] The Narayanamurthy Committee (2003), the Naresh Chandra Committee (2002), the Kumaramangalam Birla Committee (1999) and the Irani Committee (2004).

[124] See (2004)4 Comp.L.J.88 (St.) The listing agreement provides that at least 50 percent of the board of directors should comprise of independent non-executive directors in case the chairman of the company is an executive director. If the chairman is a non-executive director, one third of the board shall be independent non-executive directors. It also provides that the audit committee shall consist of a majority of independent members.

[125] *Ibid*.

The *Satyam* episode has raised questions regarding the role of independent directors. None of the independent directors raised serious objections to the *Maytas* acquisition proposal which was a related party transaction. Mr. Ramalinga Raju, the chairman of the company, confessed to have falsified the financial statements of the company. Satyam's independent directors could neither prevent nor detect the falsification of financial statements. It is yet to be seen whether any prosecutions would be launched against the independent directors of the company for their failure to properly monitor the management.

Since the concept is of recent origin one may have to wait and watch how the courts would decide on the issue of liability of independent directors. The 2011 circular issued by the Ministry of Corporate Affairs provides that independent director shall not be held liable for any act of omission or commission by the company which occurred without his knowledge attributable through board process and without his consent or connivance or where he has acted diligently in the board process.[126]

It is suggested that the imposition of responsibility should be proportionate to the power exercised by the director and a non executive director has to be considered differently for the purpose of imposing criminal liability.[127] The power and authority held by independent directors should be considered while fixing criminal liability. It is apprehended that the uncertainity surrounding liability of independent directors may prevent some good people from accepting the position.[128]

[126] *Supra* n.122.

[127] Notes , "In Defence of Non-Managing Directors", 5 U.Chi.L.R.668 (1938)

[128] Arvind Lakhawat, "Ensuring Quality of Independent Directors", (2007) 1Comp.L.J.31 (J).

Liability of Managing Director of Parent Company for Offence Committed by its Subsidiary Unit

The parent company is liable for the offences committed by its subsidiary company. Similarly the managing director of the parent company is liable to be punished for offences committed by the industrial units of the parent company. This view was upheld by the Supreme Court in *U.P. Pollution Control Board* v. *M/s. Modi Distilleries.*[129] The facts of the case were that M/s. Modi Distilleries, a unit of M/s. Modi Industries Limited, was engaged in the business of manufacture and sale of industrial alcohol. This unit had discharged its highly noxious and polluted trade effluents into the Kali river. The Pollution Control Board filed a complaint against the M/s. Modi Distilleries and its officers. The parent company was not made an accused. The Allahabad High Court quashed the proceedings on the ground that office bearers of the subsidiary company could not be made vicariously liable without prosecuting the parent company. On appeal, the Supreme Court observed that the legal infirmity of not charging the parent company could be easily cured. This infirmity had been brought about by the failure of the industrial unit M/s. Modi Distilleries to furnish the requisite information called for by the Pollution Control Board, and in view of the seriousness of the offence, the offence should not go unpunished on a slight technicality. The Supreme Court suggested that a formal application for amendment be made before the trial court to substitute the name of the parent company.

[129] 1988 Cri. L.J.1112 (S.C.)

A similar view was taken by the Madras High Court in *M.V. Arunachalam* v. *Tamil Nadu Pollution Control Board.*[130]

Senior Officers of the Company

There have been some legislative attempts to expand the concept of officer-in-default. The Companies (Amendment) Bill, 1997, the Companies Bill, 2003 and the Companies Bill, 2009 proposes inclusion of senior officers of the company in the definition of officer-in-default.

The Companies Bill, 1997 proposed to enlarge the definition of 'officer in default'.[131] The bill sought to include chief accounts officer, the auditor, the share transfer agents, bankers to the issue, registrars to the issue, merchant bankers and debenture trustees within the definition of officer in default. The new provision was contemplated to cover defaults which occur in the course of issue and transfer of securities. It was widely criticized that the enlargement of the definition was unwise.[132] With the increase in securities fraud, it was felt that criminal penalties should be provided for various intermediaries involved in securities transactions.

The Companies Bill, 2003 proposed to include non-executive directors as officer-in-default on condition that such officer gives his consent to or connived in the commission of the default or if it is committed as a result of his negligence.[133] The chief accounts officer is

[130] 1992 Cri.L.J.188 (Mad.)

[131] (1997) 3 Comp. L.J.49 (St).

[132] R. Santhanam, "Unwise Enlargement of Definition of Officer-in-Default", (1998)1 Comp.L.J.1 (J).

[133] The Companies (Amendment) Bill, 2003,cl.(ba)

another officer proposed to be included in the definition of officer-in-default.[134] The bill proposed to rope in every employee who is in receipt of remuneration more than the managing director or whole-time director and who himself or along with his spouse and dependent children holds not less than 2% of the equity share capital of the company as an officer-in-default.[135] The intention seems to be to bring those having real control over the company as officer-in-default.[136] The proposed amendment also sought to include "banker" as officer in default. Banks lend money to companies or handle accounts of the companies in which case the banker acts as agent of the company. The rationale is that the banker would have knowledge regarding the legal compliance of various provisions of the Act. If no steps are taken to ensure compliance with the provisions, the bankers would be made liable for the same. Share transfer agents, bankers, registrars, merchant bankers in respect of issue and transfer of securities are also sought to be included.[137] The provision aims at checking frauds and malpractices committed by capital market intermediaries involved in issue and transfer of securities.[138] Debenture trustees are another category of persons proposed to be included in the definition.[139]

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[134] *Id.*, cl.(bb)

[135] *Id.*, cl.(bc)

[136] Dr K.R.Chandratre, "Critical Comments on the Companies (Amendment) Bill, 2003", 2003 *Chartered Secretary* 997 at p.999.

[137] The Companies (Amendment) Bill, 2003,cl. (bd)

[138] *Supra* n.136.

[139] *Id.*, cl.(be)

The Companies Bill, 2009 provides a new definition for officer- in-default.[140] The bill introduced the concept of key managerial personnel.[141] The term key managerial personnel include the managing director, whole-time director, manager, chief executive officer, the chief financial officer and the company secretary.[142] Every company belonging

[140] The Companies Bill, 2009, cl.2(1)(zzi) reads, "officer who is in default", for the purpose of any provision in this Act which enacts that an officer of the company who is in default shall be liable to any penalty or punishment by way of imprisonment, fine or otherwise, means all or any of the following officers of a company, namely :-

(i) whole-time director or directors;

(ii) other key managerial personnel;

(iii) where there is no key managerial personnel such director or directors as specified by the Board in this behalf and who has or have given his or their consent in writing to the Board to such specification, or all the directors, if no director is so specified;

(iv) any person who, under the immediate authority of the Board or any key managerial personnel, is charged with any responsibility including maintenance, filing or distribution of accounts or records, authorises, actively participates in, knowingly permits, or knowingly fails to take active steps to prevent, any default;

(v) any person in accordance with whose advice, directions or instructions the Board of Directors of the company is accustomed to act other than a person who gives advice to the Board in a professional capacity;

(vi) every director, in respect of a contravention of any of the provisions of this Act, who is aware of such contravention by virtue of the receipt by him of any proceedings of the Board or participation in such proceedings without objecting to the same, or where such contravention had taken place with his consent or connivance;

(vii) in respect of the issue or transfer of any shares of a company, the share transfer agents, bankers, registrars and merchant bankers to the issue or transfer."

[141] Hereinafter referred as KMP.

[142] The Companies Bill, 2009, cl.2 (*zza*) "key managerial personnel", in relation to a company, means

to such class or description of company as may be prescribed by the Central Government shall have a whole time KMP.[143] The Bill has seeks to advance the concept of professionalisation of corporate managements.[144] It defines chief executive officer as an officer of a company, who has been designated as such by it.[145] Chief financial officer is defined as a person appointed as the chief Financial officer of a company.[146]

(i) the Managing Director, the Chief Executive Officer or the Manager and where there is no Managing Director or Manager, a whole-time director or directors;

(ii) the Company Secretary; and

(iii) the Chief Financial Officer".

[143] *Id.*, cl.178 reads,

(1) "Every company belonging to such class or description of companies as may be prescribed shall have whole-time key managerial personnel.

(2) Every whole-time key managerial personnel of a company shall be appointed by means of a resolution of the Board containing the terms and conditions of the appointment including the remuneration.

(3) A whole-time key managerial personnel shall not hold office in more than one company at the same time:

Provided that nothing contained in this sub-section shall disentitle a key managerial personnel from being a director of any company with the permission of the company.

(4) If the office of any key managerial personnel is vacated, the resulting vacancy shall be filled up by the Board at a meeting of the Board within a period of six months from the date of such vacancy.

(5) Where a company fails to comply with any of the provisions of this section, it shall be liable to a penalty of one lakh rupees and every director and key managerial personnel who is in default shall be liable to a penalty of twenty-five thousand rupees, for each such default."

[144] V.Gopalan, "The Companies Bill, 2009: An Appraisal of some Important Proposals", (2009)3 Comp.L.J.193 (J).

[145] The Companies Bill, 2009, cl. 2(1)(r).

[146] *Id.*, cl.2(1)(s).

A notable feature of the bill is that every director, who is aware of any contravention , default or non-compliance with any of the provisions of the Act, by virtue of the receipt by him of any proceedings of the board or participation in such proceedings can be held liable as officer-in-default.[147] This would be a remarkable step in accomplishing accountability of directors of the company. Thus it would no longer be a defence for the ordinary directors to plead that they were not party to the day today working of the company. It would induce the ordinary directors to properly monitor the affairs of the company. Any person who, under the immediate authority of the board or any key managerial personnel, is charged with any responsibility including maintenance, filing or distribution of accounts or records, authorises, actively participates in, knowingly permits, or knowingly fails to take active steps to prevent, any default is also liable for punishment. Thus for the first time the legislature has come up with a clear provision penalizing failure to take active steps to prevent any default. In respect of the issue or transfer of any shares of a company, the share transfer agents, bankers, registrars and merchant bankers to the issue or transfer are also liable as officer-in-default. Most of the securities fraud and malpractises in capital market are committed with the active participation and connivance of the capital market intermediaries. So it is a welcome step that they are also brought within the definition of officer-in-default.

The 2009 bill has lapsed and is replaced by the 2011 bill wherein the term officer-in-default has been defined in the same words as in the 2009 bill.[148] It is hoped that the bill would soon be passed by the legislature and the term 'officer-in-default' would be accepted in its present terms.

[147] *Supra* n.140.

[148] The Companies Bill, 2011, cl.2 (60).

Conclusion

The statutory scheme for attribution of criminal responsibility seeks to fasten criminal liability on officers specified in the Companies Act, 1956 by designation. Inspite of the amendments carried out so far, the attribution of criminal responsibility continues to be a complicated task. A clear regime for attribution of responsibility is required. Offences are increasing day by day and officers are escaping liability on one ground or the other. We can find many instances where the executive directors of the company have escaped liability even when gross violations had taken place. At the end of the day, no responsibility is cast on the board of directors also. This points us to the question of the propriety and necessity of appointing a board of directors to oversee and monitor the corporate managers and other officers. If the board of directors fails to monitor the corporate executives, ultimately leading to perpetration of fraud or embezzlement of corporate funds, the members of the board of directors should be held accountable for it. It will not be justified to fasten the same liability on the corporate manager and ordinary directors of the company. It is equally not justified to give total immunity to ordinary directors of the company. Directors cannot delegate their authority and transfer the responsibilities totally. It is their duty not to be passive spectators. They should be aware of what is going on and make all attempts to see that statutory requirements are carried out and complied with.

Even in cases where there has been no consent or connivance on the part of the directors, some liability should be fixed on them for failing to properly monitor the affairs of the company. When offences are committed, it is necessary to ascertain whether it occurred on account of wrong policy or on account of improper implementation of the policy. If

the policy is wrong, the decision maker has to be made responsible. Directors who have been found guilty of defective supervision or management of the corporate body should be made accountable. The outcome of reckless management and supervision might be a crime. Giving instruction to take preventive or corrective measures shall not be a ground for exonerating directors from criminal liability. He has to take necessary follow up actions. There should be well established system for feedback communication.

A notable feature of the 2011 bill is that every director, who is aware of contravention of any of the provisions of this Act, by virtue of the receipt by him of any proceedings of the board or participation in such proceedings without objecting to the same can be held liable as officer-in-default. This would be a bold attempt in accomplishing accountability of directors of the company. Thus it would no longer be a defence for the ordinary directors to plead that they were not party to the day today working of the company. It would induce the ordinary directors to properly monitor and supervise the corporate managers.

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Chapter 5

INVESTOR PROTECTION THROUGH DISCLOSURE REGULATIONS: ROLE OF CRIMINAL SANCTIONS

Nowadays the legal system widely employs disclosure regulations to ensure accountability of corporate managers. Investor protection demands that the potential investor be provided with all information necessary for making proper assessment of the risks and benefits of the proposed investment. Adequacy of disclosure is the cornerstone of a healthy capital market. Disclosure regulations aim at providing equal access to a minimal level of information. Law facilitates disclosure both at the time of initial issue of shares and thereafter. The continuous flow of information is necessary to ensure transparency in the capital market. Disclosure regulations can be meaningful only if they are effectively enforced. Effective enforcement of disclosure regulation requires prosecution and punishment of persons responsible for non-disclosure and noncompliance with disclosure norms.

Disclosure norms regulate the manner in which disclosure is made and the contents of the disclosure. It imposes a positive duty on corporate officers to disclose information and prohibits use of false statements. Disclosure is facilitated through different means such as issue of prospectus, circulation of reports and maintenance of registers. The emphasis is on providing meaningful and comprehensible information to the investors. Investors, creditors, consumers, workers, financial analysts and regulators need corporate information for different purposes. The information disclosed should be adequate to satisfy the

needs of various stakeholders. There had been many instances in India where the public lost their money by subscribing shares on the faith of misleading statements and false representations made in prospectus and financial documents of the company. In this context it is necessary to examine how far criminal liability is used to ensure compliance with disclosure norms. It is also necessary to examine the significance of disclosure regulations and its limitations in assisting the investors to make an informed decision. A comparative analysis of the mandatory disclosure rules of various countries is made to examine whether entity liability or individual liability is fixed for violation of disclosure rules.

Significance of Disclosure Regulations

The significance of the role of disclosure norms in ensuring accountability and transparency in corporate governance was emphasised by various committees appointed for improving corporate governance.[1] The value of disclosure has been expressed by Justice Brandeis of the U.S. Supreme Court in the following words:

> "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectant; electric light the most efficient policeman." [2]

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[1] See the Adrian Cadbury Committee on Financial Aspects of Corporate Governance, U.K., (1992); the Hampel Committee on Corporate Governance, U.K., (1998); the Naresh Chandra Committee on Corporate Audit and Governance (2002); the Narayanmurthy Committee on Corporate Governance (2003) and the Malegam Committee Report on Disclosure Requirements in Offer Documents (1995).

[2] Louis D. Brandeis, *Other People's Money and How the Bankers Use It* (1971), p.92 as cited in Paredes, "Blinded by the Light: Information Overload and its Consequences for Securities Regulation", 81 *Washington University Law Quarterly* 417(2003).

Disclosure based approach is based on the caveat emptor philosophy which implies that the investor has to make his own judgment and make investment decisions on the basis of the information disclosed. [3] The disclosure must be accurate, complete, timely and not misleading. [4]

Disclosure regulation enables investors and creditors to make rational and informed investment decisions. If the prospective investors have access to adequate and reliable information, they would have more confidence in the securities market and the number of investors would increase. The disclosure regulations give substance to the shareholder rights by providing the information essential to their exercise.[5] It also contributes to the fairness and efficiency of the financial market.[6] Disclosure norms eliminate the information advantage that insiders enjoy over outsiders in financial markets. It reduces the risks of insider trading.[7] Disclosure requirements induce managers to manage better and thereby improve corporate governance.[8] It helps in evaluating the management in its stewardship function. It assists shareholders in effectively exercising their voting franchise and enforcing management's

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3 Hans Tijo, "Enforcing Corporate Disclosure", 2009 *Singapore Journal of Legal Studies* 332 at p.337.

4 Zandstra, *et.al*, "Widening the Net: Accessorial liability for Continuous Disclosure Contraventions", 22 *Australian Journal of Corporate Law* 51(2008).

5 Lowenstein, "Financial Transparency and Corporate Governance: You Manage What You Measure", 96 Colum.L.R.1335 (1996).

6 *Ibid.*

7 Goshen & Parchomovsky, "The Essential Role of Securities Regulation", 55 Duke L.J.710 at p.738 (2006).

8 Elliott J. Weiss and Donald E. Schwartz, "Using Disclosure to Activate the Board of Directors", 41 L.Contem. Prob.63 (1977).

fiduciary duties[9]. Managerial behaviour can be greatly influenced by requiring it to be disclosed. In European countries disclosure rules were introduced as an alternative to governmental regulation of corporate sector.[10]

Disclosure norms help to address the agency problem that arises between the corporate managers and shareholders by reducing the cost of monitoring the manager's use of corporate assets for self profiteering purposes.[11] Diversion of corporate resources by controlling shareholders is a widespread phenomenon.[12] Disclosure regulations help to monitor tunneling of corporate assets by the controlling shareholders.[13] Disclosure deters undesirable conduct and facilitates the detection and prosecution of corporate frauds.[14] Mandatory disclosure prevents fraud by corporate issuers in the initial sale and subsequent sale of securities. Corporate disclosure reduces excessive speculation and gambling in the

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9 Fox, "Civil liability and Mandatory Disclosure", 109 Colum.L.R.239 at p.254 (2009).

10 Christian J. Meier-Schatz, "Disclosure Rules in the U.S., Germany and Switzerland", 34 *The American Journal of Comparative Law* 271 (1986).

11 Paul G.Mahoney, "Mandatory Disclosure as a Solution to Agency Problems", 62 U.Chi.L.R.1047 at p.1048 (1986).

12 Betrand, Mehta, and Mullainathan, "Ferreting out Tunnelling: An Application to Indian Business Groups", 47 *Quarterly Journal of Economics* 121 (2002).

13 'Tunnelling' refers to the transfer of corporate assets to the controlling shareholders through different means. See Johnson, *et. al.*, "Tunneling", 90 *American Economic Review* 22 (2000).

14 Cynthia A. Williams, "The Securities and Exchange Commission and Corporate Social Transparency", 112 Harv. L.R.1197 (1999); Paula J. Dalley, "The Use and Misuse of Disclosure as a Regulatory System", 34 Florida State Uni.L.R.1088 at p.1099 (2007). The irregularities at Enron were first detected by analysts and journalists relying on publicly disclosed information.

securities market.[15] Increased availability of information leads to better pricing of securities and promote efficient allocation of capital.[16] It promotes market efficiency by ensuring that the price of securities reflects the underlying value of the securities.[17] Better corporate transparency would facilitate investment flows and mobilize financial resources for economic development.

Disclosure increases secondary market liquidity.[18] Unequal possession of information would help better informed investors to reap unfair profits from trading. Disclosure duties reduce costs for searching and gathering information.[19] In the absence of mandatory disclosure duties investors would have to spent much time and money in uncovering non public information. Disclosure of financial data of peer firms allows investors to measure and monitor relative performance of their company. Mandatory disclosure can force companies to disclose such matters which they would definitely refuse to disclose voluntarily. Mandatory disclosure of the defaults committed by the company enables the potential investors to get an idea about the company's compliance with laws and regulations.[20]

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[15] Surendra S.Singhvi and Harsha B.Desai, "An Empirical Analysis of the Quality of Corporate Financial Disclosure", 46 *The Accounting Review* 129 (2007).

[16] Merrit B Fox, "Required Disclosure and Corporate Governance", 62 L.Contem. Probs.113 at p.123 (1999).

[17] *Ibid.*

[18] *Supra* n.9 at p.264.

[19] *Supra* n.7 at p.739.

[20] The Companies Act, 1956, s.58 AA (5) provides that a company which has defaulted in the repayment of a deposit from small investor shall disclose the same in every future advertisement and application form inviting deposits from the public. Nondisclosure of the failure to repay deposits is punishable with imprisonment upto three years.

Disclosure based regulation gained popularity in the 1980's.[21] It is considered as a soft form of regulation because it avoids direct governmental interference. The disclosure requirements mandated under law varies among countries depending on the governance structure of the company. Mandatory disclosure requirements play a significant role in countries where the companies have concentrated ownership structures.[22] Controlling shareholders prefer less transparency to protect their benefits of control. Mandatory disclosure regime reduces the level of diversion of corporate resources by controlling shareholders. Even in the United States where voting power of shareholders is more dispersed, the optimal level of disclosure required is higher than that required in UK.[23] A number of countries have adopted and strengthened mandatory disclosure requirements for their companies.

In India also a dramatic change in the attitude of government towards controlling corporate activities became evident in the late twentieth century. Disclosure norms have got much significance in an era of liberalization. The government has lifted many of the prohibitions and restrictions on corporate activities. Administrative regulations are being substituted with disclosure regulations. Investor protection is mainly ensured through disclosure regulations.[24] The SEBI buyback regulations

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[21] Paula J Dalley, "The Use and Misuse of Disclosure as a Regulatory System", 34 Florida State Uni.L.R.1089 at p.1093 (2007).

[22] Allen Ferrell, "The Case for Mandatory Disclosure in Securities Regulation Around the World**",** Harvard Law School, John M.Olin Center for Law, Economics and Business Discussion Paper Series, Discussion Paper No. 492/200. Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=631221

[23] *Supra* n.16 at p.127.

[24] For the protection of investors interest SEBI has come up with a number of regulations wherein disclosure regulations are used as the primary tool to control corporate

and takeover regulations mandate disclosure of all relevant information to enable investors to make a rational choice.

Limitations of Disclosure Regulations

Along with the perceived benefits, mandatory disclosure regime has got its own drawbacks. Sufficient costs are involved in publishing quality information. Malegam committee on disclosure stressed the need to strike a balance between the benefits which disclosure provides and the cost to be incurred in providing that disclosure.[25] Excessive disclosure can be counter-productive as too much information may make the document unreadable and relevant information may get submerged in a mass of relatively unimportant information.[26] The report submitted by SEBI sub committee on integrated disclosures emphasized the need to make disclosures meaningful, non-duplicative and non-burdensome.[27] All disclosures must pass the test of relevance and non-duplication. Duplication of disclosures would lead to wastage of time by companies which complain of being over-burdened with filing of huge amount of information to multiple organizations. It would increase the risk of potential technical violations.[28] It has been suggested that continuous

activities. For eg: The SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 prescribes the do's and don'ts during public offers.

[25] The Malegam Committee Report on Disclosure Requirements in Offer Documents, 2005 (India).

[26] *Ibid.*

[27] The Report of the Sub-Committee on Integrated Disclosures, Securities and Exchange Board of India (2008), para 2.1.

[28] *Id.*, para 2.2.

disclosure norms should provide only for disclosure of transaction based information so as to avoid duplicative disclosures.[29]

A number of scholars have argued that disclosure norms are unnecessary as market forces will generally ensure that firms disclose the optimal level of information.[30] The argument is that the company will voluntarily disclose the information necessary for the investors to evaluate the company and its securities.

It is also argued that disclosure regulations are no substitute for substantive regulation. Disclosure can be useful only if its recipients can process and understand the disclosed information.[31] It is an accepted fact that most of the offer documents go unread.[32] This can be attributed to the complexity of the information and lack of expertise in comprehending the intricate aspects of the disclosures made. Investors are overloaded with information and they do not use the information disclosed effectively due to limited cognitive abilities.[33] The enterprise has to incur sufficient expenditure to create, compile and publish the information.[34]

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[29] Milton H.Cohen, "Truth in Securities Revisited", 79 Harv.L.R.1340 at p.1351 (1966).

[30] Roberta Romano, "Empowering Investors: A Market Approach to Securities Regulation", 107 Yale L.J.2359 (1998); Paredes, "Blinded by the Light: Information Overload and its Consequences for Securities Regulation", 81 *Washington University Law Quarterly* 417(2003).

[31] *Supra* n. 21 at p.1104.

[32] See Note, "Fraud on the Market Theory", 95 Harv.L.R.1143 (1982)

[33] *Supra* n.30.

[34] *Supra* n.5 at p. 1356.

Methods for Disseminating Corporate Information

Disclosure of information is achieved through different ways. Registration at the registrar's office, compulsory maintenance of registers by company, publication of annual reports, half yearly reports, director's report, auditor's report are the various means through which information is disseminated to the public. Disclosures can broadly be classified into financial disclosures and non-financial disclosures. Financial disclosure gives the financial and operating results of the company and the current state of affairs of the company. Financial disclosures report on the trading performance of the enterprise. On the other hand non-financial disclosures include information regarding the objectives of the company, shareholder rights, ownership structure, transactions involving significant assets, composition of the board, remuneration payable to the directors and managers, risk factors and policies and future plans of the company. Non-financial disclosures give a picture of the governance structure and governance practices of the company. All registered companies are obliged to file information about the company's constitution, the officers of the company, the address of the registered office, the source of capital, charges on the company and all important matters pertaining to the company.

The Companies Act, 1956 mandates dissemination of information at various stages of corporate life. Incorporation of the company, appointment of directors, public issue of shares, reduction of capital, buyback of shares, takeovers and mergers are the main phases in the lifespan of a company. The law mandates disclosure of information at each of these phases. A listed company in India is required to comply with the disclosure norms under the Companies Act, 1956, the SEBI

regulations and the listing agreement with stock exchanges[35]. Failure to comply with the disclosure requirements is penalised. With the advent of MCA -21, manipulation of documents filed with registrar of companies and ante-dating of documents is not possible.[36] Maintenance of digitalized database of companies and e-filing of forms has made investigation and prosecution easier. The enforcement officers would get all information at the click of a button. The Directors Identification Number[37] is a new feature introduced under the project. DIN is to be quoted at all places in e-forms where reference to the director is required.

Violation of Disclosure Regulations: Use of Criminal Sanctions

Disclosure regulations cannot be effective unless there is a mechanism to enforce compliance with the requirements. The violation of the disclosure rule should be considered as a serious offence and not as mere administrative wrong because the cumulative effect of these

[35] The listing agreement is identical for all Indian Stock Exchanges. Clause 49 of the listing agreement requires corporate disclosures of related-party transactions, disclosure of accounting treatment, contingent liabilities and risks involved, risk management procedures, proceeds from various kinds of share issues, remuneration of directors, a management discussion and analysis section in the annual report discussing general business conditions. It requires listed companies to submit a quarterly compliance report in the prescribed format to the stock exchanges. The companies have been put under an obligation to publish their compensation philosophy and statement of compensation paid to non-executive directors in its annual report. The company is also required to disclose details of shares held by non-executive directors. It requires all compensation paid to non-executive directors to be fixed by the board of directors and to be approved by shareholders in general meeting.

[36] Pavam Kumar Vijay, "MCA-21: Arrival of a New Era of Indian Corporate World", 3 Exe.Ch.Sec.285 at p.286 (2006). MCA-21 project was implemented to ensure digital and paperless working of Ministry of Corporate Affairs. It provides for online registration of companies, filing or forms, and reporting of financial returns.

[37] Hereinafter referred as DIN.

violations can be disastrous and may ultimately come out in the form of corporate scandals.[38]

Civil liability is one method of enforcing compliance with disclosure requirements. Civil remedies are more compensatory in nature. The deterrence goal can be achieved only by imposing criminal sanctions for non disclosure and fraudulent misstatements. Actions against issuers by regulatory agencies have more deterrence effect than actions by individual investors against issuers for compensation.[39] There should always be criminal sanctions at the top of the regulatory pyramid to deal with fraudulent misstatements. It is criminalized in almost all countries like US, UK, Australia and Singapore.[40]

In Australia it is a criminal offence for a person to offer securities under a disclosure document containing misleading or deceptive statement.[41] The company incurs primary liability for not complying with the disclosure regulations. Directors, officers and advisors may also be held criminally liable for breaches of continuous disclosure provisions if they aid, abet, counsel or procure the corporation's contravention. A person charged with the criminal offence has a defence if he proves that he had made all enquiries that were reasonable in the circumstances.[42]

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[38] See Hemraj, "Preventing Corporate Scandals", 2004 J.F.C.268. The Enron debacle and the Satyam episode were perpetrated by means of misstatements, falsifications, and accounting malpractices.

[39] John Coffee Jr., "Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation", 106 Colum.L.R.1534 at p.1550 (2006).

[40] *Supra* n.3 at p.337.The Securities and Futures Act, 2001 (Singapore), Part XII provides for criminal sanctions for market misconduct which can extend to a fine of up to $250,000 and imprisonment of up to 7 years.

[41] The Corporations Act, 2001, (Australia), s. 728.

[42] *Id.*, s.731.

Bonafide belief in the accuracy of disclosure or reasonable reliance on the information given to them by another person is also a defence.[43]

Initial Disclosure, Continuous Disclosure and Instant Disclosure

Initial disclosures are made mainly through the filing of the memorandum and articles of association with the registrar of companies and by the issue of prospectus. The memorandum of the company, its articles and the agreement with any individual for appointment as its managing director or manager should be presented to the registrar at the time of registration.[44] The memorandum of association should contain the basic information including name and registered office of the company, the main objects and the proposed share capital of the company.[45]

It is an offence to make a public offer of securities without issuing a prospectus. The investors need for information does not cease the moment the shares are issued. Efficient secondary trading in shares requires a continuing flow of information about the company and its securities. Continuous disclosure is ensured by the statutory requirement of annual reporting by the managers to the shareholders and the requirement to publish half yearly reports by the listed companies. Every member of the company has a right to know how its business is carried on and the details regarding the financial position of the company. He has a right to know whether the funds are utilized for proper purpose. The information regarding the same can be collected from the financial statements and accounts submitted by the company. The Companies Act, 1956 provides for the dissemination of this information by mandating the

[43] *Id.*, s.733.

[44] The Companies Act, 1956, s.33.

[45] *Id.*, s.13.

laying of accounts before the annual general meeting of the company. Non-filing of annual returns and balance sheet is rampant in the Indian corporate sector. But the punishment by way of imprisonment has been awarded in negligible number of cases. [46]

In the United Kingdom continuous disclosure is mandatory under the Companies Act, 2006. The Act provides for the content of disclosure to be made through various accounts and reports, the format in which they are to be presented and the method of valuation to be used. The Act requires the balance sheet, the profit and loss account, the auditors report and the board's report to be presented to the shareholders[47] and delivered to the registrar every year[48]. Quoted companies are required to make available the annual accounts and reports on the website.[49] Every company is required to keep adequate accounting records.[50] The responsibility to prepare the account is on the officers of the company. Failure to keep proper accounts is a criminal offence.[51] Every officer who is in default is liable to be punished.

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[46] The Report of the Expert Group on Streamlining Prosecution Mechanism under the Companies Act, 1956 (Vaish Committee Report), 2005. For the text of the report see (2006) 2 Comp.L.J.37 (J).

[47] The Companies Act, 2006, s. 423.

[48] *Id.*, s.441.

[49] *Id.*, s.430.

[50] *Id.*, s.386.

[51] *Id.*, s.87 reads, (1) "If a company fails to comply with any provision of section 386 (duty to keep accounting records), an offence is committed by every officer of the company who is in default.

(2) It is a defence for a person charged with such an offence to show that he acted honestly and that in the circumstances in which the company´s business was carried on the default was excusable.

(3) A person guilty of an offence under this section is liable–

(a) on conviction on indictment, to imprisonment for a term not exceeding two years or a fine (or both);

Such an officer can escape liability if he shows that he acted honestly and that in the circumstances in which the company´s business was carried on the default was excusable. The information to be disclosed in the annual accounts[52] and the contents of director's report [53] are provided in the Act. The directors must prepare the directors remuneration report for each financial year.[54] Defaults in complying with the disclosure requirements are penalized.[55] The liability for failure to comply with the disclosure norms is fixed on the officers of the company.

Certain transactions require instant or rapid dissemination of information. Information regarding change in shareholdings in the company, disclosure of significant events and information which are of relevance to an assessment of the value of its securities fall in this category. The rationale behind mandating disclosure of shareholdings held by individuals in a company is to make its members aware of who is building up a stake in the company.

Initial Disclosure at the Time of Incorporation

All legal systems require memorandum and articles of a company to be filed with the registrar of companies at the time of incorporation. In India, the fundamental clauses to be contained in the memorandum of

(b) on summary conviction–

(i) in England and Wales, to imprisonment for a term not exceeding twelve months or to a fine not exceeding the statutory maximum (or both);

(ii) in Scotland or Northern Ireland, to imprisonment for a term not exceeding six months, or to a fine not exceeding the statutory maximum (or both)."

[52] *Id.*, ss. 403 - 413.

[53] *Id.*, s.417.

[54] *Id.*, s.420.

[55] *Id.*, ss.438 & 451.

association are provided under the Companies Act, 1956.[56] Every member has a right to get copies of memorandum and articles of the company.[57] If the company makes any default in providing copies of the memorandum and articles to its members, every officer of the company who is in default is punishable.[58] If any alteration is made in the memorandum or articles of the company, every copy of the memorandum and article issued after the date of alteration should incorporate the alterations carried out.[59] If the alterations are not carried out, the officer who is in default is liable to be punished.[60]

Unlimited companies, companies limited by guarantee and private companies limited by shares should compulsorily register the articles of association along with the memorandum.[61] It should contain the rules and regulations for the general administration of the company. The companies are free to adopt their own rules or the model forms given in Schedule I of the Act. Public companies are free to have or not to have articles of association. The memorandum and articles of association are public documents and are open and accessible to all. Any person has a right to inspect and take copies of these documents.[62]

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[56] The Companies Act, 1956, s.13.The memorandum of association shall disclose the name, the registered office, objects, liability and the capital of the company.

[57] The Companies Act, 1956, s.39.

[58] *Ibid.*

[59] *Id.*, s.40.

[60] *Ibid.*

[61] The disclosures to be made in articles of association shall include information regarding the number of members with which the company proposes to be registered, how the proceedings at general meetings shall be transacted and how the proceedings at meetings of board are transacted.

[62] The Companies Act, 1956, s. 610.

Disclosure Rules at the Time of Initial Public Offer

Issue of prospectus is a mandatory requirement in all jurisdictions for raising capital from the public. The information to be disclosed in the prospectus is prescribed by the law. Non-disclosure and inclusion of false or misleading statements in the prospectus is an offence.

In the United Kingdom, the Financial Securities and Markets Act, 2000 and the Prospectus Regulations, 2005 stipulates the disclosure requirements to be satisfied for offering securities to the public.[63] Failure to comply with the requirements is a criminal offence. The persons responsible for the contents of the prospectus are provided in the prospectus rules. [64] Directors of the company and persons who have accepted responsibility for the prospectus can be made liable for non-disclosures and misrepresentations in the prospectus.

In India, issue of prospectus is a mandatory requirement under the Companies Act, 1956. A listed public company raises the capital for its

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[63] The Financial Services and Markets Act, 2000, ss.84 and 85.

[64] The Prospectus Rules, 2005, para 5.5.3R(2) reads, " Each of the following persons are responsible for the prospectus:

(a) the issuer of the transferable securities

(b) if the issuer is a body corporate,(i) each person who is a director of that body corporate when the prospectus is published; and (ii) each person who has authorised himself to be named, and is named, in the prospectus as a director or as having agreed to become a director of that body corporate either immediately or at a future time"

(c) each person who accepts, and is stated in the prospectus as accepting, responsibility for the prospectus"

(d) in relation to an offer:(i) the offeror, if this is not the issuer; and (ii) if the offeror is a body corporate and is not the issuer, each person who is a director of the body corporate when the prospectus is published.".

business from the general public by means of a public offer.[65] Making of public issues without complying with the procedure prescribed under the Companies Act, 1956 and allied rules can invite criminal liability. Application forms for shares and debentures cannot be issued unless they are accompanied by a prospectus.[66] The basic function of the prospectus is to inform the public as to the soundness of the company's venture.[67] The Act provides the particulars to be disclosed in prospectus and non disclosure of the required particulars is a criminal offence.[68]

A director or any other person responsible for the issue of prospectus can escape liability if he proves that he had no knowledge regarding the nondisclosure or that the non-compliance was due to some honest mistake on his part. Liability can also be avoided on the ground that non-disclosure was in respect of information which was immaterial.[69] The public issue of shares is a team action involving not only the issuer company but also several agencies including lead managers and bankers to an issue with well-defined roles assigned to each one of them. Every one involved is required to exercise due diligence as public money is handled in the process.[70]

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[65] The Companies Act, 1956, s.3 (iii). A private company is prohibited from making any invitation to the public to subscribe shares or debentures of the company.

[66] *Id.*, s.2 (36). A prospectus has been exhaustively defined as any form of invitation of offers from the public to subscribe or purchase shares or debentures of a c corporation.

[67] Avtar Singh, *Company Law*, Eastern Book Company, Lucknow (2004), p.101.

[68] The Companies Act, 1956, s. 56.

[69] *Ibid.*

[70] The role of bankers to an issue with respect to moneys collected by them in a public issue from the public has been subjected to detailed examination by various courts and it has been held that bankers to the issue hold the application moneys in

All facts which may possibly have a bearing on the assessment of the soundness of the venture proposed to be launched by a company must be mentioned in the prospectus leaving it to the prospective subscribers to decide for themselves whether to purchase the shares offered by the company or not.[71] The information to be disclosed in the prospectus is prescribed under Schedule II of the Act. It mandates disclosure of information regarding the issuer and information pertaining to the issue. The prospectus shall contain the name and addresses of the registered office of the company[72], the capital structure of the company[73], information regarding the company's projects and its management,[74] details regarding the categories of directors and their remuneration[75] and listing agreements.[76] The Act facilitates the disclosure of information regarding the shareholder rights,[77] terms of the present issue,[78] the

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the nature of a trust fund, i.e. the statute has created a kind of trust for the protection of persons who pay the money on the faith of a promise to refund the money, in case certain conditions are not fulfilled. The bankers to the issue are expected to make sure that before withdrawal of the money, the company has got the listing permission from the stock exchange specified in the prospectus. In *Bank of Baroda* v. *SEBI*, decided SEBI on 27-7-2000, it was held that the bankers of issue are liable to refund the money received from the public which they had negligently released to the company without ensuring that the stock exchanges listed in the prospectus had accorded approval for listing. The bankers to the issue shall be liable to repay the money handed over to the company in violation of the section 73 of the Companies Act, 1956.

71 KR Chandretre, "Misleading Prospectus", (1993)2 Comp.L.J.89 (J).

72 The Companies Act, 1956, schedule II, part I , cl.I(a)

73 *Id*., part I, cl.II.

74 *Id*., part I, cl. V.

75 *Id*., part II, cl. (C) 11(i).

76 *Id*., part I, cl. I (C).

77 *Id*., part II, cl.(C) 12.

78 *Id*., part 1, cl. III.

promoters of the company[79] and the intermediaries.[80] The Act requires the management to disclose the risks involved in the projects for which an issue is floated and its perceptions on it.[81] The golden rule as to the framing of prospectus is that the disclosure made should give a true and fair view of the company's position. The chief aim of the regulations requiring mandatory disclosure of the specified matters is to protect the intending purchasers of shares from being defrauded by the promoters and directors. All powers relating to issue and transfer of securities including the power to prosecute companies for mis-statements in offer documents and fraudulent inducement to invest has been delegated to SEBI.[82]

SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 [83] have to be observed in addition to the requirements of Schedule II of the Act. The guidelines set out the additional matters to be included in the prospectus.[84] ICDR regulations were introduced to enhance

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79 *Id.*, part I, cl. (V) (c).

80 *Id.*, part II, cl.A..6 requires disclosure of the names and addresses of the intermediaries. Fee payable to the intermediaries shall also be disclosed. Intermediaries include stock brokers, share transfer agents, bankers to an issue, trustee of the trust deed , merchant bankers, underwriters, portfolio managers, and investment managers.

81 *Id.*, part 1, cl. VIII.

82 *Id.*, s.55A.

83 Hereinafter referred as ICDR regulations.

84 The SEBI (ICDR) Regulations, 2009 mandate disclosure the following matters: General risks, risks in relation to the first issue, credit rating if any, information on lead merchant bankers, details of underwriting if any, details of shares issues under employee share option scheme, details of contribution by the promoters, details regarding major shareholders, means of finance, schedule of implementation of the project, basis for issue price, details regarding property of the company, shareholdings of key managerial personnel, dividend policy, financial information regarding issuer company, management's discussion and analysis of financial condition, outstanding litigation and material developments and others.

investor protection. The violation of the disclosure requirements under ICDR regulations are punishable with fine which may extend to one crore rupees.[85] While imposing the penalty, the adjudicating officer should take into account the amount of disproportionate gain or unfair advantage made, the amount of loss caused to an investor and the repetitive nature of the default.[86] The SEBI guidelines do not provide any defence in respect of non-disclosures. Intention of the parties committing the violation is totally irrelevant under the regulation. Once the contravention is established, penalty follows.

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[85] The Securities and Exchange Board of India Act, 1992, s.15A reads, " Penalty for failure to furnish information, return, etc.- If any person, who is required under this Act or any rules or regulations made there under:-

(a) to furnish any document, return or report to the Board, fails to furnish the same, he shall be liable to a penalty of one lakh rupees for each day during which such failure continues or one crore rupees, whichever is less;

(b) to file any return or furnish any information, books or other documents within the time specified therefore in the regulations, fails to file return or furnish the same within the time specified therefore in the regulations, he shall be liable to a penalty of one lakh rupees for each day during which such failure continues or one crore rupees, whichever is less;

(c) to maintain books of accounts or records, fails to maintain the same, he shall be liable to a penalty of one lakh rupees for each day during which such failure continues or one crore rupees, whichever is less."

[86] *Id.*, s.15J reads, "Factors to be taken into account by the adjudicating officer.- While adjudging quantum of penalty under section 15 I, the adjudicating officer shall have due regard to the following factors, namely:

(a) the amount of disproportionate gain or unfair advantage, wherever quantifiable, made as a result of the default;

(b) the amount of loss caused to an investor or group of investors as a result of the default;

(c) the repetitive nature of the default."

Liability for Misstatements in Prospectus

An onerous duty is cast upon those who are involved in the preparation of a prospectus offering shares or debentures to the public. These obligations were laid down in *New Brunswick& Co.* v. *Meggeridge,*[87] in the following words:

> "Those who issue the prospectus, holding out to the public the great advantages which will accrue to persons who will take shares in a proposed 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 fact 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 extend or quality of the privileges and advantages which the prospectus holds out as inducements to take shares."[88]

The preparation of a prospectus requires greatest care. While an attractive statement of advantages offered is permissible, every statement made should be an honest one. No ambiguous phraseology or half truths can be included in the prospectus. The Act provides for civil[89] as well criminal liability[90] for untrue statements in prospectus. If any untrue

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[87] (1890)1 Dr.& Sm.363 as cited in CM Schmitthoff, *Palmer's Company Law*, Stevens and Sons, London (1980), p. 332.

[88] *Ibid*.

[89] The Companies Act, 1956, s. 62.

[90] *Id*., s. 63 reads, (1) "Where a prospectus issued after the commencement of this Act includes any untrue statement, every person who authorised the issue of the prospectus shall be punishable with imprisonment for a term which may extend to two years, or with fine which may extend to five thousand rupees, or with both,

statement is made in the prospectus, every person who authorize the issue of the prospectus can be punished. To prove the offence of mis-statement in prospectus, it has to be established that an untrue statement was included with the knowledge that it is untrue.

Untrue Statement

To establish the offence of mis-statement in prospectus it has to be proved that the statement is untrue. Aggressive advertisement campaigns are launched and the gullible investors are easily trapped in by the rosy picture presented in the prospectus, brochures and advertisements. Many public issue advertisements claim the company as 'an established company' or 'established dividend paying company', even if the company has declared dividend only once or twice during the last five years. In whatever stage the implementation of the project may be, the advertisements claim that it is 'already in operation' or that it has 'no gestation period'. Just before the public issue is made, some eminent professionals are appointed on the board of directors of the company and the advertisement claims it to be a 'professionally managed board'. Whatever may be the legal requirement of declaration of dividends, the advertisements promises 'assured dividend of some percent.'

unless he proves either that the statement was immaterial or that he had reasonable ground to believe, and did up to the time of the issue of the prospectus believe, that the statement was true.

(2) A person shall not be deemed for the purpose of this section to have authorised the issue of a prospectus by reason only of his having given -

(a) the consent required by section 58 to the inclusion therein of a statement purporting to be made by him as an expert, or

(b) the consent required by sub-section (3) of section 60."

The Andhra Pradesh High Court considered the issue of misstatement in a prospectus in *Progressive Aluminium Ltd.* v. *Registrar of Companies.*[91] The statement included in the prospectus was that the company was engaged in construction activity for two and a half decades. The real situation was that a partnership firm engaged in construction activity was taken over by the company. Taking into account the experience of the promoters of the company, the statement was given on the belief that experience of body corporate is always that of persons running it. The statement was not wholly untrue. The court observed:

> "In the case before us, it could equally be seen that the petitioners have not acted with a mala fide intention of luring the public for subscribing to the shares of the company under a false representation that the company had experience of two and a half decades. The only default, if at all it could be termed as a default, was the omission on the part of the promoters to clarify that the experience of two and a half decades in the field was of the persons who were manning the earlier partnership firm and not the partnership firm itself. However, such omission could not be treated as a deliberate omission with a mala fide intention of suppressing any truth from the public…"[92]

If the promises made in the prospectus are not fulfilled, a prima facie case of criminal liability for mis-statement in prospectus is made out.[93] In *Hafez Rustom Dalal* v. *Registrar of Companies,*[94] the allegation

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[91] (1997) 89 Com.Cas.147 (A.P.)

[92] *Id.*, p.158.

[93] *Anil D. Ambani* v. *Santosh Tyagi,* (2000) 99 Com.Cas.334 (Raj.) In this case the debentures were not converted into shares according to the conditions of the

was that various statements and forecasts made in the prospectus had not been implemented. The Gujarat High Court found that omission and delay in commencing production activities in question was not a deliberate omission made with a malafide intention. The explanation tendered by the petitioners for the delay in commercial production was found reasonable. Subsequent developments and the progress made by the company in the direction of fructifying the objects for which the company was incorporated proved that the statements in the prospectus were not made with any dishonest intention of practising fraud upon the subscribers of the company.

Companies are free to make disclosure of projections and other forward looking statements. However such forecasts should not be false, deceptive or misleading. In the US statutory protection is given to projections and predictions in order to promote the disclosure of future-

prospectus. The complainant and his wife applied for allotment of secured optionally fully convertible debentures of Rs. 50 each as offered under the prospectus issued by Reliance Polypropylene Limited. The said debentures were to bear interest at the rate of sixteen per cent. per annum until converted into shares at the option of the applicants. On an application being made by the complainant and his wife, 100 secured optionally fully convertible debenture were allotted to them. Allotment money and money due on first and second calls were also paid which was duly received by the company. The prospectus of the company provided that each of the optionally convertible debentures would on the expiry of 12 months from the date of allotment be converted into shares of Rs. 10 each at a premium of Rs. 40 per share. In the event of the debenture holders desiring not to have the debentures converted into shares, the allottees were to inform the company nine months subsequent to the date of allotment in writing by registered post. The company did not abide by the conditions of the prospectus and redeemed the debentures and refunded the amount along with the interest. The Rajasthan high Court held that the prosecutions initiated against the directors of the company was maintainable.

[94] (2005) 128 Com.Cas.883 (Guj.)

oriented information.[95] The Act shields corporations from being liable for violations of the anti-fraud provisions of the federal securities laws with respect to forward-looking statements These statements must meet certain criteria including being clearly identified as forward-looking statements and accompanied by cautionary language identifying important factors that could cause actual results to differ materially from those projected in the statement.[96]

In the United Kingdom liability for misstatements in prospectus is attached only for statement of facts. If it is only a statement of opinion about the company's prospects, the offence will not lie. In *Greenwood* v. *Leather Shod Wheel Co.*,[97] a company formed to manufacture leather tyre wheels for trolleys issued a prospectus stating that it already had orders from various substantial bodies and trial orders from others with a view to place large orders later. In fact no customer had yet expressed any intention of buying on a large scale. Anyone who read the prospectus might feel that the company was well established in business, whereas in fact it was only just beginning. Hence the prospectus was held to be ambiguous and misleading.

Similarly in *R* v. *Kylsant*[98] a shipping company issued a prospectus stating that the average annual balance available was sufficient to pay the interest on the debentures offered by the prospectus and set out the dividends paid on the company's shares from 1911 to 1927. In fact the

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95 The Securities Act, 1933 (U.S.), s. 27A.

96 Ripken, "Predictions, Projections, and Precautions: Conveying Cautionary Warnings in Corporate Forward-Looking Statements", 2005 *University of Illinois Law Review* 929.

97 [1900]1 Ch. 421.

98 [1932]1 K.B. 442.

company had suffered trading losses during these years. Dividends during those years were paid by using reserves accumulated during the first world war. The court held that the prospectus contained a false statement of fact because it impliedly represented that the dividends had been paid out of current trading profits.

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Knowledge that the statement made is untrue is an essential ingredient required to be proved to establish the offence of mis-statement in prospectus. If the accused persons prove that the statement was immaterial or that they have reasonable ground to believe, and did up to the time of the issue of the prospectus believe, that the statement was true, they can evade liability for the mis-statements occurring in the prospectus.[99]

Persons Liable for Mis-statements in Prospectus

The criminal liability for misstatements in prospectus can be fastened on every person who authorise the issue of the prospectus. The responsibility to issue a prospectus in compliance with the requirements under the Act is substantially on the directors of the company. Various other intermediaries are involved in the issue of prospectus and they are made accountable under the Act.[100] The primary responsibility for

[99] *Ibid.*

[100] The Securities and Exchange Board of India (Intermediaries) Regulations, 2008, cl.27 provides the actions that can be taken against intermediaries in case of default include suspension of certificate of registration for a specified period, cancellation of certificate of registration, prohibiting the noticee to take up any new assignment or contract or launch a new scheme for the period specified in the order, debarring a principal officer of the noticee from being employed or associated with any registered intermediary or other registered person for the

ensuring the adequacy and authenticity of disclosure in offer document is placed upon the lead merchant bankers.[101] Their main duty is vetting of prospectus to ensure that the documents are in conformity with the legal requirements. The SEBI regulations have institutionalized the role of lead merchant bankers in the issue of prospectus. The lead merchant banker has to file the draft prospectus before SEBI after certifying that the document is in conformity with the statutory requirements and ICDR guidelines. The promoters of the company and experts play a crucial role in the issue of prospectus. Statements made by experts can be included in the prospectus only if he is not engaged in the formation, promotion or management of the company.[102]

Directors, promoters, lead managers, experts and other intermediaries involved in the issue of prospectus fall within the ambit of 'persons who authorized the issue' and are liable to be prosecuted for misstatements in prospectus. Experts and auditors are not deemed to have authorized the issue merely because they have given their consent.[103]

Liability for Fraudulent Inducement to Invest

The Act prescribes criminal liability for a person who makes fraudulent inducements to invest.[104] Any person who makes a false,

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period specified in the order, debarring a branch or an office of the noticee from carrying out activities for the specified period and warning the noticee.

[101] The Securities and Exchange Board of India (ICDR) Regulations, 2009, cl.6 and 8 requires the due diligence certificate in respect of offer documents to be filed by lead merchant bankers.

[102] The Companies Act, 1956, s.57.

[103] *Id.*, s.63.

[104] *Id.*, s.68 reads, "Any person who, either by knowingly or recklessly making any statement, promise or forecast which is false, deceptive or misleading, or by any

deceptive or misleading statement or dishonest concealment of material facts with intent to induce another person to enter into an agreement for dealing with the company's securities are liable to be punished. The provision intends to deter unscrupulous promoters from making untrue or deceptive statements to obtain money from the public. All directors of the company are liable to be prosecuted as officer-in-default for fraudulently inducing others to deal in securities.[105] If a prima facie case of misstatement in prospectus is established, SEBI can issue restraint orders restraining the managing directors of the company from associating with any corporate body in accessing the securities market and prohibiting him from buying, selling or dealing in securities.[106]

Two factors are to be proved to establish a case of fraudulent inducement. Firstly, a false, deceptive or misleading statement or dishonest concealment of material facts is to be proved. Secondly it has to be proved that by such false statement any person was induced to deal in shares or debentures.

It is not the inadequacy of powers but the reluctance to use them effectively that allows unscrupulous companies and their promoters to

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dishonest concealment of material facts, induces or attempts to induce another person to enter into, or to offer to enter into -

(a) any agreement for, or with a view to, acquiring, disposing of, subscribing for, or underwriting shares or debentures; or

(b) any agreement the purpose or pretended purpose of which is to secure a profit to any of the parties from the yield of shares or debentures, or by reference to fluctuations in the value of shares or debentures;

shall be punishable with imprisonment for a term which may extend to five years, or with the fine which may extend to ten thousand rupees, or with both."

[105] *I.B. Rao* v. *Registrar of Companies*, 2007 (77) S.C.L.182 (A.P.).

[106] *Securities and Exchange Board of India* v. *Ajay Agarwal,* A.I.R.2010 S.C.3466.

get away scot-free. Though some enlightened shareholders have moved different courts to block the public issue of companies indulging in misleading and false advertisements, courts have refused to intervene.[107]

In *Kisan Mehta* v. *Universal Luggage Manufacturing Co. Ltd.,*[108] some public spirited persons approached the court alleging that the defendants have indulged in fraudulent misrepresentations to hoodwink the public investors. The Bombay High Court dismissed the petition on the ground that the petitioners have no locus standi to file the petition because they are not shareholders of the company. The court held that no public interest litigation is maintainable with regard to criminal liability for mis-statements in prospectus. Even though court accepted the fact that individual actions are rarely initiated against fraudulent misrepresentations, the court refused to grant any relief. The gallant efforts of the petitioners in exposing a public harm failed to get liberal reception at the judicial doorsteps.

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[107] See for example *N.Parthasarathy* v. *Controller of Capital Issues*, (1991) 2 Comp.L.J.1 (S.C.)

[108] (1988) 63 Com.Cas.398 (Bom.) The facts of the case were as follows: The prospectus and public statements issued by the defendants gave a very rosy picture of their company. Various items which are, in fact, liabilities, were described as profits. The statements showed that the company had made profits of Rs. 2.02 crores for the year ending May, 1985. There was really a loss of Rs. 1.15 crores on proper adjustments being made as required under the law. Similarly, in the year ending May, 1986, the profits had been shown as Rs. 1.32 crores. There was really a loss of Rs. 2.84 crores. The company had received deposits amounting to a sum of Rs. 74 lakhs, which was shown as profit on the basis that there was hardly any claim for refund of the said deposits. Similarly, there was an item of Rs. 79.44 lakhs being the amount payable to the workmen. It was shown as profit for the year ending March 31, 1986. A number of similar other items which were all in the nature of liabilities and/or in the nature of non-recurring profits, but all were shown as profits for the years ending May 1985 and May 1986.

Due to lack of reported case laws in this area, no clear inferences can be drawn as to the efficacy of the criminal liability provisions in providing redress for misstatements in the prospectus and fraudulent inducements to invest.[109] Seven prosecutions were initiated for misstatements in prospectus and six prosecutions were initiated for fraudulently inducing persons to invest money in 2009-2010.[110] During the period 2010-2011 the number of prosecutions initiated for the same came down to one. [111]

Disclaimers as a Defence to Fraudulent Misstatements

There are instances wherein directors have escaped liability for fraudulent misstatements on the strength of the disclaimers and disclosures made under the caption of 'risk factors'. In *Iridium India Telecom Ltd.* v. *Motorola Incorporated,*[112] a Private Placement Memorandum (PPM) was

[109] A search under the Company Law Journal of the last 30 years and the Manupatra database gave no record of successful prosecution under section 63 and 68 of the Companies Act, 1956. Most of the cases enlisted under the sections pertained to cases wherein either relief was granted under section 633, or where proceedings were quashed under section 482 of the Criminal Procedure Code. As per the annual report of the Ministry of Corporate Affairs, 2010-2011, the highest number of prosecution are initiated for failure to submit annual returns and the balance sheet. Only one case has been initiated for misstatement in prospectus.

[110] The 54th Annual Report on Working and Administration of Companies Act, 1956, (2009-2010), Ministry of Corporate Affairs, table: 5.5.To view the table see appendix 1, table 4.

[111] The 55th Annual Report on Working and Administration of Companies Act, 1956 (2010-2011), Ministry of Corporate Affairs, table: 5.5.To view the table see appendix I, table 2.

[112] A.I.R.2011 S.C.20. The Bombay High Court had found that there was no fraudulent inducement on the ground that the 1992 PPM contained a separate chapter titled "Risk Factors". This portion related to the most important risk factors which were as follows: The Company is a new business venture of global scope that will require substantial licensing and authorizations from numerous sovereign

floated to obtain investments to finance the 'Iridium Project'. Many representations were made stating that the system would provide a subscriber link on a global basis which would be accessible virtually from anywhere on the earth surface. The respondent invested Rs 150 crores in the project. It was discovered that Iridium System was a complete failure and all the material representations made were totally false and fraudulent. Within nine months of the huge investment made in Iridium, it applied for bankruptcy protection under the U.S. Bankruptcy Code. The respondents filed a compliant for cheating. The Bombay High Court quashed the proceedings on the ground that the promoters had given sufficient warning regarding the risk factors involved in the project. On appeal, the Supreme Court perused the statements made in the PPM and found that a prima facie case of fraudulent inducement was established in the case.

Cheating and Criminal Breach of Trust

Criminal proceedings can be initiated under the Indian Penal Code, 1860 for making false statements with intention to induce others to subscribe shares in the company. The making of a false statement and the intention to defraud are the ingredients to be proved to establish the offence of cheating under the penal code.

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nations before its business can be conducted in the manner contemplated by its current business plan. Therefore in deciding whether to invest in Shares, prospective investors must evaluate among other things, the potential feasibility and future performance of the Company based on its business plan without benefit of any operating history, and prior to application for an receipt of such licensing and authorizations. No assurance can be given that any of the necessary licenses and authorizations will be obtained in a timely or at all. The High Court quashed the criminal proceedings. But the Supreme Court set aside the decision of the High Court.

In *Re: M.K. Srinivasan*, [113] the directors of the company were prosecuted for conspiracy to cheat the public and for criminal breach of trust. The allegation was that the accused were parties to a conspiracy to cheat the public by omitting certain material facts from the prospectus to induce them to buy the shares of the company. The prospectus failed to disclose that the company was in arrears in making payments to the suppliers. When the prospectus was issued they were in a desperate financial condition. They owed large sums to the Quilon Bank which had stopped their credit. The Madras High Court found that the failure to disclose the above facts was a deliberate suppression of material facts. An agreement to issue a document by the concealment of facts to deceive the public so as to fraudulently or dishonestly induce them to deliver property completes the offence of conspiracy to cheat. The essential ingredients are deception and an intention to defraud. These must either be proved directly or inferred from the document itself and the surrounding circumstances. Where the necessary intention has to be inferred from the nature of the document itself and the circumstances, the facts and circumstances must be such as to exclude any reasonable hypothesis of good faith.

The Rajasthan High Court has held that no offence of cheating would lie if a proper explanation was given for the failure to fulfill the promises made in the prospectus. [114] However if the intention to cheat

[113] A.I.R.1944 Mad.410. Prosecution was launched under Section 120B, 409 and 415 of the Indian Penal Code. Under Section 415, a person cheats who, by deceiving any person, fraudulently or dishonestly induces the person so deceived to deliver any property to any person. The explanation to Section 415 states that a dishonest concealment of facts is a deception within the meaning of the section.

[114] *Dilip S. Dahanukar* v. *Padam Kumar Khaitan*, 1996 Cri.L.J.1569 (Raj.) The grievance of the complainant was that that he was misled by the prospectus and

can be reasonably inferred from the subsequent conduct of the parties, they can be booked for cheating and criminal breach of trust. In *Sundaram Finance Services Ltd.* v. *Grandtrust Finance Ltd.*, [115] the Madras High Court held that the charge against the applicants for cheating and criminal breach of trust can be sustained for false representation made to the complainant. Here the complainant purchased shares on a promise that the shares would be offered for public sale. The Court reviewed the chain of events taking place from 1995 to 1996 and found it sufficient to show deception at time of representation. The intention to fraudulently induce the parties could be inferred from the subsequent conduct of the parties also. The Court relied on the decision in *Nagpur Steel and Alloys Pvt. Ltd.* v. *P.Radhakrishna*,[116] wherein it had been held that a criminal compliant cannot be quashed merely because the offence was committed during the course of commercial transaction.

It has been doubted whether resort can be had to the provisions of Indian Penal Code, 1860 when there is a special statute providing for criminal prosecution of fraudulent inducements. In *Kanwar Deep Singh* v. *State of West Bengal*,[117] the Calcutta High Court held that provisions

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induced to buy shares of the company. The company failed to come out with public issue as stipulated in the prospectus and he suffered loss. The honourable High Court quashed the complaint on the ground that the act of the company in not coming out with public issue was well explained. The company had by then stood merged with Good Value Marketing Pvt. Ltd. and the merger was approved by the shareholders. The court observed that the main grievance of the complainant that he got only one share of Good Value Marketing Ltd. in lieu of 25 shares of the company was not a matter to be agitated vide a criminal complaint.

[115] (2002)112 Com.Cas.361(Mad.).

[116] 1997 S.C.C. (Crl.) 1073.

[117] 2004 Cri.L.J.1116 (Cal.) The following false and misleading statements were made in the case. (i) It was falsely written that the returns on the debentures were tax

of the Penal Code cannot be used in cases where there are specific provisions in the Companies Act, 1956 for effective redressal of grievances. The Supreme Court took a different view in *A.V.Mohan Rao* v. *M. Kishan Rao.*[118] It refused to quash proceedings for fraudulent misstatement under the Companies Act, 1956 stating that fraudulent misstatement is actionable both under the Penal Code and the Companies Act, 1956.

The approach of the Supreme Court is laudable because if proceedings under the Penal Code are quashed on the basis that the offences are covered under the Companies Act, 1956 it will help the unscrupulous promoters to escape the clutches of law. Proceedings under IPC can be initiated even under a private complaint. This paves way for investigation and detection of crimes at the right time. Investigation and prosecution of crimes under the Companies Act, 1956 are under the exclusive jurisdiction of the officers, who may fail to take prompt action.

free, though it was not.(ii) It was falsely stated that the secured debentures issued by the company were assigned credit rating by its banker, but it was not so.(iii) The debentures were issued without obtaining necessary permission from SEBI which is mandatory.(iv) Those debentures were described to be issued for private placement, but those were issued publicly by engaging commission agent with high rate of commission. The FIR was registered ion the basis of private complaints alleging that the accused were guilty of cheating and breach of trust.

[118] A.I.R.2002 S.C.2653.Facts of the case were as follows. The allegations against the accused persons was that by making false, deceptive and misleading statements and by suppressing relevant facts, they had induced various persons to pay money for purchase of shares of the Power Company. Millions of dollars were raised from non-Resident Indians (NRIs). Those funds were siphoned off into bogus companies exclusively owned by them in off-shore countries. The shares of the Power Company in India were purchased in the names of bogus off-shore companies controlled by them.

Disclosure through Annual Returns

Every company has to file annual returns with the registrar of companies. The return has to be filed within 60 days from the date of annual general meeting. The particulars to be disclosed in the annual returns are provided in the Act.[119] The matters to be disclosed include information regarding its registered office, the members, the debenture holders, its shares and debentures, its indebtedness, its directors and managing directors. The object of filing annual returns is to enable the registrar to record the changes that have occurred in the constitution of the company. If a company fails to file the annual returns the company and every officer of the company who is in default shall be punishable with fine.[120]

The obligation to file the returns is not excused by any default in calling the annual general meeting because the returns can be prepared independently of the annual meeting.[121] The earlier view was that the annual accounts have to be submitted to the members even if the annual general meeting was not held at all.

In *Sevaram Pasari* v. *Registrar of Companies,*[122] the managing director and other directors of a company were prosecuted for not laying the annual accounts of the company. The main issue for consideration in the case was whether the petitioners could be prosecuted for the offence of omission to lay the accounts when the annual general meeting was not held at all. The petitioners argued that since the annual general meeting of

[119] The Companies Act, 1956, s.159.

[120] *Id.*, s.162.

[121] *State of Bombay* v. *Bandam Ram Bhandani,* A.I.R.1961 S.C.186.

[122] A.I.R.1964 Ori.14.

the company was not held, the question of laying the balance sheet or the profit and loss account does not arise. Consequently there can be no separate conviction for not laying the accounts apart from the conviction for not holding the annual general meeting of the company. The Orissa High Court rejected the contention on the ground that an offence of omission to call an annual general meeting of the company within the statutory period is distinct from the offence of omission of the director of a company to take all reasonable steps to lay the balance-sheet and profit and loss account at the annual general meeting. Reasonable steps for laying the profit and loss account and balance-sheet could be taken even before the actual date on which such meeting is held. If there is an omission to take such steps, the offence of omission to take all reasonable steps to lay the balance-sheet and profit and loss account is complete. Moreover a person should not be permitted to take advantage of his own wrong. The Court observed that the managing director was primarily responsible for calling a general meeting of the company. If he fails to call such a meeting he cannot be permitted to take advantage of the omission and plead that he could not lay the balance-sheet or profit and loss account because no meeting was called.

But the Supreme Court in *State of A.P.* v. *A.P Potteries Ltd.*,[123] held that if annual general meeting is not held, the obligation to file the accounts do not arise. Hence no offence can be committed for failing to file the accounts in cases where the annual meeting is not held.

In view of this decision, section 220 of the Companies Act, 1956 was amended in 1977 which provided that the balance sheet and the profit and loss account are to be filed within thirty days from the last date

[123] A.I.R.1973 S.C. 2429.

on which the annual general meeting ought to have been held.[124] The object of filing the balance sheet and profit and loss account periodically before the registrar is to provide facilities to the shareholders or creditors to inspect the same and to obtain copies thereof for safeguarding their interest. The object of the amendment was to ensure that the defaulters do not escape because the annual general meeting was not held.

Disclosure of Financial Statements through the Annual Reports

For proper accountability relating to financial matters it is essential that accounts are prepared, published and made available to the shareholders for inspection. Every company should hold the annual general meeting in each year.[125] At every annual general meeting of a company, the board of directors shall lay before the members of the company, the annual accounts showing the results of the company's trading during the relevant period.[126] The annual report is an important vehicle for communication between the managers and the shareholders. The time and manner of preparation of annual report is also laid down under the Act. The annual report should give a true and fair view of the state of affairs of the company. However there is no objective standard to decide what constitutes a true and fair view.[127] The information

[124] The Companies Act, 1956, s.220.

[125] *Id.*, s.166. Annual general meeting is an important institution for the protection of the shareholders of a company. AGM provides an opportunity for the shareholders to come together once in a year to review the working of the company. Failure to call AGM is an offence under section 168 of the Companies Act, 1956.

[126] *Id.*, s.210.

[127] Fincy Pellissery, "Disclosure in Financial Statements: A Critique", [2007] C.U.L.R.139 at p.141.

contained in the balance sheet,[128] the profit and loss account[129] and the director's report constitute the annual report. The balance sheet shows the net assets of the company and how they are financed.[130] The profit and loss account of a company should give a true and fair view of the profit and loss of the company for the financial year.[131] The profit and loss account and balance sheet of the company should comply with the accounting standards.[132] Use of different accounting standards will make it difficult for the investors to make intercompany comparisons. If the accounts do not comply with the accounting standards, the company shall disclose the deviation from the accounting standards, the reasons for such deviation and the financial effect arising due to such deviation. [133]

Every director of the company who fails to take reasonable steps to lay the annual accounts and the balance sheet at the annual general

[128] The balance of sheet shows the share capital, reserves and the liabilities of the company and the manner in which they are distributed over the several types of assets of the company. It indicates the financial state of affairs of the company at a particular date. Schedule VI of the Companies Act, 1956 provides the format in which the balance sheet may be filed.

[129] The Companies Act, 1956, part II, schedule VI gives the format in which the profit and loss account may be filed. Profit and loss account is a record of the financial fortunes of the company during the period of account. It shows the company's trading record for the period, the income received on investments and interest paid to its creditors.

[130] Farrar and Hannigan, *Farrar's Company Law,* Butterworths, London (1998), p. 469.

[131] The Companies Act, 1956, s. 211.

[132] *Id.,* s.211 (3A).The accounting standards are prescribed by the Institute of Chartered Accountants of India constituted under the Chartered Accountants Act, 1949.

[133] *Id.,* s. 211(3B).

meeting is punishable.[134] A person who has resigned from the office of director cannot be held liable for not filing the accounts for the period during which he seized to be a director.[135]

In case of failure to lay the accounts of a company, the court would examine whether any reasonable steps had been taken by the directors to comply with the law. In *State* v. *Linkers Private Ltd.,*[136] the directors of the company were prosecuted for failure to call annual general meeting and to lay the profit and loss account. It was contended that the default was due to auditor's failure to submit audit report in time. The Patna High Court held that in the absence of any evidence or record to show that the directors took steps to get the audit report expedited for being made available in time, all the directors must be held liable.

Directors may be excused from filing the return if they can satisfy the court that they were prevented from doing so on account of some genuine reasons. In *S.Pattabhiraman* v. *Registrar of Companies,*[137] the

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[134] *Id.,* s. 210(5).

[135] *A.G. Gaggar* v. *State*, MANU/DE/0014/2008.The facts of the case were that prosecution was initiated against the accused for failure to file the balance sheet and profit and loss account of the company as on March 31, 2004 with the office of the Registrar of Companies. The Petitioner contended that he had resigned as director on 14th July, 1998. He had submitted Form 32 to the registrar on 25th September, 1998 which was accepted without demur. Admittedly Form 32 filed by the petitioner was available with the ROC. Therefore registrar could not plead ignorance of the fact of resignation of the petitioner as director of the company. In these circumstances the Delhi High Court quashed the proceedings against the petitioner and held that prior to initiation of prosecution, it is incumbent upon Registrar of Companies to hold due enquiry as to whether any resignation has been duly filed .

[136] A..I.R.1968 Pat. 445.

[137] (2009)148 Com.Cas.705(Mad.)

Madras High Court excused the director from complying with statutory obligations relating to filing of annual returns. There was some dispute between the directors and all the books and papers of the company were kept in the registered office, which was the residence of the Mr. S. Venkataramanam. The petitioner had no access to the books, records and papers of the company. The petitioner had filed petition before the Company Law Board against the other director and the matter was pending. The inability to file annual accounts was established and hence he was granted relief from being prosecuted.

It is a defence for the accused director to prove that a competent and reliable person was charged with the duty of seeing that the provisions of the section are complied with and was in a position to discharge that duty.[138] If the person charged by the board of directors with the duty of seeing that the provisions of the section are complied with commits default, he becomes punishable.[139] The sentence of imprisonment cannot be imposed on such officer unless the offence was committed wilfully.[140]

The directors can get rid of liability if an officer has been charged with the duty to comply with disclosure requirements. This would not go in tune with the nature of duties imposed and required to be carried out by the directors of the company. The duty of overseeing and supervising the officers of the company cannot be ousted by shifting the whole responsibility on another officer appointed as the compliance officer. Even if such a compliance officer is charged with the duty to

[138] *Ibid.*

[139] The Companies Act, 1956, s.210 (6).

[140] *Ibid.*

ensure compliance with disclosure regulations, the liability for default should be borne by the officer as well as the directors of the company. Unfortunately the Ministry of Corporate Affairs is not in favour of arraying non-executive director as delinquent directors. [141]

Non-disclosure of information required to be made in the balance sheet and profit and loss account is also penalised.[142] Every profit and loss account should comply with requirements under the Act.[143] A copy of the balance sheet, profit and loss account and auditor's report must be sent to every member of the company twenty one days before the meeting.[144] Default in complying with this provision is punishable. Three copies of the balance sheet shall be filed with the registrar. Default in this regard is also punishable.[145] Thus criminal sanctions are provided for failure to lay the annual accounts at the AGM, for failure to send copy of annual report to the members and for failure to file it with the registrar of companies.

Furnishing false information in any of the documents required to be maintained under the Act is prohibited.[146] Liability would arise only if

[141] Circular No.2/13/2003/CL- V, Government of India, Ministry of Corporate Affairs dated 08/2011, discussed in chapter 4.

[142] The Companies Act,1956, s.211(7)

[143] The profit and loss account shall comply with requirements of Part II of Schedule VI of The Companies Act, 1956. Schedule VI has been revised by way of a notification and has been made more align with the international accounting standards. See C A Vijayanthi and Dr PT Giridharan, "Schedule VI to the Companies Act, 1956: Revised, Re-Characterised and Resheduled", (2011)4 Comp.L.J.27 (J).

[144] The Companies Act, 1956, s.219.

[145] *Id.*, s. 220.

[146] *Id.*, s.628: If in any return, report, certificate, balance sheet, prospectus, statement or other document required by or for the purposes of any of the provisions of this Act, any person makes a statement

the statement was included 'knowing it to be false'. Motive to mislead the public is an essential element to be proved to establish the offence. The impact of the statement made upon the ordinary investor reading the statement is the crucial factor in determining the falsity of a balance sheet or a prospectus.[147] Concealment of any material fact would attract liability.[148]

Disclosure through the Books of Accounts

Every company is bound to keep proper books of account.[149] Accounts must give a true and fair view of the state of affairs of the company. All sums of money received and expended by the company should be disclosed in the books of account. All sales and purchases of

(a) which is false in any material particular, knowing it to be false; or

(b) which omits any material fact knowing it to be material; he shall, save as otherwise expressly provided in this Act, be punishable with imprisonment for a term which may extend to two years and shall also be liable to fine.

[147] *Legal Remembrancer* v. *Akhil Bandhu Guha,* (1936) 6 Com.Cas.464 (Cal.)

[148] The Companies Act, 1956, s.628.

[149] *Id.*, s.209(1) Every company shall keep at its registered office proper books of account with respect to (a) all sums of money received and expended by the company and the matters in respect of which the receipt and expenditure take place;

(b) all sales and purchases of goods by the company;

(c) the assets and liabilities of the company;

(d) in the case of a company pertaining to any class of companies engaged in production, processing, manufacturing or mining activities, such particulars relating to utilization of material or labor or to other items of cost as may be prescribed, if such class of companies is required by the Central Government to include such particular in the books of account provided that all or any of the books of account aforesaid may be kept at such other place in India as the Board of directors may decide and when the Board of directors so decides, the company shall, within seven days of decision, file with the Registrar a notice in writing giving the full address of that other place.

goods made by the company should be recorded. In case of companies engaged in production, processing, manufacturing or mining activities, all particulars relating to utilization of material or labour or to other items of cost as may be prescribed by the central government shall be recorded in the books of account.

The liability for filing the books of accounts in accordance with the requirements of the Act has been fixed on the managing director and manager of the company.[150] Liability for disclosure violation falls on the directors where the company does not have a managing director or a manager. The managing director or the board of directors may entrust any other person with the responsibility of maintaining proper books of accounts. If the person charged by the board of directors with the duty of ensuring that the provisions of the section are complied with commits default, he is punishable.[151] . Books of account for the preceding eight years are to be preserved in good condition.[152] Punishing the company itself for nondisclosure will lead to penalizing the shareholders themselves who are the victims of nondisclosure. It is in tune with this philosophy that officers of the company are vested with the duty of maintaining books of accounts of the company.

Every director of the company has a right to inspect the books of account during the business hours.[153] The Registrar of Companies and the authorized officers of SEBI are vested with the right to inspect the

[150] *Id.*, s.209 (5).

[151] *Id.*, s.209 (7).

[152] *Id.*, s.209(4A).

[153] *Id.*, s. 209.

accounts.[154] In *Amit Kumar Sen* v. *K.A. Rao, Deputy Registrar of Companies*, [155] inspection in relation to books of account and statutory records of the company revealed many irregularities. The Calcutta High Court held that statutory liability to submit a statement showing name of employees in receipt of remuneration in excess of that drawn by the managing director or whole time director or manager arises only if the company has such employee during the relevant period. The omission to submit a statement that there was no such employee in the company during the relevant period cannot fasten penal liability.

The Act penalizes falsification of books of accounts and other documents belonging to the company.[156] It is punishable with imprisonment. But the offence applies only in case of companies being wound up. The regulators must closely monitor the disclosures made and prosecutions should be launched for misstatements and falsification of accounts. This would greatly help in avoiding *Satyam* like episodes. It is a shame that SEBI could not uncover the falsifications buried in the disclosures made by *Satyam* in its accounts and statements.

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[154] *Id.*, s.209A.

[155] (2006) 132 Com.Cas.675 (Cal).

[156] The Companies Act, 1956, s.539 reads, " Penalty for Falsification of Books: If with intent to defraud or deceive any person, any officer or contributory of a company which is being wound up -

(a) destroys, mutilates, alters, falsifies or secretes, or is privy to the destruction, mutilation, alteration, falsification or secreting of, any books, papers or securities; or

(b) makes, or is privy to the making of, any false or fraudulent entry in any register, book of account or document belonging to the company; he shall be punishable with imprisonment for a term which may extend to seven years, and shall also be liable to fine."

The significance of auditors report is to be examined in this respect. The auditor is required to submit a report on the accounts of the company to its members.[157] The matters to be contained in the report are enumerated under the Companies Act, 1956. The report should state whether the accounts are kept in accordance with the provisions of the Act and whether they give a true and fair view of the state of affairs of the company. The auditors have a duty to monitor and report violations, failures to disclose and acts of financial misconduct. The law should impose a positive duty on auditors to discover and report violations. Accessorial liability should be imposed on auditors for failing in their duty to discover and report violations and failures to disclose.

Directors' Report

Every balance sheet laid before a company in general meeting should be accompanied by a report of the board of directors.[158] The

[157] *Id.*, s.227 (2).

[158] The Companies Act, 1956, s.217. The report shall contain the following particulars. The state of the company's affairs; the amounts, if any, which the company proposes to carry to any reserves in such balance sheet; the amount, if any, which it recommends should be paid by way of dividend; material changes and commitments, if any, affecting the financial position of the company which have occurred between the end of the financial year of the company to which the balance sheet relates and the date of the report; the conservation of energy, technology absorption, foreign exchange earnings and outgo, in such manner as may be prescribed; any changes which have occurred during the financial year in the nature of the company's business; in the company's subsidiaries or in the nature of the business carried on by them ; statement showing the name of every employee of the company who was in receipt of remuneration for that year which, in the aggregate, was not less than such sum as may be prescribed and the reasons for the failure, if any, to complete the buyback within the time specified in sub-section (4) of section 77A.

board's report should also include a director's responsibility statement.[159] Any director of the company failing to take reasonable steps to submit the board's report is punishable with imprisonment. [160] However no such person is liable to be sentenced to imprisonment unless the offence was committed wilfully. The accused director can escape liability if he can prove that a competent and reliable person was charged with the duty of ensuring that the provisions of the section are complied with and was in a position to discharge that duty. If the person charged by the board of directors with the duty of ensuring that the provisions of the section are complied with commits default, he is punishable.[161] The sentence of imprisonment cannot be imposed on such officer unless the offence was committed wilfully.

Disclosure of Interested Transactions

The Companies Act, 1956 uses disclosure regulations to prevent abuse of power by the directors. The directors of a company act as agents of the company while entering into contracts and arrangements on behalf of the company. As agents of the company the directors have a duty to avoid conflict of interest between the interest of the company and their personal interests. The directors having any personal interest in the transactions or contracts to be entered into by the company are required to disclose the nature of their interest in a meeting of the board of

[159] *Id.*, s.217 (2AA) The statement shall indicate that in the preparation of annual accounts the applicable accounting standards had been followed along with proper explanation relating to material deviation, that the directors had selected such accounting policies that are reasonable and prudent to give a true and fair view of the state of affairs of the company.

[160] *Ibid.*

[161] *Ibid.*

directors of the company.[162] The object of the provision is to bring to the knowledge of the board of directors, the extent of the interest of a director, in any contract proposed to be entered with the company by the director or any of his specified associates. Failure to make the required disclosure renders the director liable to punishment.[163] The company has an option to avoid the contract, but does not make the contract illegal, unenforceable or void.[164] The contravention of the section also results in automatic removal of the director. [165]

The director is not prohibited from entering into contracts with the company. But he has a duty to make disclosure of his concern or interest. Every company is required maintain a register to include the details of all arrangements and contracts entered into by the company in which the directors are interested.[166] Such contracts or arrangements are required to be entered into within seven days of meeting of the board or approval of the central government. The register would be kept at the registered office of the company and shall be open to inspection by any member of the company. Every officer of the company who is in default shall be punishable for default in maintaining the register.[167]

In *M.O. Varghese* v. *Stephen Varghese & Co. Ltd*.,[168] the director of a public company was prosecuted for nondisclosure of his interest in P. Oommen & Sons company with whom there was an arrangement to

[162] The Companies Act, 1956, s.299.

[163] *Ibid.*

[164] *Ibid.*

[165] The Companies Act, 1956, s. 283(1)(i) .

[166] *Id.*, s. 301.

[167] *Ibid.*

[168] (1970) 40 Com.Cas.1131 (Ker).

supply goods on credit. The arrangement with P. Oommen & Sons was a very old one which the petitioner's father had entered into several years ago. He became a co-owner of that business by succession on his father's death. The said business was being managed by one of his brothers. There was no case that the petitioner took any unfair advantage in respect of the continuance of that arrangement by virtue of his position as director. The continuance of the arrangement was also to the advantage of the company. The interest that the petitioner had in the said arrangement as a co-owner of the above business was well-known at all times to all the other directors. Hence the petitioner was excused from the liability on the ground that acted honestly and reasonably.

Disclosure of Major Transactions Affecting the Company

Disclosure regarding all major transactions affecting the company is required to be disclosed to the investors. It is meant to assist the investor in taking a reasoned decision as to whether he should continue to be a shareholder of the company or to quit the company. It also facilitates the investor in properly appreciating the impact of the proposed transactions on his shareholder rights particularly on the minority shareholder rights. Takeover and buy-back are some of the major transactions affecting the company which requires instant disclosure of adequate information to the members.

Buyback of shares in India has been legalized by the Companies (Amendment) Act, 1999. The buy-back of the shares or other specified securities listed on any recognised stock exchange should be in accordance with the SEBI (Buy Back of Securities) Regulations, 1999. A special resolution has to be passed in the general meeting of the company authorising buy-back of shares. The notice of the meeting at which

special resolution is proposed to be passed should be accompanied by an explanatory statement containing a full and complete disclosure of all material facts. The necessity for the buy-back, the class of security intended to be purchased under the buy-back, the amount to be invested under the buy-back and the time-limit for completion of buy-back should be disclosed.[169] This is meant to enable the shareholder to understand the need for the buyback and its impact on the capital structure of the company. The company should maintain a register of the securities/shares bought back. [170] After completion of the buy-back, companies should file a return with the registrar of companies and Securities and Exchange Board of India containing all particulars relating to the buy-back. If a company makes default in complying with the provisions, the company and every officer of the company who is in default is punishable.[171]

The takeover of companies is regulated by disclosure regulations. The main objective of the regulation is to ensure transparency in transactions while contemplating acquisition of shares and voting rights in a target company. Any person, who holds more than five per cent shares or voting rights in any company, should disclose his aggregate shareholding in that company, to the company.[172] The company should disclose the aggregate number of shares held by such persons to the stock

[169] The Companies Act, 1956, s.77 A (3)

[170] *Id.*, s.77 A (9). The notice shall contain particulars such as the consideration paid for the securities bought-back, the date of cancellation of securities, the date of extinguishing and physically destroying of securities and such other particulars as may be prescribed.

[171] *Id.*, s.77A (11). The officer in default is punishable with imprisonment for a term which may extend to two years, or with fine which may extend to fifty thousand rupees, or with both.

[172] The SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997, cl. 6, 8.

exchange. Promoters or persons having control over a company should disclose the number and percentage of shares or voting rights held by him and by persons acting in concert with him in that company. A person who holds shares carrying ten per cent or less of voting rights in the capital of the company cannot acquire any further shares in the company from the open market unless such acquirer makes a public announcement of his intention to acquire shares.[173]

The takeover regulations were amended many times to modify the trigger points for disclosure.[174] No acquirer can acquire shares or voting rights of 15 percent or more in a listed company without making an open offer. A public announcement is to be made by way of an announcement in the newspapers.[175]

The acquirer should disclose the offer price, the number of shares to be acquired from the public, the identity of the acquirer, the purposes of acquisition, the future plans of the acquirer, if any, regarding the target company, the change in control over the target company, if any, the procedure to be followed by acquirer in accepting the shares tendered by the shareholders and the period within which all the formalities pertaining to the offer would be completed.[176] The basic objective behind the public announcement is to ensure that the shareholders of the target company are aware of the exit opportunity available to them in case of a takeover or substantial acquisition of shares of the target company. It

[173] *Id*., cl. 10.

[174] The SEBI (Substantial Acquisition of Shares and Takeovers) (Second Amendment) Regulations, 2002; the SEBI (Substantial Acquisition of Shares and Takeovers) (Amendment) Regulations, 2005.

[175] The SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997, cl.15.

[176] *Id*., cl.16.

aims to give an opportunity to existing shareholders of the target company to offload their holdings if they do not feel faith in the new management of the acquirer company.

The Bombay High Court explained the object of the disclosure rules in the takeover regulation in the following words:

> "The regulations disclose a scheme to bring about transparency in the transactions relating to acquisition of large block of shares which may ultimately lead to a take-over. That is why it insists on public announcement being made when the shareholding and, consequently, the voting power is increased beyond the extent contemplated by regulations 9 and 10. By obliging the acquirer to make a public announcement or a public offer, it ensures that a member of the company or an investor is able to take an informed decision on such public offer. The particulars which are required to be disclosed in the public offer are intended to give a clear picture to a member of the company or a prospective investor, as the case may be, as to the purpose for which such shares are being acquired and by whom. It also ensures to existing shareholders a fair return on their investment, and permits any other person to make a matching bid which may ultimately benefit the shareholders of the company. On the basis of the particulars furnished, the shareholder is enabled to take a decision as to whether he should retain his holding or dispose of them for the price offered. Thus, transparency in dealings as well as fairness to the shareholders of the company are ensured."[177]

[177] *Shirish Finance and Investment Ltd.,* v. *M Sreenivasulu Reddy* (2002)2 Comp.L.J.286 at p.312.

The regulations have laid down the general obligations of the acquirer, the target company and the merchant banker. The directors of the target company and the merchant banker can be made liable for any misstatement to the shareholders or concealment of material information required to be disclosed to the shareholders. [178]

In the matter of *International Diamond Services Ltd.,*[179] the director of the company disclosed the information about the sale of shares to the company. But the company made some delay in disclosing the sale of shares by the director of the company amounting to 21% of the total share capital of the company to the stock exchange. SEBI imposed a penalty of three lakhs for failure in disseminating information to the stock market.

Conclusion

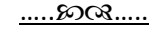
There are umpteen number of provisions in the Companies Act, 1956 wherein violation of disclosure regulations are penalised. But the fact is that mensrea has been made an essential ingredient of the offence. This makes it easy for the directors to evade penal sanctions by pleading that they were ignorant of the contravention. Mensrea requirement dilutes the vigour of the mandatory disclosure regime. The scheme provided in the Companies Act, 1956 is that non intentional default in complying with disclosure requirements are punished only with fine. Imprisonment is imposed only in cases where it is proved that the offence was committed wilfully. This approach seriously impairs the force of mandatory disclosure regime. The stigma of penal sanctions brought out by imposing imprisonment is seldom realised in case of

[178] The SEBI (Substantial Acquisition of Shares and Takeovers), 1997, cl. 45(5).

[179] Decided on March 22, 2010, SEBI, Barnali Mukherji (Adjudicating officer), decision available at www.sebi.gov.in.

violation of disclosure requirements. The focus should be on whether the directors took reasonable steps to comply with disclosure requirements and not on whether the violation was done wilfully. Another suggestion is that the shifting of the whole responsibility on compliance officers to ensure compliance with disclosure regulations has to be done away with. It shall be the responsibility of each and every director to oversee compliance with disclosure regulations. In case of default the liability should fall on the compliance officers as well as on every director of the company.

The Act compels public disclosure of corporate activity from its inception to its dissolution. Disclosure regulations are widely used in India as well as other jurisdictions to promote investor protection. Criminal sanctions are provided for violation of disclosure norms. These provisions would be rendered redundant if they are not properly enforced. It is not the dearth of provisions but laches on the part of prosecuting authorities to initiate proper action at the right time which give rise to corporate scams and scandals. Given the Indian scenario where the investors are susceptible to fraudulent inducements, SEBI should remain constantly vigilant and book the offenders at the earliest so that the investors may not be cheated. The intermediaries should also be made accountable for statements certified by them. There should be proper mechanism to verify the accounts filed by the companies.



Chapter 6

ROLE OF CRIMINAL SANCTIONS IN REGULATING SECURITIES MARKET

Investment in securities is considered as the most attractive investment option because the investment can easily be converted into money through stock markets.[1] Stock exchange provides a market place for purchase and sale of securities. At the same time, investment in corporate securities has many risks. Market manipulation is very much rampant in all emerging financial markets including the Indian capital market. Market manipulation has undermined investor confidence in the securities market and is pointed out as the major reason for withdrawal of retail investors from the securities market.[2] Restoration of investor confidence requires strict regulation of securities markets.[3] There has to be adequate mechanism for detecting managerial misconduct in securities market and for punishing the offenders.

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1 Stock markets provide liquidity to investment in corporate securities. Investment can be made in different kinds of securities. The Securities Contracts (Regulation) Act,1956, s.2(h)(i) defines "securities" to include "shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate".

2 Rajesh K. Aggarwal and Guojun Wu, "Stock Market Manipulations", 79 *The Journal of Business* 1915 (2006); L.C.Gupta, "What Ails the Indian Capital Market?", 33 *Economic and Political Weekly* 1961(1998). Corporate managements in India are notorious for enriching themselves at the cost of ordinary shareholders.

3 T. J. F., "An Explanation of Fundamentals of Stock Market Practice and Procedure in the Light of the Securities Exchange Act of 1934", 21 Virg.L.R.103 at p.111 (1934).

In India there are various legislations to regulate securities market.[4] The main purpose of regulating securities transactions is to protect the interests of investors.[5] Investor protection is very crucial for the development of financial markets.[6] Financial development accelerates the economic growth of the nation by enhancing savings and channelising these savings into real investment in more productive uses and thus facilitating efficient resource allocation. [7]

Corporate managers indulge in different activities which may lead to manipulation in the securities market. Giving false information to the public during initial public offers and follow on offers can lead to market

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[4] The main laws related to investor protection in India are the Companies Act, 1956; the Securities Contracts (Regulation) Act, 1956; the Securities and Exchange Board of India Act, 1992; and the Depositories Act, 1996. The SEBI Act, 1992, established the Securities and Exchange Board of India (SEBI) as the regulatory authority to protect investors and develop and regulate the securities market. The Companies Act, 1956, provides for the mode of incorporating business concerns and the rights of the shareholders and allied matters. The Securities Contracts (Regulation) Act, 1956, provides for regulation of transactions in securities through control over stock exchanges. The Depositories Act, 1996, provides for electronic maintenance and transfer and ownership of demat securities ensuring free transferability of securities. Justice Dhanuka committee has recommended that the securities law be consolidated into a single statute. For the full text of the Report of the Committee on Review and Reform of Security Laws,1998, see (1998)3 Comp.L.J.97(J)

[5] Investor can be defined as a person who invests his money in the company. The term has not been defined in the Companies Act, 1956. The term shareholder and member are used interchangeably. The Companies Act, 1956, s. 41 defines the term 'member' to mean the subscribers to the memorandum of association, every other person who has agreed in writing to become a member of the company, and every person holding equity share capital of the company and whose name is entered in as the beneficial owner in the records of the depository. One may become a shareholder of a company by subscribing to the memorandum of association, by allotment, by transfer (purchase of shares in the open market) or by transmission (on death of the shareholder).

[6] LaPorta R, *et. al*, "Investor protection and corporate governance", 58 *Journal of Financial Economics* 3 (2000).

[7] *Id.*, p.14.

manipulation. Giving false information is regulated by disclosure regulations. The prospective subscribers to a new issue of shares are protected by imposing liability for misrepresentation and nondisclosure in documents inviting subscription from the public. Investor protection through regulation of securities market attempts to protect the interests of investors by ensuring a fair price for sale and purchase of securities. Corporate directors and managers may engage in market manipulation through price rigging, circular trading, creation of artificial sales and pooling. Managers and directors resort to insider trading to reap illegal profits. Market manipulation can also occur during corporate re-organisations.[8] In this context, it is necessary to examine the role of criminal sanctions in regulating corporate managerial misconduct in securities transactions.[9]

Use of Criminal Sanctions to Regulate Securities Transactions: A Historical Account

The legal system in US had been following the policy of laissez faire in stock market affairs. But at the same time, freedom of market players has been restricted to protect the investors against various abuses of corporate power.[10] Certain obligations were assumed by persons dealing in the stock market. All contracts in the stock market with respect to buying and selling of securities are entered into based on the information regarding the stock. It is an established rule that any

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[8] For example, a takeover bid may be announced with the sole object of increasing the stock price of the target firm. See Mark Bagnoli and Barton L. Lipman, "Stock Price Manipulation Through Takeover Bids", 27 *The RAND Journal of Economics* 124 (1996).

[9] Investor protection through disclosure regulation is dealt in chapter 5.

[10] A.A.Berle Jr., "Liability for Stock Market Manipulation", 31Colum.L.R.264 at p.279 (1931).

statement issued which is likely to affect the value of stock has to be accurate.[11] Making false statements with an intention to induce persons to deal in securities amounts to fraud. Both civil and criminal liability was imposed on those persons responsible for issuing false statement.[12] Another rule is that the stock exchange shall promptly report all transactions to the public. This constitutes important market information for evaluating the value of stocks. Information regarding price at which transactions has been carried on is a representation to the prospective buyers which helps in subsequent appraisal of stocks.

The fundamental rule governing securities market is that the parties shall not indulge in any fraudulent activities. The approximation of the value of the security shall occur as a result of the interplay of the forces of demand and supply in a free market.[13] Tampering with the price of the security hampers free competition and makes the stock manipulated.[14] Manipulation is broadly defined as:

> "the effecting of changes in security prices by means of artificial stimuli, as opposed to the normal changes that occur in the free market, subject only to the interplay of supply and demand."[15]

Thus manipulation is a deliberate interference with the free play of supply and demand in the securities market. It denotes trading with a bad

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[11] *Id*., p.264.

[12] W.J.S., "Corporations: Stock Market Manipulation: Rescission for Fraud", 34 Mich.L.R.268 (1935).

[13] *Supra* n.10 at p.271.

[14] Notes, "Illegality of Stock Market Manipulation", 34 Colum.L.R.500 at p.505 (1934).

[15] Paul L. Porterfield, "Securities: Stock Market Manipulation at Common Law and under Recent Federal Securities", 28 Calif.L.R.378 (1940).

intent.[16] The trading practices commonly identified as manipulative include wash sales, matched orders, creation of artificial scarcity, rigging and pooling.

Wash Sales and Matched Orders

A wash sale occurs when an individual sells the shares to himself.[17] Wash sale is actionable as a false representation in common law. When a person or his associate is both the buyer and seller in a transaction, it is a fraud. A 'matched order' occurs where a person and his associates place, buy and sell orders for substantially the same number of securities at substantially the same price. 'Matched order' refers to transactions wherein two or more sellers and buyers acting in concert buys and sells securities at a prefixed price.[18] Wash sales and matched orders create an appearance of market activity. They have the effect of trading with bad intent amounting to fraud.

In the famous case of *United States* v. *Brown*,[19] decided by the United States District Court of New York, the defendants were found guilty under the United States Mail Fraud Act, 1872 for manipulating

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[16] Daniel R. Fischel and David J. Ross, "Should the Law Prohibit "Manipulation" in Financial Markets?", 105 Harv.L.R.503 at p.508 (1991).

[17] Notes, "Regulation of Stock Market Manipulation", 56 Yale L.J.509 at p.513 (1947)

[18] T. J. F., "Stock Exchanges: Manipulation of Security Prices- Wash Sales", 20 Virg.L.R.682 at p.683 (1934).

[19] 5 F. Supp. 81 (S.D.N.Y.1934) as cited in A. A. Berle, Jr., "Stock Market Manipulation", 38 Colum. L.R.393 at p.398 (1938). The facts of the case were that the defendants were charged with the operation of a pool to advance the price of Manhattan Electric Supply Co. stock. The methods charged included actual purchases of stock as well as wash sales, bribing brokers' employees to tout the stock and paying a market letter service company to circularize false representations as to the company's condition, dividends and prospects.

the stock prices through wash sales and matched orders. Criminal liability was imposed for conspiracy to defraud and for the use of mails in connection with the transactions. Wash sales amounted to fraudulent misrepresentations that the stock was actively traded. It created an impression that the prices were prices obtained in a free market. The case established the rule that apart from civil action for deceit, criminal action could be brought under the respective State or Federal statute.

Pegging and Pooling

Pegging is another kind of manipulation resorted to stabilize the market price of a stock. [20] The distributors of securities would enter into bids to counteract the selling pressure of shares. The depression in the market price is absorbed by controlling the selling pressure through bidding or purchasing in the open market.[21] Stabilization of the price of a security amounts to fraud. There is also an equally strong argument that stabilization is a lawful activity as it operates only to support the market as contrasted with the creation of a fictitious market by manipulation.[22]

A joint undertaking by a group of speculators to alter the price of a security is referred as pooling.[23] Pools intended to either raise the price of stock is termed as 'bull' and pools intended to lower the price and is

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[20] *Supra* n. 17 at p. 514.

[21] *Ibid.*

[22] Christopher Branda Jr, "Manipulation of the Stock Markets under the Securities Laws", 99 *University of Pennsylvania Law Review* 651at p. 680 (1951).

[23] *Id.*, p.659.

'bear'.[24] When the price of a security no longer represents its true value, the market is said to be rigged.[25]

Market manipulation through wash sales, matched orders, pegging and pooling were controlled through the common law concept of fraud. Criminal prosecutions for conspiracy to defraud had many inadequacies. The difficulty in establishing illegal purpose and fraudulent intent resulted in poor enforcement.[26]

Regulation of Securities Market in the U.S.

The Securities Act, 1933 and the Securities Exchange Act, 1934 are the two significant federal securities statutes in the U.S. The 1933 Act mainly aimed at the elimination of information asymmetries between the issuers and the investors. The objective of the 1934 Act was maintenance of honest and fair markets for securities transactions. It is opined that the Securities Exchange Act, 1934 did nothing more than codifying the common law rules applicable to securities market.[27] The Act forbids use of false or misleading statements.[28] Pegging and artificial stabilisation of the price of securities are prohibited.[29] The Act gave broad powers of investigation to the Securities Exchange Commission to detect manipulation. The commission maintains an effective system for market

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[24] *Ibid.*

[25] T.J.F., "An Explanation of Fundamentals of Stock Market Practice and Procedure in the Light of the Securities Exchange Act of 1934", 21 Virg.L.R.103 at p.108 (1934).

[26] *Supra* n.17 at p.517.

[27] *Supra* n.10 at p.279.

[28] The Securities Exchange Act, 1934, s.9.

[29] *Ibid*.

watching. [30] The data on securities trading are studied and investigations are made for every unexplained variation in stock price. A wide range of administrative regulations are provided under the Act including revocation of registration and expulsion from stock exchange membership. Criminal sanctions are also provided under the Act. The Commission can make recommendations to the Attorney General to initiate criminal proceedings.[31] Where any issuer violates the provisions of the Act, any officer, director, employee, or agent of an issuer who wilfully violates the Act is liable to be punished with imprisonment.[32] Criminal liability can be imposed only when the violations have been committed 'wilfully'. The term 'wilfully' as used in criminal provisions has been interpreted to mean a higher level of intent. In order to sustain a criminal conviction the prosecution has to establish a realization on the defendants' part that he was doing a wrongful act.[33]

Many amendments were made to the 1933 Act and the 1934 Act in the subsequent years to address various abuses in the securities market.[34] Market manipulation cases in the United States are often brought under general anti-fraud rule 10b-5 of the 1934 Act.[35] This is mainly because

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30 *Supra* n.17 at p.533.

31 *Id.*, s.21.

32 The Securities Exchange Act, 1934, s.32.

33 William B. Herlands, "Criminal Law Aspects of the Securities Exchange Act of 1934", 21Virg.L.R.139 at p.196 (1934).

34 See Arthur H. Dean, "Twenty-Five Years of Federal Securities Regulation by the Securities and Exchange Commission", 59 Colum.L.R.697 at p.715 (1959).

35 The Securities Exchange Act,1934, Rule 10b-5 reads: "It shall be unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary

prohibitions under the 1934 Act are applicable to the stock listed on a national securities exchange. Whereas Rule 10b-5, is applicable to all stocks including those traded at the over the counter market.[36]

Majority of manipulation cases in the U.S. involve attempts to increase stock price.[37] The corporate insiders, large shareholders and brokers were the manipulators in most of the cases. Ever since the Corporate Fraud Task Force was established in 2002, hundreds of chief executive officers and corporate presidents were convicted for fraud and market manipulation.[38] Most of the defendants convicted for corporate fraud have been high level officers occupying positions of responsibility and authority in the company.[39] There had also been a significant number of guilty pleas. The federal prosecutors enjoy a satisfactory conviction rate and it is a clear evidence of the utility of relying on prosecution of corporate officers to address systemic corporate fraud.[40]

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in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security".

[36] For a discussion on regulation of over the counter markets, see William Taft Lesh, "Federal Regulation of over-the-Counter Brokers and Dealers in Securities", 59 Harv.L.R.1237 (1946).

[37] Rajesh K. Aggarwal and Guojun Wu, "Stock Market Manipulations", 79 *The Journal of Business* 1915 at p.1917 (2006).

[38] The Report to the President, Corporate Fraud Task Force, 2008 available at http://www.justice.gov/archive/dag/cftf/2008 accessed on 8/5/2011.

[39] Kathleen F. Brickey, "In Enron's Wake: Corporate Executives on Trial", 96 J.Crim.L.Criminology 397 at p.404 (2006).

[40] *Id.*, p.419.

Regulation of Market Manipulation in the U.K.

In the United Kingdom also, the courts have relied on the common law doctrine of fraud to deal with market manipulation. The first case in the English courts involving manipulation was *Rex* v. *DeBerenger.*[41] The accused conspired with the members of British aristocracy and circulated false rumors that Napoleon had been killed. They were convicted for a conspiracy to raise the price of government securities by means of the false representations with intent to injure the public. The court observed that the state had a right to ensure that the capital market is not tampered with. Through this decision the law of criminal conspiracy was adapted to address market manipulation.

In *Reg.* v. *Aspinall*s[42] the defendants were convicted for defrauding the public by fictitious allotment and false representations to get listed in the London Stock Exchange. They were convicted for conspiracy to obtain listing in stock exchange and inducing traders to believe that the rules of the exchange had been complied with.

The leading English case on pooling is *Scott* v. *Brown.*[43] The defendants entered into an agreement for large scale buying and selling of stock with the object of inflating the price. One among them sued the others for breach of contract. Recovery was denied on the ground that it was an illegal contract. The court denounced the activities of the group. By way of dictum, the court declared that it would be ground for a civil action for damages and a criminal indictment for conspiracy to defraud.

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41 105 Eng.Rep.536 (K.B. 1814) as cited in *supra* n.22 at p.653.

42 (1876) 1 Q.B.D.730.

43 (1892) 2 Q.B.724.

Through the above cases courts recognized the free and open market concept and the public interest involved in the securities market.[44]

The common law crime of conspiracy to defraud was used to police rigging and protect the securities market. The Financial Services Act, 1986 outlawed misleading statements and manipulative practices as unlawful interference with the operation of securities market. This Act was replaced by the Financial Services and Market Act, 2000 (UK) which provided criminal sanctions for market abuse and manipulative conduct.[45] The offense is defined in objective terms and the element of mensrea is dispensed with.

Creating a false or misleading impression as to the market or the price or the value of any investments and thereby inducing another person to trade in those investments is prohibited.[46] Intention is an essential

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[44] James Wm. Moore and Frank M. Wiseman, "Market Manipulation and the Exchange Act" 2 U. Chi.L.R.46 at p.58 (1934).

[45] The Financial Services and Market Act, 2000 (UK), s.397 (3) reads, "Market abuse is basically defined as:

1. behaviour (action or inaction) anywhere in the world, directly or indirectly affecting investments traded on a UK market ;
2. that is likely to be regarded by regular users of the market as falling below the standard reasonably expected of a person in that position ; and
3. which is at least one of three types:
   a. based on information not generally available to the market but which is likely to be regarded by a regular user as relevant in deciding the term on which to deal in such investments (ie insider dealing);
   b. likely to give a regular user a false or misleading impression as to the market or value of such investments (ie misleading statements and practices); or
   c. regarded by a regular user as likely to distort the market in such investments (ie rigging the market)".

[46] *Ibid.*

element required to be proved for imposing criminal liability under the Act. However the burden of proof is so onerous in criminal prosecution that it is difficult to secure a conviction.[47] Proving the elements of the crimes 'beyond reasonable doubt' has resulted in few successful prosecutions. Hence criminal penalties are reserved for serious breaches. The Financial Services Authority has the power to reprimand and impose fine for 'market abuse' based on a civil burden of proof. The authority pursues deterrence policy against insider dealing and market manipulation.[48]

Thus it can be found that market manipulation is penalised in most of the developed nations and is backed with the punishment of imprisonment.[49] In the US and UK, there is an extensive reliance on criminal sanctions for regulating securities market.

Regulation of Managerial Misconduct in Indian Securities Market

Price rigging, insider trading, circular trading, price maintenance, takeover violations and issue related manipulations are the main evils found in the Indian securities market.[50] Corporate managers and directors resort to these malpractices for gaining illegal profits and to retain corporate power.

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[47] Iain MacNeil, "The Future for Financial Regulation: The Financial Services and Markets Bill", 62 M.L.R.725 at p.737 (1999).

[48] The FSA Annual Report, 2010-2011 available at www.fsa.gov.uk/pubs/ annual/ ar10_11/ar10_11.pdf. Five convictions were achieved for insider dealing during 2010-2011. Twelve defendants are awaiting trial.

[49] In Singapore, market misconduct is punishable with criminal sanctions. The Securities and Futures Act (Singapore), ss.199, 203, 204. Market misconduct is punishable with a fine of up to $250,000 and imprisonment up to 7 years.

[50] Data available from www.sebi.gov.in/annualreport/9798/ar97982g.html accessed on 1/3/2010.

The responsibility of protecting the interests of investors in securities and promoting the development of the securities market is vested with the Securities and Exchange Board of India.[51] The Securities and Exchange Board of India [52] (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Markets) Regulations, 1995[53] prohibits manipulative and fraudulent transactions in securities market.

During the year 2010-11, about 54 percent of the cases taken up by SEBI for investigation pertained to market manipulation and price rigging.[54] Other cases pertain to insider trading, takeover violations, and irregularities in initial issues. Market manipulation is not peculiar to Indian securities market. It is rampant throughout the Asian region.[55]

Investigation of Market Manipulation

The Investigation, Enforcement and Surveillance Department of SEBI monitors abnormal market movements and detects market manipulations. Market Surveillance Division is vested with the responsibility of monitoring the market movements, identifying price volatility, analysing its causes and overseeing the surveillance activities of the stock exchanges. The main source of information for the Market

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[51] The Securities and Exchange Board of India Act, 1992, s.11.

[52] Hereinafter referred as SEBI.

[53] Hereinafter referred as FUTP regulations.

[54] For details of investigation of cases taken up and completed during the period, see the Annual Report of the Securities and Exchange Board of India for 2010-2011, table 3.20. To view the table see appendix I table 6.

[55] The Findings of the Asia-Pacific Regional Committee Survey on Investor Protection, 5th OECD Roundtable on Capital Market Reform in Asia, 19-20 Nov 2003, p.9.

Surveillance Division is the trading data obtained from the stock exchanges, newspaper reports and investor complaints.

There is frequent exchange of information between the SEBI and stock exchanges to facilitate market monitoring and surveillance. Investigation can be ordered against any person associated with the securities market.[56] SEBI can call for information and conduct enquiry against any investor alleged to be involved in price manipulation.[57]

Penalties for Market Manipulation

On completion of investigation, SEBI is empowered to issue directions including imposition of monetary penalties, suspension of activities and cancellation of registration, refund of issue proceeds, prohibiting access to the securities markets and ordering compensation of undue or ill-gotten gains.[58]

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[56] The Securities and Exchange Board of India Act, 1992, s.11C reads, " (1) Where the Board has reasonable ground to believe that

(a) the transactions in securities are being dealt with in a manner detrimental to the investors or the securities market; or

(b) any intermediary or any person associated with the securities market has violated any of the provisions of this Act or the rules or the regulations made or directions issued by the Board thereunder,

It may, at any time by order in writing, direct any person (hereafter in this section referred to as the Investigating Authority) specified in the order to investigate the affairs of such intermediary or persons associated with the securities market and to report thereon to the Board".

[57] *Karnataka FinCap Ltd.* v. *SEBI,* (1996) 87 Com.Cas.186 (Guj.) The summons issued to an investor in respect of investigation under FUTP Regulations, 1995 was challenged before the Gujarat High Court. The High Court while interpreting section 11(2)(i) of the SEBI Act held that the expression "persons associated with the securities market" is not limited to intermediaries but includes "investors" also.

[58] The Securities and Exchange Board of India (FUTP) Regulations,1995, cl.11.

Remedial actions can be taken against intermediaries including stock brokers, merchant bankers, registrars to an issue and share transfer agents, bankers to an issue and debenture trustees. While determining the quantum of penalty, the adjudicating officer should have due regard to the amount of disproportionate gain or unfair advantage wherever quantifiable, made as a result of the default. The amount of loss caused to the investors as result of the default and the repetitive nature of the default are also to be taken into consideration while imposing the penalty.[59]

The liability for indulging in fraudulent and unfair trade practices is fixed at Rs.25 crore or three times the amount of profits made out of such deals.[60] SEBI can also issue orders suspending trading of the security found to be involved in fraudulent and unfair trade practice in a recognized stock exchange. It can also restrain persons from accessing the securities market and prohibit any person associated with securities market to buy, sell or deal in securities.[61]

The SEBI Act, 1992 and regulations are not construed as penal but as regulatory in nature. It has been held that levy of penalties are adjudicatory in nature and are not criminal proceedings.[62] The adjudicating officer performs quasi-judicial functions for the purpose of determining the liability for the breach of civil obligations imposed by the SEBI Act and regulations.

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[59] The Securities and Exchange Board of India Act, 1992, s.15J.

[60] *Id.*, s.15 HA.

[61] The Securities and Exchange Board of India (FUTP) Regulations, 2003, cl.11.

[62] *Securities and Exchange Board of India* v. *Cabot International Capital Corporation*, (2004)2 Comp.L.J.363 (Bom.).

Initiation of Prosecution

SEBI can initiate criminal proceedings by filing a complaint before the appropriate criminal court alleging violation of FUTP regulations.[63] Offences under the regulations are to be tried by the court of sessions.[64] No court can take cognizance of any offence except on a complaint made by SEBI. The need for prior sanction of the central government has been dispensed with by the 2002 amendment. The company as well as the persons responsible for the violation is punishable with imprisonment and fine.[65]

The central government can grant immunity from prosecution if it is satisfied that the person accused has made a full and true disclosure in respect of the alleged violation.[66] SEBI can make recommendations to the government in this respect, but the recommendations are not binding. The government can impose conditions as it may think fit for granting immunity from prosecution. The immunity granted may be withdrawn by the central government, if it is satisfied that such person had not complied with the conditions or had given false evidence in the court.[67]

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[63] The Securities and Exchange Board of India Act, 1992, s.26.

[64] *Ibid.*

[65] *Id.*, s.24 reads, (1) "Without prejudice to any award of penalty by the Adjudicating Officer under this Act, if any person contravenes or attempts to contravene or abets the contravention of the provisions of this Act or of any rules or regulations made there under, he shall be punishable with imprisonment for a term which may extend to ten years, or with fine, which may extend to twenty-five crore rupees or with both.

(2) If any person fails to pay the penalty imposed by the Adjudicating Officer or fails to comply with any of his directions or orders, he shall be punishable with imprisonment for a term which shall not be less than one month, but which may extend to ten years or with fine, which may extend to twenty-five crore rupees or with both".

[66] *Id.,* s.24B.

[67] *Ibid.*

The company as well as every person who was in charge of and was responsible to the company for the conduct of the business of the company is liable to be punished for offences under the SEBI Act, 1992.[68] The officer can escape liability if he proves that the offence was committed without his knowledge or that he had exercised all due diligence to prevent the commission of such offence. Any other director, manager, secretary or other officer of the company can also be punished if it is proved that the offence has been committed with the consent or connivance of, or is attributable to any neglect on the part of such person.[69]

In the financial year 2010-11, 24 prosecution cases were disposed by courts and 17 new cases were initiated.[70] The general criminal law provisions pertaining to cheating and criminal breach of trust are used to fix responsibility for fraud in the securities market. But due to the lack of reported case law in this area, it remains unclear, whether the Indian Penal Code, 1860 is sufficient to address manipulation in the securities market.

Prohibitions Under the FUTP Regulations

The FUTP regulations provide an inclusive definition for fraudulent and unfair trade practice.[71] Any act or omission amounting to manipulation of the price of a security is an offence irrespective of whether there is any wrongful gain or avoidance of any loss in such dealings. Any pretentious transaction which causes fluctuations in prices

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[68] *Id.*, s.27.

[69] *Ibid.*

[70] For details of investigation cases taken up and completed during the period see the Annual Report of Securities and Exchange Board of India, 2010-2011, table 3.20 and table 3.25., To view the table see appendix I, table 5.

[71] The Securities and Exchange Board of India (FUTP) Regulations, 2003, cl.3 & 4.

to induce others to buy or sell securities is prohibited. Artificially raising or depressing the prices of securities and thereby inducing the sale or purchase of securities by investor's amount to price manipulation. This leads to inefficient pricing and sizeable loss of investor wealth. Price can be manipulated by circular trading, synchronized trading and many other dubious methods.

Market manipulation is effected through a series of transactions intended to artificially raise or lower the price of a security or to give the appearance of trading for the purpose of establishing an artificial price for the scrip.[72] Investors rely on the market forces of demand and supply for taking investment decisions. Dealing in securities is deemed to be a fraudulent and unfair if it involves fraud.[73]

Creation of a false or misleading appearance of trading on the securities market is prohibited.[74] Dealing in a security with an intention of not effecting transfer of beneficial ownership but to inflate, depress or cause fluctuations in the price of such security is prohibited.[75] Advancing or agreeing to advance money to any person thereby inducing such person to buy any security in any issue with the intention of securing the minimum subscription to such issue amounts to a fraudulent trade practice.[76] Paying or offering money to any person for inducing him to deal in any security

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[72] The Investigation Module for Market Manipulation, National Stock Exchange of India, Financial Institutions Reforms and Expansion (FIRE) Project, August 13, 1997, p.5.

[73] The Securities and Exchange Board of India (FUTP) Regulations, 2003, cl.4 (2)

[74] *Id.*, cl.4 (2)(a).

[75] *Id.*, cl.4 (2)(b).

[76] *Id.*, cl.4 (2)(c).

with the object of inflating, depressing, maintaining or causing fluctuation in the price of such security is an unfair trade practice.[77]

Price rigging is also prohibited as an unfair trade practice.[78] The term rigging denotes the practice of inflating the price of given stocks or enhancing their quoted value by a system of pretended purchases. The purchases are designed to give the impression of an unusual demand for such stocks.[79] Creation of artificial scarcity of shares is also a fraudulent trade practice.[80] It leads to illiquidity in the shares and volatility in prices.

The regulations prohibit persons dealing in securities from publishing or reporting any information which is untrue.[81] Entering into a transaction in securities without intention of performing it or without the intention of change of ownership of such security is an unfair trade practice.[82] The regulations prohibit selling, dealing or pledging of stolen or counterfeit security in physical or dematerialized form.[83]

Circular Trading

In circular trading a false or misleading appearance of trading is created to manipulate the price of the share. The shares which are once

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[77] *Id*., cl.4(2)(d).

[78] *Id.*, cl.4(2) (e).

[79] *Sanman Consultants* v. *Securities & Exchange Board of India*, Order by C.Achuthan (Presiding Officer) SAT, Mumbai dated January 31, 2001, available at www.sebi.gov.in/satorders/Sanman.html.

[80] *M/s.Tirupati Finlease Ltd*., v. *Securities & Exchange Board of India*, Order by C.Achuthan (Presiding Officer), SAT, Mumbai dated August 2000, available at www. sebi.gov.in/satorders.

[81] The Securities And Exchange Board of India (FUTP) Regulations, 2003, cl.4 (2)(f).

[82] *Id*., cl.4 (2) (g).

[83] *Id*., cl.4 (2) (h).

sold are bought by the same person (seller himself or person acting in concert) without any transfer in beneficial ownership. It is effected with the help of stock brokers who collude with the seller/purchaser and his group to give a false appearance of active trading. In circular trading, the shares which are once sold by the offender comes back to him through other brokers. The circle is thus completed when shares comes into the possession of the very same seller.

Circular trades create an impression of a high demand for the share and result in distortion of the market equilibrium. The common investors are vulnerable to be misled by the falsely created volume of trading. Trading activity arouses strong interest among public investors who are induced to purchase shares of that particular company.

The *Haresh Ponsak* case is a typical case of circular trading.[84] On receiving complaints from the Bombay Stock Exchange, SEBI conducted an investigation in the trading in the scrip of K Sera Sera Productions Ltd. The investigation revealed a circular trading pattern in the scrip amongst certain stock brokers, for their client Haresh Ponsak. The trades were circular and reversal of trades resulted in the creation of artificial volume of trading. The majority of the trades effected amongst the group of stock brokers were through synchronized orders. The stock broking

[84] Order by the Mr D. Ravikumar, (Adjudicating Officer), SEBI dated February 28, 2011, available at http://www.sebi.gov.in/sebiweb/home/list/2/9/2/0/Orders-of-Chairman-Members. The investigation revealed that during the period of May and August 2005, the price of the scrip opened at 74.35 on May 2, 2005 and touched its period high of 97.50 on May 24, 2005 and closed at 89.25 on July 1, 2005. The average daily volumes during the period May 2, 2005 to June 23, 2005 were 63,000 shares. A spurt in the volume was observed from June 24, 2005 onwards and the daily average volume was of 23 lakh shares.

entities executed trades with a pre-determined plan to match their trades. The transactions did not result in transfer of beneficial ownership but created artificial volume of trading. The defendant indulged in circular trading over a period of 16 trading days which created high volume of trading and inflated the price of the scrip. The allegations against the defendant were proved and he was found guilty.

Creation of Misleading Appearance of Trading

Creation of misleading appearance of trading is prohibited under the FUTP regulations. In *Jatin Shah's* case[85] the investigation conducted by SEBI found that the defendants were instrumental in bringing common clients together to transfer the shares in off market and subsequently off loading the same in the market. The modus-operandi amounted to using common clients for creating artificial volume of trading. During the investigation period, there was a steep decline in the shareholding of the promoters and persons acting in concert. The defendants were entities connected to the company, its directors and promoters. They were instrumental in transferring the shares in the off market to some common clients who eventually sold the shares in the market. This generated volumes in the scrip of the company thereby impacting the investors at large. The notices were found guilty for creating artificial appearance of trading.

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[85] P.K.Bindlish (Adjudicating Officer), SEBI dated 9/11/2009 available at http://www.sebi.gov.in/sebiweb/home/list/2/9/2/0/Orders-of-Chairman-Members. A penalty of Rupees ten lakh was imposed on Shri. Jatin Shah and five lakh on the other noticees.

Price Rigging

When the market forces of demand and supply is tampered with, the price is said to be rigged. The rigging scheme is operated with the help of genuine buyers and sellers in the market who are themselves the victims of the scheme. Hence before penalising the person, it is absolutely necessary to find out whether the particular person was a manipulator or genuine investor.

In *Sanman Consultants* v. *Securities & Exchange Board of India*[86] the Securities Appellate Tribunal held that unless there is sufficient proof to establish that the defendant was manipulating the market at some point of time, no penalty can be imposed on him for price rigging. In a market, where share price is rigged, even unsuspecting and genuine investors may get involved. Genuine investors are the casualities of such manipulations. The tribunal observed that it may not be correct to generalise that all those who had transacted in the shares of the company during that particular period were manipulators. On the basis of a stray case of purchase or sale, it cannot be concluded that it was a case of manipulation. In order to sustain the charge of price rigging, adequate proof of the role played by the investor in price rigging is necessary.

Insider Trading

Insider trading in securities occurs when a person in possession of material non public price sensitive information about a company trades

[86] Order by C.Achuthan (Presiding Officer), SAT, Mumbai dated January 31, 2001, available at www.sebi.gov.in/satorders/Sanman.html.

in the company's securities to make a profit or avoid a loss.[87] The essence of the offence is trading on the basis of the information which is known to the trader but is not available to the market generally. Insider trading undermine investor confidence in the securities market and thereby discourage investment.

Legal scholars are divided on the issue of whether insider trading is to be criminalized or not. Some scholars argue that insider dealing is good for the economy.[88] They do not consider insider trading as something unethical or illegal. They argue that insiders who are also shareholders should have the same rights as ordinary shareholders to trade based on their information and judgment.[89]

The supporters of insider trading regulation argue that frequent traders are the victims of insider trading.[90] The misappropriation theory regards the use of price sensitive information as a theft of the property of the company.[91] Securing the confidence of investors in the securities market

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87 Janet Dine & Marios Koutsias, *Company Law*, Palgrave Macmillian Law Makers, Newyork (2007), p.232.

88 Henry G Manne, *Insider Trading and Stock Market*, Free Press, New York (1966), p. 3.

89 See Yulong Ma, "Where Should the Line Be Drawn on Insider Trading Ethics?", 17 *Journal of Business Ethics* 67 (1998).

90 Harold Marshal, Henry Manne, "Insider Trading and Stock Market", (Book Review) 66 Mich.L.R.1317 (1968); William K S Wang, "Stock Market Insider Trading: Victims, Violators and Remedies-Including an Analogy to Fraud in the Sale of a Used Car With a Generic Defect", 45 *Villanova Law Review* 27 (2000).

91 Keith Adam Simon, "The Misappropriation Theory: A Valid Application of Section 10(B) to Protect Property Rights in Information", 88 J.Crim.L.Criminology 1049 (1998).

provides the rationale for criminalizing insider trading.[92] Allowing insiders to trade at the expense of uninformed outsiders hurts the integrity of capital markets.[93] In the presence of insider trading an uninformed investor is likely to be a buyer when stock is overvalued and a seller when it is undervalued. In anticipation of losses, he may choose not to trade at all.[94] If insider trading is not regulated, trading becomes a game between the informed and uninformed players.

Regulations on Insider Trading

In the United Kingdom, regulation of self-dealing evolved from the common law equitable rule that illegal use of price sensitive information for the personal advantage of the officer amounts to breach of fiduciary duties owed to the company.[95] The officers are liable to account for any profits they have made.[96] The first proposal to prohibit insider trading was made by the Jenkins Committee.[97] Again the Justice Committee Report on Insider Trading recommended that insider trading should be penalised.[98]

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92 Paul L Davies, *Gower's Principles of Company Law*, Sweet & Maxwell, London (1997), p.457.

93 Brudney, "Insiders, Outsiders, and the Informational Advantages under the Federal Securities Laws",93 Harv.L.R.322.(1979)

94 This phenomenon is referred as adverse selection problem. See Manove, "The Harm from Insider Trading and Informed Speculation", 104 *Quarterly Journal of Economics* 823 (1989).

95 Paul L Davies, *Gower's Principles of Company Law*, Sweet & Maxwell, London (2008), p.1088.

96 *Ibid*.

97 Report of the Company Law Committee, 1962, Board of Trade, UK.

98 Maurice Kay, "The Justice Report on Insider Trading", 36 M.L.R.185 (1973).

In the UK, insider trading became an offence in 1980.[99] The provisions relating to insider trading were later consolidated into the Company Securities (Insider Dealing) Act, 1985. Later the offence was brought under Part V of the Criminal Justice Act, 1993 to make the law in conformity with the European Community Directive on insider trading. Directors, managers and other officers of the issuing company are covered under the definition of 'insider' and are liable to be prosecuted under the Act. The Act creates two types of insider dealing offences namely, the dealing offence and the tipping offence. The dealing offence is aimed at those who deal in securities on the basis of inside information.[100] The tipping offence is committed either by disclosing the inside information or by encouraging another to deal in particular kinds of securities and in specified circumstances.

The UK experience has shown that only a small proportion of the insider trading cases are prosecuted.[101] Both the offence and the transactions which constitute the crime are complicated. It is extremely difficult to secure convictions for the offence. [102] Subsequently insider

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[99] The Companies Act, 1980, s.68 reads, "An individual must not deal in the securities of a company if he has information which:

(a) he holds by virtue of being connected with the company;

(b) it would be reasonable to expect a person so connected and in the position by virtue of which he is so connected not to disclose except for the proper performance of the function attaching to that position; and

(c) he knows is unpublished price sensitive information in relation to those securities".

[100] Alexander F. Loke, "From the Fiduciary Theory to Information Abuse: The Changing Fabric of Insider Trading Law in the U.K., Australia and Singapore", 54 *The American Journal of Comparative Law* 123 (2006).

[101] *Supra* n. 95 at p.1091.

[102] *Ibid.*

trading was brought under the market abuse regime of the Financial Services and Management Act, 2000.

Regulation of Insider Trading in the US

In the US, detection and prosecution of insider trading is one of the top enforcement priorities of the Securities and Exchange Commission. Insider trading came to be regulated since the passage of the Securities Exchange Act, 1934.[103]

The US courts have propounded various theories to justify the prohibition on insider trading. In *Cady, Roberts & Co.*[104] the Securities Exchange Commission established the "disclose-or-abstain" rule to determine liability for insider trading. The disclose or abstain rule is based on the equal access theory which operates under the assumption that all traders owe a duty to the market to disclose or refrain from trading based on nonpublic corporate information. The rule requires those who have access to material non-public information to either disclose it or else abstain from trading based on that information. As a fiduciary, the corporate officers owe a duty not to take undue advantage of their position.

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[103] Insider trading is regulated under rule 10b-5 promulgated under 10(b) of the Securities Exchange Act, 1934.The other legislations that cover illegal insider trading include the Securities Act, 1933; the Securities Exchange Act, 1934 and the SEC rules; the Insider Trading Sanctions Act,1984 (ITSA), and the Insider Trading and Securities Fraud Enforcement Act, 1988 (ITSFEA).

[104] 40 S.E.C.907 (1961).The facts of the case were that administrative proceedings were brought to determine whether leakage of the news of an impending dividend cut by a board member to a stockbroker and subsequent sale of securities by the broker violated the insider trading rule. The broker was found guilty and suspended from the New York Stock Exchange for 20 days.

The disclose-or-abstain rule was later successfully applied in the case of the *SEC* v. *Texas Gulf Sulphur Co.*[105] in which the purchase of company stock by insiders prior to the announcement of a mineral discovery was held to be in violation of insider trading regulations. Any one who has access, directly or indirectly to information intended to be available for a corporate purpose is bound by the insider trading regulations. The second circuit court laid down the test for assessing 'materiality' of information. The court found that any fact which in reasonable and objective contemplation might affect the value of the corporation's stock or securities is 'material'. Such facts include not only information pertaining to a corporation's earnings and distributions, but also those facts which affect the probable future of the company. Information which can affect the desire of investors to buy, sell or hold the company's securities is also a material fact.

The US Supreme Court rejected the equal access theory and adopted the fiduciary duty theory in *Chiarella* v. *United States.*[106] The Court of Appeal for the second circuit found the accused guilty of insider trading on the ground that an individual who received information from a source outside the company is equally bound not to misuse the information. Anyone who regularly receives material non-public information is bound by

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[105] 401 F.2d 833 (2d Cir. 1968).

[106] 445 U.S.222 (1980). The defendant was a markup man who worked for a financial printer in New York that printed announcements of corporate takeover bids. Name of the target company was not revealed until the last minute. The defendant deduced the identity of the target company. He gained more than $30,000 in fourteen months by using this information to buy shares of the target corporations so that he could benefit from the price rises when the takeover bids were announced. The SEC ordered the defendant to return his profits to the sellers of the shares. He was prosecuted for violating section 10(b) and Rule l0b-5.

the disclosure obligation. However the US Supreme Court reversed the conviction of the accused on the ground that traders have no general duty to disclose any special information in their possession to their trading partners. The court observed that a duty to disclose cannot arise in the absence of a pre-existing fiduciary relationship.

In *Dirks* v. *S.E.C.*, [107] the fiduciary duty theory was extended to include constructive insiders. There exists a confidential relationship between the lawyers, accountants, underwriters and the company. The tippers (persons who passes the information) and tippees (persons to whom information is passed) owe the obligation either to 'disclose the information or abstain from trading'. The Supreme Court reiterated the view that the duty to disclose arises only if there exits a pre-existing fiduciary obligation between the parties.

[107] 463 U.S.646 (1983).The facts of the case were as follows: Raymond Dirks was an officer in a broker-dealer firm in New York. He was specialized in providing investment analyses of insurance companies for institutional investors. He received information from a former officer of Equity Funding of America, a company whose primary business was selling life insurance and mutual funds. A former Equity Funding officer told Dirks that there was massive fraud occurring inside Equity Funding and that its assets were vastly overrated. Dirk interviewed many Equity Funding employees. Though senior management denied the rumors of internal fraud, other employees confirmed the allegations. Dirks told other investment advisors about the fraud he was uncovering. These advisors then traded the stock in Equity Funding held by their clients. The price of the stock declined sharply. Later the California insurance authorities took action, the SEC began an investigation. Though Dirks had never owned stock in Equity Funding, nor had his brokerage company traded in the firm, Dirks was charged insider trading because those to whom he selectively revealed his information had sold early, avoiding the catastrophic losses that occurred when the scandal broke. SEC argued that Dirks had been a "tippee" of inside information and that he had illegally used it in the market without first publicly disclosing it. Dirks was found guilty of violating section 10(b) and Rule 10b-5, but was censured. On appeal, D.C. Circuit affirmed the conviction, but the Supreme Court reversed the conviction.

Fiduciary theory requires a fiduciary relationship between the issuer whose shares are traded and the person who misuses the information. A theory of insider trading based solely on fiduciary duties was criticized as inadequate to regulate insider trading.[108]

The US Supreme Court developed the misappropriation theory in *United States* v. *Carpenter*'[109] The misappropriation theory holds that a person commits fraud in connection with a securities transaction, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of information. The misappropriation theory was developed to widen the reach of the insider trading rules to company outsiders who trade illicitly on confidential information. In *United States* v. *O'Hagan,*[110] the partner at a law firm involved in tender offer was found guilty of insider trading

Recently the United States District Court for the Southern District of New York convicted Raj Rajaratnam, a New York-based hedge fund management firm for insider trading. He was found guilty of conspiracy and securities fraud and was sentenced to 11 years in prison.[111]

It is widely criticized that criminal sanctions have been ineffective in regulating insider trading.[112] Criminal liability was imposed only in isolated cases. The enforcement system has been blamed for the failure

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[108] Kim Lane Scheppele, "It's Just Not Right": The Ethics of Insider Trading", 56 L.Contem.Prob.123 at p.126 (1993).

[109] 463 U.S. 646 (1983).

[110] 521 U.S. 642 (1997).

[111] Data available from en.wikipedia.org/wiki/Raj_Rajaratnam accessed on 1/12/2011.

[112] Daniel J.Bacastow, "Due Process and Criminal Penalties under Rule 10b-5: The Unconstitutionality and Inefficiency of Criminal Prosecutions for Insider Trading", 73 J.Crim.L. Criminology 96 (1982).

of the regulations.[113] Surveying the cases reported after the *Texas Gulf Sulphar* case,[114] it was found that very less number of prosecutions has been initiated and penalties imposed have been mild.[115]

Regulations on Insider Trading in India

In India, the Sachar Committee, 1978 and the Patel Committee, 1986 recommended reforms in the Companies Act, 1956 to restrict stock dealings by insiders. The SEBI (Prohibition on Insider Trading) Regulations**,** 1992 prohibits an insider of a company from trading in securities of the company when he is in possession of unpublished price sensitive information.[116] Two conditions are to be fulfilled to establish the offence.[117] Firstly, the 'insider' must be a person who is connected with the company and should be a person who is reasonably expected to

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[113] Michael P. Dooley, "Enforcement of Insider Trading Restrictions", 66 Virg.L.R.1 at p.5 (1980).

[114] *Supra* n.105.

[115] *Supra* n.113 at p. 18.

[116] The SEBI (Prohibition of Insider Trading) Regulations, 1992, cl.3 reads, " No insider shall-

(i) either on his own behalf or on behalf of any other person, deal in securities of a company listed on any stock exchange when in possession of any unpublished price sensitive information; or

(ii) communicate counsel or procure directly or indirectly any unpublished price sensitive information to any person who while in possession of such unpublished price sensitive information shall not deal in securities :

Provided that nothing contained above shall be applicable to any communication required in the ordinary course of business or profession or employment or under any law."

[117] *Id.*, cl.(2) (e) reads, "insider" means any person who,

(i) is or was connected with the company or is deemed to have been connected with the company and is reasonably expected to have access to unpublished price sensitive information in respect of securities of a company, or

(ii) has received or has had access to such unpublished price sensitive information."

have access to unpublished price sensitive information. The managers and the controlling shareholders of a company are treated as insiders. Merchant bankers, subsidiary companies and share transfer agents are deemed to be a 'connected person'. [118] Secondly, it has to be established that, he had traded in those securities on the basis of unpublished price sensitive information. The information should be unpublished.[119] Price sensitive information can include any information which is likely to

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[118] *Id*., cl.2 (h) reads, (i) "person is deemed to be a connected person", if such person is a company under the same management or group, or any subsidiary company thereof within the meaning of sub-section (1B) of section 370, or sub-section (11) of section 372, of the Companies Act, 1956, or sub-clause (g) of section 2 of the Monopolies and Restrictive Trade Practices Act, 1969 as the case may be;

(ii) is an intermediary as specified in section 12 of the Act, Investment company, Trustee Company, Asset Management Company or an employee or director thereof or an official of a stock exchange or of clearing house or corporation;

(iii) is a merchant banker, share transfer agent, registrar to an issue, debenture trustee, broker, portfolio manager, Investment Advisor, sub-broker, Investment Company or an employee thereof, or, is a member of the Board of Trustees of mutual fund or a member of the Board of Directors of the Asset Management Company of a mutual fund or is an employee thereof who has a fiduciary relationship with the company;

(iv) is a Member of the Board of Directors, or an employee, of a public financial institution as defined in section 4A of the Companies Act, 1956;

(v) is an official or an employee of a Self-regulatory Organisation recognised or authorised by the Board of a regulatory body;

(vi) is a relative of any of the aforementioned persons;

(vii) is a banker of the company;

(viii) relatives of the connected person; or

(ix) is a concern, firm, trust, Hindu undivided family, company or association of persons wherein any of the connected persons mentioned in sub-clause (i) of clause (c), of this regulation or any of the persons mentioned in sub-clause (vi), (vii) or (viii) of this clause have more than 10 per cent of the holding or interest;

[119] *Id*., cl.2 (k) reads, "unpublished" means information which is not published by the company or its agents and is not specific in nature.

Explanation- Speculative reports in print or electronic media shall not be considered as published information."

materially affect the price of securities of a company.[120] All directors, officers and designated employees of the company are now subject to certain trading restrictions, whereby no trades can be effected by them during the period when the board takes price sensitive decisions.

SEBI is conferred with wide powers of investigation. If the board has suspicion that any person has violated the provisions of the regulation it can make inquiries to form a prima facie opinion as to whether a violation has occurred.[121] SEBI can also appoint officers to inspect the books of accounts of the insider. The board can also appoint an investigating authority to investigate complaints from investors or intermediaries on allegations of insider trading.[122]

Insider trading draws a penalty of Rs. 25 crores or three times the profits made out of defined illegal transactions.[123] Apart from initiating criminal prosecution, the following remedial orders can be issued by SEBI. The insider can be directed not to deal in securities in any

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[120] *Id.*, cl.2 (ha) reads, "price sensitive information" means any information which relates directly or indirectly to a company and which if published is likely to materially affect the price of securities of company.

Explanation.— The following shall be deemed to be price sensitive information :-

(i) periodical financial results of the company;

(ii) intended declaration of dividends (both interim and final);

(iii) issue of securities or buy-back of securities;

(iv) any major expansion plans or execution of new projects;

(v) amalgamation, mergers or takeovers;

(vi) disposal of the whole or substantial part of the undertaking; and

(vii) significant changes in policies, plans or operations of the company."

[121] *Id.*, cl.4A.

[122] *Id.*, cl.5.

[123] The Securities and Exchange Board of India Act, 1992, s.15 G.

particular manner.[124] He can be prohibited from disposing of securities acquired in violation of the regulations. SEBI can restrain the insider from communicating to or counseling others to deal in securities. SEBI is also empowered to declare the transaction in securities as null and void. SEBI can direct the person who acquired the securities in violation of the regulations to deliver the securities back to the seller and to transfer the proceeds of the deal to the investor protection fund of a stock exchange.[125]

Elements of the Offence: Grey Areas

It is very difficult to establish the offence of insider trading. The difficulty in proving the ingredients of the offence has resulted in very few successful prosecutions. Firstly it has to be proved that trading was effected on the basis of 'unpublished price sensitive information'. In *Hindustan Lever Ltd.*, v. *SEBI,*[126] the Hindustan Lever Ltd. and its

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[124] The Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992, cl.11.

[125] *Ibid.*

[126] (1998) 3 Comp.L.J.473 (A.A.) The allegation was that Hindustan Lever Ltd. had indulged in insider trading in the purchase of shares of Brook Bond Lipton India Ltd. from UTI two weeks prior to the public announcement of the merger of the two companies. SEBI conducted enquiries and passed an order charging HLL with insider trading. SEBI directed HLL to pay compensation to UTI, and also initiated criminal proceedings against the five common directors of HLL and BBLIL. Later HLL filed an appeal with the appellate authority (Central Government). HLL-BBLIL merger was a case of merger of two healthy companies having a similar management structure. There was enough circumstantial evidence to show that the transaction of acquiring 8 lakh of shares of BBLIL by HLL from UTI was motivated by the impending merger. SEBI's conclusion that HLL was a deemed connected person of BBLIL and that it received information by virtue of such connection was held to be justified. However the appellate Authority found persuasive evidence which pointed towards market knowledge and widespread speculation about the possibility of merger before the purchase of shares in question. It was also found that UTI continued to sell BBLIL shares in the market after the merger at prices close to the price at which they had sold shares to HLL.

directors were exonerated from the charge of insider trading on the ground that there was widespread speculation about the possibility of merger before the purchase of shares in question. It was found that the information based on which trading was effected cannot be treated as 'unpublished price sensitive information'.

Trading with bad intent is treated as an essential element of the offence of insider trading. The burden is on the prosecution to establish that the trading was effected with a bad intent. The most infamous case highlighting the vulnerability of insider trading regulation is *Rakesh Agarwal* v. *SEBI.*[127] The Securities Appellate Tribunal (SAT) held the

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This was considered as a crucial aspect which weakened the charge of insider trading. Further the appellate authority observed that an order of prosecution should be based on conclusive determination of all aspects of insider trading and on specific justification in terms of gravity of the offence. Hence it was held that SEBI was not justified in ordering prosecution of the appellants.

[127] MANU/SB/0208/2003, decided by C.Achuthan (Presiding Officer), Securities Appellate Tribunal. Rakesh Agarwal, the Managing Director of ABS Industries Ltd., was involved in negotiations with Bayer A.G, regarding their intentions to takeover ABS. Therefore, he had access to this unpublished price sensitive information. It was alleged by SEBI that prior to the announcement of the acquisition, Rakesh Agarwal, through his brother in law, Mr. I.P. Kedia had purchased shares of ABS from the market and tendered the said shares in the open offer made by Bayer thereby making a substantial profit. The investigations of SEBI affirmed these allegations. Bayer AG subsequently acquired ABS. Further he was also an insider as far as ABS is concerned. By dealing in the shares of ABS through his brother-in-law while the information regarding the acquisition of 51% stake by Bayer was not public, the appellant had acted in violation of the Insider Trading Regulations. Rakesh Agarwal contended that he did this in the interests of the company. He desperately wanted this deal to click and pursuant to Bayer's condition to acquire at least 51% shares of ABS, he tried his best at his personal level to supply them with the requisite number of shares, thus, resulting in him asking his brother-in-law to buy the aforesaid shares and later sell them to Bayer. Rakesh Agarwal was found guilty and was asked to deposit the ill gotten gains with the Investor Education & Protection Funds. On appeal, the Securities Appellate Tribunal held that the charge cannot be sustained because the trading was effected in the interests of the ABS company.

charge of insider trading cannot be sustained because the alleged trading was effected in the interests of the company. No evidence was adduced to prove that the appellant had gained any unfair personal advantage over other shareholders. Even though SEBI regulations have defined the offence in absolute terms, the appellate authority exonerated the defendants on the basis of absence of bad intent.

The cases discussed above throw light to the fact that the main difficulty faced by SEBI is in establishing that trading was effected on the basis of unpublished price sensitive information. The necessity of proving the materiality of information is another problem for the regulator. There is lack of clarity on whether intention is an ingredient of the offence. It is hoped that the higher judiciary would be addressing these issues in an appropriate case that comes before it.

Corporate Restructuring: Regulation Through Criminal Sanctions

Globalisation and liberalization has increased merger and acquisition activities world wide.[128] Corporations opt for mergers, amalgamations and takeovers to meet the changing needs of business environment.[129] Takeover implies acquisition of control of a company through purchase of its shares

[128] J Fred Weston *et. al*, *Takeovers, Restructuring and Corporate Governance*, Pearson Prentice Hall, New Delhi (2011), p.1.

[129] The term merger, amalgamation and takeovers are used interchangeably in common parlance. Takeovers can be divided into friendly takeovers and hostile takeovers. Friendly takeover means takeover of one company by change in its management and control through negotiations between the existing promoters and prospective acquirers in a friendly manner. Hostile takeover is one where the acquirer company unilaterally pursues the acquisition of shares of target company. The company which intends to acquire shares in another company is known as acquirer company. The company whose shares are being acquired is known as target company.

or voting rights.[130] It involves not only a transfer of shares but a shift in the control of the company.[131] Hostile takeovers play a significant role in making managers accountable to shareholders.[132] The threat of a hostile bid motivates managers to strive for shareholder wealth maximization.

The takeover boom of the 1960's in the United Kingdom was accompanied by a variety of malpractices and abuses. Inequality of terms offered to the investors of the target company, the manoeuvres adopted to defend the bid and failure to make accurate disclosure of the terms of the deal were the most frequent complaints raised in relation to takeover deals.[133] The strategy adopted to control takeovers can vary from country to country depending on economic policies followed by them. The UK City Code on Takeovers and Mergers follows a shareholder oriented approach.[134] The code is administered by the takeover panel. The Companies Act, 2006 has given statutory recognition to the takeover panel.[135] The code mainly addresses two main concerns.[136] Firstly, it seeks to prevent the management from taking any steps to frustrate a takeover bid. This rule is justified on the principle that the target shareholders should be given complete freedom to decide the fate of the

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[130] K R Chandratre, *Corporate Restructuring*, Bharat Law House, New Delhi (2010), p.421.

[131] *Supra* n.95 at p.961.

[132] John Armour and David A. Skeel, "Who Writes the Rules for Hostile Takeovers, and Why?-The Peculiar Divergence of U.S. and U.K. Takeover Regulation", 95 *The Georgetown Law Journal* 1727(2007).

[133] Tom Hadden, *Company Law and Capitalism,* Weidenfeld and Nicolson, UK (1972), p.375.

[134] *Supra* n.132 at p.1729.

[135] The Companies Act, 2006, s.942.

[136] *Supra* n.95 at p.962.

offer.[137] Secondly, it seeks to protect the non-controlling shareholders by guaranteeing equality of treatment of the target shareholders.

In contrast, the managers of target companies in the US are permitted to use different kinds of defenses to frustrate the takeover bid.[138] The duties owed by the directors of the US and UK target companies are strikingly different. UK has become a fertile land for defensive takeovers because of the ban on use of defensive techniques by the managers.

Takeover Regulation in India

Merger and acquisition activities are booming in India also.[139] The first attempt at regulating takeovers was made through the listing agreement.[140] The SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1994 aimed at ensuring transparency in relation to takeover activities. The 1994 regulations were replaced by the 1997 regulations. It was the outcome of the report and recommendations of Justice P.N. Bhagwati Committee on Takeovers.[141] The committee expressed the need for regulating takeovers in the following words:

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[137] Albert O. Saulsbury, "The Availability of Takeover Defenses and Deal Protection Devices for Anglo-American Target Companies", 37 *Delaware Journal of Corporate Law* 115(2012)

[138] *Ibid.*

[139] Vikramaditya Singh Malik and Vikrant Pachnanda, "Growth via Merger v. Organic Growth: The Indian Context", (2009)4 Comp.L.J.24 (J.).

[140] The Listing Agreement, cl.40 required every person acquiring 25% or more of voting rights of a company to make a public offer. The term 'takeover' is not defined under the Companies Act, 1956. But the provisions relating compromise, arrangement, amalgamation and reconstruction as enumerated under section 391 to 396 of the Act are applicable to takeovers and substantial acquisition of shares.

[141] For the full text of the report see (1997)1 Comp.L.J.98 (J).

> "The confidence of retail investors in the capital market is a crucial factor for its development. Therefore, their interest needs to be protected, an exit opportunity will be given to the investors if they do not want to continue with the new management., full and truthful disclosure will be made of all material information relating to the open offer so as to take an informed decision, the acquirer will ensure the sufficiency of financial resources for the payment of acquisition price to the investors., the process of acquisition and mergers will be completed in a time bound manner. Disclosures will be made of all material transactions at earliest opportunity."[142]

Thus it can be found that investor protection is the main purpose of regulating takeovers in India. The committee favoured strengthening of the takeover regulations by providing criminal sanctions for its violation.

SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 has incorporated many provisions for protecting the interest of shareholders. Disclosure is triggered on acquisition of 5%, 10%, 14%, 54% and 74% of shares or voting rights in a company.[143] Any further acquisition or sale of 2% or more shares of a company by a person holding over 15% of shares in that company triggers disclosure requirements.[144] The regulations provide for continuous disclosure of holdings by a promoter of the company and any person holding more

[142] *Ibid.*

[143] The Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997, cl.7.

[144] *Ibid.*

than 15% of the shares in a company.[145] It mandates the acquirer to make a public offer to shareholders on acquiring 15% or more of voting rights in a company.[146] To enable the takeover of fraud hit companies an amendment had been introduced enabling SEBI to relax the conditions laid down in the regulations on application by the target company.[147]

The obligation of the acquirer and target companies are codified under the regulations.[148] Many restrictions are imposed on target companies during the offer period.[149] Competitive bids can be offered within 21 days of the public announcement of the first offer.[150] A public offer cannot be withdrawn except under the conditions prescribed.[151] The

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[145] *Id*., cl.8.

[146] *Id*., cl.10.

[147] The SEBI (Substantial Acquisition of Shares and Takeovers) (Second Amendment) Regulations, 2009. For full text see (2009)1 Comp.L.J.87(St.)

[148] The Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, cl.22 and 23.

[149] *Id*., cl.23 reads, (1) "Unless the approval of the general body of shareholders is obtained after the date of the public announcement of offer, the board of directors of the target company shall not, during the offer period,—

(a) sell, transfer, encumber or otherwise dispose of or enter into an agreement for sale, transfer, encumbrance or for disposal of assets otherwise, not being sale or disposal of assets in the ordinary course of business, of the company or its subsidiaries; or

(b) issue or allot any authorised but unissued securities carrying voting rights during the offer period; or

(c) enter into any material contracts".

[150] *Id*., cl. 25.

[151] *Id*., cl.27 (1) reads, "No public offer, once made, shall be withdrawn except under the following circumstances:-

(a) omitted

(b) the statutory approval(s) required have been refused;

(c) the sole acquirer, being a natural person, has died;

(d) such circumstances as in the opinion of the Board merit withdrawal".

acquirer is required to deposit money in an escrow account. This is meant as a security for performance of obligations by the acquirer.[152]

SEBI can undertake investigations on any matter in relation to substantial acquisition of shares either suo moto or on receiving complaints from investors or intermediaries.[153] Any person violating the provisions of the regulations is liable to be prosecuted.[154] The acquirer company, its directors, the target company, its directors and the merchant banker can be prosecuted for any mis-statement to the shareholders or for concealment of material information required to be disclosed to the shareholders.[155]

The directors and managers of target company as well as the acquirer owe fiduciary duties to its shareholders. For example the acquirers are expected to act diligently in making acquisition decisions.[156] The SEBI regulation is silent on such obligations. The regulation does not contain any provision to safeguard the interests of shareholders who have dissented to the takeover proposal. If the fiduciary obligations of directors in the context of takeovers are codified and penalties are attached for its non-observance it would be a great step towards achieving shareholder protection.

Securities Laws: Enforcement Pattern in India

The annual report on the administration and working of the Companies Act, 1956 provides the details regarding the prosecutions

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[152] *Id.,* cl.28.

[153] *Id*., cl.38.

[154] *Id*., cl.45.

[155] *Ibid.*

[156] S.M.Rakshitha, "Due Diligence in Mergers and Acquisitions", (2008)1 Comp. L.J.150 (J).

initiated against the companies and its officers for violating various provisions of the Act. As on 31.3.2011 a total of 61149 prosecutions were pending in various courts. A total of 4541 prosecutions were instituted during the year 2010-2011.[157] A total of 5437 prosecutions were disposed of during the year. The nature of defaults and number of prosecutions are given in table 5.5 of the annual report.[158] Comparative data showing the progress of prosecutions during the last five years from 2006-07 to 2010-11 is given in table 5.6.[159] There has been considerable decrease in the number of companies prosecuted during the year, in the number of convictions and in the total amount of fine imposed during the period 2010-2011.The percentage of conviction to total cases decided has declined from 49% in the year 2009-2010 to 46% in the year 2010-2011.

The annual report of SEBI provides data regarding the number of prosecutions initiated, the number of convictions, the number of prosecutions dismissed, the number of prosecutions compounded and the

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[157] See the 55th Annual Report on the Working and Administration of Companies Act, 1956, (2011), Ministry of Corporate Affairs, Table 5.6, Progress of Prosecutions: 2006-07 to 2010-11. To view the table see appendix I, table 3.

[158] *Id*., table 5.5 Nature of Defaults and number of prosecutions filed during 2010-11. To view the table see appendix I table 2.

[159] *Id*., table 5.6 It provides the details regarding the number of companies prosecuted during the year, the number of prosecutions started during the year, the number of prosecutions pending at the beginning of the year, number of prosecutions disposed during the year, the total number of convictions, number of prosecutions ending in acquittals, number of prosecutions withdrawn, number of prosecutions pending at the end of the year, the total fine imposed (in rupees), the total amount awarded as cost to Registrar(in rupees), percentage of conviction to total cases decided, average number of prosecutions per company prosecuted and the average fine imposed per case ending in conviction. The information collected from the office of Registrar of Companies also reveals that criminal sanctions are not widely used as an enforcement strategy. Prosecutions were initiated in very few cases. The information collected is annexed as appendix 2 to 8.

total number of acquittals in each year. Investigations were taken up in cases of price rigging, creation of false market, circular trading, price maintenance, dealing in fake shares, insider trading, front running and takeover of companies without compliance with the relevant regulations.[160] The highest number of prosecutions launched pertained to collective investment scheme cases.

Unfortunately the report is silent on the number of corporate officers convicted and sentenced to imprisonment. The information collected from SEBI under the Right to Information Act, 2005 reveals that there is not even a single case wherein a corporate officer was convicted.[161] It is surprising to find that number of cases where they were sentenced to imprisonment had been only one or two. Reluctance to rely on imprisonment as a means of deterring potential offenders is apparent.

Conclusion

In India there are various regulations to control corporate managerial conduct in securities transactions. It is not the lack of regulations that hamper the effective regulation of corporate manager's conduct in the securities market. But the fault lies with the laxity of enforcement. The insider trading regulation, takeover regulation and the prevention of unfair trade practices regulation prohibit manipulative and fraudulent acts. The violation of the provisions are penalised. But contrary to the western practices, the regulatory agencies in India are relying more on civil penalties than on criminal sanctions in regulating market manipulations. Criminal sanctions remain as a paper tiger. The

[160] *Supra* n.54.

[161] See annexures 9 and 10.

regulatory agencies should rely more on the criminal justice system to make the securities market a safe place for trading. Enforcement of law plays a very important role than the quality of the laws. The Indian legal system has to improve on detection, investigation and prosecution side. Potential offenders will forgo punishment only when the likelihood of apprehension is high. Hence the regulatory agencies should focus more on apprehension and detection. The prosecutors should not be reluctant to apply the public enforcement mechanism.

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Chapter 7

CRIMINAL LIABILITY FOR FRAUDULENT TRADING

Corporate bankruptcies among companies have brought into focus the director's duty to prevent fraudulent trading. Today corporate failure is viewed as a problem resulting from corporate mismanagement. Law has to provide incentives to minimize the likelihood of corporate failures. Imposing liability for fraudulent trading is one mechanism through which law regulates managerial conduct. The duty imposed on directors to prevent fraudulent trading is a mandatory rule meant for creditor protection.

Directors shall take into consideration the interests of creditors during the times of financial distress. Where the company becomes insolvent, it may be put into liquidation or some kind of formal insolvency procedure to protect the creditor's interests. Rescue operations aimed at reviving the business may also be undertaken. If the directors continue trading as usual it can cause potential harm to the creditors. Fraudulent trading provisions seek to address such illicit trading by directors.

The intention behind the fraudulent trading provision is to activate an early managerial response to a financial crisis and to deter them from indulging in unreasonable conduct that may increase the debt burden of the company.[1] Directors are duty bound to monitor their companies' financial condition. Fraudulent trading provisions are intended to address the situation where directors are aware that their company is in financial

[1] Thomas Bachner, "Wrongful Trading-A New European Model for Creditor Protection", 5 E.B.O.R.293 at p.297(2004).

difficulty and they do nothing to protect creditors' interests. If the company is experiencing any financial stress, its directors should avoid any action that may increase the company's debt burden. The provisions are based on a concern for the welfare of creditors exposed to the operation of the principle of limited liability.

In this context it is necessary to trace the evolution of the duty of directors of companies in financial distress and to analyse the arguments for and against the imposition of liability for fraudulent trading. It is also essential to examine whether the concept of 'fraudulent trading' serves the purpose of deterring the controllers of the company from violating the duty to prevent fraudulent trading. An overview of the current fraudulent trading provisions in UK, Australia and India is made and the fundamental differences in the approach followed in the countries are examined. The ramifications, strengths and weaknesses of the respective approaches are also identified.

Before discussing the liability for fraudulent trading, it is essential to understand different categories of corporate creditors and risks faced by them. While imposing liability on directors for fraudulent trading the following issues become relevant. Who has the duty to prevent insolvent trading? When is the duty triggered? When can the company be said to be insolvent? What is the scope of the duty to prevent insolvent trading? What are the defences provided by the legal system? While answering the above questions the chapter analyses whether the existing legal regime of fraudulent trading affords adequate protection to the creditors. If not, the reasons for its failure. Some suggestions to overcome the inadequacies are also proposed.

Corporate Creditors and the Risks

Corporate creditors can be categorised into voluntary creditors and involuntary creditors.[2] Creditors who voluntarily enter into relationship with the corporation are called voluntary creditors or consensual creditors. They include trade creditors, institutional lenders, employees and debenture holders.[3] Involuntary creditors or the non-consensual creditors include the state as tax creditor, other public agencies and tort creditors or the accident victims. Creditors can also be categorised as secured creditors and unsecured creditors on the basis of whether a charge is created over the assets of the company or not.

The primary interest of creditor is in being repaid when the debt is due. The main risk faced by a creditor is that the debtor will not have sufficient funds when payment is due. The possibility that a corporate debtor will fail to meet its debt obligations is referred to as default risk.[4] Creditors face high risk when controllers carry on a high risk strategy to get over a crisis. If the business strategy fails the financial condition of the corporate debtor will become worse. It becomes a typical case of fraudulent trading. The controllers of the company may siphon off

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2 Peter O. Mulbert, "A Synthetic View of Different Concepts of Creditor Protection: A High-Level Framework for Corporate Creditor Protection", 7 E.B.O.R.357 at p.365 (2006).

3 Trade creditors supply goods and services to the company and advance credit by not requiring immediate payment. Banks are the most important group of institutional lenders. A key method of bank lending is the overdraft which allows a company to borrow by overdrawing on a bank account. Employees lend human capital to the company. They are creditors of the company to the extent of money owed to them for wages and other benefits. The standard way in which a company borrows money is by means of issuing debentures. A debenture is a certificate of loan issued by the company.

4 Brain R Cheffins, *Company Law: Theory, Structure and Operation,* Clarendon Press, Oxford (1997), p.69.

company assets into their hands. The controllers may make payments to certain creditors especially themselves in preference to other creditors. The creditors need to be protected against the controllers of the company.[5] Controllers may use the decision making power opportunistically to the prejudice of other stakeholders. If corporations are to survive, creditor protection needs to be an important goal of company law. Corporations may become insolvent on account of fraudulent trading, opportunistic behaviour on part of corporate directors or as a result of a genuine business failure. The high risk of non-performance by the company arises on account of the principle of limited liability. As a consequence of the principle of limited liability, the shareholders are not personally liable to creditors for corporate debts. It encourages excessive risk taking at the expense of creditors.[6] Limited liability directly contradicts the goal of deterrence and punishment.[7] Tort victims are the real risk bearers of limited liability.[8] A creditor can rely on a number of strategies to accommodate the default risk. But the self-help strategies such as diversification of portfolios, inserting covenants into the contract and obtaining collateral from the corporation or its directors do not provide adequate protection to the creditors and they remain in a vulnerable position.[9] The doctrine of limited liability shifts

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5 Thomas Bachner, *Creditor Protection in Private Companies: Anglo German Perspectives For a European Legal Discourse*, Cambridge University Press, Cambridge (2009), p.21.

6 Hansmann and Kraakman, "Toward Unlimited Shareholder Liability for Corporate Torts", 100 Yale L.J.1879 at p.1882 (1991)

7 Cooper Alexander, "Unlimited Shareholder Liability Through a Procedural Lens", 106 Harv.L.R.387 at p. 390 (1992).

8 See Leebron, "Limited Liability, Tort Victims, and Creditors", 91 Colum.L.R.1565 (1991).

9 See Andrew Keay, "Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors," 66 M.L.R.665 (2003) Contractarian theory suggests that creditors can accommodate risk by the inclusion

the risk of failure from the shareholders to the creditors which can be mitigated by imposing a duty to take account of creditor's interest.[10]

The legal system protects corporate creditors to encourage lending. The protection of corporate creditors is based on ethical considerations and notions of fairness.[11] The legal system employs a wide variety of legal techniques to make the controllers of companies accountable to creditors who have supplied capital to the company. The mechanisms used for protection of shareholders' interest are intended to protect corporate creditors also. The disclosure requirements enable prospective creditors to assess the company's financial position. Maintenance of accounts, records and registers also enable creditors to gather information regarding financial position of the company. In order to ensure that companies operate on a financially sound basis, company law imposes a series of restrictions on corporate transactions. The rules relating to raising and maintenance of capital are essentially meant for creditor protection.[12] Criminal sanctions are used for creditor protection in very limited situations. Fraudulent trading is an exceptional situation wherein criminal liability is provided for breach of director's duties towards creditors.

Evolution of the Duty Towards Creditors

In the early days, courts were reluctant to hold that directors must have regard to the interests of creditors.[13] The view prevalent during the

of appropriate measures when contracting with the respective corporate group entities. In practice no such additional protection is gained due to lack of negotiating power, the level of competition and the inferior bargaining position of the creditors.

[10] Andrew Keay, "The Duty of Directors to Take Account of Creditor's Interests: Has It Any Role to Play?", 2002 J.B.L.379 at p. 386.

[11] *Supra* n.2 and 9.

[12] Farrar and Hannigan, *Farrar's Company Law*, Butterworths, London (1998), p.183.

[13] Adolf A. Berle, Jr. & Gardiner C. Means, *The Modern Corporation and Private Property*, Brace & World Inc, New York (1932), p.279.

first decade of the twentieth century was that the director's fiduciary duties were owed solely to the shareholders. During this period a director would not be in breach of his duty to the company if he diminished company's assets in order to pay dividends.[14] In the later years there was a shift of emphasis from the pro-dividend approach. In the landmark case *Trevor* v. *Whitworth* [15] the court established the capital maintenance rule that a company could not buy back its shares. In *Percival* v. *Wright,*[16] the court in answering the question of 'to whom does the director owe a fiduciary duty' held that the directors owed a fiduciary duty to act in the best interests of the company as a whole. Directors are not trustees of the individual shareholders. Directors are treated as trustees of money which is under their control.[17] Directors owe a duty not to misapply company's property. If a director is involved in the misapplication of company's assets he is liable to make good any loss as if he were a trustee of the assets. [18]

During the 1980's there was a wide academic discussion on the question of judicial extension of directors' common law duties towards creditors.[19] There was a strong argument that directors should never owe a duty to creditors as the expanded duty would make directors avoid

[14] *Dent* v. *London Tramways Company* (1880)16 Ch. D.344.

[15] (1887)12 App.Cas.409.

[16] [1902] 2 Ch.D. 421.

[17] *Selangor United Rubber Estates* v. *Cradock*, [1968] 2 All E.R.1073 (Ch.D).

[18] Ross Grantham, "The Judicial Extension of Director's Duties to Creditors", 1991 J.B.L.1.

[19] R C Clark, "The Duties of Corporate Debtor to its Creditors", 90 Harv.L.R.505 (1977); J H Farrar, "The Obligation of a Company's Directors to its Creditors Before Liquidation", 1985 J.B.L.413; Neil Hawke, "Creditor's Interest in Solvent and Insolvent Companies", 1989 J.B.L.54.

entrepreneurial risk.[20] However courts started showing sympathy for the position of creditors. In *Winkworth* v. *Edward Baron development Co. Ltd.,* [21] Lord Templeman stated that a company owes a duty to its creditors, present and future.[22] He observed:

> "A duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited to the prejudice of the creditors."[23]

The directors' duties to creditors were emphasized by Mason J. of the Australian High Court in *Walker* v. *Wimborne*[24] in the following words:

> "In this respect it should be observed that the directors of the company in discharging their duty to the company must take into account the interests of its shareholders and creditors. Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for them."[25]

The duty of directors towards creditors was examined by the House of Lords in *Lohnro* v. *Shell Petroleum Co Ltd.*[26] It was held that the best

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[20] Henry T. C. Hu & Jay Lawrence Westbrook, "Abolition of the Corporate Duty to Creditors", 107 Colum.L.R.1321 (2007); Frederick Tung, "The New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors", 57 Emory L.J.809 (2008).

[21] [1987] 1 All E.R.114 (H.L.).

[22] *Id.*, p.118.

[23] *Ibid.*

[24] (1976)3A.C.L.R.529 (H.C)

[25] *Id.*, p.532.

[26] [1980] 1 W.L.R.627 (H.L.).

interests of the company does not mean the interests of the shareholders exclusively, but it includes the interests of its creditors.

Notwithstanding the broad statements made in the above judgments, in the later cases that followed courts took the view that the duty to protect the interests arises only when the company is insolvent.[27] So long as the company remains a growing concern the company's best interests may be served by having regard to interests of its members. If the company's capital has been lost the shareholders ceases to have stake in the company. During insolvency the company will be effectively trading with the creditor's money. The creditors become the major stakeholders in a financially distressed company and are in effect the real owners of the company.

The judicial opinion is divided as to the circumstances which will cause directors to consider creditor's interest. In *Nicholson* v. *Permakraft (NZ) Ltd.*,[28] the court held that creditors' interests are entitled to consideration if the company is insolvent, or near insolvent or of doubtful solvency. If a contemplated payment or other cause of action would jeopardize the solvency of a company, then also directors should have regard to the creditor's interests. In *Brady* v. *Brady* [29] the House of

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[27] *Liquidator of West Mercia Safety Wear Ltd.,* v. *Dodd,* [1988] B.C.L.C.250 (C.A.).

[28] (1985) 3A.C.L.C.453(C.A.)

[29] [1988]2 All E.R.617 (H.L) The facts of the case were that there was some disagreement between the two brothers who operated the family business. So the business was divided and a new company was formed wholly owned by one of the brothers. This company acquired shares in the original company against loan stock representing half the value of the assets of the original company. This loan stock was issued but there were no assets in the new company. Thereafter the loan stock was redeemed by the original company through a transfer of half its assets to the new company. One of the brother's later alleged that the original company's net assets were undervalued so that he had suffered a loss huge. When he refused to proceed with the arrangement, the

Lords observed that creditor's interest shall take predominance in circumstances of insolvency or doubtful solvency. The creditor's interest can be said to be prejudicially affected only when the company becomes unable to pay its debt. [30]

Insolvency based duty-shifting approach is a well settled principle in the United States also.[31] In *Credit Lyonnais Bank Nederland, N.V.* v. *Pathe Communications Corp.*,[32] Delaware court held that where a corporation is operating in the vicinity of insolvency, the board of directors shall owe its duty to the corporate enterprise as a whole. The directors should not act as mere agents of the shareholders. The shareholders are the residue risk bearers in a solvent company. When the company is solvent, directors owe fiduciary duties to the company which is equated with the interest of the shareholders. As the company becomes insolvent, the creditors become the residue risk bearers and the interest of the company can be equated with the interest of the creditors.

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other brother initiated proceedings for specific performance. The issue for consideration before the court was whether the company's provision of financial assistance to the new company for the acquisition of its shares through the redemption of loan stock issued by the new company was contrary to section 151(2) of the Companies Act, 1985. To save the transaction, it had to fall within the exception provided by section 153(1)(b) where "… the assistance is given in good faith in the interests of the company." The court found that the proportion of assets being removed was so large that it was essential for the question of creditor's interests to be addressed.

30 *Id.*, p.632.

31 See Lipson, "The Expressive Function of Director's Duties to Creditors", 12 *Stanford Journal of Law Business and Finance* 5(2007); Laura Lin, "Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors", 46 Vand.L.R.1485(1993).

32 1991 WL 277613 (Del.Ch.1991) as cited in Remus D. Valsan & Moin A. Yahya, "Shareholders, Creditors and Directors' Fiduciary Duties: A Law and Finance Approach", 2 *Virginia Law & Business Review* 1at p.11 (2007).

The legal system imposes additional responsibilities on company directors where the company approaches the zone of insolvency or financial distress. Continued trading can cause serious harm to the creditors. When a company reaches some stage of financial distress the duty of directors shall shift from a focus on the interests of shareholders to that of creditors. If directors of a company in liquidation are shown to have failed to take steps which they ought to have been taken to minimize loss to the company's creditors they may be held liable for wrongful trading and required to make personal contribution to the company's assets.[33] Specific transactions entered into during the twilight zone[34] and which are prejudicial to the creditors such as transactions at undervalue,[35] fraudulent preferences[36] and transactions with intend to defraud creditors are liable to be set aside.

Insolvency triggers the duty to prevent insolvent trading. Law imposes certain restrictions on specific forms of undesirable conduct by the directors and managers of the firm. Directors shall take some precautionary measures in times of difficulty. If the directors continue trading regardless of the fact that the company is insolvent, it may invite civil as well as criminal sanctions. Law does not require that a company that finds itself insolvent must stop trading and be wound up as soon as possible.[37] Now the emphasis is on corporate rescue and every viable

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[33] The Insolvency Act, 1986 (U.K.), s.214.

[34] The 'twilight zone' is the term used to describe a period of trading when a company has or is predicted to have insufficient cash to pay its debt. See David Milman, "Strategies for Regulating Managerial Performance in the 'Twilight Zone'-Familiar Dilemmas: New Considerations" 2004 J.B.L.493.

[35] The Insolvency Act, 1986 (U.K.), s.238.

[36] *Id.*, s.239.

[37] Goode, *Principles of Corporate Insolvency Law,* Sweet & Maxwell, London (1997), p.472.

business should be continued.[38] It may not be possible to lay down guidelines as to what shall be the appropriate response of managers to a crisis situation. What needs to be done in each case will depend on the facts and circumstances. The directors should take active steps to revive the company. The managers may seek professional advice on how to address the difficulties faced by the company. If the directors disregard the 'warnings' from the professional advisers they may be found guilty of wrongful trading.

In articulating the scope and ambit of the duty to protect the interests of creditors, it is beyond the capacity of courts to give clear guidelines on the do's and don'ts in the twilight zone.[39] An ex-post examination of whether the acts of directors were detrimental to the interests of the creditors is perhaps the only way out. Almost all legal systems recognize that directors owe duties to the creditors. Fraudulent trading is a criminal offence in many jurisdictions.[40]

Justifications for Penalising Fraudulent Trading

The directors of a company that has gone into liquidation can face many consequences. Directors involved in fraudulent trading can be asked to contribute to the funds of the company.[41] They can be disqualified from acting as directors.[42] Misfeasance proceedings can also

[38] Hunter, "The Nature and Functions of a Rescue Culture", 1999 J.B.L.491.

[39] *Ibid.*

[40] The English law has recognized statutory piercing of corporate veil in the case of fraudulent trading since 1929.

[41] *Supra* n.33.

[42] The Directors Disqualification Act, 1986 (U.K.), s.6.

be initiated against such directors.[43] The directors may also be subjected to criminal liability and sentenced to imprisonment.[44]

Criminal liability for fraudulent trading is justified because fraud needs to be deterred. Fraudulent trading provisions protect the creditors from the abuse of limited liability principle. Limited liability principle enables the directors to externalize the risk to creditors. It creates incentives for the directors to make investment in high risk projects. The duty to prevent insolvent trading imposes an obligation on directors to take into consideration the interests of the creditors when the company is in financial difficulties. Liability for fraudulent trading is justified because it is necessary to prevent unreasonable gambling with the money that would have otherwise gone to the creditors upon the dissolution of the company.[45] When a company is insolvent, it is trading with the creditor's money. If the funds which are otherwise payable to creditors are improperly employed to continue trading, the directors are to be made accountable. The existence of criminal liability would encourage directors to be more prudent and discourage them from undertaking risky ventures.

Civil liability for fraudulent trading does not serve the deterrent and preventive objective of proscribing fraudulent trading. Another major limitation with regard to imposing civil liability on directors for fraudulent trading is that only the directors of companies that have gone into liquidation are made liable. Companies that has been rescued by the government by infusion of capital or taken over by another company will never go through the liquidation proceedings. In such

[43] The Companies Act, 1956, s.543.

[44] The Companies Act, 2001 (UK), s.993; the Companies Act, 1956, s.542.

[45] *Supra* n.32 at p.13.

cases it is doubtful whether any fraudulent trading proceedings could ever be initiated against the rogue directors. Disqualification is not an effective deterrent in preventing fraudulent trading.[46] Disqualification has only a marginal effect in improving the behaviour of companies. Hence it is essential that fraudulent trading be backed by criminal sanctions so as to deter directors from resorting to dishonest trading and borrowing.

The argument that fraudulent trading should not be penalised is equally strong. The Australian Law Reform Commission recommended that there shall be no criminal liability for fraudulent trading.[47] Those who oppose insolvent trading provisions argue that it has the effect of making directors unduly risk-averse.[48] Risk taking is a significant factor in promoting economic growth. There is a danger that businesses will be closed down too early by putting companies into voluntary administration or liquidation for fear of personal liability.[49] Such provisions can also deter qualified people from becoming managers. Insolvent trading provisions would inhibit investments that are risky, but are profitable.[50] Liability for insolvent trading over compensates the creditors because

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[46] Andrew Hicks, "Directors Disqualification: Can it Deliver?", 2001 J.B.L.433. The article refers to an empirical study wherein it was found that the threat of disqualification never influenced the directors as to how they ran the business.

[47] The General Insolvency Enquiry, Australia Law Reform Commission, Harmer Report (1988), para 283. Available at www.austlii.edu.au/au/other/alrc/publications/reports/45 visited on 2/10/2009.

[48] *Ibid.*

[49] See Cooke and Hicks, "Wrongful Trading-Predicting Insolvency", 1993 J.B.L.338.

[50] Whincop, "Taking the Corporate Contract More Seriously: The Economic Cases Against and a Transaction Cost Rationale for Insolvent Trading Provisions", 5 Griffith L.R.1at p.28 (1996).

they are already paid for the risk undertaken by means of the contractual agreement.[51]

It cannot be denied that liability for fraudulent trading deters unreasonable trading by corporate directors in times of financial crisis. The liability arises only when the company incurs a debt when it is insolvent. Hence there is every justification for criminalizing fraudulent trading.

Liability for Fraudulent Trading: A Comparative Analysis

It may now be appropriate to examine how fraudulent trading is regulated in UK, Australia and India. Fraudulent trading is regulated under the respective company law statutes. The rights of creditors against the insolvent company are regulated by the insolvency law.[52] Insolvency law aims at maximizing the pool of assets available to the company's creditors for redistributing them among the unsecured creditors.

Fraudulent Trading Law in the UK

The Companies Act, 2006 penalises persons knowingly taking part in a company's business with intend to defraud creditors.[53] The

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[51] *Ibid*.

[52] When the company is solvent the law allows creditors to follow their own strategies to recover the amount due to them. Once the company becomes insolvent the insolvency law steps in imposing restrictions on the creditor's freedom of action to make recoveries. Insolvency law envisages collective action on behalf of all creditors applying the *pari passu* principle in settlement of claims. See Finch, "The Measures of Insolvency Law", 17 O.J.L.S. 227(1997); Sally Wheeler, "Swelling the Assets for Distribution in Corporate Insolvency", 1993 J.B.L.256.

[53] The Companies Act, 2006, s.993 reads,

(1) "If any business of a company is carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, every person who is knowingly a party to the carrying on of the business in that manner commits an offence.

punishment for the offence has been enhanced.[54] Under the Companies Act, 1985 also fraudulent trading was a criminal offence.[55] Every person who was knowingly a party to the carrying on of the business with intent to defraud creditors or for any fraudulent purpose was punishable with imprisonment.[56] The civil remedy for fraudulent trading is provided under the Insolvency Act, 1986.[57] To establish the offence of fraudulent trading the prosecution has to prove the following facts.

Participation in the carrying on of the business

The prosecution has to prove that the defendant took an active part in the carrying on of the business. Under the English law 'every person who is a party to the carrying on of the business of the company' has a duty to avoid fraudulent trading. The term 'party to the carrying on of the

(2) This applies whether or not the company has been, or is in the course of being, wound up.

(3) A person guilty of an offence under this section is liable– (a) on conviction on indictment, to imprisonment for a term not exceeding ten years or a fine (or both); (b) on summary conviction– (i) in England and Wales, to imprisonment for a term not exceeding twelve months or a fine not exceeding the statutory maximum (or both); (ii) in Scotland or Northern Ireland, to imprisonment for a term not exceeding six months or a fine not exceeding the statutory maximum or both".

[54] *Ibid*.

[55] The Companies Act, 1985, s.458 reads, "If any business of a company is carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, every person who was knowingly a party to the carrying on of the business in that manner is liable to imprisonment or a fine, or both. This applies whether or not the company has been, or is in the course of being, wound up".

[56] *Ibid.*

[57] The Insolvency Act, 1986, s.213 reads,

(1) "If in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, the following has effect.

(2) The court, on the application of the liquidator may declare that any persons who were knowingly parties to the carrying on of the business in the manner above-mentioned are to be liable to make such contributions (if any) to the company's assets as the court thinks proper".

business of the company' would encompass the managers and other officers of the company having managerial powers.

In *Re Maidstone Buildings Provisions Ltd.*,[58] the Court of Chancery Division held that a company secretary cannot be included within the term 'parties to the carrying on of the business with intent to defraud creditors'. The liquidator brought proceedings against the company secretary for having failed to advice the directors that the company was insolvent and should cease to trade. The court observed that in order to be a party to the carrying on of the business a person must have taken some positive steps. Mere inertia was not enough. The allegation against the defendant was that he omitted to take steps to prevent the company from trading. He was not concerned with the management of the company. Mere silence and omission cannot make him a party to the carrying on of the business of the company. There was nothing on record to prove that the secretary was involved in the management of the company. Lack of managerial powers prompted the court to absolve the liability of the defendant.

In *Re Gerald Cooper Chemicals Limited (in liquidation),*[59] the corporate creditor was found liable for the offence of fraudulent trading. The creditor had accepted money from the company which he knew had been obtained by committing fraud on another creditor. Templeman J said:

> "In my judgment, a creditor is party to the carrying on of a business with intent to defraud creditors if he accepts money

[58] [1971] 3 All E.R.363 (Ch.D). The court interpreted the term 'party to the carrying on of the business of the company' under section 332 of the Companies Act, 1948.

[59] [1978] 2 All E.R.49 (Ch.D).

which he knows fully well has in fact been procured by carrying on the business with intent to defraud creditors."[60]

The meaning of the term 'parties to the carrying on of the business 'as it appears in section 213 of the Insolvency Act, 1986 was discussed in *Morris* v. *Bank of India.*[61] The Chancery Court held that the term is wide enough to cover creditors who in some way or the other participated in the fraudulent act.

Intention to defraud creditors

Intention to defraud creditors is an essential element of the offence of fraudulent trading. An intention to defraud creditors can be inferred if there was dishonesty involving real moral blame according to current notions of fair trading.

In *R* v. *Grantham,*[62] it was held that there is intend to defraud where a person takes part in the management of a company's affairs and obtains

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[60] *Id.*, p.53.

[61] [2004] 2 B.C.L.C.279 (Ch.D). The facts of the case were that the liquidators of Bank of Commerce and Credit International (BCCI) brought proceedings against the defendant, Bank of India (BOI). It was alleged that BOI had knowingly participated in the carrying on of BCCI's business for a fraudulent purpose and with the intent to defraud BCCI's creditors. Transactions between BCCI and BOI enabled BCCI to conceal bad debts from its auditors and to conceal the fact that it was insolvent. BOI provided loan facilities for a number of companies at BCCI's request. BCCI made equivalent deposits with BOI and guaranteed the loans. BCCI concealed its liabilities to BOI when preparing the accounts. BOI denied having any knowledge that it had participated in the fraud. To establish the case against the defendant the liquidators had to prove that BOI, through its relevant officers and employees, had knowledge that the transactions were for a fraudulent purpose. The court held that it was not necessary that such persons knew the details of the fraud, but rather that they knew that a fraudulent activity was taking place with a view to defrauding someone or for a fraudulent purpose.

[62] [1984] 3 All E.R.166 (C.A).The facts of the case were that the company was involved in the business of livestock. The company bought 39 loads of potatoes

credit for the company when there is no reason for thinking that the funds will become available to pay the debt when it becomes due. There is an intention to defraud the creditor if the debtor intends that the creditor shall never be paid.[63]

Intention to defraud can be inferred where the creditor carries on obtaining credit in a way generally regarded as dishonest. If the directors knew that a particular transaction would prejudicially affect the company's ability to discharge its debts promptly, they should avoid the transaction. An intention to defraud creditors can be inferred in circumstances where the company carries on the business and incurs debts, when there is no reasonable prospect of the company being able to pay them.

It is immaterial that only one creditor has been defrauded. A single transaction can constitute fraudulent trading, provided the transaction can properly be described as fraud on the creditor perpetrated in the course of carrying on the business.[64]

Dishonest Act

The prosecution has to prove that the defendant was acting dishonestly. Fraudulent trading can arise by contracting a new debt or carrying on the business in a reckless way. The defendant can be said to have acted dishonestly and fraudulently if he had knowledge that the company will never be able to meet its liabilities as they fall due. Where a company is seen to have carried on business and incurred debts at a

from a supplier in France. The creditor was induced to supply potatoes at a time when there was no real prospect of being paid.

63 *Id.*, p.169.

64 *Supra* n.59 at p.54.

time when, to the knowledge of the persons concerned, there was no reasonable prospect of creditors ever receiving payment of those debts, an inference to defraud can be drawn.[65] The court has to find that the directors were acting dishonestly, not just that they were acting unreasonably.[66] Difficulty arises in proving that the persons concerned had the knowledge that there was no reasonable prospect of making payment of the debts. The 'dishonesty requirement' casts an unduly excessive burden on the prosecution.[67] The difficulty of establishing dishonest intention has made the remedy little used.[68]

Initiation of Prosecution

Under the Companies Act, 1948 prosecution for the offence of fraudulent trading could be initiated only if an order had been passed to the effect that the persons involved had indulged in trading with intent to defraud creditors or for any fraudulent purpose.

The issue of whether any person can be prosecuted for an offence of fraudulent trading before the company has been put into liquidation was considered by the House of Lords in *D.P.P.* v. *Schildkamp.*[69] The House of Lords considered answered the question in the negative on the ground that the offence of fraudulent trading applied only to acts done before or in the course of winding up. Since the company in question had never been wound up, the defendant was acquitted even though he pleaded guilty to the charge.

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[65] *Re William C. Leitch Bros. Ltd*., [1932] 2 Ch.D.71.

[66] *Re L. Todd (Swanscombe) Ltd.*, [1990] B.C.L.C.454 (Ch.D).The case involved fraudulent evasion of tax.

[67] The Report of the Review Committee on Insolvency Law and Practice, (Cork Report), 1982 (UK), Para 1776.

[68] Janet Dine, "Punishing Directors", 1994 J.B.L.325 at p.333.

[69] [1969]3 All E.R.1640 (H.L.)

In *R* v. *Rollafson,*[70] the Court of Appeal took a similar view and quashed a conviction for fraudulent trading on the ground that the offence was intended to cover acts committed before or during a winding up.

Under the Companies Act, 2006, criminal proceedings can be initiated whether or not winding up proceedings are initiated. The offence will lie whether or not the company has been, or is in the course of being wound up.[71] The new provision is welcome because fraudulent trading ought to be actionable irrespective of whether the company is ultimately wound up or not. It would deter directors from indulging in reckless trading and would make the duty to prevent fraudulent trading more meaningful. This does not mean that every venture involving a risk has to be avoided by the directors. The directors of companies who abuse the facility of limited liability and indulge in reckless trading should be made accountable. The fact that the company ultimately survived the financial crisis shall not be a ground for discharging the directors from liability for fraudulent trading. The offence should be made actionable by the regulatory authorities. Only then would the fraudulent trading provision be able to play a role in preventing corporate failures.

An analysis of the fraudulent trading provisions in the UK would show that a heavy burden is cast on the prosecution to prove fraud and dishonesty to the standard of proof required by criminal law. This diminishes the availability of the remedy. There have been only a few reported cases involving director liability for fraudulent trading.[72] There

[70] [1969] 2 All E.R.833 (C.A.) The case dealt with liability for fraudulent trading under section 332 of the Companies Act, 1948.

[71] The Companies Act, 2006, s. 993(2).

[72] *Supra* n.4 at p.547.

is no accountability in the real sense because liability is incurred only if the persons concerned had knowingly committed the offence and does not address negligence or failure on the part of managers and directors of the company to take proper action in times of financial distress.

Fraudulent Trading Law in Australia

The Australian law imposes a duty on directors to prevent trading when there are reasonable grounds for suspecting insolvency.[73] The director is said to commit the offence if the company incurs a debt at a time when it is insolvent.[74] Criminal liability can be imposed only when the director's duty to prevent the company from incurring the debt was dishonest.

Persons Subject to the Duty

The directors of the company have a duty to prevent insolvent trading. It has been criticized that the duty cast on the corporate director

[73] The Corporations Act, 2001, s.588G (1) reads, "This section applies if:

(a) a person is a director of a company at the time when the company incurs a debt and

(b) the company is insolvent at that time, or becomes insolvent by incurring that debt, or by incurring at that time debts including that debt; and

(c) at that time, there are reasonable grounds for suspecting that the company is insolvent, or would so become insolvent, as the case may be; and

(d) that time is at or after the commencement of this Act".

[74] The Corporations Act, 2001, s. 588G (3) reads, "A person commits an offence if:

(a) a company incurs a debt at a particular time; and (aa) at that time, a person is a director of the company; and

(b) the company is insolvent at that time, or becomes insolvent by incurring that debt, or by incurring at that time debts including that debt; and

(c) the person suspected at the time when the company incurred the debt that the company was insolvent or would become insolvent as a result of incurring that debt or other debts (as in paragraph (1)(b)); and

(d) the person's failure to prevent the company incurring the debt was dishonest".

is an onerous obligation.[75] In comparison with the English position, the Australian position is wider. The duty to prevent insolvent trading is imposed on all the directors of the company. Under English law only 'the persons knowingly party to the carrying on of the business of the company' have such duty.

Earlier any person who took part in the management of the company was liable to be prosecuted for insolvent trading. Managers were held liable under the old provision.[76] The Australian Law Reform Commission recommended that senior managers should not be made liable for insolvent trading and that only those persons entrusted with the overall management of the company shall have the responsibility.[77] Under the current provision the managers who are also members of the board of directors alone can be punished for the offence of fraudulent trading.

Acts Constituting the Offence

Liability for fraudulent trading arises on incurring a debt during the period of insolvency. A company is deemed to incur a debt when it pays dividend, makes reduction of share capital, buy back shares, issues shares and redeems redeemable preference shares, financially assists a person to acquire shares in the company or its holding company and enters into uncommercial transactions.[78] Uncommercial transactions refer to a transaction that a reasonable person in the company's

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[75] JH Farrer, "Responsibility of Directors and Shareholders for a Company's Debts", 4 Canter.L.R.12 at p.32. (1984).

[76] *3M Australia Pty Ltd* v. *Kemish* (1986) 10 A.C.L.R.371(H.C.); *Hussein* v. *Good* (1990) 1 A.C.S.R.71(S.C.).

[77] Supra n. 47 at para 143.

[78] The Corporations Act, 2001,s.588 G (1A)

circumstances would not have entered into, having regard to the benefits and detriment to the company from entering into the transaction.[79] The courts of law decide whether an action is an uncommercial transaction or not. Unliquidated damages obligations or equitable compensation liabilities do not constitute incurring of debt for the purpose of the provision.[80] A debt is incurred when a company obtains goods on credit.[81] The actions coming under the category of 'deemed debts' mostly relate to the rules of capital maintenance.

Thus the Australian company law sets out a range of transactions that constitute the offence and it is supplemented by judicial decisions. Hence it gives sufficient warning for the directors to act diligently in times of financial crisis.

Trading While Insolvent

Duty to prevent insolvent trading arises only when the company is insolvent. A director can be held liable for insolvent trading if the company was insolvent at the time the relevant debt was incurred. This raises the issue of what test is to be applied to determine insolvency. Under Australian law, a company is insolvent if it is unable to pay all of its debts as and when they become due and payable.[82] The directors have to ascertain whether there is an excess of liabilities over assets. Balance

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[79] *Id.*, s.588 (FB).

[80] *Jelin Pvt. Ltd* v. *Johnson* (1987) 5 A.C.L.C.463 (S.C.); *Geraldton Building Co Pty Ltd* v. *Woodmore* (1992) 8 A.C.S.R. 585 (S.C.).

[81] *Credit Corporation Australia Pty Ltd* v. *Atkin,* (1999) 17 A.C.L.C.756 (S.C.).

[82] The Corporations Act, 2001, s. 95A reads,

(1) "A person is solvent if, and only if, the person is able to pay all the person's debts, as and when they become due and payable.

(2) A person who is not solvent is insolvent".

sheet tests and solvency tests are used to assess whether the company is in the vicinity of insolvency.[83] Statutory presumption of insolvency can be made where the company fails to keep proper accounts. [84]

Insolvency is a question of fact to be ascertained from a consideration of the company's financial position taken as a whole.[85] In considering the company's financial position as a whole, the court must have regard to commercial realities. Commercial realities are taken into consideration to decide what resources are available to the company to meet its liabilities and what resources are realisable by sale or borrowing upon security.[86] An objective test is applied to determine whether there were reasonable grounds for suspecting insolvency.[87] Whether there are reasonable grounds for suspecting that the company was insolvent when it incurred the debt in question is to be judged according to a director of ordinary competence who is capable of having a basic understanding of the company's financial status.

Defences Available to Directors

The Act provides four defences to proceedings for a contravention of duty to prevent fraudulent trading.[88] Firstly, a director may furnish evidence that when the debt was incurred, the director had reasonable grounds to expect that the company was solvent and would remain

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[83] Gerald Spindler, "Trading in the Vicinity of Insolvency", 7 E.B.O.R.339 at p.347 (2006). Solvency tests are based on prospects of future cash flow and balance sheet tests are based on study of balance sheet of the company.

[84] The Corporations Act, 2001, s. 588E.

[85] *White Constructions (ACT) Pty Ltd.,* v. *White,* (2004) 49 A.C.S.R.220 (S.C.).

[86] *Id.*, p.289.

[87] *Supra* n.81.

[88] The Corporations Act, 2001, s.588H.

solvent even if it incurred the debt at that time. Secondly, a director may establish that, at the time when the debt was incurred, that he had reasonably relied on an advisor or delegate to monitor the solvency of the company. Thirdly, a director may argue that at the time the debt was incurred, he did not take part in the management of the company because of illness or for some other good reason. Finally, the director may submit that he took reasonable steps not to incur the debt but was over-ruled by the rest of the board. Reasonable steps necessary to avoid potential loss to the directors would include stopping the company from incurring new debt, informing the creditors, applying for appointment of liquidators, and recovery of debts due to the company. It has been found that the defences do not provide adequate relief to the directors in Australia.[89] The directors may be granted relief if it is shown that the director had acted honestly and having regard to all the circumstances of the contravention the person ought fairly to be excused for the contravention.[90]

Initiation of Prosecution

If the Australian Securities and Investment Commission is satisfied that there is sufficient evidence to support a criminal case, it is referred to the Director of Public Prosecutions. [91] If serious criminality is involved criminal action is recommended. No criminal action for fraudulent trading will lie unless there is proof of insolvency.

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[89] An empirical study undertaken in 2004 found that in 75% of cases where the plea of defence was raised it was unsuccessful: See P James, I Ramsay and P Silva, "Insolvent Trading-An Empirical Study", 12 Insolv.L.J.210 at p.221 (2004).

[90] The Corporations Act, 2001, s.1317.

[91] Australian Securities and Investment Commission is the regulatory body set up under the Australian Securities and the Investments Commission Act, 2001 to administer the Corporations Act, 2001.

Even though strong penalties are provided, insolvent trading cases are rare because they are difficult to be proved.[92] It is said that insolvent trading provisions are well intentioned but, in the end, not helpful.[93] The Australian law relating to insolvent trading is more rigorous than that prevailing elsewhere in the world.[94] At the same time due to erratic enforcement policies, they do not deter reckless and fraudulent trading.[95]

Liability for Fraudulent Trading in India

Fraudulent conduct of business is a criminal offence in India also. Where any business of the company is carried on with intend to defraud creditors, every person who was knowingly a party to the carrying on of the business is punishable.[96] Civil and criminal liability for fraudulent

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92 Leon Wolff, "The Dark Side to Australia's Equity Revolution: Credit Crunch, Creditor Protection and Corporate Law", 26 *Ritsumeikan Law Review* 95 (2009).

93 Oesterle, "Corporate Directors' Personal Liability for Insolvent Trading in Australia, Reckless Trading in New Zealand and Wrongful Trading in England: A Recipe for Timid Directors, Hamstrung Controlling Shareholders and Skittish Lenders" in Ramsay (Ed.),*Company Directors' Liability For Insolvent Trading*, Centre For Corporate Law and Securities Regulation, University of Melbourne (2000), p.42.

94 Farrar, J.H, "Directors' Duties and Corporate Governance in Troubled Companies", 8 Canter.L.R.99 (2001).

95 *Ibid.*

96 The Companies Act,1956, s. 542 reads, (1) "If in the course of the winding up of a company, it appears that any business of the company has been carried on, with intent to defraud creditors of the company or any other persons, or for any fraudulent purpose, the Court, on the application of the Official Liquidator, or the liquidator or any creditor or contributory of the company, may, if it thinks it proper so to do, declare that any persons who were knowingly parties to the carrying on of the business in the manner aforesaid shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the Court may direct. On the hearing of an application under this sub-section, the Official Liquidator, or the liquidator, as the case may be, may himself give evidence or call witnesses.

conduct of business is provided under the same provision. The civil liability to contribute such sum to the assets of the company by way of compensation envisaged under the fraudulent trading provision is independent of any criminal liability arising for any misfeasance or breach of trust.[97] The Companies Bill, 2011 proposes to enhance the punishment for fraudulent trading.[98]

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(2) (a) Where the Court makes any such declaration, it may give such further directions as it thinks proper for the purpose of giving effect to that declaration.

(b) In particular, the Court may make provision for making the liability of any such person under the declaration a charge on any debt or obligation due from the company to him, or on any mortgage or charge or any interest in any mortgage or charge on any assets of the company held by or vested in him, or any person on his behalf, or any person claiming as assignee from or through the person liable or any person acting on his behalf.

(c) The Court may, from time to time, make such further order as may be necessary for the purpose of enforcing any charge imposed under this sub-section.

(d) For the purpose of this sub-section, the expression "assignee" includes any person to whom or in whose favour, by the directions of the person liable, the debt. obligation, mortgage or charge was created, issued or transferred or the interest was created, but does not include an assignee for valuable consideration (not including consideration by way of marriage) given in good faith and without notice of any of the matters on the ground of which the declaration is made.

(3) Where any business of a company is carried on with such intent or for such purpose as is mentioned in sub-section (1), every person who was knowingly a party to the carrying on the business in the manner aforesaid, shall be punishable with imprisonment for a term which may extend to two years, or with fine which may extend to five thousand rupees, or with both.

(4) This section shall apply, notwithstanding that the person concerned may be criminally liable in respect of the matters on the ground of which the declaration is to be made".

97 *Official Liquidator* v. *Joginder Singh Kohli,* (1978) 48 Com.Cas.357 (Del).

98 The Companies Bill, 2011, cl.447 reads, "Without prejudice to any liability including repayment of any debt under this Act or any other law for the time being in force, any person who is found to be guilty of fraud, shall be punishable with imprisonment for a term which shall not be less than six months but which may extend to ten years and shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud".

The National Company Law Tribunal has been empowered to deal with sick companies.[99] The number of companies going into liquidation has been steadily increasing in India.[100] But there had been very few fraudulent trading prosecutions in India.

Persons who can be made liable

Under the Indian law 'any person who is knowingly a party to the carrying on of the business of the company' with intend to defraud creditors of the company or for any fraudulent purpose is liable to be punished for the offence of fraudulent trading.

In *Re: Popular Bank Ltd. (In Liquidation)* [101] proceedings were initiated against the directors of the bank for covering up the fraud committed by causing false and fictitious entries in the books of the bank. The defence raised by the directors was that they were not in the executive committee at the relevant period. They had placed implicit trust and confidence in the managers and in the members of the executive committee to whom the power of managing the affairs of the bank had been delegated. The Kerala High Court observed that irrespective of the size and standing of the bank, the volume of business transacted therein, and the efficiency and trustworthiness of the persons to whom responsibilities were entrusted, directors had a duty to ensure that the

[99] The Companies (Amendment) Act, 2002 has consolidated the powers exercised by Company Law Board (CLB), Board of Industrial and Financial Reconstruction (BIFR) and the High Court and entrusted it to the NCLT.

[100] The data on the number of companies under liquidation is provided by the Ministry of Corporate Affairs and is available at www.companyliquidator.gov.in/LiquidationList.htm. The data on number of cases registered before the BIFR is available at www.bifr.nic.in/casesregd.htm.

[101] MANU/KE/0081/1968.

executive committee functioned properly and discharged their functions satisfactorily.

But in subsequent cases the judiciary has taken a narrow approach restricting the liability to persons involved in day today affairs of the company. In *Sandal Chit Fund Financiers Ltd.,* v. *Narinder Kumar Sharma,*[102] the Punjab and Haryana High Court quashed the prosecution for fraudulent trading on the ground that there was no allegation against the directors that they were actively running the affairs of the company. To establish liability against the directors, specific allegations are to be raised. Where there is no specific allegation against a particular director, he cannot be made liable.

It is suggested that the board of directors should be brought within the broad ambit of 'parties to the carrying on of the business of the company'. In the light of the duty of the board of directors to oversee and supervise the managers, laxity of supervision can be a ground for imposing liability for fraudulent trading. Where fraudulent activities are carried on by the managers, the board of directors are bound to see that the fraud is checked at the earliest and that rescue operations are carried out.

Intention to defraud

The fraudulent intent or the fraudulent purpose can be made out from the facts and circumstances of the case. It can be demonstrated by a number of judicial decisions.

In *Official Liquidator* v. *Ram Swaroop,*[103] it was found that the ex-directors had withdrawn huge amounts of money as interest free loan.

[102] (1994) 79 Com.Cas.25 (P.& H.).

[103] A.I.R.1997All.72.

The sum was not returned to the company despite the fact that the financial condition of the company was in a dire state and huge amounts were due towards income-tax, provident fund of the workmen and other dues. The court found that if the ex-directors had not misapplied the funds, the company probably would not have had to face liquidation. The directors of the company had unjustifiably withdrawn huge amount out of the capital of the company and continued to carry on the business of the company even thereafter knowing fully well that the company was running at a loss and was unable to pay its dues. The court held that the allegations were sufficient to charge the directors with liability for fraudulent trading.

The litmus test to determine intention to defraud is whether the directors of the company were aware that there was no reasonable prospect of repayment, at the time of incurring additional liabilities. In *South India Paper Mills Pvt. Ltd* v. *Sree Rama Vilasam Press Publications,* [104] the Kerala High Court held that if the directors had acted on a bonafide belief of rescuing the company, then they cannot be made liable for the offence of fraudulent trading. The court observed:

> "A company may actually be insolvent at a given time; but its directors may bona fide hold a different view. Even in a case where they are aware of the true position, they may still think

[104] (1982) 52 Com.Cas.145 (Ker.) The facts of the case are as follows: The company in liquidation was a printing and publishing concern. The present application was filed by one of the creditor for a declaration that the directors were liable to pay the debt owed to him. The applicant was supplying paper to the company. The allegation against the directors was that the company was obtaining credit facilities after stoppage of business and commencement of winding up proceedings. Supplies were obtained without disclosing the above facts. Court held that carrying on of business after the presentation of a winding-up petition, without disclosing the pendency of the proceedings cannot by itself be presumed to be fraudulent.

that all was not lost and that they would be able to stem the rot by further borrowings and improving the business."[105]

In *Hypine Carbons Limited* v. *J.C. Bhatia,* [106] the court held that mere failure to initiate legal steps against the debtors of the company for the recovery of the amounts due from them would not make the respondents liable for fraudulent trading unless it is shown that the respondents had failed to do so with fraudulent intentions to defraud the creditors, or any other person, or for any other fraudulent purpose.

Dishonesty is an essential element to be proved to establish the offence of fraudulent trading. The intention to defraud is very difficult to make out.

Initiation of prosecution

The Company Law Tribunal cannot pass a penal order for fraudulent trading.[107] The official liquidator can file an application for prosecuting the guilty person.[108] The tribunal may permit the official liquidator to move the court of criminal jurisdiction for appropriate orders.

Criminal proceedings can be initiated only if the tribunal had passed an order that the persons concerned had indulged in fraudulent trading.[109] Ordinarily the proceedings are initiated after determining the

[105] *Id*., p.147.

[106] (2001)103 Com.Cas. 422 (H.P.)

[107] *Hema* v. *M Muthuswamy, Administrator, RPS Benefit Fund Ltd., (In Liquidation),* (2007)139 Com.Cas.214(Mad.)

[108] The Companies Act, 1956, s. 457(1)(a).

[109] *Supra* n.97.

value of the assets of the company and the extent of its liabilities.[110] A declaration that the persons concerned has indulged in fraudulent trading is a precondition for initiation of criminal proceedings. The declaration can be made only if winding up proceedings are completed. If the company has somehow or the other survived the crisis, then the question of examining the conduct of directors would not arise. This rule would not go in tune with the duty of directors to take care of the interests of the creditors when the company is in financial difficulties. The requirement of the event of liquidation and a declaration that the persons concerned has indulged in insolvent trading as a precondition to the initiation of criminal proceedings is not desirable. The law as it stands today is that once the company has overcome its financial difficulties and has become a going concern, the persons in charge of the business cannot be prosecuted for indulging in fraudulent trading. The directors can be prosecuted only if the company in question is wound up. The rule that criminal proceedings can be initiated only if there a declaration that the persons concerned has indulged in insolvent trading should be re-examined so as to enhance the deterrence value of the provision.

A review of the fraudulent trading remedy in India would reveal that its effectiveness is considerably weakened by the conditions that have to be satisfied for its application. The provision remains as a mere paper tiger and does not address the issue of accountability for fraudulent acts. Even though the provision appears to be prima facie harsh, the prospect of a director being found guilty is very low. Reforms are necessary to enhance directorial performance and to prevent corporate failures.

[110] *Ibid.*

Conclusion

It can rightly be said that in reality fraudulent trading provision has failed to provide an efficient mechanism for penalising fraudulent trading activities. There are both substantive and procedural problems involved in the enforcement of the provision. The substantive difficulties are on account of proving the ingredients of the offence especially because of the need to satisfy the criminal burden of proof. The procedural problems arise on account of the conditions to be satisfied for initiating the prosecution. Hence reforms are necessary to make the offence easier to establish. The provision as it exits only barks but never bites. It is suggested that standard of proof required to establish the offence may be lowered.

There is divergence of opinion as to whether the directors or the managers should bear the responsibility for fraudulent trading. It would be appropriate to hold both the mangers and the directors accountable. Manager's liability shall be based on acts of commission or omission. Director's liability shall be based on failure to oversee the affairs of the company. The directors have a duty to be informed under the duty of care owed by directors. Directors are bound to be aware of the financial condition of the company and if they fail to take active steps to recover a company in financial distress, the law should make them responsible for the same. At the same time law should have inbuilt protection to ensure that the officers are not penalised for mere errors of judgment.

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Chapter 8

CONCLUSIONS AND SUGGESTIONS

The corporate failures of the recent times have caused great harm to the society and the economy. Entrepreneurial excess was the main reason for the failures. Investor confidence in the capital market has been eroded. The corporation is widely being used as a vehicle for carrying out criminal activity. The corporate managers who occupy position of power use the organisational resources to commit various crimes. Financial mismanagement and fudging of accounts has taken a heavy toll ruining the lives of thousands of people. Embezzlement of corporate funds is a bane to the Indian capital market. These scams reveal an urgent need to make the laws more deterrent. The legal system uses different mechanisms to make managers accountable for their offensive acts. There is an ever increasing demand from the public to prosecute the perpetrators of corporate crime. The corporate managers and officers who work behind the corporate veil are the real perpetrators of corporate crime. Behind every manipulation there lies a human hand and a human mind. To promote investor confidence in our capital market, law has to ensure that the corporate managers and directors are held accountable for their negligent, reckless or fraudulent conduct. Failure of individual accountability undermines the attempt to regulate corporate crime. The real challenge faced by the legal system is to maintain a proper balance between freedom of corporate managers and corporate managerial accountability. The directors must not feel overburdened with a fear of responsibility that

their decision making is seriously constrained or impaired. The following are the major findings of the study.

a) History of Use of Criminal Sanctions Against Corporate Managers

A brief history of the evolution of the law on managerial accountability shows that criminal sanctions have been used against corporate managers where their failure to properly supervise the affairs of the company resulted in the commission of a crime. Corporate managers ought to be made accountable because they deal with the shareholders money. The acts of the corporations not only affect the shareholders but the society at large. Administrative controls, disclosure requirements, auditing and accounting, doctrine of ultravires, doctrine of capital maintenance and shareholder controls aim at ensuring corporate accountability. The internal control mechanisms have its own limitations in regulating managers' conduct. The mechanisms meant for regulating the behaviour and conduct of corporate managers are backed by criminal sanctions.

b) Corporate Criminal Liability Models and its Efficacy

The theories of corporate criminal liability have solved the substantive and procedural obstacles in imposing criminal liability on corporations to a great extend. But still it is very difficult to establish corporate guilt. Detection and prosecution of corporate crime is beset with many hurdles. Corporate criminal liability has failed to achieve the desired effects. Even if a corporation is convicted, very low punishment is awarded. The sanctions imposed are not sufficient to ensure corporate deterrence. The benefits of crime often outweigh the cost of fines. Corporate criminal liability does not ensure internal accountability. Internal disciplinary actions are seldom taken. Companies are rather

reluctant to embarrass their managers. Hence there arises the need for developing an alternate regime for imposing criminal liability on corporate managers.

c) Rationale for Use of Criminal Sanctions in the Corporate Field

Traditionally criminal sanctions are justified on the rationale of retribution, deterrence, prevention and reformation. These rationales can be extended to the use of criminal sanctions against corporate managers also. The twentieth century witnessed a tremendous growth of corporations. This phenomenon was accompanied by the creation of strict liability offences which theoretically enabled the imposition of criminal sanctions on corporate managers. The developed nations started relying more on criminal sanctions to regulate managerial misconduct. This is particularly evident in case of environmental offences, health and safety offences, antitrust offences and offences relating to product safety. In developed nations, criminal law is playing a significant role in policing corporate crime. The upward trend in criminal prosecution of corporate managers started during the 1980's. Despite the existence of provisions enabling criminal prosecutions against directors, managers and other corporate officers in Indian statutes, corporate managers are prosecuted only in limited number of cases. It is doubtful whether the regulatory agencies have understood the significance of criminal sanctions in its proper perspective. An agent cannot escape liability on the ground that he is acting for the principal. Similarly corporate managers should not be allowed to evade liability because he is acting on behalf of company.

Social realities demand application of criminal sanctions to influence the behaviour of corporate managers to achieve greater end of accountability for corporate crime. There is lack of empirical data on the

extent to which punishing corporate managers would deter corporate crime. It is rather impossible to gather such data and to assess the comparative merits of imposing liability on corporate managers rather than the corporation. In India criminal sanctions have not played a significant role in policing corporate managerial misconduct. The problem lies with the mode of implementation and enforcement. The threat of detection has to be real one and the sanctions should be severe so as to outweigh the benefits out of the crime.

d) Conflicting Judicial Views in India on Individual Responsibility

The Indian judiciary has rendered conflicting decisions on how to conclude that a person has sufficient responsibility within the company so as to fasten criminal responsibility for offences committed by the company. There are divergent views on what degree of control within the corporate organization can be taken as a threshold for imposing personal liability. The principles followed in western jurisdictions are very instructive in this respect. The responsible corporate officer doctrine and wilful blindness doctrine can be adopted into the Indian legal system. It would definitely pave way for increased accountability and responsibility. The judiciary is unwilling to stigmatise and punish corporate managers. Class bias of the judiciary is a major reason for this attitude of the judiciary. Convictions are a rare phenomenon. Even if the prosecution ends in conviction, very low penalties are imposed. This sentencing policy should undergo a positive sociological change for the better.

e) Statutory Attribution of Criminal Responsibility

The company as well as the officer enumerated as 'officer-in-default' under section 5 of the Companies Act, 1956 are punishable for

offences under the Act. Statutory attribution of criminal responsibility was provided to fasten liability on officers exercising power and authority in the company. The provision for statutory attribution of criminal responsibility in regulatory statutes stipulates that the person in charge of the affairs of the company at the time of commission of the offense shall be deemed to be guilty of the offense. The obstacles in the way of attributing criminal responsibility on corporate managers have been explored with the help of case laws.

India still does not have a clear legal regime for statutory attribution of criminal responsibility. There are many instances where the accused persons have escaped liability on the ground that the prosecution has charged liability on the wrong person. If the company has an executive director, then there is a tendency for courts to absolve non-executive directors from liability. The executive directors as well as the members of corporate board should be held responsible for offences committed by the company. Directors should be made accountable for defective supervision of corporate affairs. Liability should be proportionate to the power exercised by the directors. Giving absolute immunity to ordinary directors would be counter-productive. Law should provide sufficient disincentives for passive directors.

e) Violation of Disclosure Rules: Use of Criminal Sanctions

Violation of the disclosure rules are penalised under the Companies Act, 1956 and other allied statutes. In India use of false representations in the prospectus to induce public to subscribe shares is rampant. In India most of the companies vanish after tapping capital from the market. The erring corporate officers are never traced. Making false representations in issue documents are penalised. But it is very difficult to establish the

ingredients of the offence. The law mandates continuous disclosure of financial information. Timely disclosure of financial information regarding the company is very essential to protect shareholders and creditors. The highest number of prosecutions initiated in India is for non-filing of annual returns and balance sheets. The mensrea requirement has diluted the vigour of criminal sanctions. Imprisonment can be awarded only in cases where it is proved that the offence was committed willfully. Most of the corporate failures and scandals in India were the result of manipulation of company accounts. Still, there is lack of proper mechanism for detecting manipulations.

f) Market Manipulation: Use of Criminal Sanctions

Market manipulation interferes with the natural forces of demand and supply. Price rigging, insider trading and other forms of market manipulation have undermined the integrity of capital markets in India. The manipulation is carried out by corporate managers and capital market intermediaries who collude with the managers. Fraudsters reap huge profits at the expense of small investors. Law has played a very limited role in protecting the interests of investors in corporate securities. The regulatory agencies in India are relying more on civil penalties for regulating managerial misconduct in securities market. Very few prosecutions are initiated each year. Intend to manipulate is a key element to be proved to establish a criminal case.

g) Fraudulent Trading: Use of Criminal Sanctions

Fraudulent trading is penalised in India. However the effectiveness of the remedy is considerably weakened by the conditions that have to be satisfied for its application. The prospect of a director being found guilty

is very low. Reforms are necessary to enhance directorial performance and to prevent corporate failures. There are instances where companies were losing profits, while the top managers continued to earn millions as salaries and directors enjoying all benefits and perks. The companies are either taken over or wound up. There is divergence of opinion as to whether the directors or the managers should bear the responsibility for fraudulent trading. Both the mangers and the directors should be held accountable for fraudulent trading. Manager's liability should be based on acts of commission or omission. Director's liability should be based on failure to oversee the affairs of the company. Directors are bound to be aware of the financial condition of the company and if they fail to take active steps to recover a company from financial distress, the law should make them responsible for the same. At the same time law should have inbuilt protection to ensure that the officers are not penalised for mere errors of judgment.

Suggestions

In the light of the analysis and discussions made in the foregoing chapters, the following suggestions are made to make individual accountability more meaningful.

a) Need for ensuring individual accountability of corporate managers

Reliance upon criminal enforcement strategy to regulate corporate managerial misconduct should be retained in the Indian legal system. The existing criminal enforcement system should be strengthened. Regulation through individual responsibility should be the strategy of the criminal enforcement system in its fight against corporate crime. Corporations do not misbehave, it is the individuals who misbehave.

Punishment is likely to have a deterrent effect when an individual such as a corporate officer is held responsible. The suggestion is not that corporate criminal liability should be abolished. Even though individual criminal liability would not be able to do the whole job of regulating corporations, both the liability models should play a co-extensive role in the fight against corporate crime. Hence criminal liability should be imposed simultaneously on the corporations and on those wayward directors and managers whose act has resulted in the commission of the crime.

b) Need for a new regime for statutory attribution of criminal responsibility

Offences committed by companies are on the increase. There is an urgent need to develop new regime for fastening criminal responsibility on corporate managers. The Indian Penal Code, 1860 does not contain any provision for attributing responsibility on corporate officers. It is a serious lacunae that has to be remedied at the earliest. Directors who have been found guilty of defective supervision or management of the corporate body should be made accountable. The outcome of reckless management and supervision might be a criminal violation. Giving instruction to take preventive or corrective measures should not be a ground for exonerating directors from criminal liability. He has to take necessary follow up actions. There should be well established system for feedback communication. The ordinary directors should not be given immunity from prosecution. When offences are committed, it has to be ascertained whether the crime has occurred on account of wrong policy or on account of improper implementation of the policy by the managers. If the corporation pursues a wrong policy, the decision makers including all the members of the corporate board has to be made responsible. If the

crime is the result of improper implementation of the policy by any of the manager, then he alone should be made criminally responsible.

c) Need for a standard pattern for designating officers in corporate hierarchy

Some companies have managing directors, some others have managers and some others have both of them. In addition a company may have a chief executive officer. This often creates confusion for regulatory agencies in determining the 'person in charge of affairs of the company' for the purpose of fixing criminal responsibility under various regulatory statutes. Hence there is a need for adopting a uniform pattern for designating officers in a company.

d) Need to appoint directors as compliance officers

Only the directors of the company should be allowed to be appointed as compliance officers. The whole responsibility of ensuring compliance with various provisions of law cannot be shifted to a paid officer of the company. It would only enable persons who are in charge of affairs of the company to evade responsibility for acts and omissions committed by the company.

e) Need to reduce mental state requirements

The mental state requirements in respect of crimes committed by corporations should be reduced. The 'mensrea requirement' has to be dispensed with in appropriate instances and new standards of liability should be developed. 'Omission' based liability, liability based on failure to take reasonable care and liability based on failure to exercise proper control over corporate activities are different alternative liability models that can be adopted from Western jurisdictions to fasten criminal

responsibility on corporate managers. Intention to commit the crime should be attributed to the responsible officers of the company in circumstances where an omission to take proper measures and exercise proper control over the affairs of the company has resulted in the commission of a crime. The responsible corporate officer doctrine and the willful blindness doctrine can be adopted for fixing liability on corporate managers.

f) Need for lowering the standard of proof

The conviction for a criminal offence requires proof beyond reasonable doubt. Adopting the same standard of proof for corporate crime has resulted in cases being lost because of failure to meet higher evidentiary burden. All the factual circumstances should be taken into consideration to determine the guilt of the corporate managers. The burden of proof in establishing a criminal charge is very onerous. The requirement of intent is very strict that securing conviction has become extremely difficult. The standard of proof beyond reasonable doubt should be substituted with 'proof on the basis of reasonable probability' or 'preponderance of probability'. If it can be inferred that the act or omission on the part of the manager has facilitated the crime, he should be held guilty. Adopting a reasonably lower standard of proof would have enabled courts to fasten responsibility on corporate managers in *Bhopal* like cases.

g) Need for strict enforcement of penal provisions

Once a policy decision has been taken to use criminal sanctions to control corporate crime, the authorities should strictly implement it without any laxity. It is to be made clear that managerial misconduct

would not be tolerated regardless of who and how powerful the culprits are. Corporate crime is more costly than conventional crime, both economically and in terms of human lives. The capacity of criminal law to prevent and control corporate crime through imposition of individual responsibility on corporate managers is greater than other control mechanisms. However it can be achieved only if the criminal provisions are properly implemented in its true spirit. By increasing the certainty of punishment and severity of punishments managers would avoid misconduct. An increase in the probability of apprehension and conviction would deter corporate managers. The magnitude of punishment imposed also acts as deterrence. Even if prosecution is not successful in securing convictions, initiation of criminal prosecution against the erring managers can cause severe damage to the reputation of the executive as well as the corporation. It would give sufficient warning to the offenders that they would be dealt with strictly. Deterrence comes from the overall criminal process including the filing of charge-sheet, trial, conviction and sentencing.

h) Need for formulating a new policy for prosecuting corporate offenders

There is need for evolving a policy for prosecuting corporate entities and corporate officers. The apprehension that criminal prosecution may be launched in cases where criminal enforcement would not be appropriate can be addressed by formulating a clear prosecutorial policy and an enforcement program to tackle corporate crimes. Guidelines can be provided to determine liability of executive directors, non-executive directors, nominee directors and independent directors. Prosecutorial discretion may be used to decline marginal cases. Further the legal system can rely on the wisdom of its trial judges to avoid prosecution in unwanted cases.

i) Need for dedicated regulatory agencies and expert prosecutors.

Threat of criminal enforcement can be meaningful only if there is a dedicated regulatory body to detect, investigate and initiate prosecutions. Different regulatory agencies are entrusted with the duty of protecting the interests of the company, the investors, the workers, the society and the environment. They should always be vigilant to initiate proper action at the right time to prevent loss to the various stakeholders. There should be proper mechanism for periodic inspection of records filed with the regulatory bodies. Cases relating to securities fraud and manipulation should be entrusted with expert prosecutors specialized in the respective field of law.

j) Need for whistle blower protection law.

Detecting the fraud at the earliest opportunity would prevent greater harm to the ordinary investors. Corporate fraud and crime are hatched in secrecy. Regulatory agencies face many difficulties in detecting the crime. Hence law has to provide sufficient incentive for corporate officers and employees to report crimes. A whistle blower protection law with adequate safeguards for persons who give information about corporate crime is the need of the hour. It would induce such persons to assist the investigation team without fear of retaliation.

It is sincerely believed that the suggestions made above would be helpful in formulating a better legal framework for imposing criminal sanctions against corporate managers.

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APPENDICES

Appendix -I

Table 1

Details of Investigation Cases Pending Before Different Courts (as on 31.3.2011)[1]

Name of the Company	Pending Cases		Total Pending
	Company Law	IPC	cases
Daewoo Motors India Ltd.	21	02	23
Design Auto Systems Ltd.	11	02	13
Bonanza Biotech Ltd	16	01	17
Vatsa Corporation Ltd.	106	08	114
Mardia Chemicals Ltd.	22	01	23
Soundcraft Industries Ltd.	35	09	44
Kolar Biotech Ltd.	24	04	28
Adam Comsof Ltd	21	04	25
DSQ Software Ltd.	23	02	25
Usha India Ltd	27	07	34
Malvika Steels Ltd	27	06	33
Koshika Telecom Ltd	41	03	44
Chitrakoot Computers	16	02	18
Classic Credit Ltd	05	01	06
Classic Shares & Stock Broking Services Ltd	09	--	09
Goldfsh Computer P Ltd	22	01	23
KNP Securities Pvt Ltd	15	--	15
Luminant Investrade P Ltd	11	--	11
Manmandir Estate Dev.	02	01	03
N H Securities Ltd	24	01	25
Panther Fincap and Management Services Ltd	24	02	26
Panther Industrial Products Ltd.	25	--	25
Panther Investrade Ltd	14	01	15

[1] The 55th Annual Report on the Working and Administration of Companies Act, 1956, Ministry of Corporate Affairs, 2010-2011, table 5.4. Available at http://www.mca.gov.in/annualreport11 accessed on 10/5/2011

Saimangal Investrade Ltd	18	01	19
Triumph International Finance India Ltd	10	02	12
V N Parekh Securities Pvt Ltd	12	--	12
Triumph Securities P Ltd	22	01	23
Nakshatra Software Pvt Ltd.	17	02	19
Morepen Laboratories Ltd.	12	05	17
Shonk Tech. Ltd.	17	01	18
Shonk Tech. Int. Ltd	09	--	09
Satyam Computer Services Ltd	07	--	07
SHCIL Services Ltd.	09	01	10
JVG Publication Ltd	05	--	05
JVG Steels Ltd.	05	--	05
JVG Holdings Ltd	03	--	03
JVG Farm Fresh Ltd.	06	--	06
JVG Overseas Ltd.	07	--	07
JVG Hotels Ltd.	08	--	08
JVG Industries Ltd.	10	--	10
JVG Techno India Ltd.	06	--	06
Total	**724**	**71**	**795**

Table - 2

Nature of Defaults and Number of Prosecutions Filed During 2010-11[2]

Section of the Act or Rule	Nature of Defaults	Number of Cases Filed
17	Special resolution & Configuration by CLB	1
22	Rectification name of company	2
49	Investments of company to be held in its own name	2
58A(1)	Acceptance of Deposits	11
63	Criminal liability for Mis-statements in Prospectus	1
68	Penalty for fraudulently inducing persons to invest money.	1
73	allotment of shares &debentures to be dealt on stock exchange	2
75	Return as to allotments	1
85	Failure to comply with the provision of said section	1
97	Notice of increase of share capital or of members	4
113	Limitation of the time for issue of certificate	2
125	Failure to company with the provision of said section	1
138	Failure to comply with the provision of said section	1
142	Non compliance of registration of change &satisfaction	9
143	Company's Register of charges	6
146	Registered office of company	8
147	Publication of name by company	10
149	Restriction on Commencement of business	3
150	Register of Members	2
154	Power to close register of members or debenture holders	4
159	Reg Annual Report	61
159/162	Annual return to be made by company having a share capital	1472
163	place of keeping and inspection for registers and returns	1
165/168	Statutory meeting and statutory report of company	79
176(2)	Notices of AGM was not made with reasonable prominence	4
192	Registration of certain resolutions and agreements	5
193	Minutes of proceedings of general meetings and of Board and other meetings	9
196	Default in inspection of minutes of general meetings	1
197	Publication of reports of proceedings of general	1
209A	Inspection of books of accounts etc. of companies	24
209(3)B	non keeping of books as accurals basis	3
209A(5)	Powers of the officer making an Inspection	11

[2] The 55th Annual Report on the Working and Administration of Companies Act, 1956, Ministry of Corporate Affairs, 2010-2011,table 5.5.Available at http://www.mca.gov.in/ annualreport11 accessed on 10/5/2011

210	Annual accounts and balance sheets	12
211	Forms and contents of Balance sheets and profit and loss account	252
212	Reg Balance Sheet	2
215	Authentication of B/s & P.L.A/C	1
217	Board's report	66
219	Right of member to copies of Balance Sheet and auditors report	1
220	Three copies of balance sheet etc. to be fled with Registrar	1981
221	Non disclosures of payments of directors	1
224	Auditors Duty	9
227(3) (d)	Compliances of accounting standard	26
233	Penalty of non compliance of auditor with Section 227 and 229p	227
234	Power of Registrar to call for information or explanation	17
238	Firm body corporate	5
240	production of documents and evidence	1
269	Appointment of Managing or whole time director or Manager to require Government Approval only in certain cases	9
274	Disqualification of Directors	1
283	vacation of office by directors	1
291	General power of board	1
292	Certain powers to be exercised by board only at meeting	11
293	Restriction on power of Board	2
295	Loans to directors etc.	4
297	Board's sanction to be required for certain contracts in which particular directors are interested	12
209	Disclosure of interests by director	5
300	Interested director no. to participate or vote in Boards proceedings	10
301	Register of contracts, companies and firms in which Directors are interested	11
302	Non disclose to members of directors interest in contract appointing manage	1
303	Register of directors managing agents, secretaries and measurers etc.	7
305	failure to company with the provision of said section	7
307	Register of Director's share holdings etc.	5
372	Purchase of shares by company of other companies	7
383A	Certain companies to have secretaries	4
391	Power to compromise or make arrangements with creditors & members	1
394	Provision for facilitating reconstruction & amalgamation of companies	1
614A(2)	failure to comply with the provision of said section	5
628	Penalty for false statements	3
629	Penalty for false evidence	1
629A	Penalty where no specific penalty is provided elsewhere in the Act	58
631	Penalty for improper use of word "Limited" & PA Ltd.	1
Others		29
Total		4541

Table 3
Progress of Prosecutions: 2006-07 to 2010-11[3]

Subject	2006-07	2007-08	2008-09	2009-10	2010-11
Number of companies prosecuted during the year	2668	2140	3616	3196	1653
Number of prosecutions started during the year	10601	17080	13971	9021	4541
Number of prosecutions pending at the beginning of the year	45705	46837	54294	60303	61149
Number of prosecutions disposed during the year	8509	6993	10506	7647	5437
Convictions	2273	4272	3751	3716	2518
Number of prosecutions ending in acquittals	310	226	165	417	198
Number of prosecutions withdrawn or otherwise disposed of (including condonations)	4576	2495	2540	3050	2104
Number of prosecutions pending at the end of the year	47797	54422	57759	61677	60258
Total fne imposed (in rupees)	5814261	11184020	11058647	9230317	7084542
Total amount awarded as cost to Registrar (in rupees)	2729661	3080607	3234539	2901472	2633641
Percentage of conviction to total cases decided	27	61	36	49	46
Average number of prosecutions per company prosecuted	3	3	3	2.4	3.3
Average fine imposed per case ending in conviction (in Rs.)	2557.97	2617.98	2948.18	2483.94	2813.56

[3] 55th Annual Report on the Working and Administration of Companies Act, 1956, Ministry of Corporate Affairs, 2010-2011, table 5.6, Available at http://www.mca.gov.in/annualreport11 accessed on 10/5/2011

Table - 4

Nature of Defaults and Number of Prosecutions Filed During 2009-10[4]

Sl. No.	Section of the Companies Act, 1956 or a Rule	Nature of defaults	Number of Cases fled during the year
(1)	(2)	(3)	(4)
1	21	Change of name by company	2
2	22	Rectifcation name of company	5
3	49	Investments of company to be held in its own name	1
4	58A(1)	Acceptance of Deposits	13
5	58A(9)	Default in repayment of Deposits	5
6	58AA(9)	Intimation to CLB regarding default in repayment of deposits to small Investors	2
7	63	Criminal liability for mis-statements in prospectus	7
8	68	Penalty for fraudulently inducing persons to invest money	6
9	94/95	Non fling of form No. 5 for increase of A/C	1
10	97	Notice of increase of share capital or of members	6
11	143	Company's register of charges	6
12	146	Registered offce of company	46
13	147	Publication of name by company	11
14	149	Restrictions on commencement of business	1
15	150	Register of members	2
16	154	Power to close register of members or debenture holders	21
17	159/162	Annual return to be made by company having a share capital	3818
18	165/168	Statutory meeting and statutory report of company	12
19	166/168	Annual General Meeting	90
20	176(2)	Notice of AGM was not made with reasonable prominence	2
21	192	Registration of Certain resolutions and agreements	2
22	193	Minutes of proceedings of general meetings and of Board and other meetings	14
23	198	Overall maximum managerial remuneration and managerial remuneration in case of absence or inadequacy of profts	2
24	205A	Unpaid dividends to be transferred to special dividend account	2
25	209A	Inspection of books of accounts etc. of companies	19
26	209A(5)	Powers of the offcer making an Inspection	8
27	209(3)(b)	Non-keeping of books on accrual basis	17
28	210	Annual Accounts and balance sheets	134
29	211	Forms and contents of Balance sheets and proft and loss account	228
30	215	Authentication of B/S & P.L. A/C	3

[4] The 54th Annual Report on Working and Administration of Companies Act, 1956, (2009-2010), Ministry of Corporate Affairs, Table: 5.5.

31	217	Board's report	84
32	219	Right of member to copies of Balance Sheet and auditors report	1
33	220	Three copies of balance sheet etc. to be fled with Registrar	4089
34	224	Auditors duty	5
35	227(3)(d)	Compliances of accounting standard	18
36	233	Penalty of non-compliance of auditor with sections 227 and 229.	142
37	234	Power of Registrar to call for information or explanation	25
38	252	Minimum number of Directors	2
39	257	Right of persons other than retiring directors to stand for directorship	1
40	269	Appointment of managing or whole time director or manager to require Government approval only in certain cases	6
41	274	Disqualifcation of Directors	2
42	285	Non meet of Board at least once in every three calendar months	2
43	292	Certain powers to be exercised by Board only at meeting	17
44	293	Restriction on power of Board	2
45	295	Loans to directors etc.	4
46	297	Board's sanction to be required for certain contracts in which particular directors are interested	5
47	299	Disclosure of interests by director	7
48	300	Interested director not to participate or vote in Boards proceedings	3
49	301	Register of Contracts, companies and frms in which Directors are interested	7
50	303	Register of Director's managing agents, secretaries and measurers etc.	6
51	307	Register of Director's share holdings etc.	
52	314	Director etc. not to hold offce or place of proft	1
53	372	Purchase of shares by company of other companies	4
54	383A	Certain companies to have secretaries	13
55	614A	Power of Courts trying offences under the Act to direct the flling of documents with the Registrar	1
56	628	Penalty for false statements	14
57	629	Penalty for false evidence	1
58	629A	Penalty where no specifc penalty is provided elsewhere in the Act	4
59	Rule X	Non fling of returns in form annex to rule 10	4
60	Others		58
	Total		**9021**

Table 5

Nature of Investigations Taken up and Completed by SEBI, 2010-2011[5]

Particulars	Investigations Taken up		Investigations Completed	
	2009-10	2010-11	2009-10	2010-11
1	**2**	**3**	**4**	**5**
Market Manipulation and Price Rigging	44	56	46	51
Capital "Issue" related Manipulation	2	6	7	2
Insider Trading	10	28	10	15
Takeovers	2	4	5	4
Miscellaneouus	13	10	6	10
Total	**71**	**104**	**74**	**82**

Table 6
Prosecutions Launched by SEBI [6]

Year	No. of cases in which prosecution has been launched	No. of persons/ entities against whom prosecution has been launched
1	**2**	**3**
Up to and including 1995-96	9	67
1996 -1997	6	46
1997 -1998	8	63
1998 -1999	11	92
1999 -2000	25	154
2000 -2001	28	128
2001 -2002	95	512
2002 -2003	229	864
2003 -2004	480	2406
2004 -2005	86	432
2005 -2006	30	101
2006 -2007	23	152
2007 -2008	40	185
2008 -2009	29	114
2009 -2010	30	109
2010 -2011	17	67
Total	**1,146**	**5,492**

[5] The Annual Report of the Securities and Exchange Board of India for 2010-2011, Table 3.20.
[6] The Annual Report of the Securities and Exchange Board of India for 2010-2011, table 3.25.

Appendix -2

QUESTIONS ASKED TO REGISTRAR OF COMPANIES UNDER RIGHT TO INFORMATION ACT, 2005.

1) The total number of prosecutions initiated by the officers of the R.O.C. against the managing director/ manager/ directors of the companies in India for violation of sections 58A, 162, 168, 207, 209, 210, 211, 217, 220, 295, 299 & 308 of the Companies Act, 1956 during the year 2006, 2007 and 2008.

2) The total number of cases wherein the managing director, manager and directors of the company had been convicted for violating the above mentioned provisions of The Companies Act,1956 during the year 2006, 2007 and 2008.

3) The total number of cases wherein the managing director/ manager/ directors of the company had been acquitted for prosecutions under the above mentioned provisions of The Companies Act, 1956 during the year 2006, 2007 and 2008. A brief account of the reasons for acquitting the managing director/ manager/ directors of the company for prosecutions under various provisions of the Act during the period may also be given.

Appendix -3

Reply Furnished by R.O.C: Kerala

The companies Act,1956 relevant section	No: of prosecutions launched			No: of convictions			No: of acquittals			No: of cases wherein imprisonment was awarded.		
	2006	2007	2008	2006	2007	2008	2006	2007	2008	2006	2007	2008
58A	1	0	2	0	1	0	1	0	0	0	0	0
162	295	566	536	188	374	511	11	1	2	0	0	0
168	0	4	0	0	1	1	0	0	0	0	0	0
207	0	0	0	0	0	0	0	0	0	0	0	0
209	0	1	2	3	1	2	0	0	0	0	0	0
210	1	3	3	0	2	4	0	0	0	0	0	0
211	0	12	9	0	0	5	0	1	0	0	0	0
217	0	5	3	2	0	2	0	0	0	0	0	0
220	300	566	539	197	400	515	12	1	2	0	0	o
295	0	0	0	0	0	1	0	33	0	0	0	0
299	0	0	0	0	0	0	0	0	0	0	0	0
308	0	0	0	0	0	0	0	0	0	0	0	0
Others	3	14	13	38	4	12	5	0	5	0	1	1
Total	6000	1171	1107	428	783	1053	29	36	09	0	1	0

Appendix -4

Reply furnished by R.O.C: Mumbai

The companies Act,1956 relevant section	No: of prosecutions launched			No: of convictions			No: of acquittals			No: of cases wherein imprisonment was awarded.		
	2006	2007	2008	2006	2007	2008	2006	2007	2008	2006	2007	2008
58A	1	1	0	0	8	0	1	0	0	0	0	0
162	7	310	502	0	0	0	0	1	1	0	0	0
168	0	1	3	0	0	0	0	0	0	0	0	0
207	1	0	0	0	0	0	0	0	0	0	0	0
209	6	2	12	0	0	0	2	10	4	0	0	0
210	0	1	4	0	0	0	0	1	2	0	0	0
211	5	0	45	0	0	0	29	21	17	0	0	0
217	1	0	13	0	0	0	0	4	3	0	0	0
220	10	312	502	0	0	0	0	1	1	0	0	0
295	0	0	3	0	0	0	0	2	2	0	0	0
299	0	0	0	0	0	0	0	0	0	0	0	0
308	0	0	0	0	0	0	0	0	0	0	0	0
Others	13	10	63	0	8	1	45	91	77	0	0	0
Total	44	637	1147	0	8	1	45	91	77	0	0	0

Appendix -5

Reply Furnished by R.O.C: Delhi and Haryana

The companies Act,1956 relevant section	No: of prosecutions launched			No: of convictions			No: of acquittals			No: of cases wherein imprisonment was awarded.		
	2006	2007	2008	2006	2007	2008	2006	2007	2008	2006	2007	2008
58A	0	2	2	0	0	0	0	0	0	0	0	0
162	134	200	215	70	80	315	5	56	0	0	0	0
168	0	0	0	0	0	0	0	0	0	0	0	0
207	0	0	0	0	0	0	0	0	0	0	0	0
209	0	4	6	0	0	30	0	0	0	0	0	0
210	0	0	0	0	0	0	0	0	0	0	0	0
211	5	9	7	9	10	0	0	0	0	0	0	0
217	0	11	9	0	0	0	0	0	0	0	0	0
220	134	202	212	120	80	110	5	30	0	0	0	0
295	0	4	3	0	0	15	0	0	0	0	0	0
299	0	4	7	0	0	10	0	0	0	0	0	0
308	0	0	0	0	0	0	0	0	0	0	0	0
Others	0	13	10	0	53	90	7	40	0	0	0	0
Total	273	449	471	199	223	592	17	126	0	0	0	0

Appendix -6

Reply Furnished by R.O.C: Bangalore

The companies Act,1956 relevant section	No: of prosecutions launched			No: of convictions			No: of acquittals			No: of cases wherein imprisonment was awarded.		
	2006	2007	2008	2006	2007	2008	2006	2007	2008	2006	2007	2008
58A	o	o	2	0	0	1	1	0	0	0	0	0
162	210	277	382	154	95	250	0	0	5	0	0	0
168	10	17	8	2	3	6	0	0	5	0	0	0
207	0	0	0	0	0	0	0	0	0	0	0	0
209	4	0	7	0	1	0	0	0	0	0	0	0
210	11	18	9	12	5	3	00	5	0	0	0	0
211	2	2	9	0	2	0	0	0	0	0	0	0
217	3	1	3	0	1	0	0	0	0	0	0	0
220	251	280	382	207	109	252	0	0	5	0	0	0
295	0	1	0	0	0	0	0	0	0	0	0	0
299	0	0	1	0	0	0	0	0	0	0	0	0
308	0	0	0	0	0	0	0	0	0	0	0	0
Others	11	11	13	0	0	0	0	0	0	0	0	0
Total	502	607	816	375	216	511	1	0	20	0	0	0

Appendix -7

Reply furnished by R.O.C: Chennai

The companies Act,1956 relevant section	No: of prosecutions launched			No: of convictions			No: of acquittals			No: of cases wherein imprisonment was awarded.		
	2006	2007	2008	2006	2007	2008	2006	2007	2008	2006	2007	2008
58A	0	0	4	0	0	0	0	0	0	0	0	0
162	411	136	335	20	79	63	0	4	2	0	0	0
168	0	0	0	0	0	0	0	0	0	0	0	0
207	0	0	0	0	0	0	0	0	0	0	0	0
209	0	0	0	0	0	0	0	0	0	0	0	0
210	0	0	0	0	0	0	0	0	0	0	0	0
211	0	0	4	0	0	0	0	0	0	0	0	0
217	0	0	2	0	0	0	0	0	0	0	0	0
220	412	135	336	21	79	64	0	2	0	0	0	0
295	0	0	0	0	0	0	0	0	0	0	0	0
299	0	0	0	0	0	0	0	0	0	0	0	0
308	0	0	0	0	0	0	0	0	0	0	0	0
Others	0	0	0	0	0	0	0	0	0	0	0	0
Total	823	271	681	41	158	127	0	6	2	0	0	0

Appendix -8

Reply furnished by R.O.C: Kolkota

The companies Act,1956 relevant section	No: of prosecutions launched			No: of convictions			No: of acquittals			No: of cases wherein imprisonment was awarded.		
	2006	2007	2008	2006	2007	2008	2006	2007	2008	2006	2007	2008
58A	8	6	17	0	0	0	0	0	0	0	0	0
162	473	196	459	35	21	2	4	0	0	0	0	0
168	0	2	1	0	0	0	0	0	0	0	0	0
207	0	0	0	0	0	0	0	0	0	1	0	0
209	5	10	31	5	4	0	0	0	0	0	0	0
210	3	2	2	3	0	0	0	0	0	0	0	0
211	18	95	396	27	4	38	0	0	0	0	0	0
217	10	10	58	11	0	3	0	0	0	0	0	0
220	493	204	496	39	24	2	4	0	0	0	0	0
295	0	0	0	4	2	0	0	0	0	0	0	0
299	1	0	4	0	0	0	0	0	0	0	0	0
308	0	0	0	0	0	0	0	0	0	0	0	0
Others	45	67	213	19	11	5	0	0	0	0	1	1
Total	1056	592	1677	143	66	50	8	0	0	2	1	0

Appendix -9

QUESTIONS RAISED TO SECURITIES AND EXCHANGE BOARD OF INDIA UNDER RIGHT TO INFORMATION ACT, 2005.

1) The total number of prosecutions (criminal cases) initiated against the managing director/ manager/ directors of the companies in India for violation of Fraudulent and Unfair Trade Practice Regulations during the period 2008, 2009, 2010, 2011.

2) The total number of prosecutions (criminal cases) initiated against the managing director/ manager/ directors of the companies in India for violation of Insider Trading regulations during the period 2008, 2009, 2010, 2011.

3) The total number of prosecutions (criminal cases) initiated against the managing director/ manager/ directors of the companies in India for violation of SEBI- Issue of Capital and Disclosure Regulations during the period 2009, 2010, 2011.

4) The total number of cases wherein the managing director/ manager/ directors of the company has been convicted for violating for violation of FUTP regulations during the period 2008,2009,2010, 2011.

5) The total number of cases wherein the managing director/ manager/ directors of the company has been convicted for violating for violation of insider trading regulations during the period 2008,2009,2010, 2011.

6) The total number of cases wherein the managing director/ manager/ directors of the company has been convicted for violating for violation of SEBI-ICDR regulations during the period 2009,2010, 2011.

7) Which are the respective provisions of the Indian Penal Code under which corporate executives have been prosecuted for violation of FUTP regulation and Insider Trading Regulations?

8) The total number of prosecutions (criminal cases) initiated against the managing director/ manager/ directors of the companies/ accountants/auditors/ company secretaries in India for accounting frauds during the period 2008, 2009, 2010, 2011.

9) The total number of cases wherein the managing director/ manager/ directors / accountants/ auditors/secretaries of the company has been convicted for committing accounting frauds during the period 2008,2009,2010, 2011.

10) Name of the cases and the court wherein imprisonment has been awarded for violation of FUTP regulation and Insider Trading Regulations.

11) The total number of cases wherein the managing director/ manager/ directors of the company has been acquitted for prosecutions under FUTP regulations and Insider trading Regulations during 2008, 2009,2010,2011.

Appendix -10

REPLY FURNISHED BY SECURITIES AND EXCHANGE BOARD OF INDIA

Reply to question no:1, 2 &7.

The information sought is available on sebi website i.e. www.sebi.gov.in

on the following link

http://www.sebi.gov.in/sebiweb/home/homeaction.do?dolistdept=yes&deptID=14

Reply to question no: 3, 4, 5, 6, 8, 9, 10 &11.

None

Appendix -11

Information Sought from Kerala Pollution Control Board under Right to Information Act, 2005.

1) What are the guidelines followed by the board in prosecuting offences by companies?
2) Whether the persons in charge of the company (managing director/ manager/ directors) are also prosecuted along with the company for offences committed by the company.
3) How many prosecutions were initiated by the board against companies and its managing director/ manager/ directors of the companies in the State of Kerala for violation of the Air Act, Water Act, Environment Protection Act, Indian Penal Code and other statutes for protection of environment during the last three years 2009, 2010 and 2011.
4) What is the total number of cases wherein the managing director/ manager/ directors of the company has been convicted for violating the above mentioned statutes during the year 2009,2010 and 2011.
5) The total number of cases wherein the managing director/ manager/ directors of the company has been awarded the sentence of imprisonment for violating the above mentioned statutes during the year 2009,2010 and 2011.
6) What is the the total number of cases wherein the managing director/ manager/ directors of the company has been acquitted for prosecutions under the above mentioned statutes during the year 2009, 2010 and 2011.
7) What were the main grounds under which the managing director/ manager/ directors of the company were acquitted for prosecutions under various provisions of the Acts during the period.
8) How many cases are pending before the courts of law wherein the managing director/ manager/ directors of the company has been charged for violating the above mentioned statutes during the year 2009,2010 and 2011.
9) Whether any criminal charges are pending against the managers/officers of the Coco Cola plant in Plachimada for violation of various environment protection statutes.

Appendix -12

REPLY FURNISHED BY KERALA STATE POLLUTION CONTROL BOARD.

1. Reply to question no:1.

The Board follows the provisions in the Water act, Air Act and Environment Protection Act and the rules made thereunder for prosecuting offences committed by companies.

2. Reply to question no:2

Prosecution against the company for offences can be launched as per section 47 of the water act, section 40 of Air act and section 16 of Environment (Protection) Act, 1986.

3. Reply to questions no:3 to 8

Nil.

4. Reply to question no:9

The board has not filed any criminal charges against the managers and officers of Coco cola plant in Plachimada. The board has refused the consent o operate issued to the company and directed to stop production. The board has filed special leave petition before the Honourable Supreme court and the Slp No: 25867/2005 is pending. The company is not operating now.

Appendix -13

Research Articles Published by the Research Scholar in the Area of Study

- Preetha S, "The Fraudulent Trading Offence: Need for a Relook", 2011 National University of Juridical Science Law Review published by West Bengal National University of Juridical Sciences, pp. 231-249.
- Preetha S, "Statutory Attribution of Criminal Responsibility for Corporate Crimes" in 2011 Cochin University Law Review, pp. 304 – 344.

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