

**REMEDIES AVAILABLE TO SHAREHOLDERS FOR
MISMANAGEMENT AND FRAUD UNDER THE COMPANIES ACT, 1956**

Process for investigations under § 235

The Companies Act, 1956 (“Act”) confers on the Central Government and the Company Law Board (“CLB”) the power to investigate the affairs of a company *suo moto* or on petition by members of a company. This investigative procedure is allowed under § 235 and § 237 of the Act. § 235 of the Act states as follows:

“(1) The Central Government may, where a report has been made by the Registrar, appoint one or more competent persons as inspectors to investigate the affairs of a company and to report thereon in such manner as the Central Government may direct.

(2) Where—

(a) in the case of a company having a share capital, an application has been received from not less than two hundred members or from members holding not less than one-tenth of the total voting power therein, and

(b) in the case of a company having no share capital, an application has been received from not less than one-fifth of the persons on the company’s Register of Members,

the Company Law Board may, after giving the parties an opportunity of being heard, by order, declare that the affairs of the company ought to be investigated by an inspector or inspectors, and on such a declaration being made the Central Government shall appoint one or more competent persons as inspectors to investigate the affairs of the company and to report thereon in such manner as the Central Government may direct.”

Thus, under § 235 of the Act, the Central Government can order an investigation at the instigation of the Registrar (§ 235(1)) or the CLB (§ 235(2)). The Central Government cannot on its own accord order an investigation into the affairs of a business under § 235. An investigation, furthermore, cannot be instigated simply on the basis of allegations made by one shareholder. (Sri Ramdas Motor

Transport Ltd. v. Tadi Adhinarayana Reddy (1997) 90 Com Cases 383 (SC))
However, as provided in § 235(2), a group of shareholders can collectively petition the CLB to institute an investigation. The powers conferred on the Central Government for ordering an investigation of the affairs of companies under § 235(1) are discretionary, while those conferred by §235(2) are obligatory. The petition under sub-section (2) has to be made to the Principal Bench of the CLB in New Delhi and, as prescribed in the Regulations of the CLB, must be accompanied by the following documents:

- (1) Documentary and/or other evidence in support of the statements made in the petition, as are reasonably known to the petitioner(s);
- (2) Documentary evidence in proof of the eligibility and status of the petitioner(s) with the voting power held by each of them;
- (3) Affidavit verifying the petition;
- (4) Bank draft evidencing payment of application fee;
- (5) Memorandum of appearance in Form No. 5 of Annexure 1 with copy of the Board Resolution or the executed Vakalatnama, as the case may be;
- (6) Three extra copies of the petition; and
- (7) A copy of the petition must also be served on the Registrar and the Central Government.

Investigations under § 237

Investigations for mismanagement and fraud can also be undertaken under § 237 of the Act. This section states as follows:

“Without prejudice to its powers under Section 235, the Central Government-

- (a) shall appoint one or more competent persons as inspectors to investigate the affairs of a company and to report thereon in such manner as the Central Government may direct, if-

(i) the company, by special resolution, or

(ii) the Court, by order,

declares that the affairs of the company ought to be investigated by an inspector appointed by the Central Government; and

(b) may do so, if, in the opinion of the Company Law Board, there are circumstances suggesting-

(i) that the business of the company is being conducted with **intent to defraud** its creditors, members or any other persons, or otherwise for a **fraudulent or unlawful purpose**, or in a manner **oppressive** of any of its members, or that the company was formed for any fraudulent or unlawful purpose;

(ii) that persons concerned in the formation of the company or the management of its affairs have in connection therewith been guilty of **fraud, misfeasance or other misconduct** towards the company or towards any of its members; or

(iii) that the members of the company have not been given all the information with respect to its affairs which they might reasonably expect, including information relating to the calculation of the commission payable to a managing or other director or the manager, of the company.”

Under this section, the Central Government must start an investigation if the company by special resolution, or a court declares that an investigation ought to take place. The Central Government cannot refuse to order investigation in the cases mentioned in § 237(a). The CLB may also take the initiative in instituting an investigation. It may do so *suo moto* or on the application of or information supplied by any shareholder or other person. But before ordering an investigation by the Central Government, the CLB must satisfy itself that the circumstances of the case fall under one or other in the sub-clause (i), (ii), (iii) of § 237(b). (Rohtas Industries Ltd. v. S.D. Agarwal (1969) 39 Com Cases 781 (SC)) The powers granted to the CLB under § 237(b) are discretionary. The CLB can refuse to order the Central Government to undertake an investigation.

Scope of investigations under § 235 and § 237

Under § 235 and § 237, the investigation begins broadly with a view to examine the management of the affairs of the company to find out whether any irregularities have been committed or not. An inspector is appointed only to investigate the affairs of a company and to make a report. The investigation is no more than the work of a fact finding commission. The fact that a prosecution under § 242(1) may ultimately result in criminal proceedings will not retrospectively change the character of the proceedings before the inspector when he makes the investigation. (Raja Narayan Bansilal v. Maneck Phiroz Mistry (1960) 30 Com Cases 644)

Investigation into affairs of a company means investigation of all its business affairs — profits and losses, assets including goodwill, contracts and transactions, investments and other property interests and control of subsidiary companies. Furthermore, the Act does not fix any time limit on the investigation.

Power of inspectors to carry out investigations in the affairs of related companies (§ 239 of the Act)

An inspector appointed under § 235 or § 237 can investigate into the affairs of related companies. This section states as follows:

- “(1) If an inspector appointed under section 235 or 237 to investigate the affairs of the company thinks it necessary for the purposes of his investigation to investigate also the affairs of—
- (a) any other body corporate which is, or has at any relevant time been the company’s subsidiary or holding company, or a subsidiary of its holding company, or a holding company of its subsidiary;
 - (b) any other body corporate which is, or has at any relevant time been managed by any person as managing director or as manager, who is, or was, at the relevant time, the managing director or the manager of the company; or
 - (c) any other body corporate which is, or has at any relevant time been, managed by the company or whose Board of Directors comprises of

nominees of the company or is accustomed to act in accordance with the directions or instructions of –

- (i) the company, or
- (ii) any of the directors of the company, or
- (iii) any company, any of whose directorships is held by the employees or nominees of those having the control and management of the first-mentioned company; or
- (d) any person who is or has at any relevant time been the company's managing director or manager,

the inspector shall, subject to the provisions of sub-section (2), have power so to do and shall report on the affairs of the other body corporate or of the managing director or manager, so far as he thinks that the results of his investigation thereof are relevant to the investigation of the affairs of the first-mentioned company.

- (2) In the case of any body corporate or person referred to in clause (b)(ii), b(iii), (c) or (d) of sub-section (1), the inspector shall not exercise his power of investigation into, and reporting on, its or his affairs without first having obtained the prior approval of the Central Government thereto:

Provided that before according approval under this sub-section, the Central Government shall give the body corporate or person a reasonable opportunity to show cause why such approval should not be accorded.”

Therefore, inspectors have the power to investigate the affairs of related companies. However, as a safeguard against possible abuse of powers by the inspector, it is provided in Section 2 that in case of any body corporate or person referred to in §§ 239(1)(c) and 239(1)(d), the prior approval of the Central Government must be obtained before investigation. The Central Government is required to give reasonable opportunity to the concerned body corporate or person to show cause against such approval.

Criminal proceedings under § 242(1)

The Act gives the Central Government the authority to commence criminal proceedings based on the information derived from investigations carried on pursuant to §§ 235-237. This authority is expounded in § 242(1) of the Act. This Section states:

“(1) If, from any report made under section 241, it appears to the Central Government that any person has, in relation to the company or in relation to any other body corporate whose affairs have been investigated by virtue of section 239, been guilty of any offence for which he is criminally liable, the Central Government may, after taking such legal advice as it thinks fit, prosecute such person for the offence; and it shall be the duty of all officers and other employees and agents of the company, or body corporate, as the case may be (other than the accused in the proceedings), to give the Central Government all assistance in connection with the prosecution which they are reasonably able to give.”

This section comes into play only as an aftermath of the investigation and subsequent report under § 241. Moreover, this provision does not in any way prohibit prosecution of the accused under the Indian Penal Code. (M. Vaidyanathan v. Sub-divisional Magistrate, Erode (1957) 27 Com Cases 97)

Advantage of investigation in contra-distinction to other reliefs

§§ 235-237 indicate a procedure which could, in appropriate cases, be held to be a necessary prelude to proceedings under §§ 397-398 (*see discussion infra.*) The sections on investigations empower the Central Government to appoint inspectors to investigate the affairs of a company and to submit a report, which is legally admissible as evidence under § 246 of the Act. Such a report could provide the basis of action by the Central Government against a company under either § 397 and/or § 398 of the Act (§ 243 of the Act), or, for recovery of damages in respect of any fraud, misfeasance, or other misconduct in the management of the company's affairs, where this is necessary in public interest (§ 244 of the Act). It could, therefore, be urged, in cases where a detailed inquiry into the conduct of the affairs of a company is called for, that a petition under either § 397 or § 398 of the Act, without applying for such an inquiry, under section 236 of the Act, may be premature. (Raghunath Swarup Mathur v. Har Swarup Mathur (1970) 40 Com Cases 292, 295 (All))

Remedies available under § 397

In addition to §§ 235-237, which allow for investigations, the Act also provides for other types of remedies. § 397 along with § 398 provides for prevention of oppression and mismanagement. § 397 states as follows:

- “(1) Any members of a company who complain that the affairs of the company are being conducted in a manner prejudicial to public interest or in a manner oppressive to any member or members (including any one or more of themselves) may apply to the Company Law Board for an order under this section, provided such members have a right so to apply by virtue of Section 399.
- (2) If, on any application under sub-section (1), the Company Law Board is of the opinion—
- (a) that the company’s affairs are being conducted in a manner prejudicial to public interest or in a manner oppressive to any member or members; and
 - (b) that to wind up the company would unfairly prejudice such member or members, but that otherwise the facts would justify the making of a winding-up order on the ground that it was just and equitable that the company should be wound up;

the Company Law Board may, with a view to bringing to an end the matter complained of, make such order as it thinks fit.”

The meaning of “oppression”

Under § 397, it is necessary to show not merely that there has been some sort of oppression of any shareholders but that the affairs of the company are being conducted in an oppressive manner. Oppression under the Act takes various forms and caselaw seems to suggest a meaning which indicates a lack of probity and fair dealing in the affairs of a company to the prejudice of some portion of its members or to public interest. (Scottish Co-operative Whole Sale Society Ltd. v. Meyer (1958) 3 All ER 66 (HL))

Caselaw also indicates that a person complaining of oppression must show that he has been constrained to submit to conduct which lacks in probity, conduct which is unfair to him and which causes prejudice to him in the exercise of his legal and proprietary rights as a shareholder. Furthermore, even though isolated acts in contravention of law are not *per se* oppressive, a series of acts in contravention of law by some shareholders or directors will usually be deemed to be a form of oppression. (Sheth Mohanlal Ganpatram v. Shri Savaji Jubilee Cotton and Jute Mills co. Ltd. (1964) 34 Com Cases 777 (Guj)) Courts and the CLB have also treated loss of substratum (Janikiram (K.) v. Bafna Re-Rolling Mills Pvt. Ltd. (1989) 2 Corpt. LA 4 (Bom)), continuous losses (Asoka Betelnut Co. P. Ltd. v. M. K. Chandrakanath (1997) 88 Com Cases 274 (Mad)), and misuse of funds (Narain Das (K.) v. Bristol Grill (P.) Ltd. (1997) 90 Com Cases 79 (CLB - N Delhi)) as forms of oppression to shareholders.

§ 397 as an alternative to a winding-up application

The language of clause (b) of sub-section (2) along with caselaw indicates that the CLB will entertain an application under this section only when the CLB is of the opinion that an order for winding up will unfairly prejudice the interest of the members on whose behalf the application is made. (Needle Industries (India) Ltd. v. Needle Industries Newey (India) Holding Ltd. AIR 1981 SC 1298)

Remedies available under § 398

§ 398 of the Act is very similar to § 397. This section also empowers the CLB to shape any kind of relief that it thinks fit. This section states:

- “(1) Any members of a company who complain—
- (a) that the affairs of the company are being conducted in a manner prejudicial to public interest or in a manner prejudicial to the interests of the company; or
 - (b) that a material change not being a change brought about by, or in the interests of, any creditors including debenture-holders, or any class of shareholders, of the company has taken place in the management or control of the company whether by an alteration in its Board of Directors, or manager or in the ownership of the company’s shares, or if it has no share capital, in its membership, or in any other manner whatsoever, and that by reason of such

change, it is likely that the affairs of the company will be conducted in a manner prejudicial to public interest or in a manner prejudicial to the interests of the company,

may apply to the Company Law Board for an order under this section, provided such members have a right so to apply in virtue of section 399.

- (2) If, on any application under sub-section (1), the Company Law Board is of opinion that the affairs of the company are being conducted as aforesaid or that by reason of any material change as aforesaid in the management or control of the company, it is likely that the affairs of the company will be conducted as aforesaid, the Company Law Board may, with a view to bringing to an end or preventing the matters complained of or apprehended, make such order as it thinks fit.”

Unlike § 397, § 398 deals with mismanagement instead of oppression. In a case where there is no oppression but the affairs of the company are managed in a manner prejudicial to its interests, the CLB can interfere under this section. (Sahasrangu Sen v. Brahmaputra Fertilisers & Distributers Private Ltd. (1977) Com News & Reports C/62) Furthermore, § 398, as it was conceived, is not an alternative to a winding-up. Under this section it is enough if the affairs of the company are conducted in a manner prejudicial to the interests of the company or to public interest. (Cf. Richardson & Cruddas Ltd. v. Harian Mundra (1959) 29 Com Cases 549)

The meaning of “mismanagement” under § 398

As per various rulings, the uncertainty as to the *de jure* character of the Board of Directors and difficulty of having the state of affairs rectified in the usual way, the patent fact that a company was being run by the Board in their own interest overriding the wishes and interest of the majority of shareholders is deemed to be mismanagement. (In Re, Albert David (1964) CWN 163, 172) Courts have also ruled that erosion of a company’s substratum (AIR Asiatic Ltd. Re (1994) 3 Comp LJ 294 (CLB)), abuse of fiduciary duties (Hemant D. Vakil v. RDI Print and Publishing P. Ltd. (1995) 84 Com Cases 838 (CLB – N. Delhi)), and misuse of funds (Narain Das (K.) v. Bristol Grill (P.) Ltd. (1997) 90 Com Cases 79) are all instances of mismanagement that come within the ambit of § 398.

§ 399 and its requirements

§ 399 declares that only certain people have the right to apply under §§ 397-398. The pertinent parts of this section state as follows:

- “(1) The following members of a company shall have the right to apply under section 397 or 398:-
- (a) in the case of a company having a share capital, not less than one hundred members of the company or not less than one-tenth of the total number of its members, whichever is less or any member or members holding not less than one-tenth of the issued share capital of the company, provided that the applicant or applicants have paid all calls and other sums due on their shares;
 - (b) in the case of a company not having a share capital, not less than one-fifth of the total number of its members.”
- “(4) The Central Government may, if in its opinion circumstances exist which make it just and equitable so to do, authorise any member or members of the company to apply to the Company Law Board under section 397 or 398, notwithstanding that the requirements of clause (a) or clause (b), as the case may be, of sub-section (1) are not fulfilled.”

Petitioning the CLB under §§ 397-398

Petition to exercise powers in connection with prevention of mismanagement and oppression can be made before the Principal Bench of the Company Law Board in Form No. 1 of Annexure II to CLB Regulations, 1991 with a fee of Rs. 5000/-and accompanied by the following documents:

- (1) Documents and/or other evidence in support of the statements made in the petition, as are reasonably known to the petitioner(s);
- (2) Documentary evidence in proof of the eligibility and status of the petitioner(s) with the voting power held by each of them;

- (3) Where the petition is presented on behalf of members, the letter of consent given by them;
- (4) Statement of particulars showing names, addresses, numbers of shares held and whether all calls and other monies due on shares have been paid in respect of members who have given consent to the petition being presented on their behalf;
- (5) Where the petition is presented by a member or members authorised by the Central Government under section 399(4) the order of the Central Government authorizing such members to present the petition shall be similarly annexed to the petition;
- (6) Affidavit verifying the petition;
- (7) Bank draft evidencing payment of application fee;
- (8) Memorandum of appearance in Form No. 5 of Annexure I with copy of the Board Resolution or the executed Vakalatnama, as the case may be; and
- (9) Three spare copies of the petition.

Composite petition

Reliefs under § 397 and § 398 can both be invoked in the same petition. (Re, Copeland & Craddock Ltd. (1997) BCC 294)

Remedy available to the managing director under § Section 409

The managing director, or any other director or manager of the company may make a complaint to the CLB if as a result of a change or a likely change in the ownership of any shares held in the company, a change in the Board of Directors is likely to take place and such change will prejudicially affect the affairs of the company. On the basis of such a complaint, the CLB may initiate such inquiry as it thinks fit. If as a result of inquiry the CLB deems it fit to be just and proper, it may by order, direct that any resolution passed or action taken to effect a change in the board of directors after the date of complaint shall not be effective unless

confirmed by the CLB. This provision was discussed and affirmed in the recent case of *P.H.Rao v. Skycell Communications Ltd.* (CP 66 of 2000, CLB New Delhi)

Conclusion

The rights of minority shareholders in Indian companies have substantially been protected. Minority shareholders can take recourse to the provisions of §§ 235 to 237, and §§ 397 and 398 in cases where companies indulge in oppression or mismanagement, prejudicial to the affairs of the company and public interest. The CLB has got teeth and regularly takes action against errant company.