Corporate Governance: Statutory Framework for Addressing Mismanagement

While it has become the norm in the PE/VC ecosystem to include elaborate provisions in shareholders' agreements to deal with violations of agreed governance principles (refer to our previous articles), statutory remedies under Companies Act, 2013 (the Act) continue to be highly relevant, particularly because of their enforceability. In this article, we provide an overview of key statutory remedies available to stakeholders and their interplay with contractual arrangements.

The National Company Law Tribunal (NCLT) is the principle statutory body under the Act for adjudicating company law matters. The National Company Law Appellate Tribunal (NCLAT) is the appellate authority for orders passed by the NCLT. Notably, Section 430 of the Act bars the jurisdiction of civil courts from entertaining any proceedings in matters for which the NCLT or the NCLAT are empowered to determine under the Act. Both the bodies have powers, akin to a civil court, including the power to initiate contempt proceedings under the Contempt of Courts Act, 1971.

Oppression and Mismanagement

Section 241 of the Act permits members of a company to approach NCLT for relief in cases where (a) the affairs of the company are being conducted in a manner prejudicial to the interests of the company / its members or against public interest; or (b) a material change in the management of the company is likely to result in the affairs of the company being conducted prejudicially to the interests of its members or a particular class of members. Pertinently and as an anti-abuse provision, this right is available to members who meet a certain threshold, being at least 100 members or 10% of the total number of members (whichever is lesser), or 10% of the issued share capital of the company. Interestingly, the NCLT does have the power to waive these thresholds if it deems fit. Further, the Central Government may also apply to the NCLT in respect of mismanagement, if it is of the opinion that a company's affairs are contrary to public interest, or where any person involved in the management of a company has been found guilty of fraud, misfeasance, persistent negligence, etc.

Class Actions

Class Actions: Section 245 of the Act allows members and depositors (i.e., a class of creditors) of a company (in representative capacity on behalf of the larger group) to approach the NCLT to seek restraining orders or claiming damages for specified instances of mismanagement. Instances where class action claims can be sought include inter alia, restraining a company from committing an act which is ultra vires of the charter documents of the company or in breach of any law; restraining a company from taking action contrary to any resolution passed by its members; etc. A class action suit can be initiated by 100 members of a company or 5% of the total number of its members (whichever is less), or at least 5% of the issued share capital of the company for unlisted companies and 2% for listed companies.

While adjudicating oppressive mismanagement and class action claims, the NCLT is empowered to take actions not just against a company but also persons involved in such default including any persons involved in preparing improper statements in the audit report or who acted in a fraudulent, unlawful or wrongful manner.

Investigations and SFIO Probes

Preliminary Investigations: Section 206 to 209 of the Act empower the Registrar of Companies (ROC) and certain other regulatory authorities to conduct preliminary inquiries, inspections and examinations into the affairs of a company. Upon reason to believe that a company is non complaint with the Act, the ROC can call for information and basis the same proceed with an inspection of records. During such inspections, the ROC can examine documents and question officers. Basis findings, reports are submitted to the Central Government, wherein further investigation may be triggered.
The Central Government is also empowered to direct an inquiry in specified situations including cases where public interest is involved or inter alia, if there's suspicion of serious misconduct / fraud / abuse of governance mechanisms. NCLT may also order an investigation upon application by shareholders (representing prescribed thresholds), if it is satisfied that a company's affairs are being conducted in a fraudulent, unlawful or oppressive manner.
Investigations by SFIO: The Central Government may assign cases to the Serious Fraud Investigation Office (SFIO), a specialized fraud investigation agency formed under the Ministry of Corporate Affairs (MCA), where it considers a matter to involve complex financial fraud, to be in public interest or based on recommendations of the ROC. The SFIO possesses powers to arrest individuals and conduct searches, summon and examine persons associated with the company. The report filed by the SFIO shall be deemed to be a police report filed by a police officer under the provisions of the civil procedure code. Some examples of SFIO probes include the Satyam scandal and the Nirav Modi - Punjab National bank case. These enforcement provisions also act as powerful deterrents against fraud and empower minority shareholders to act against any major wrongdoings.

Whistleblowers (Section 177 of the Act)

The Act requires listed companies and certain prescribed public companies to establish a vigil mechanism, popularly known as a whistle blower policy, for directors and employees to report genuine concerns about unethical behaviour, fraud, violation of company's code of conduct etc. This creates a formal channel for employees to raise concerns against the company on any wrongdoings, especially in an anonymous manner. The audit committee is responsible for overseeing the functioning of this mechanism, ensuring that concerns are investigated and addressed in a fair manner, with adequate safeguards against victimisation of persons.

Financial statements, removal of directors

The Act lays down the framework for preparation, disclosure and audit of financial statements, forming the backbone of corporate governance through financial transparency. Section 129 of the Act mandates companies to prepare financial statements that give a true and fair view of the financials of a company. These statements must be approved by the board and filed with the ROC within prescribed timelines.
Auditors also play a critical role in the governance of a company, with auditors being mandated to report fraud by officers or employees failing which it can lead to penalties or disqualification. Similarly, directors are disqualified if, inter alia, they have been convicted of an offense involving moral turpitude or are undischarged insolvents or have not filed their financial statements / annual returns for 3 consecutive years. From a corporate governance perspective, these provisions ensure that individuals have

fiduciary duties towards a company and its shareholders and maintain ethical standards that ensures shareholder confidence in the organisation.

Interplay between exercise of contractual remedies and statutory remedies

Under Indian corporate law, the statutory governance remedies set out above are designed to uphold fiduciary standards enabling transparency and stakeholder protection in a company. These are imposed by law on all companies and their officers, as non-negotiable governance requirements to be followed by organisations. In contrast, contractual remedies, set out in shareholders agreements (as detailed in our previous articles) provide for rights and obligations between shareholders such as pre-emptive rights, ROFO, ROFR, Tag, drag, exit rights, information rights, etc. These ensure pre-agreed privately enforceable measures that protect an investor and ring fences shareholders in companies.

The two frameworks operate in tandem, as for instance a minority shareholder may invoke statutory remedies for oppression, while also relying on contractual protections such as inspection rights to investigate the affairs of a company. However, it must be noted that contractual rights cannot override statutory provisions and courts are likely to uphold statutory protections in case of conflicts with the shareholders agreement. Hence, effective corporate governance often requires harmonising both statutory compliance and well drafted contractual protection frameworks, especially in closely held companies and companies with PE / VC investors.

Authors:

Poonam Sharma | Karan Kalra

Contact: poonam@bombaylawchambers.com | karan@bombaychambers.com