BEFORE THE SECURITIES APPELLATE TRIBUNAL MUMBAI

Appeal No.33 of 2012

Date of Decision: 5.10.2012

Mr. K. Natarahjan
F-2, Gurukrupa Enclave,
10/11, Muthuramalingam Street,
Rajaji Colony, Virugambakkam,
Chennai- 600 092. …… Appellant

Versus

Securities and Exchange Board of India
SEBI Bhavan, Plot No. C-4A, G Block,
Bandra Kurla Complex, Bandra (East),
Mumbai - 400 051. …… Respondent

Mr. Anant Upadhyay, Advocate with Mr. Vinay Chauhan, Advocate for the Appellant.

Mr. Shiraz Rustomjee, Senior Advocate with Ms. Harshada Nagare, Advocate for the Respondent.

CORAM : P. K. Malhotra, Member & Presiding Officer (*Offg*.)
S.S.N. Moorthy, Member

Per : S.S.N. Moorthy

Same order as in Appeal no.29 of 2012 decided on October 5, 2012.

Sd/-
P.K. Malhotra
Member &
Presiding Officer (*Offg*.)

Sd/-
S.S.N. Moorthy
Member

5.10.2012
Prepared and compared by
RHN

BEFORE THE SECURITIES APPELLATE TRIBUNAL MUMBAI

Appeal No.29 of 2012

Date of Decision: 5.10.2012

Mr. N. Narayanan
No.6, First Floor, 'Vishwakamal'
Old No.245, R.K. Mutt Road,
Mylapore, Chennai – 600 004. …… Appellant

Versus

The Adjudicating Officer
Securities and Exchange Board of India
SEBI Bhavan, Plot No. C-4A, G Block,
Bandra Kurla Complex, Bandra (East),
Mumbai - 400 051. …… Respondent

Mr. P.N. Modi, Advocate with Mr. Vinay Chauhan and Mr. Anant Upadhyay, Advocates for the Appellant.

Mr. Shiraz Rustomjee, Senior Advocate with Ms. Harshada Nagare, Advocate for the Respondent.

CORAM : P. K. Malhotra, Member & Presiding Officer (*Offg*.)
S.S.N. Moorthy, Member

Per : S.S.N. Moorthy

This order will dispose of eight Appeals no.28, 29, 30, 31, 32, 33, 34 and 35 of 2012.

2. Since the issue involved in these appeals is identical, a common order covering all the appellants is passed for the sake of convenience.

3. The appellants, Shri N. Narayanan, Shri K. Natarahjan, Shri K.S. Kashiraman and Shri G. Ramakrishanan, were directors of Pyramid Saimira Theatre Ltd. (the company). The company was engaged in the business of film distribution, running of cinema theatres etc. The shares of the company were listed on different stock exchanges in the country. The role of each of the appellants in the company is listed below.

Shri N. Narayanan – promoter and whole time director

Shri K. Natarahjan – independent director and chairman of audit committee

Shri K.S. Kashiraman - independent director and member of audit committee

Mr. G. Ramakrishanan - independent director and member of audit committee

4. The appeals arise out of investigation conducted by the Securities and Exchange Board of India (for short the Board) for the financial year 2007-08 and consequential action taken against the appellants by way of directions under section 11B of the Securities and Exchange Board of India Act, 1992 (the Act) and adjudication proceedings initiated under chapter VI A of the Act. Acting under the powers conferred upon him under section 19 read with sections 11 and 11B of the Act, the whole time member restrained Shri N. Narayanan and Shri V. Natarajan for a period of two years and three years respectively from buying, selling or dealing in securities in any manner whatsoever or accessing the securities market directly or indirectly and from being a director of any listed company. In the case of the appellants, Shri K. Natarahjan, Shri K.S. Kashiraman and Shri G. Ramakrishanan, the whole time member passed orders restraining them from being an independent director or member of audit committee of any listed company for a period of two years from the date of the order. All of them were found to be guilty of violating regulations 3 and 4 of the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 2003 (FUTP Regulations).

5. In adjudication proceedings connected with the same default under regulations 3 and 4 of the FUTP Regulations, the appellant Shri N. Narayanan was imposed a monetary penalty of ` 50 lacs. In the case of the other appellants monetary penalty was imposed as under:-

Mr. K. Natarahjan – 40 lacs

Mr. K.S. Kashiraman – 40 lacs

Mr. G. Ramakrishanan – 25 lacs

The present appeal is directed against the orders mentioned hereinabove by which restraint orders have been passed and penalty imposed.

6. The brief facts leading to the impugned order are the following. The Board conducted investigation in the quarterly and annual financial results of the company for the financial year 2007-08. The investigation revealed that the financial results contained in the quarterly report filed with the stock exchanges contained inflated figures of the company’s revenue profits, security deposits and receivables. The manipulation in the

financial results of the company resulted in price rise of the scrip of the company and the promoters pledged their shares to raise substantial funds from financial institutions. In the show cause notice, it was also alleged that the company and its directors published/ caused to publish false and misleading financial results of the company. To be more precise, it was alleged that the annual financial results for the year 2007-08 reported to the stock exchanges contained inflated figures of the company's revenue profits, security deposits and receivables which were relied upon by investors for making investment decision while the said reports did not reflect a true and fair view of the affairs of the company. The appellants were directed to show cause why enquiry should not be conducted and directions given/penal action taken if found guilty. The appellants filed detailed replies to the show cause notice denying all the allegations. After a careful consideration of the replies filed by the appellants, the whole time member and the adjudicating officer passed orders as mentioned above. Hence these appeals.

7. We have heard Shri Mr. P.N. Modi and Shri Vinay Chauhan, learned counsel for the appellants and Shri Shiraz Rustomjee, learned senior counsel for the respondent Board.

8. The common thread running through the submissions of the appellants is that they were not personally involved in the day to day management of the company and the financial results as verified and certified by the chief financial officer and auditors was approved by them. They had no role in the verification and authentication of the financial results since they had been already verified and certified by duly appointed and competent professionals. In respect of Shri N. Narayanan, promoter and whole time director, it was contended that his expertise was in human resource management and he was involved only in man management, leadership and team building in the company. He was fully engrossed in recruitment of personnel, training and team buildup. According to the appellant, all business operations, financial matters and verification of accounts were handled by Shri P.S. Saminathan, managing director of the company. It is the case of the appellant Shri N. Narayanan that he, being a human resource expert, totally trusted the financial statements duly audited by statutory auditors, verified by the audit committee and reviewed by the managing director. It is strenuously argued by the appellant's learned counsel that Shri N. Narayanan relied on the concurrence and

approval of accounts by the finance division and the managing director in good faith. It is also pointed out that the price rise, alleged to be manipulated, was, in fact, dictated by the normal upward movement of the stock market. The appellants' learned counsel argued at length holding the view that in a company the role of each director is confined to his field of operation and there is no justification for holding a director to be in over all charge and control of the affairs of the company. The role of the appellant, Shri N. Narayanan, was confined to only human resource management and he could not be expected to exercise control over other departments like finance and accounting since (1) he had no expertise in the area and (2) systems were in place for effective control and management. In short, the allegation regarding failure to exercise his duty of care is without any basis in the facts of the case. It is the case of the appellant that when the alleged irregularities in accounts termed as "red flags" by the whole time member and adjudicating officer could not be detected by the auditors and audit committee how the director can be held responsible, especially when he is not an expert in finances. The appellants' learned counsel also submitted that the pledge of the shares of the company after its price rise was not meant for any individual advantage but only for acquiring further capital and development of the company. It is also argued at length that there was no "dealing in securities" so as to attract penal action under section 12A of the Act or under FUTP Regulations. It is contended by the appellants' learned counsel that the Board has proceeded from the angle of vicarious liability of the directors whereas in the facts of the case, due regard has to be given to the delegation of powers to various professionals and the appellant deserves to be exonerated.

9. In the case of Shri K. Natarahjan, Shri K.S. Kashiraman and Shri G. Ramakrishanan identical arguments with respect to the role and responsibility of a director is advanced. It is contended that they were independent directors who did not participate in the day to day affairs of the company. They used to attend board meetings where verified and vetted documents were produced for approval and they approved the same in good faith. It is submitted that even though they were members of the audit committee, no irregularity could be pointed out since the professionals working in the company, who have been delegated with the task of preparing, consolidating and verifying the accounts did not raise any alarm bell. As in the case of the whole time

director, Shri N. Narayanan, the three other appellants mentioned above also submitted that finance was the portfolio of the managing director and the accounts were accepted by them in board meetings since their veracity and accuracy have been tested by the professionals duly appointed for the job.

10. Shri Shiraz Rustomjee, learned senior counsel for the Board took us through the records of the case, the provisions of the Act, the regulations and the minutes of the board meetings. According to him, the whole time director and other directors had a predominant responsibility of the duty of care and this has been abdicated by the appellants in this case. It is submitted that a director is statutorily expected to show the diligence and care of a prudent person while verifying the documents placed for approval in board meetings. With reference to the apparent irregularities/abnormalities noticed in the accounts, the learned senior counsel for the Board submitted that there were certain basic factors which stood out in the accounts which should have aroused the curiosity of the appellants. According to him, failure on the part of the appellants to exercise due care in spite of the existence of circumstances which lead to the knowledge of irregularities, indicates deliberate disregard of those facts and the appellants are, therefore, responsible for the mischief alleged in the impugned order. Shri N. Narayanan, whole time director was not merely a human resource manager but had been assigned various other duties relating to bank transactions, signing of annual accounts, transfer of shares, investor grievance etc. With regard to the other appellants it is submitted by him that prima facie they were members of the audit committee and this role envisaged more diligent handling of the accounts and verification of financial details which could have alerted them to the basic irregularities in the accounts. The very fact that the appellants other than Shri N. Narayanan were members of the audit committee should have kept them alert to the nuances of the accounts and blind reliance placed on the auditors and managing director is a real abdication of statutory responsibility. A reference was also made to the decision of this Tribunal in the case of Shri V. Natarajan vs. Securities and Exchange Board of India [Appeal no.104 of 2011 dated June 29, 2011] in which identical issues came up for consideration of this Tribunal.

11. We have considered the rival submissions. The facts of the case and the basic issues in the financial reports of the company leading to the allegation stand undisputed.

The basic irregularity highlighted in the impugned order is of inflation of revenue and profits of the company by various devices. Show cause notice contains a detailed analysis of the irregularities detected in the accounts for the period 2007-2008. In short, these relate to inflation of revenues/profits, inflation in the theater receivable accounts, non maintenance of proper agreement for lease and hire with several theaters, fictitious/false security deposit figures, pledging of the shares by promoters for raising further loan etc. The irregularities in accounts have been summed up in the show cause notice in the case of Shri N. Narayanan.

> "…..more than 63% of the total revenue from the theatres for the financial year 2007-08 (around Rs.347 crores) was accounted in the books of accounts by passing fictitious entries in order to show inflated revenues. The fictitious revenues shown were either adjusted as security deposit or shown as receivable. Therefore, there was no actual cash inflow for the said revenues shown by the company. The company showed negative cash flow from operating activities for the said financial year. Therefore, in order to meet the liquidity requirements, the company had to raise additional funds. Thus, by taking advantage of the rise in market price of the shares which resulted from the publication of the inflated results, finances were raised by pledging of the shares held by Shri Saminathan along with other two promoters."

12. On a consideration of the facts on record and the submissions made by the parties we have to conclude that the appellants have not acted in compliance with the statutory requirements of the director of a company. The director of a company is expected to exercise due care and diligence in the approval of documents brought on the table during Board meetings. It is the responsibility of a director to identify deficiencies wherever possible by employing verification and scrutiny expected of a prudent man. Meetings of Board of Directors are not rituals where documents are signed at the behest of the chairman or managing director. A director cannot take a stand that he has approved the documents totally depending on the integrity and expertise of the managing director. We are not observing that the director of a company should be a know all, but the duty expected of a prudent person cannot be abdicated by him.

13. In the present case it is an admitted fact that Shri N. Narayanan was the promoter and whole time director of the company. Incidentally it may also be noted that he was appointed chairman of the company immediately afterwards. It is also an admitted fact that he signed the financial accounts of the company in the year 2007-08 and also attended the relevant board meetings. A whole time director is a director employed to devote the whole of his time and attention in carrying on all the affairs of the company.

The role of a whole time director is very significant and material in running day to day affairs of a company. His role and responsibility are equivalent to that of a managing director in as much as he is expected to spend his whole time in the management of the company. This implies a high level of accountability and knowledge of the overall functioning of the company. He cannot take shelter, under the argument that he was in charge of only human resource management and other aspects like business operations, financial management and preparation of accounts were totally alien to him. As a whole time director he was duty bound to examine the accounts with a critical eye as expected from a prudent person and identify irregularities which were prominent in the financials of the company. A verification of the minutes of the board meeting conducted in February, 2008 clearly shows that the appellant, Shri N. Narayanan, was assigned with various duties concerning financial and banking matters and so the plea of ignorance of financial matters cannot be accepted. The board meetings assigned Shri N. Narayanan various powers in banking transactions, redressal of investor grievance etc. He has been authorized to sign cheques and in certain cases of unlimited financial powers. The chairman, managing director and Shri N. Narayanan are specially assigned powers of drawal of cheque without any limit. It cannot be accepted that a whole time director of the status of Shri N. Narayanan would be signing cheques in a casual manner or in total ignorance of the implications of the same. This is only one of the instances. He has been made member of almost every committee other than the audit committee. The fact that Shri N. Narayanan was the whole time director and he was actively involved in the functioning of the various committees, which control the day to day management of the company, shows that his duty and responsibility were expected to be of a high order. In this background, the plea taken by him in the appeal that all matters concerning finances were exclusively handled by the managing director and he believed him and the documents presented in the board meeting without any verification cannot be accepted.

14. It is on record that the appellants Shri K. Natarahjan, Shri K.S. Kashiraman and Shri G. Ramakrishanan were independent directors but were members of the audit committee. Shri K. Natarahjan and Shri K.S. Kashiraman attended all the audit committee meetings while Shri G. Ramakrishanan attended audit committee meeting towards the end of financial year 2007-08. However, all of them were party to the

approval of financial results of the year 2007-08. In this respect, it is worthwhile to refer to the powers and role of the audit committee as set out in the minutes of the board meeting of the company on January 30, 2008.

"**RESOLVED FURTHAR THAT** the committee be and is hereby instructed to ac t in accordance with following terms of reference.

(A) Meeting of Audit Committee

The audit committee should meet at least four times in a year and not more than four months shall clapse between two meetings. The quorum shall be either two members or one third of the members of the audit committee whichever is greater, but there should be a minimum of two independent members present.

(B) Powers of Audit Committee

The audit committee shall have powers, which should include the following:

1. To investigate any activity within its terms of reference.
2. To seek information from any employee.
3. To obtain outside legal or other professional advice.
4. To secure attendance of outsiders with relevant expertise, if it considers necessary.

(C) Role of Audit Committee

The role of the audit committee shall include the following:

1. Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.
2. Recommending to the Board, the appointment, re-appointment and, if required, the replacement or removal of the statutory auditor and the fixation of audit fees.
3. Approval of payment to statutory auditors for any other services rendered by the statutory auditors.

4. Reviewing, with the management, the annual financial statements before submissions to the board for approval, with particular reference to:

    a. Matters required to be included in the Director's Responsibility Statement to be included in the Board's report in terms of clause (2AA) of section 217 of the Companies Act, 1956.
    b. Changes, if any, in accounting policies and practices and reasons for the same.
    c. Major accounting entries involving estimates based on the exercise of judgment by management.
    d. Significant adjustments made in the financial statements arising out of audit findings
    e. Compliance with listing and other legal requirements relating to financial statements.
    f. Disclosure of any related party transactions
    g. Qualifications in the draft audit report."

The role of the audit committee is clearly spelt out in the above resolution of the board. The members of the audit committee are expected to exercise due oversight of the company's financial reporting process and to ensure that the financial statement is correct, sufficient and credible. It is also expected to conduct a meaningful review with special emphasis on major accounting entries and significant adjustments made in the accounts before putting up the statements for the approval of the Board. The board of directors of the company has entrusted the audit committee with an onerous duty to see that the financial statements are correct and complete in every respect. In this background, the members of the audit committee cannot take shelter under the verifications made by the internal auditor and other professionals. The details extracted in the show cause notice and the impugned order illustrate that there were several prominent irregularities which should have alerted the directors. The appellant's learned counsel submitted that abnormal profits, mismatch in receivables, insufficient security deposit in the bank did not act as an alert when the accounts have been certified by qualified professionals. We cannot accept the stand of the learned counsel for the appellants. The whole time director attending to the affairs of the company on a full time basis and the directors being members of the audit committee could not have ignored the "red flag" while considering the accounts of the company.

15. The appellants' learned counsel laid emphasis on the proposition that each director is responsible only in his area of operation and irregularities or deficiencies cannot be investigated by the director unless brought on the table by delegated authorities. He drew our attention to the following case laws:

1. Life Insurance Corporation of India vs. Hari Das Mundhra and others [(1966) Vol. 36 CC 371.
2. [House of Lords] Dovey and The Metropolitan Bank (of England and Wales) Limited vs. John Cory. [(1901) AC Privy Council 477].
3. In re Denham & Co. [752 Chancery Division volume 25].

We do not find the factual situation in these cases applicable to the present case in view of the changed scenario regarding duties and responsibilities of directors in a company. In fact, the following case laws cited by the learned senior counsel for the Board clearly bring out the role, responsibility and accountability of directors.

1. 829 Equitable Life Assurance Society vs. Bowlye and Others Queen's Bench Division (Commercial Court) [(2003) EWHC 2263 (Comm)]
2. Official liquidator Supreme Bank Ltd. vs. P.A. Tendolkar [AIR 1973 Supreme Court 1104].

In the case of Equitable Life Assurance Society, the 'duty of care' owed by a director has been clearly illustrated. The first is the skill and knowledge expected from a reasonably diligent person. The second is actual knowledge, skill and experience of a director. The following observations are very relevant to the issue at hand.

> "Mr Milligan QC referred me to another general statement about the duties of directors which I find helpful as it both expresses what may be expected of a 'reasonably diligent' director and acknowledges the obvious qualification that what the test requires must depend on the particular circumstances before the court. The reference is in the judgment of Morritt LJ in Baker v Secretary of State for Trade and Industry [2001] BCC 273 at p.285 where the Court of Appeal approved the summary given by Jonathan Parker J at first instance in these terms:
>
> > '(i) Directors have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties as directors.
> >
> > (ii) Whilst directors are entitled (subject to the articles of association of the company) to delegate particular functions to those below them in the management chain, and to trust their competence and integrity to a reasonable extent, the exercise of the power of delegation does not absolve a director from the duty to supervise the discharge of the delegated functions.
> >
> > (iii) No rule of universal application can be formulated as to the duty referred to in (ii) above. The extent of the duty, and the question whether it has been discharged, must depend on the facts of each particular case, including the director's role in the management of the company."

In Tendolkar's case also the legal position has been brought out as under-

> "It is certainly a question of fact, to be determined upon the evidence in each case, whether a Director, alleged to be liable for misfeasance, had acted reasonably as well as honestly and with due diligence, so that he could not be held liable for conniving at fraud and misappropriation which takes place. A Director may be shown to be so placed and to have been so closely and so long associated personally with the management of the Company that he will be deemed to be not merely cognizant of but liable for fraud in the conduct of the business of a Company even though no specific act of dishonesty is proved against him personally. He cannot shut his eyes to what must be obvious to everyone who examines the affairs of the Company even superficially. If he does so he could be held liable for dereliction of duties undertaken by him and compelled to make good the losses incurred by the Company due to his neglect even if he is not shown to be guilty of participating in the commission of fraud. It is enough if his negligence is of such a character as to enable frauds to be committed and losses thereby incurred by the Company."

16. With the changing scenario in the corporate world the concept of corporate responsibilities is also rapidly changing day by day. The director of a company cannot confine himself to lending his name to the company but taking light responsibility for its day to day management. While functions may be delegated to professionals, the duty of care, diligence, verification of critical points by directors cannot be abdicated. The directors are expected to have a hands on approach in the running of the company and take up responsibility not only for the achievements of the company but also the failings thereto.

17. When we examine the conduct of the appellants in the present case we have to hold that they have not lived up to the responsibility of duty of care explained above.

18. The appellants' learned counsel drew our attention to the provisions of the Act and FUTP Regulations and submitted that the appellants have not 'dealt in' the shares of the company, nor have they directly indulged in any device which would attract the provisions of the Act and the FUTP Regulations. We cannot accept the above contention. The provisions of section 12A of the Act and regulation 2(c) of the FUTP Regulations squarely cover the facts of the case. The appellants have employed a device so as to defraud investors in dealing in the securities. They have also perpetrated fraud as defined in regulation 2(c) of the FUTP Regulations. We cannot restrict the above provisions to the narrow confines of 'dealing in securities' as canvassed by the appellants' learned counsel. The provisions of section 12A of the Act and the definition of fraud in regulation 2(c) of the FUTP Regulations are very wide in their scope and the device employed by the appellants squarely fall within the mischief.

19. During the hearing of the appeal, the learned counsel for the parties took us through the various provisions of Companies Act, 1956. We do not consider it necessary to discuss those provisions here because the facts of the case are squarely covered by the provisions of the Act and FUTP Regulations.

20. It is noteworthy that this Tribunal has decided the appeal of Shri V. Natarajan, chairman of the company, during the relevant period (Shri V. Natarajan vs. Securities and Exchange Board of India, Appeal no.104 of 2011 dated June 29, 2011). The observations of this Tribunal therein are relevant to the present appeal also.

"…..we are satisfied that the provisions of Regulations 3 and 4 of the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 were violated. These regulations, among others, prohibit any person from employing any device, scheme or artifice to defraud in connection with dealing in or issue of securities which are listed or proposed to be listed on an exchange. They also prohibit persons from engaging in any act, practice, course of business which operates or would operate as fraud or deceit upon any person in connection with any dealing in or issue of securities that are listed on stock exchanges. These regulations also prohibit persons from indulging in a fraudulent or unfair trade practice in securities which includes publishing any information which is not true or which he does not believe to be true. Any advertisement that is misleading or contains information in a distorted manner which may influence the decision of the investors is also an unfair trade practice in securities which is prohibited. The regulations also make it clear that planting false or misleading news which may induce the public for selling or purchasing securities would also come within the ambit of unfair trade practice in securities. It is by now well understood that unaudited financial results that are required to be published by every listed company on a quarterly basis do form the basis for the investing public to take informed decisions. Any false information or false accounts depicting inflated revenues and profits by fictitious entries in accounts is, indeed, a very serious wrong doing which directly impacts the securities market and the investors. Since the appellant was a part of the board of directors which approved the financial results of the company which were actually false and untrue, we are satisfied that the appellant is guilty of the charges levelled against him. Having regard to the nature of the serious market violation committed by the appellant, the Board was justified in keeping him out of the market for a period of three years and not allowing him to be a director on any listed company for that period."

In view of the discussion above, we uphold the impugned orders by which restraint orders have been passed against the appellants and also monetary penalty has been imposed. Appeals dismissed. No costs.

Sd/-
P.K. Malhotra
Member &
Presiding Officer (*Offg*.)

Sd/-
S.S.N. Moorthy
Member

5.10.2012
Prepared and compared by
RHN