



CS Makarand Joshi

CORPORATE LAWS Case Law Update

SEBI

Order of Adjudicating Officer of Securities and Exchange Board of India

Name of the Case: In respect of Carnation Industries Limited (hereinafter referred to as 'Noticee 1/CIL/Company/by Name')

Facts of the case:

1. Securities and Exchange Board of India (hereinafter referred to as 'SEBI') conducted an investigation into the irregularities of CIL's financial statements and observed certain accounting-related issues pertaining to the accounting of interest therein during the financial years ending March 31, 2018, & March 31, 2019, and quarter ending on June 30, 2019, & quarter ending September 30, 2019 (hereinafter referred as "Investigation period/IP").
2. On investigation, SEBI found that accounts of CIL were declared as Non-Performing Assets (NPA) by State Bank of India (hereinafter referred to

as 'SBI') and Punjab National Bank (hereinafter referred to as 'PNB'), (collectively referred as banks) from which, the Company had availed credit facilities. Further, SEBI found that on declaring the accounts of CIL as NPA by banks during FY 2017-18, CIL reversed the interest expense on loans provided in FY 2017-18 and stopped providing for interest expenses in the ensuing financial statements. Further SEBI noted that statutory auditors of the company M/s. Jain Saraogi & Co., Chartered Accountants, had qualified their audit reports for FY 2017-18 & FY 2018-19 and limited review reports for the quarters ended June 30, 2019, & September 30, 2019.

3. SEBI alleged that instant accounting treatment of reversal and non-provisioning of interest was not found to be in accordance with the applicable and notified Accounting Standards and consequently, the published financial statements of the company did not present a true and fair view of the

company's affairs. SEBI observed that Noticee's 2 to 5 (viz. Ravindra P Sehgal, MD and Member of Audit Committee - Noticee 2, Suvobrata Saha, Joint MD - Noticee 3, Arun Kumar Bose, Executive Director – Noticee 4, Sephali Roy, Chairman of Audit Committee – Noticee 5) were directors of the company during the financial investigation period. Further, Noticee 6 was the Chief Financial Officer ('CFO') of the Company in the FY 2017-18 and Noticee 7 was the current CFO of the Company from February 1, 2019. SEBI issued a show cause notice ('SCN') to CIL, its Executive Directors, erstwhile and current Chief Financial Officer (hereinafter referred to as 'CFO') of CIL (collectively referred to as 'Noticees').

4. SEBI stated that as per Regulation 17(8) of SEBI (Listing Obligations and Disclosure Requirements) Regulations ['LODR Regulations'], the CEO and CFO shall provide compliance certificates to the board of directors. In addition to that, in terms of regulation 33(2)(a) of LODR Regulations, it is the duty of the CEO and CFO of the listed entity to certify that the published financial results do not contain any false or misleading statements or figures and do not omit any material fact which may make the statements or figures contained therein misleading while publishing the financial results. SEBI observed that there was no person designated as CEO during the investigation period. In the absence of any designated CEO, the principal roles and responsibilities lie with the Managing Director and the Joint Managing Director. The Managing

Director, the Joint Managing Director and the CFO of Carnation Industries Ltd have signed the compliance certificate. SEBI stated that the Managing Director and Joint Managing Director and CFO of Carnation Industries Ltd. have submitted an untrue compliance certificate in terms of regulations 17(8) and 33(2)(a) of LODR Regulations, to the board of directors in the FY 2017-18 and 2018-19. SEBI further stated that Noticee 6 was the CFO of the company till August 7, 2018, and had signed the compliance certificate for the financial year ended March 31, 2018, and Noticee 7 was appointed as the CFO on February 1, 2019, and has signed the compliance certificate for the financial year ended March 31, 2019, the quarter ended June 30, 2019, and quarter ended September 30, 2019. It appears that Noticees 6 & 7 have submitted a false compliance certificate in terms of regulations 17(8) and 33(2)(a) of LODR Regulations, to the board of directors in the FY 2017-18 and FY 2018-19, the quarter ended June 30, 2019, & quarter ended September 30, 2019, respectively.

Charge

SEBI alleged that Noticees and CIL have violated Sections 12A(a), (b), (c) of the Securities and Exchange Board of India Act, 1992 (hereinafter referred to as 'SEBI Act') r/w regulations 3(b), (c) & (d), 4(1), 4(2)(f) of the SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 2003 (hereinafter referred as PFUTP Regulations) & Regulations 4(1)(a), 4(1)(b), 33(1), 34(3), 48 of SEBI (Listing Obligations & Disclosure Requirement), 2015

(hereinafter referred as ‘LODR Regulations 2015’).

Arguments by Noticees

A. Underestimate losses by not provisioning expenses: Noticees submitted that CIL had taken credit facilities from two banks viz. State Bank of Hyderabad (now State Bank of India) and Punjab National Bank. The State Bank of India classified the accounts of the Company as an NPA on March 21, 2018, and did not give the Company, the interest amount charged by them since the account was classified as NPA. In absence of relevant information from the Bank, CIL could not assess the interest and penal interest amount which would be levied by the State Bank of India (“SBI”) on the credit facility to CIL. Hence the same could not be provided for in the books of account. Noticee further stated that CIL thought it would be fair not to assume any wrong notional figure as additional interest. Calculation of the notional interest charges that the Bank would have charged was very difficult to calculate because they had an interchangeable limit facility for export by the way of floating packing credit which got converted into bill limit after the shipment of the cargo against the purchase order, (which was the basis of the grant of the packing credit). 100% of the Company’s turnover was based on Exports and they were an MSME Unit. The funding received from the Bank was not on a fixed interest rate for the whole year, it was of floating interest rate based on RBI guidelines and subject to refund of

interest subvention by the Government of India. This whole process made the calculation of notional interest a complicated and frivolous exercise. Noticees further stated that Company did not reverse anything in its books of account. In fact, it considered the balance in the Bank account as of 31st March 2018 and debited whatever interest was debited by the bank to its account. The company took the net balance of the interest charged and provided the same in its books of account. While it did not reverse anything in its books of account. Noticees further highlighted that it has been an industry trend not to provide for interest once the account of the company has been declared NPA. The Annual Accounts of the Company have been regularly filed with the Ministry of Corporate Affairs but at no point of time the Ministry of Corporate Affairs had raised any issue with respect to non-provision of interest after the account of the company has become a non-performing asset.

B. Complied with Accounting Standards & Companies Act, 2013 (‘CA 2013’): Noticees submitted that Regulation 48 of LODR Regulations provides that the listed entity shall comply with all the applicable and notified Accounting Standards from time to time. Further Section 129(1) of the Companies Act, 2013 states that the financial statements shall, inter alia, comply with the accounting standards notified under Section 133 of the said Act. Sub Section (5) of Section 129 provides that where the financial statements of a company

do not comply with the accounting standards, the company shall disclose in its financial statements the deviation from the accounting standards, the reasons for such deviation and the financial effect, if any, arising out of such deviation. Section 134(5)(a) of the Companies Act cast an obligation on the Directors to disclose in their Directors' Responsibility Statement the fact of preparation of annual accounts following the applicable accounting standards along with proper explanation relating to material departures. Thus, it is explicit from the above that the Companies Act, 2013 contains elaborate provisions relating to the applicability of accounting standards and consequences arising out of any material departure therefrom. Noticees further stated that CIL has duly complied with the provisions of the Companies Act, 2013 and disclosed in its financial statements and the Boards' Report the reasons for deviation from the accounting standards and the financial effect of such deviation. Thus, the financial statements read with the Notes presented a true and fair view of the accounts and were not misleading in any manner. Noticees further submitted that Company had clearly stated the position of the Bank interest matter in its notes of the Annual Report as highlighted to SEBI.

- C. **Interest was not ascertainable:** Noticees submitted that in the case of Export Finance, the interest amount is not pre-determined at the time of availing the loan. SBI's sanction letter dated 31.03.2017 clearly states that the rate is floating. This shows that in case of the

limits sanctioned, the rates of interest would vary from time to time based on the Bank's lending rates and the Rating of the Company. This information is confidential in nature and due to this, CIL was unable to calculate interest. Further, once an account becomes NPA there is no renewal of bank limits, no ascertainment of the Company's rating and no fixation of any interest rates on the outstanding against export financing.

Arguments by SEBI

- A. **Underestimate losses by not provisioning expenses:** SEBI stated that as per Reserve Bank of India's Income Recognition & Asset Classification Norms ['IRAC'], all Banks are required to classify income on NPA differently from that of Standard Accounts. In FY 2017-18, the credit facilities extended by Banks to the Company were declared as NPA and SBI reversed ₹ 16.85 lacs and transferred it to unrealised interest. SEBI stated that in the case of NPA accounts, banks in general calculate the interest periodically and transfer it to accrued interest. As it can be seen that SBI had reversed interest in FY2017-18 as per the IRAC norms, however, this did not absolve the liability of the Noticees to pay the interest on the outstanding loan amount. SEBI further stated that Noticees had argued their inability to calculate interest liability due to the floating rate of interest. To this, SEBI stated that if the contention of Noticees is that they were unable to calculate interest liability then Noticees should have approached the concerned

bank where the information about the interest charged was readily available. To the argument of the Noticees that it is an industry practice SEBI stated that accounting standards clearly define the treatment of interest expense and liability in the financial statements. SEBI further stated that accounting standards cannot be ignored given the reason that company followed industry standards. In view of this, the contention of the Noticees in this regard cannot be accepted.

- B. Complied with Accounting Standards & Companies Act, 2013:** SEBI stated that Noticees have not provided clear reasoning to depart from the accounting standards. SEBI further stated that Noticees have mentioned in notes to accounts as follows, “... *In the absence of advice/information, finance cost for the month of March 2018 could not be ascertained and accounted for...*” SEBI stated that this reasoning is not acceptable. SEBI further stated that had the Noticees approached banks, they would have obtained the interest liability on their outstanding amount. Further, the Noticees did not provide for the financial effect of its deviation from accounting standards for the quarter ended June & September 2019. Further SEBI stated that information related to interest charged was readily available with banks as banks aggregated interest amounts and principal amounts at the time of approval of the resolution plan. Further, SEBI stated that as per the loan agreement signed between Noticee 1 & SBI (erstwhile State

Bank of Hyderabad), dated March 31, 2017, the loan covenant for irregular drawings is stipulated where SBI has clearly mentioned that if the account is irregular for more than 60 days, the penal interest of 2% on the entire outstanding would be charged. Therefore, the contention of the Noticee 1 that the Bank did not charge interest is incorrect and unacceptable.

- C. Interest was not ascertainable:** Noticees contended that they did not have a reliable estimate of the amount of the obligation. In this regard, SEBI stated that the information was readily available with the banks as they periodically calculate the interest on the outstanding loan. Further, SEBI stated that as per IND AS 109, the financial liability can be removed from the balance sheet only when the same is extinguished i.e. when the obligation specified in the contract is discharged or cancelled or expires. In the instant case, the company had acknowledged in its letter dated January 7, 2019, that the financial resolution was being discussed and planned with the banks. Therefore, the financial liability of the company for the interest component was not extinguished at the time of publishing of financial statements during the IP. This is also corroborated by the fact that the settlement of loans was done on December 4, 2019, by SBI and November 13, 2019, by PNB. Further, SEBI stated that banks had not waived off the interest liability of the company at the time of publishing of financial statements. The financial liability of the company cannot be

considered to be extinguished and the same had to be accounted for in the books of accounts and disclosed in the financial statements by the company. Therefore, in this regard, the contention raised by Noticees doesn't hold any merit.

SEBI views on the Role of the audit committee: SEBI stated that it was the responsibility of the Audit Committee to comply with the underlying accounting standards in the matter of dealing with interest expenses. Despite the statutory auditor raising the issue of non-compliance with Accounting Standard by way of a qualified opinion in its audit report and limited review report, the Audit Committee has failed to ensure that the published financial statements were in accordance with the applicable accounting standards and presented a true and fair view of the company's affairs. In view of the above, it can be inferred that Noticees 2 & 5 (Chairman and Members of Audit Committee) have failed to discharge their duties and thereby violated the provisions of Regulation 18(3) read with clauses A (1), (4), (5) under Part C of Schedule II of the SEBI (LODR) Regulations, 2015.

SEBI views on the Role of audit CFO: SEBI further stated that as per provisions of Regulations 17(8) of SEBI (LODR) Regulations, 2015, the Chief Financial Officer ('CFO') shall provide the compliance certificate to the board of directors. Further, under

regulation 33(2)(a) of SEBI (LODR) Regulations, 2015, it is the duty of the CFO of the listed entity to certify that the published financial results do not contain any false or misleading statements or figures and do not omit any material fact which may make the statements or figures contained therein misleading while placing the financial results. CFO is a person of knowledge, who understands the concept of conservatism and why it is considered as one of the basic principles while preparing accounts. It is a well-known concept in finance to recognise expenses and liabilities as soon as possible when there is uncertainty about the outcome but to only recognize revenues and assets when they are assured of being received. The Statutory auditor raised the concern of not considering interest expense and also provided the qualification for the same, however, the CFO chose not to follow the underlying accounting standards and signed the compliance certificate and certified that the financial statement of the company is as per accounting standards and true to his knowledge. It shows the lackadaisical attitude of the CFO and unprofessionalism on the part of the CFO. In view of the same, it was noted that Noticees 2, 4, 6 & 7 (Managing Director, Executive Director and both CFOs) have violated the provisions of regulations 17(8), 33(2)(a) of the LODR Regulations.

Penalty

| Noticee no. | Name of Noticee | Penalty |
|--------------------|------------------------------|----------------|
| 1 | Carnation Industries Limited | ₹ 500,000 |
| 2 | Ravindra Sehgal | ₹ 100,000 |
| 3 | Suvobrata Saha | ₹ 100,000 |
| 4 | Arun Kumar Bose | ₹ 100,000 |
| 5 | Sephali roy | ₹ 100,000 |
| 6 | Biplab Ganguly | ₹ 100,000 |
| 7 | Somnath Pradhan | ₹ 100,000 |

Cases quoted by Noticee

1. Adjudicating officer, SEBI in the matter of Radha Madhav Corporation Limited & Ors dated April 13, 2019.

Cases quoted by SEBI

1. ***Hon'ble High Court of Allahabad in the matter of Girish Chandra Tiwari vs. UCO Bank vide writ C No. 67132 of 2013 decided on 09.09.2014.***
2. ***Hon'ble Supreme Court of India in the matter of Chairman, SEBI vs. Shriram Mutual Fund {[2006]5 SCC 361}***
3. ***Suzlon Energy Ltd. and Anr. vs. SEBI (Appeal No. 201 of 2018) dated May 03, 2021.***
4. ***M/s NDTV vs. SEBI (Appeal no. 358 of 2015) dated August 07, 2019.***
5. ***Oasis Securities Ltd. & Ors. vs. SEBI (Appeal no. 316 of 2018), dated March 17, 2020.***

IBC

In the matter of Somesh Choudhary-Suspended Director at M/s Global Fragrances Private Limited (Appellant) vs. Knight Riders Sports Private Limited (Respondent 1) & Ms Arti Baluja, Interim Resolution Professional (Respondent 2) order passed at National Company Law Appellate Tribunal (NCLAT), Principal Bench, New Delhi dated 18th August 2022.

Facts of the Case

- Global Fragrances Private Limited - Corporate Debtor ('CD') had entered into a licensing agreement dated 3rd March 2014 for the term starting from 3rd March 2014 to 31st December 2016 with Knight Riders Sports Private Limited (Respondent 1) whereby the respondent had granted exclusive rights and allowance to the CD to use the trademark 'KKR', to manufacture, distribute and advertise licensed products namely Deodorants, Hair gels, and Perfumes (the licensed products) In return, the CD was obligated to pay Minimum Guaranteed Royalties ('MGR') as identified in the licensing agreement as compensation for enjoying the exclusive rights
- The respondent had raised invoices for an aggregate sum of ₹ 40,60,147/- towards the outstanding MGR payable by the CD under the licensing agreement and only part payment was received. The invoices towards MGR had to be paid irrespective of the sales made by the CD. On failure of the CD to pay the balance MGR, the respondent filed an application at

the National Company Law Tribunal (NCLT) for initiation of the Corporate Insolvency Resolution Process (CIRP) u/s 9 of the Insolvency and Bankruptcy Code, 2016 (IBC/Code).

- The application was admitted by the NCLT on the grounds that incorporeal rights like trademarks, copyrights, patents, and rights in personam capable of transfer or transmission are included in the ambit of “goods”. Further for a claim to fall within the definition of ‘operational debt’, the operational creditor must establish that it has a right to payment in respect of the provision of goods or services and that CD committed a default towards its liability or obligation in respect of such outstanding claim.
- Aggrieved by the order of NCLT, Mr Somesh Choudhary – Suspended Director and Shareholder of the CD filed the appeal before NCLAT.

Arguments by the Appellant

- It was argued that the invoices were raised towards payment of MGR which were to be paid irrespective of the sales made by the CD. It was submitted that the ‘Claim’ arises out of non-payment of MGR, which admittedly does not arise out of non-payment of any goods or services and therefore cannot be an ‘Operational Debt’
- The amount claimed is not an ‘Operational Debt’ as there is no transaction having a correlation of direct input into the output levels or supplied by the CD. The reliance was also placed on the decision of NCLAT

as held in **‘M. Ravindranath Reddy’ vs. ‘Mr. G. Krishan & Ors.’ in Company Appeal (AT) (Ins.) No. 331/2019** in support that any ‘debt’ arising without nexus to the direct input to the output produced or supplied by the ‘Corporate Debtor’, cannot be considered as an ‘Operational Debt’.

- Further, also placed reliance on the Judgement of this Tribunal in **‘Promila Taneja’ vs. ‘Surendra Design Pvt. Ltd.’, Company Appeal (AT) (Ins.) No.459/2020**, wherein the NCLAT has held that the definition of goods and services cannot be lifted from taxation statutes unless it is specifically provided for under the Code and once again reaffirmed the decision of **‘M. Ravindranath Reddy’ (Supra)**.
- Also, it was submitted that the first Respondent had failed to show that the Appellant had used the trademark of the first Respondent for the purpose of sale, marketing etc. and that their claim was with respect to non-payment of MGR which is not an ‘Operational Debt’

Arguments by the Respondent 1

- As per the agreement, the CD was obligated to pay certain considerations in form of ‘compensation’ to the respondent for the payment of Royalties. The MGR were payable quarterly as the schedule agreed in the agreement. The Royalties would consider the MGR paid for the corresponding period as stated in the agreement.
- Further, the CD was required to all Royalties for each calendar quarter

not later than 15 days following the last day of such calendar quarter, failing which the late charge interest at 1.5% per month or the maximum rate permitted by law, whichever is less, along with any costs/attorney fee, etc., payable on such dues. Pursuant to the terms of the Agreement, several invoices were upon the CD. However, the CD deliberately/intentionally did not make the payments of the invoices. Further several reminders were also sent in this regard, but CD failed to respond.

- On 11th June 2015, the CD gave a post-dated cheque for a sum of ₹ 5 Lakhs issued by Xtreme Perfumes and Personal Care Private Limited - a Company in which the Appellant is also a director, however, it was returned as the drawer of the cheque did not have privity of contract. Despite repeated admission of debt, the CD defaulted in making the payments.
- Further, attention was drawn to the e-mail dated 13th June 2015 wherein the CD stated that the delay in payment was on account of pending commitments and that ₹ 5 Lakhs was being transferred by RTGS and the balance amount would also be paid in that month. Thereafter, two cheques for an amount of ₹ 10 Lakhs were handed over by the CD, but subsequently, the cheques were dishonoured on the ground that 'payment was stopped.
- Also, contended that in the email dated 1st October 2015, the CD agreed to pay the royalties as per their commitments. Despite repeated reminders, when the

amounts were not paid, a legal notice dated 30th March 2016 was issued and also a Criminal Complaint was lodged on 5th July 2017 against the CD and the Appellant herein.

- A demand notice dated 28th March 2018 with a complete annexure was served upon the CD u/s 8 of the Code. The payment reminder was also sent to the CD's email ID registered in the Company's Master Data, but there was no reply
- NCLT rightly observed that there was no 'Pre-Existing Dispute' between the parties and allowed the Section 9 Application

Held

- The NCLAT looked into the definition of goods under the Sale of Goods Act, 1930 to determine whether non-payment of the MGR would constitute an operational debt, wherein the term goods included all moveable property other than actionable claims and money.
- The NCLAT also observed and relied on the decision of *the Hon'ble Supreme Court in Vikas Sales Corporation vs. Commissioner of Sales Tax* wherein it was held that trademarks and copyrights would constitute moveable property and accordingly would be considered as goods under the Sale of Goods Act, 1930.
- The NCLAT also examined the terms of MGR and observed that a guaranteed minimum royalty is a periodic payment made by a licensee towards a licensor

to utilise a licensed product for an agreed period.

- Further, the NCLAT observed that pursuant to *Section 7 of the Central Goods and Service Act 2017*, any utilisation or enjoyment of intellectual property rights would be considered a service provided by the intellectual property rights holder.
- The NCLAT also referred to the decision of *the Madras High Court in the matter of AGS Entertainment Private Limited vs. Union of India* wherein it was held, that by providing the CD rights to utilise the trademark of ‘KKR’ in its licensed products, the respondent had temporarily provided permission to use its trademark, which would constitute the provision of a service by the respondent. Consequently, the outstanding MGR payable in connection with the provision of such service would constitute an operational debt under section 5(21) of the Code.
- Further, the NCLAT set aside the contention of the CD on the premise that as per Ravindranath Reddy (Supra)

there was no direct nexus established between the MGR payable and the business operations of the CD.

- The NCLAT also referred to the decision by its larger bench in *Jaipur Trades Expocentre Private Limited vs. M/s. Metro Jet Airways Training Private Limited* and stated the **Ravindranath Reddy (Supra)** had been overturned as it did not correctly deal with the meaning of “service” under section 5(21) of the Code.
- The NCLAT examined the licensing agreement between the CD and the respondent and held that the trademark ‘KKR’ was used in the development, packaging, and advertisement of the licensed products. This establishes a direct nexus between the payment of the MGR and the business operations of the CD. Accordingly, such MGR dues constituted an operational debt under the Code. Accordingly, the appeal was dismissed and stated that the claims arising out of the grant of an exclusive license to use intellectual property rights fall within the ambit of the definition of operational debt.



“Do not believe in a thing because you have read about it in a book. Do not believe in a thing because another man has said it was true. Do not believe in words because they are hallowed by tradition. Find out the truth for yourself. Reason it out. That is realization.”

— Swami Vivekananda