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CORPORATE LAWS Case Law Update

Securities And Exchange Board of India (SEBI) Order In The Matter Of Geodesic Limited, dated 19th December 2022

Facts of the case

- SEBI had received a letter from the Company Registrar of the Bombay High Court, along with a copy of the order dated December 22, 2015, in the matter of ***HDFC Bank Ltd. vs. Geodesic Limited.***
- In the said order, SEBI as well as the Enforcement Directorate were directed to take immediate action against the Directors of Geodesic Limited (“the Company”) as well as one Shri Dinesh Jajodia, under the appropriate provisions of law, including attachment of their properties as permissible in law.
- The Company in question was incorporated in the year 1982 and was in the business of providing products and solutions for Content, Communication, Collaboration and Electronic Computing etc. At the time of investigation, the company was under liquidation and had 5 subsidiaries.

- There were 5 directors at that relevant time in the Company, who are as follows:
 1. Kiran Kulkarni, Managing Director (Noticee no.3),
 2. Pankaj Kumar, Chairman/Director (Noticee no. 1),
 3. Prashant Mulekar, Director & Compliance Officer (Noticee no. 2),
 4. Vinod Sethi, Independent Non-Executive Director (resigned on May 16, 2013) (Noticee no. 4),
 5. Nitin Potdar, Independent Non-Executive Director (resigned on December 4, 2012) (Noticee no. 5).
- Based on certain complaints received from various stakeholders, SEBI had already initiated an investigation into the books of accounts of the Company to ascertain the possible violations of the SEBI Act, 1992 and regulations made thereunder, and to find out the veracity of the alleged irregularities in the books and accounts of the Company. The investigation was conducted for the

period of April 01, 2011, to March 31, 2012.

- Further, in pursuance of the said investigation, a Forensic Auditor had been appointed by SEBI for conducting a Forensic Audit and examining the books of accounts of the Company. Resultantly, a Forensic Audit Report was filed with SEBI.
- The Forensic Audit Report made the following observations:
 - The revenues booked and the profits purported to have been generated by the Company were false and non-existent, and thus the Company was misleading and misrepresenting the facts about the actual status of its affairs.
 - The company had raised funds from overseas investors during January 2008 by issuing FCCB bonds for USD 125 Million, redemption due date for which was January 18, 2013. Subsequently, the company failed to redeem the bonds on the due date. The company along with one of the main overseas subsidiaries, GTSL, were ordered for liquidation by the Bombay High court.
 - The FCCB bonds were to be used only for overseas acquisitions and investments in joint ventures/ wholly owned subsidiaries and or for any other purpose as permitted by the RBI. However, it was discovered that funds were actually diverted by giving loans to various other entities, thus violating RBI norms.
 - While the assets which were in the form of investments as per

the audited balance sheets were confirmed to be available, however after further probing into the investments statements, mail communications of directors, the beneficiary owner Mr. Dinesh Jajodia (the alleged tax consultant of the Company) and the banker it was revealed that the investments were actually diluted and diverted into other investments.

- Further, the monies were invested or given as loans to companies in which Mr. Dinesh Jajodia was personally interested as director.
- Additionally, the investigative audit of the books of accounts for the availability of the reserves created by the company, debtors and creditors for realisation revealed that the same were non-realizable as they all were shell companies and outstanding amounts against these companies were generated by bogus entries.
- With respect to the Audited Balance Sheets of the Company, it was revealed that the forensic audit of the books of accounts for the past three years was examined in detail, and the status of sales, purchases, returns, reserves and surpluses were found to be non-existent.
- Pursuant to the investigation, a common Show Cause Notice (“SCN”) was issued to the Noticees alleging that:
 - a) The Audited Balance Sheet of the Company for the Financial Year 2011-12 failed to provide a true and fair view of the status of the affairs of the Company on the

existence of its investments, profits, and reserves.

- b) Noticee Nos. 1 and 3, being signatories to the Annual Report of the Company that contained manipulated financials, had misled the investors by not providing a true and fair picture of its quarterly and yearly financials.
- c) Noticee nos. 2, 4 and 5, who were the members of the Audit Committee of the Company, had failed to oversee the correctness of the financial statements, which were false and misleading, and by accepting the same they have failed to discharge their duties as members of the Audit Committee.
- d) The Noticees engaged in manipulation of the books of accounts for the Financial Year 2011-12 by publishing the same in the Annual Report of the Company, which was not true, by planting false/misleading news about its financials, thus misleading the investors by not providing a true and fair view of its quarterly and yearly financials.

- Additionally, in another related investigation conducted by SEBI in 2020, a Supplementary SCN was served upon Noticee nos. 1, 3, 4 and 5.

Issues

One of the primary issues discussed was whether the Noticee nos. 4 & 5 (Independent Directors), had failed to oversee the correctness of the financial statements for the FY 2011-12 which were found to contain false and misleading figures and amounts and thereby had failed to discharge their duties as Independent Directors?

Rules Applicable

The Noticees were alleged to have violated the following provisions:

- Section 12A(a), (b), (c) of the SEBI Act, 1992
- Regulations 3(b), (c), (d) and 4(1), 4(2)(f), (k) and (r) of the SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 (“PFUTP Regulations”).

Arguments on behalf of Independent Directors

- No specific role had been attributed and only sweeping allegations were made. Therefore, the allegations of fraud were not sustainable. Further, the charges of failure to oversee the financial statements ran contradictory to the charges of having committed fraud. In order to prove the charges of “fraud”, some kind of element of “inducement” must be shown, which was lacking in the present case.
- Being Independent Directors, the Noticees were not responsible for the day-to-day affairs of the Company and had insight only through Board processes.
- In order to pin liability on Independent Directors, it needs to be indicated that being Independent Directors, the said Noticees participated in fraud or fraud that took place with their connivance/ consent or that the said Noticees failed to act with diligence, despite having knowledge of fraud through Board processes. Such standards have also been codified under SEBI (LODR) Regulations, 2015 as well as under various Circulars of the Ministry of Corporate Affairs.

- Reliance was placed on an MCA Circular dated July 29, 2011, and an MCA letter dated November 09, 2016, to support the contention that Independent Directors shall not be made liable for a violation which occurred without their knowledge and without their consent or connivance or in cases where they have acted diligently through the Board process.
- The Audit Committee was presented with the facts of only the first leg of transactions, through which funds were transferred to subsidiaries and group companies, and thus there was no allegation with respect to the said transactions.
- The funds were further diverted from such subsidiaries/group companies to other entities where the Executive Directors and Mr. Dinesh Jajodia were alleged to be personally interested, and the Noticees were not aware of such transactions forming the basis of the allegations.
- The relevant documents pertaining to the affairs of the subsidiary's companies were never placed before the Board of Directors.
- The Forensic Report admitted that the further investments made were not mentioned in the Audited Balance Sheet for the FY 2011-12.
- The report dated November 23, 2015, prepared by the Ministry of Corporate Affairs ("MCA") also pointed out towards complicity of the Executive Directors cum Promoters in taking all the financial decisions.
- The said report also indicated that the Executive Directors of the Company had been able to collect funds from the banks/Financial Institutions by falsifying the accounts and showing healthy balance sheets.
- There was no obligation on the Audit Committee Members to review the accounting entries themselves for which internal and statutory auditors were appointed. The test that had to be applied was "*what would a person with reasonable prudence would have commented on the documents presented during the meetings*".
- The SCN and Supplementary SCN treated all the Directors as guilty of fraud only due to their directorship, thus ignoring the law laid down under various judgments.
- Noticee no. 5 resigned on December 04, 2012, while Noticee no. 4 resigned on May 16, 2013, from the Directorship.
- Furthermore, Noticee no. 4 resigned on January 16, 2013, from the Audit Committee, as he was dissatisfied with the Management's inability to answer the questions raised by him. Copy of the emails indicating the same had been furnished by Noticee no. 4.
- The Management's accounts and audit confirmations provided to the Statutory Auditor and the Statutory Auditor's report dated December 03, 2012, did not contain any findings of fraud.
- The financial statements were recast on February 14, 2014, by that time, both had resigned from the directorship.
- Copy of minutes of meetings of Audit Committee for FY 2011-12 based on which allegations had been made was neither discussed nor furnished with the SCN and such documents are also not in possession of SEBI.
- SCN to Noticee no. 4 was issued by the MCA with respect to the irregularities

in the financial statements, however, ultimately, the MCA vide its letter exonerated him, based on the replies given.

- The materials available on record did not indicate that the Independent Directors could have detected the fraud by the management and being Independent Directors, the said Noticees had insight into the affairs of the Company only through Board processes.
- Reliance had been placed on the order dated September 09, 2019, passed by the Hon'ble SAT in the matter of ***Price Waterhouse & Co. vs. SEBI (Appeal No. 6 of 2018)***, to contend that even a Statutory Auditor (leave alone Audit Committee Member) cannot unearth a complex fraud.
- As diligent Directors, queries were raised and upon not being satisfied, they resigned immediately from the post of the directorship even before the publication of the scam.
- There were no unusual changes in the financial statements of the previous year to raise any red flags.

Observation of Adjudicating Officer (“AO”) of SEBI

- The AO found force in the submissions of Noticee Nos. 4 and 5 and observed that it was not a disputed fact that the Noticees, being Non-Executive Directors of the Company, were not involved in the day-to-day management of the Company and had also discharged their responsibilities in good faith and with due diligence
- There was no evidence on record which even remotely indicated that the alleged actions committed by the Executive Directors were committed with the

knowledge, consent or approval of the Board of Directors and no specific adverse facts attributing their conduct or knowledge in the violations committed by the Company had been alleged in the SCN.

- Noticee no. 4 exercised his diligence by immediately resigning after becoming aware of the wrongdoings in the Company. Hence, he could not be held liable for the wrongdoings of the Company, which had been committed against the wish and consent of the Noticee.
- There was enough evidence which indicated that the complex, layered transactions were executed on behalf of the Company and the persons behind such acts were the Noticee nos. 1, 2 and 3 who were the Promoter-Directors of the Company, while there is nothing to show that the Audit Committee Members had knowledge of such transactions.
- The AO observed that while the Noticees i.e., Noticees no. 4 & 5 were certainly holding the post of Directors during the relevant period and that the two Directors were members of the Audit Committee, however, after perusing the submissions of the Noticees along with the materials available on record, the view that the submissions advanced by Noticee nos. 4 and 5, with supporting documents including the MCA letter holding Noticee no. 4 not as an officer in default, could not be ignored.
- Additionally, in the peculiar facts and circumstances of the present case, it had come to light that the facts, figures and the real state of affairs of the Company were concealed by the Executive Directors from the Audit Committee. In

this regard, the AO took note of the fact that Noticee no. 4 had resigned from the Directorship on account of the reasons cited.

- It was observed that the grave issues pertaining to Forex Trades, which led to a loss of INR 150 Crore to the Company, were kept hidden by the management from the Audit Committee Members. The AO also observed that such a glaring act of concealing the wrongdoings from the Audit Committee speaks volumes about the deceitful conduct of the Executive Directors, who were running the show of the Company.
- The aforesaid facts, even on a stand-alone basis, carried sufficient weightage to exonerate the Independent Directors of the Company.
- There was also no evidence to indicate their direct or indirect participation in the execution of the scheme devised by the Executive Directors, against whom strong observation had also been passed by the Hon'ble High Court for their wrongdoings, which also does not indicate any involvement or knowledge of the Independent Directors.
- The two Noticees had successfully exhibited that due diligence had been carried out by them while acting in the capacity of Independent Directors and that they had not acted as a mute or silent spectator to the nefarious activities of the Company.

Held

- The two Noticees had been successful in showing that due diligence had been carried out by them while acting in the capacity of Independent Directors and that they had not acted as mute or silent

spectators to the nefarious activities of the Company.

- After becoming aware that the Company was not observing transparency in its affairs, Noticee nos. 4 and 5 had taken the decision to step down from the position of directorship.
- The charges made against Noticees no. 4 and 5 fell short of bringing home the allegations made in the SCN against them. Hence, such charges were not sustainable in light of the facts of the matter. Accordingly, the proceedings against them deserved to be dropped.
- The aforesaid observations thus exhibited the fact that the Independent Directors, who were part of the Audit Committee, were not furnished with complete and adequate information about the financial affairs of the Company. Furthermore, the essential information regarding huge losses incurred from Forex trading was also concealed from Noticee Nos. 4 and 5. Such conduct on the part of the management revealed the ill-intent of Executive Directors to keep the actual financials undisclosed from the investing public and regulatory authorities.
- In light of the facts, circumstances, as well as contentions of the Noticees, appraised thereof, it was observed that the facts of the case failed to provide adequate probabilities to establish the charges against the Noticee nos. 4 and 5.
- Therefore, both of the said Noticees were held to be exonerated from the impugned proceedings.

