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Material Misstatements in DRHP: SEBI's Enforcement Actions

Introduction:

In recent years, India has seen a wave of IPOs, making it more important than ever for regulators to keep a close watch on company disclosures. For businesses looking to go public, this means they need to be completely transparent and provide accurate information. At the same time, merchant bankers must dive deeper into due diligence to catch any mistakes or misstatements in the Draft Red Herring Prospectus (DRHP). Any slip-ups can lead to delays, regulatory action, or even rejection of the IPO. In this article, we shall see areas where mis-statement in prospectus could be seen and some Securities and Exchange Board of India (SEBI)'s enforcements in this regard.

What is a material Misstatement?

A material misstatement in a DRHP can be seen as any false, misleading, or incomplete information that has the potential to impact an investor's decision-making process.

Regulation 185 (1) of SEBI (ICDR) states that "*The offer document shall contain all material disclosures which are true, correct and adequate to enable the applicants to take an informed investment decision.*" It makes one thing clear that transparency is non-negotiable when it comes to IPOs. Companies must provide disclosures that are true, accurate, and detailed enough for investors to make informed decisions. At the same time, lead managers have a crucial role to play, they must conduct thorough due diligence and ensure that every detail in the draft and final offer documents is genuine and complete.[i]

Key Areas in DRHP Where Misstatements Occurred:

1. **Misstatements in Objects of the Issue:**

   False Representation of Fund Utilization:

   In the adjudication order passed by SEBI in the matter of Trafiksol ITS Technologies limited[ii] :

   SEBI found that, The company stated in its prospectus that IPO proceeds would be used to acquire software from a third-party vendor (TPV). SEBI's investigation revealed that the TPV was a shell entity with no technical expertise, indicating that the transaction was not genuine and claim regarding the utilization of the IPO proceeds was misleading.

   SEBI held that,

   "Having concluded that the TPV is a 'shell entity', the next question to consider is the broader implications of this finding. The Company, as stated earlier, offered multiple, and at times conflicting, explanations for its engagement with the TPV. It vehemently claimed that it merely obtained a quote from the TPV, that the TPV was selected after adhering to the rigorous procedures outlined in its procurement policy, and that the TPV was just an intermediate entity which would sub-contract the software development. However, what the Company has conspicuously failed to provide is a single credible justification for engaging such an entity in the first place.

...This, however, does not take away the fact that the Company relied on a sham entity and participated in a cover-up when the credentials of the TPV were being examined..."

SEBI directed company to refund the amount to investors.

2. **General Corporate Purposes (GCP):** In the adjudication order passed by SEBI in the matter of IPO of Onelife Capital Advisors limited (2018)[iii] SEBI observed that a false statement was made in the prospectus. SEBI held that,

   "At page 32 of the Prospectus dated October 10, 2011 under the head 'General Corporate Purposes' (GCP) it is stated that, the funds under General Corporate Purposes were supposed to be used for strategic initiatives or unforeseen circumstances and also that as on date of prospectus, the Company has not entered into any letter of intent or any other commitment for any such acquisition/investments or definitive commitment for any such strategic initiatives. In the Board Meeting of OCAL dated September 30, 2011, it was decided to avail of short-term borrowing from prudential group to pay finder fees to Fincare and Precise and the short-term loan was to be repaid using IPO proceeds. The payment of finder fee was to be done with the IPO proceeds designated as 'General Corporate Purposes'. However, the same was not disclosed in the Prospectus dated October 10, 2011. Hence, it was observed that a false statement was made in the Prospectus."

   Hence, non-disclosure of specific allocations under GCP, leading to fund misutilization counted as material misstatement in the offer document.

3. **Use of Bridge Loans:** It means non-disclosure of short-term borrowings taken before the IPO. In the adjudication order passed by SEBI in the matter of IPO of Onelife Capital Advisors limited (2018)[iv] , SEBI found that false statement were made in the prospectus regarding pre-IPO borrowings (or bridge loans).

   SEBI held that,

   "In the Prospectus dated October 10, 2011 it is stated at point no 17 at page no. 28 that "Our Company has not raised any bridge loans against the Issue Proceeds". However, it was observed that OCAL raised a loan of Rs.11.5 crore from Prudential Group vide loan agreements dated October 03, 2011 when the public issue was in progress and before the date of Prospectus. Thus, the above is a false statement in the Prospectus."

   SEBI imposed penalty the merchant banker for the issue Artherstone Capital Markets.

4. **Promoter and Group Company Details:** This includes concealment of related-party transactions or promoter linkages with undisclosed entities. This was observed in the prospectus of DLF. DLF's IPO prospectus in 2007 contained misstatements and omissions regarding related party transactions and material disclosures. Initially, three companies, Sudipti Estates, Shalika Estate Developers, and Felicite Builders were disclosed as associates, but later omitted from the revised DRHP. SEBI found that the share transfers were sham transactions, and DLF continued to control these entities, despite claiming otherwise.

Additionally, related party transactions and financial details of subsidiaries were not disclosed, violating SEBI's disclosure norms. DLF also failed to report an FIR against Sudipti, which was a key litigation matter. SEBI ruled that DLF misled investors, leading to a three-year market ban on the company and its executives.

SEBI held that,

"...Resorting to sham transaction of share transfer with a view to camouflage association of DLF with Felicite, Shalika and Sudipti as dissociation and thereby misleading the investors by not disclosing material information relating to Felicite, Shalika and Sudipti in the offer documents is no doubt highly objectionable. Such a dubious method adopted by DLF is highly detrimental to the investors/general public in the securities market. Therefore, with a view to send stern message to DLF and to other listed companies that such dubious methods are not adopted again, it was necessary for SEBI to take remedial action under Section 11/11B of SEBI Act..."[v]

5. **Litigation and Regulatory Proceedings:** Omission of material legal cases or pending investigations affecting the company.
6. **Risk Factors:** Downplaying or failing to disclose significant business, financial, or regulatory risks.
7. **Financial Statements & Projections:** Inflated revenue, understated liabilities, or misleading future growth estimates.

The areas mentioned above are some of the most common risk zones where misstatements in a DRHP have occurred and can occur. While they don't cover every possible issue, they highlight why accuracy and transparency are absolutely essential when preparing an IPO document.

To avoid these pitfalls, thorough due diligence is a must. This isn't just the company's responsibility Book Running Lead Managers (BRLMs) play a crucial role too. Under Schedule V of SEBI (ICDR) Regulations, 2018, BRLMs must submit a due diligence certificate, confirming that all disclosures in the DRHP are true, complete, and sufficient for investors to make informed decisions.

That's why every detail financials, legal matters, risk disclosures, and fund utilization needs to be carefully verified. A single misstatement can lead to regulatory scrutiny, investor distrust, and legal trouble. Taking the time to get it right not only ensures

Conclusion:

Misstatements in a DRHP are more than just compliance lapses, they can lead to regulatory penalties, legal consequences, and a loss of investor trust. SEBI has consistently taken strict action against companies that fail to provide accurate disclosures, reinforcing the importance of transparency and due diligence in the IPO process.

For companies and Book Running Lead Managers (BRLMs), the message is clear: every detail in the DRHP must be verified, accurate, and complete. A single misleading statement can derail an IPO, invite regulatory scrutiny, and damage long-term credibility. On the other hand, a well-prepared DRHP not only ensures compliance but also builds investor confidence and market reputation.

As IPO activity in India continues to grow, so will SEBI's vigilance. The key to navigating this evolving landscape is simple; full and fair disclosure, backed by rigorous due diligence.

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[i] Regulation 185 (3) of SEBI ICDR Regulations 2018: *The lead manager(s) shall exercise due diligence and satisfy themselves about all aspects of the issue including the veracity and adequacy of disclosure in the draft offer document and the offer documents.*
[ii] https://www.sebi.gov.in/sebi_data/attachdocs/dec-2024/1733225149153.pdf
[iii] SEBI Adjudication Order NO. EAD/BJD/BKM/ 169 /2017-18 in the matter of IPO of Onelife Capital Advisors Limited
[iv] SEBI Adjudication Order NO. EAD/BJD/BKM/ 169 /2017-18 in the matter of IPO of Onelife Capital Advisors Limited
[v] Order of Hon'ble SAT in the matter of DLF Ltd. Vs. SEBI (13 March, 2015)

Article on Role of Independent Directors in scanning Related Party Transactions

Introduction:

In today's business environment, corporate governance has become more important than ever. One of the fundamental components of good governance is ensuring that a company's operations are transparent, fair, and compliant with legal regulations. Independent Directors (IDs) play a critical role in overseeing corporate practices, particularly in the context of Related Party Transactions (RPTs). RPTs are business dealings between a company and its related entities, such as its directors, promoters, or key managerial personnel (KMPs). While these transactions are not inherently illegal, they are closely scrutinized due to their potential for conflicts of interest and financial manipulation.

This article explores the critical role of Independent Directors in scanning and overseeing Related Party Transactions, ensuring that these transactions are conducted ethically, legally, and in the best interests of all stakeholders.

Independent Directors:

Independent Directors are appointed as per the provisions of Section 149 of the Companies Act, 2013 and Regulation 17 of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015.

The role of the Independent Directors is very crucial in the Corporate Governance of a Company. They ensure that the Board of Directors of the Company have optimum combination of Executive and Non- Executive Directors and helps to bring transparency and accountability in the Board process.

Independent Directors have huge responsibility on them to ensure that, the Company complies with the applicable Rules and Regulations and do the business in the best interests of all stakeholders of the Company be it employees, customers, vendors, government and regulatory agencies.

Independent Directors are also responsible for ensuring that Company have adequate Internal Control System and Financials of the Company are free from material misstatements. Independent Directors being members of Audit Committee have important responsibilities to ensure that Company maintain financial statement in proper manner and Audit is done as per requirements of Law. Audit Committee shall interact with Auditors ask them important questions about financial health of the Company. Auditors shall share them periodical reports about any irregularities, or any potential financial fraud that may have impact on the financial condition of the Company. There should be proper dialogue between the Audit Committee and Auditors of the Company about the Financial reporting and Audit process.

Related Party Transactions:

Related Party Transactions are governed by the provisions of Section 177,188 of the Companies Act, 2013 and Regulation 23 of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015. Companies while doing business have to incur various transactions with various parties.

These transactions are basically business transactions like purchase or sale of goods or services, availing or rendering of services, leasing of land or building, appointment of any related party to any office or place of profit, underwriting the subscription of any securities etc.

Related parties are basically Promoters, Directors, KMP's, Immediate Relatives Promoters, Directors & KMPs, Companies, partnership firm in which they have interest by being Director, Partner.

Law per se is not against that, the Companies Should not do the transactions with related parties, those are not prohibited but those transactions shall be done in accordance with law in true letter and spirit and in the best interests of the Company and not to defraud any of the stakeholders of the Company.

Role of Independent Directors in scanning the RPTs:

As per the Law Independent Directors shall ensure that, Related Party Transactions are in the Ordinary Course of Business of the Company and are conducted on arm's length basis and are fair to the Company, effectively protecting the interests of minority shareholders of the Company.

They shall ensure that, the Business and transactions that Company do with Related Parties is as per the Objects of the Company as per its Memorandum of Association and shall not do any business which it is not authorized by Memorandum.

Also, transactions shall be on arm's length basis which means it is as good as done with unrelated parties and terms of payment, pricing and tenure of payment should be such that, it should not give undue advantage to any of the related parties. If anyone get undue advantage from these transactions that will affect financial health of the Company which is not a good sign for the prospects of the Business of the Company.

Conclusion:

Independent Directors shall ensure below aspects about the Related Party Transactions:

1. **Proper documentation** about the related party transactions that Company undertakes and proper record of List of Related Parties, Nature of Transaction, Duration of transaction, Pricing of the transaction, Rationale for the transaction
2. **Approval of the Audit Committee** and Board of Directors whenever requited
3. **Approval of the shareholders** for material related party transactions.
4. **Rationale and basis for RPT** should be placed before the Audit Committee and Board meaningful discussions should be done to understand need for such transaction, how it is beneficial for the Company.
5. If transaction is for any acquisition of any asset or business, then what is the **financial impact** of the same transaction.
6. They shall also ensure that, interested directors do not participate on that transaction where they have conflicts of interest.
7. **Only Independent Directors** shall **approve** the **Related Party Transaction** in the Audit Committee to ensure transparency and fairness in the approval process.

8. Independent Directors ensure that, **financial reporting process is fair and transparent**.
9. **Company complies with the provisions of Companies Act, 2013, SEBI LODR** and all applicable provisions of law and pay taxes to the government within the time and there should not be any cases of evasion of taxes.
10. **Raising important questions in the Audit Committee and Board Meeting** on those transactions which they think that are need more clarity and explanation and needs to be discussed at the meeting.
11. They should insist on that, **Board members be fully aware about the operations** of the Company and all Directors and KMP disclose to the Company all information that is necessary for ensuring compliances with all laws.
12. They **shall not have any material pecuniary relationship** with the Company, the Directors, KMP or promoters of the Company which could impact their judgement and decision making on Company's affairs and which can impact their independence.

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Power of Tribunal to make modifications to the scheme of Compromise or Arrangement

Introduction

Chapter XV of the Companies Act, 2013 outlines the process for mergers and amalgamations, including the rights and duties of stakeholders. According to this chapter, a scheme of compromise or arrangement is presented to the Tribunal for approval either by the company, its members, creditors, or the liquidator. Upon receiving the application and necessary documents, the Tribunal may order meetings of members/creditors as deemed fit. Once the scheme is approved by the requisite majority of the creditors, or class of creditors or members or class of members, as the case may be, the Tribunal may either sanction or reject the scheme. Additionally, the Tribunal has the authority to modify the scheme of compromise or arrangement, either during the process of sanctioning or after the scheme has been sanctioned, to ensure proper implementation.

Provisions with respect to modification of the scheme under Companies Act, 2013

The Tribunal has the authority to either approve or reject the scheme proposed under section 230. Section 231(1)[i] read with Rule 17 of The Companies (Compromises, Arrangements and Amalgamations) Rules, 2016, states that the Tribunal may at the time of making such order or anytime thereafter, give such directions in regard to any matter or make such modifications in the compromise or arrangement as it may consider necessary for proper implementation of compromise or arrangement.

Definition of Modification

Section 2(29)[ii] of the Companies Act, 1956 defined modification as, "modify" and "modification" shall include the making of additions and omissions. However, it must be noted that this definition of "modify" and "modification" was not incorporated in the Companies Act, 2013. Therefore, now reference has to be made to dictionaries to find the meaning of modification. The Black's Law dictionary defines "modification" as, "Modification" is not exactly synonymous with "amendment," for the former term denotes some minor change in the substance of the tiling, without reference to its improvement or deterioration". Whereas, the Cambridge dictionary defines "modification" as, "to change something such as a plan, opinion, law, or way of behaviour slightly, usually to improve it or make it more acceptable."

Analysis of all the above definitions suggests that modification refers to a minor change in the scheme, made with an intention to increase its efficiency.

The purpose of this article is to explore various aspects of modification, such as when does the Tribunal feel the need to make modification to the scheme and to what extent can it be made. The analysis of some important judgements will help to understand the reasons why Tribunal resorts to modification.

Factors considered by the Tribunal while making any modification to the scheme

The Act permits the Tribunal to modify the scheme of compromise or arrangement during or after approval but does not specify the circumstances or extent. To address these ambiguities, judicial pronouncements provide guidance. In one such pronouncement, the

honourable Bombay High Court outlined certain factors to be considered when determining whether the scheme can be modified as requested by the petitioners.

In the case of T. Mathew v. Smt. Saroj G. Poddar[iii],

A winding-up order was issued against the company following a petition by Mahindra Ugine Ltd., and the official liquidator took possession of its assets. While several assets were sold, a leasehold land remained pending for auction. Saroj G. Poddar and others proposed a scheme of compromise and arrangement to revive the company and exit liquidation. The court stayed the auction and directed meetings of various creditor classes. The scheme was subsequently approved by the majority of creditors and shareholders.

T. Mathew, sought to modify the Podar scheme and introduce a new one, proposing a denim manufacturing unit, better worker payments, and re-employment. However, the court ruled that he lacked the legal standing to propose changes, as he was neither a shareholder, creditor, nor official liquidator. Legal precedents allow modifications only if essential for the scheme's functioning. The court also found that Mathew had a vested interest in the valuable land and had influenced workers to form a new union. As a result, his proposal was rejected.

The court found that the Podar scheme also lacked genuine intent to revive the company and was instead driven by profit from rising land prices, misusing the Companies Act. Key information, such as payments to creditors and a misfeasance summons against directors, was withheld. Preference shareholders had transferred their shares beforehand, rendering their votes meaningless. Additionally, the scheme involved Bhaveshwar Estate Private Limited purchasing Podar-held shares at an unjustified high price of Rs. 40,125 per share, with no supporting valuation provided.

It is important to note that though the scheme of Podar's was approved by the requisite majority, the court was also required to satisfy itself that the scheme was not only fair and reasonable but also in public interest.

During the hearing, multiple orders were discussed and, the Court laid the following factors to be considered while modifying the scheme.

"(a) that scheme can be modified by Court before i.e. at the time of sanction or after the sanction of the Court;

(b) that such modification would include substitution of a sponsor also;

(c) that the modification/substitution should be necessary for the proper, efficient and smooth working of the scheme which is of paramount consideration;

(d) that only persons mentioned in section 391(1) will be entitled to propound a scheme;

(e) that whether the substitution of a sponsor affects the basic fabric of the scheme or not is a question to be determined in the facts and circumstances of the case;

(f) that modification can be made at the instance of any person interested in the affairs of the company and the Court itself can even take such action suo moto; and

(g) that the Court should examine the bona fides of the person applying to be substituted as sponsor, his capacity, his interest qua the company and other relevant considerations."

The honourable Bombay High Court rejected both the schemes as both the schemes were sponsored with the sole objective of acquiring the said land. The honourable Bombay High Court delivered this judgment under the Companies Act, 1956.

Let us now examine these situations through cases where the Court/Tribunal modified the scheme during the process of sanctioning, after sanctioning the scheme, and instances where modifications were rejected.

Modifications made by the Court/Tribunal while sanctioning the scheme

In case of Panchmahal Steel Ltd[iv].,

The petitioner-company initiated a Steel Melt Shop (SMS) project failed to achieve financial closure due to a recession in the steel sector. The company's accumulated losses exceeded its net worth, leading to its classification as a sick industrial company under SICA. The company's cost-cutting measures and focus on value-added products showed positive results. In 2004 and 2006, ARCIL acquired debts from certain banks and proposed a restructuring scheme in consultation with the petitioner-company.

The Court had directed the petitioner-company to convene separate meetings of the secured lenders and equity shareholders. In compliance with the order of the Court, a meeting of the secured creditors was held on. Three secured lenders, representing ₹142.55 crore, attended through authorized representatives. ARCIL proposed modifications to the restructuring, GIIC objected to both the modifications and the scheme. Despite this, the modifications were approved by the requisite statutory at the meeting of creditors and unanimously at meeting of shareholders.

GIIC raised several objections to the modified scheme - petitioner-company had not correctly considered its outstanding dues, interest rates proposed under the scheme (5% and 0%) were significantly lower than the Reserve Bank of India's bank rate, scheme was silence on interest payable for the year 2004-05 and demanded its inclusion further the objection raised were not discussed during the meeting of secured creditors. GIIC further claimed that they should be treated a separate class of creditors from ARCIL as ARCIL had purchased the debts at a much lower value than their actual outstanding amounts, which gave it the financial flexibility to accept larger sacrifices under the restructuring scheme.

However, as the Court found substantial force in the objections raised by the (GIIC)second creditor, sanction was granted to the scheme with further modifications considering the interest of the objector. The court further stated that once ARCIL stepped into the shoes of the original lenders, it had the same rights and voting power as any other secured creditor. The Court modified the scheme while granting its approval and highlighted in the following words, the caution that is required to be exercised while modifying the scheme.

"The "Act" as well as the "hon'ble Supreme Court" cast duty on the sanctioning Court to satisfy itself that the members or class of members or creditors or class of creditors, as the case may be, are acting bona fide and in good faith and are not coercing the minority in order to promote any interest adverse to that of the latter comprising the same class whom they purported to represent."

Modifications made by the Court/Tribunal after the scheme was sanctioned

In S.K. Gupta and Ors. vs. K.P. Jain & Ors [v]

A scheme of compromise/arrangement between the company and its unsecured creditors was approved and sanctioned by Court, post which application was filed for modification of the scheme and substitution of the proponent/sponsor. The honourable Supreme Court while approving the substitution of the sponsor, highlighted the following.

The honourable Supreme Court considered the meaning of the word "modification" as defined under the Companies Act 1956. "*The noticeable feature is that it is an inclusive definition, and where in a definition clause the word 'include' is used, it is so done in order to enlarge the meaning of the words or phrases occurring in the body of the statute and when it is so used, these words or phrases must be construed as comprehending not only such things which they signify according to their natural import, but also those things which the interpretation clause declares that they shall include*"

A key consideration was that the court, when sanctioning the scheme, may not foresee the challenges that could arise during its implementation. When unforeseen situations occur, seeking approval from the concerned parties for modifications would be burdensome. Therefore, the court is granted the power to make necessary modifications to ensure the smooth functioning of the scheme.

The honourable Supreme Court held that substitution of the proponent/sponsor would not lead to change in basic fabric of the scheme. Section 392 of the Companies Act 1956 empowers the honourable High Court to make necessary changes to the scheme to the extent that the scheme remains workable and ensure that the modification does not change the basic fabric of the scheme.

Modifications rejected by the Court/Tribunal after the scheme was sanctioned

In Reliance Natural Resources Limited v Reliance Industries Limited[vi]

Reliance Industries Limited (RIL) and Reliance Natural Resources Ltd (RNRL) were contending legally over the supply of gas from D6 block in the Krishna-Godavari basin.

The primary reason of the dispute was the MOU entered between the two brothers, the details of which were not made available to the stakeholders. MOU was a private family arrangement and the same was neither approved by the shareholders nor was attached to the scheme. Hence the MOU was not the part of the scheme approved by shareholders and hence was not legally binding.

The honourable Supreme Court relied on the order in case of S.K. Gupta and Ors. vs. K.P. Jain & Ors

The position derived from S.K. Gupta and Ors. vs. K.P. Jain & Ors was that power of the Court under section 392[vii] was wide enough to make suitable changes for the working of the scheme. Further, it was also made clear that the power of the Court does not extend to re-writing the scheme in any manner.

As the terms and conditions of the supply of gas, specified in the MOU entered between the parties were not disclosed to all the shareholders and stakeholders, including in this case the Government of India (as a party to Production Sharing Contract), such a document could not have been read into and incorporated in the scheme propounded by the Board, approved by the shareholders and sanctioned by the Company Court. This would result in tearing apart, the basic fabric of the scheme and hence was not permitted.

The **term *'fabric of the scheme'*** has been frequently discussed in various rulings but lacks a formal definition. To broadly understand its meaning, reference can be made to an argument presented by the petitioner in the Reliance Industries Limited case. Although this explanation is not part of the decision itself, it provides insight to the term "basic fabric", as described below:

"What does the expression "basic fabric" mean? "Fabric" can imply both the end result and also equally importantly, the processes, procedures and steps that were taken to weave the "fabric" of the scheme. During the course of weaving of the "fabric ", decisions could be taken to leave out certain aspects as unacceptable to the board or the shareholders and stakeholders or the Court. Further, those processes necessarily involved certain steps in obtaining shareholders' permissions. Such processes are the very essence of the fabric and not just some technicalities that are to be consigned to history and ignored in making modifications. Whatever changes are made can only be minor ones which would not tamper with the essence of the scheme."

Essentials for modification

A conjoint reading of the above cases highlights key considerations for modifying a scheme, either during approval or post-approval. These points are relevant for petitioners requesting modifications and for the Tribunal when granting them. They can be summarised as follows:

- The proposed or approved modification should not alter the essence of the scheme; the fundamental processes and intended outcomes must remain unchanged.
- Modifications that fundamentally change the scheme approved by members and creditors require fresh approval from them.
- Modifications should aim solely at facilitating the smooth implementation of the scheme by addressing the practical difficulties in its execution.

Conclusion

The Tribunal is vested with powers to modify a scheme of arrangement that was approved by the shareholders or creditors without hampering its fundamental structure. However, while making such modifications the Tribunal must also ensure that the modifications are necessary for the proper implementation of the scheme. Where the Tribunal is satisfied that the sanctioned compromise or arrangement under Section 230 cannot be effectively implemented, with or without modifications, and the company is unable to pay its debts as per the scheme, it may order the company to be wound up. This order will be considered as one made under Section 273.

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[i] Section 231(1)(b) of the Companies Act, 2013
[ii] Section 2(29)[ii] of the Companies Act, 1956
[iii] *T. Mathew v Saroj G Poddar* 1996 SCC Online Bom 750 : (1996) 22 CLA 200
[iv] *Panchmahal Steel Ltd., In re* 2008 SCC OnLine Guj 652 : (2009) 90 CLA 238
[v] *S.K. Gupta and Ors. vs. K.P. Jain & Ors.* ((1979) 3 SCC 54)
[vi] *Reliance Natural Resources Limited vs. Reliance Industries Limited* ((2010) 7 SCC 1)
[vii] Section 392(1)(b) of the Companies Act,1956

Interpretation of term ‘Resident of India’ under Schedule V of Companies Act 2013

Background:

Section 196(4) of the Companies Act, 2013 (‘**the Act**’) states that – “Subject to the provisions of section 197 and **Schedule V**, a managing director, whole-time director or manager (‘**managerial person**’) shall be appointed and the terms and conditions of such appointment and remuneration payable be approved by the Board of Directors at a meeting which shall be subject to approval by a resolution at the next general meeting of the company and by the Central Government (‘**CG**’) in case such appointment is at variance to the conditions specified in Part I of that Schedule V.”

One such condition is residency in India which is provided as an explanation – “*For the purpose of this Schedule, resident in India **includes a person who has been staying in India for a continuous period of not less than twelve months immediately preceding the date of his appointment as a managerial person.***

It is understood in the layman terms that a person should stay in India for a continuous period of 12 months to be considered as an Indian resident. This understanding leads to several ambiguities.

Problem statement:

Does this mean that temporary absences, short visits/ trips abroad, etc. affects the residency of an individual? What if the person goes out of India for a week for some urgent commitment and comes back to India for his routine life?
Does the explanation actually define the term ‘resident’ as it may lead to many people being termed as ‘non-residents’ if we consider this interpretation?

Our Analysis:

In considering whether there is ambiguity, the Court must look at the statute as a whole and consider the appropriateness of the meaning in a particular context avoiding absurdity and inconsistencies or unreasonableness which may render the statute unconstitutional - ***Nathi Devi v Radha Devi Gupta AIR 205 SC 648;2005 AIR SCW 287***

Hence, let us deliberate upon the key terms used in the explanation.

Inclusive language:

The explanation used for providing ‘residency criteria’ is **inclusive.** As per the Supreme Court case law of ***Associated Indian Mechanical (P) Ltd v. W.B. Small Industries Development Corporation Ltd. (2007) 3 SCC 607,*** *“it is well settled that the word “include” is generally used in interpretation of clauses **in order to enlarge the meaning of the words or phrases occurring in the body of the statute**; and when it is so used those words or phrases must be construed as comprehending, not only such things which the interpretation clause declares that they shall include.”*

Also, when a statutory definition uses the word "includes", it provides an extended meaning thereto but the words are required to be construed in terms of the ***legislative intent**. **If the words are general and not precise, their interpretations are to be restricted to the fitness of the matter**. **[R D Goyal v Reliance Industries Ltd. [2003] 113 Comp Cas 1 (SC)]***

Thus, even if the Act states that resident would be a person who is staying in India for a continuous period of 12 months, since it is an inclusive definition, we would have to construe it in terms of the legislative intent of the law and enable the interpretation of this meaning to the relevance of this matter.

What would be the legislative intent of the law is a matter of question?

Deliberation on the term 'stay' and 'continuous period':

The general meaning of the term 'stay' means *'to remain or wait in the same place', 'to not move away from or leave a place or situation'.* Further, there is also a term '**continuous period'** which means '*without a pause or interruption', 'uninterrupted extension in space, time, or sequence'.*

Would the short breaks be considered as 'interruption' here and hamper the stay for continuous period?

Would the legislative intent of the law be to consider continuous stay without any short breaks?

Lord Hoffman states that *'Meaning of words is a matter of dictionaries and grammars; the **meaning of document is what parties using those words against the relevant background would reasonably have been understood to mean**. The background may not merely enable the reasonable man to choose between possible meanings of words which are ambiguous but (even as occasionally happens in ordinary life) to conclude that the parties must, for whatever reason, have used the wrong words or syntax.'*

Thus, if the law required an absolute **day-to-day stay without even a single day's absence**, it would be **impractical and restrictive**, especially for those professionals or executives who are required to go out and travel as a part of their assignment/ work. The key question is whether the individual has **established India as their primary place of stay and residence** for the 12 months preceding the appointment.

We have a case law which demonstrate that short breaks do not hamper continuity:

Kuldip Nayar vs Union of India & Ors on 22 August, 2006 – *In the context of continuous employment and service benefits, the court ruled that short breaks do not break continuity unless there is clear intent to sever ties.*

Considering the above, interpreting the residency as '**continuous'** stay of 12 months does not seem to be a legislative intent. It seems that the intent of the individual to stay in India proven by his acts should be a major factor to consider residency for a continuous period

during which the short breaks, work travels of short span, etc. can be considered to continue the residency in India.
Hence, the explanation used in the Schedule V seems to use a duration-based condition for evaluating residency based on the intent and does not actually determine the term 'residency'.

So, what can be considered as a period of stay to determine 'residency'?

Let us try to understand the meanings populated for the term 'resident' in other statutes:

References from other statutes:

Section 6 of Income Tax, 1961:

"resident means:
For the purposes of this Act, —
(1) An individual is said to be resident in India in any previous year, if he—
(a) ***is in India in that year for a period or periods amounting in all to one hundred and eighty-two days or more;*** *or*
(b) ……"

Section 2(v)(i) of Foreign Exchange Management Act, 1999:

"person resident in India" means— (i) ***a person residing in India for more than one hundred and eighty-two days during the course of the preceding financial year*** *….."*

Companies (Incorporation) 3rd amendment Rules, 2018:

The term 'resident of India', ***means*** *a person who has stayed in India for a period of not less than 182 days during the immediately preceding financial year which has been amended to 120 days w.e.f. 1st April, 2021.*

Section 149(3) of the Act:

Every company shall have at least one director who stays in India for a total period of not less than 182 days during the financial year.

Interpretation & Conclusion:

Going through the above statutes, it can be observed that Income Tax Act and FEMA Act identify residents on the basis of stay of an individual for 182 days or more in India and does not include a requirement of 'continuous stay' as their criteria.

Further, the definitions under incorporation rules and section 149(3) of the Act also consider a person as resident of India if he stays for a period of 182 days or more in a particular financial year. Short breaks, family tours, office trips, etc. may not be a bar here provided that a person stays for 182 days or more in India after all such breaks showing his acts and intent to be a resident of India.

Hence, it would be incorrect to interpret that the legislation would intend to interpret 'residency' differently for two provisions of the Act unless specifically clarified without ambiguity.

Now, since there is an ambiguity in the meaning of 'residency' in Sch V of the Act and the Act considers a period of 182 days as residency for other provisions as stated above and other statutes also define the term 'residency' in the same manner as stated above, it seems that the legislative intent can be applied here and the same definition/ meaning can be construed here as well.

Thus, **it is reasonable to extend the 182-day rule to whole-time directors, managing directors and managers under Schedule V for considering residency in India under Schedule V of the Act.**

This article is published on Taxmann. The link for the same

https://www.taxmann.com/research/company-and-sebi/top-story/105010000000026402/interpretation-of-term-resident-of-india-under-schedule-v-of-companies-act-2013-experts-opinion

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Employee Stock Option under Foreign Exchange Management Act

Introduction:

Employee Stock option plan (ESOP) is an employee benefit scheme that enables employees to own shares in the company. These shares are purchased by employees at price below market price, or at a discounted price. Thus, an Employee Stock Option Plan (ESOP) is an employee benefit plan that gives the employees ownership interest in the company in the form of shares or stock of the company.

Employee Stock option (hereinafter referred to as "ESOP" under Foreign Exchange Management Act can classified two ways:

i. Issuance of ESOPs by an Overseas Entity to Resident Indian employees of its Indian subsidiary and;
ii. Issuance of ESOPs by an Indian Entity to Non-resident employees of the Indian Company.

Regulatory framework under the Foreign Exchange Management governing the ESOPs :

The key regulatory framework governing overseas investments (including issuance of ESOPs by a foreign company) to a person resident in India is contained in Foreign Exchange Management (Overseas Investment Rules), 2022 ("OI Rules"), Foreign Exchange Management (Overseas Investment) Regulations, 2022 ("OI Regulations") and the Foreign Exchange Management (Overseas Investment) Directions, 2022 ("OI Directions") issued by the RBI on August 22, 2022, as amended from time to time.

The ESOPs issued by Indian Entity to its Non-resident employees are governed by the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019.

Now let us understand what is ESOP by referring the definitions of ESOP under the Foreign Exchange Management Act:

i. The Foreign Exchange Management (Overseas Investment) Rules, 2022 does not define ESOP, however gives us explanation of the expression Employee Benefit Scheme in para 3 "Acquisition of shares or interest under Employee Stock Ownership Plan or Employee Benefits Scheme or sweat equity shares" of Schedule III which speaks about "Manner of making Overseas Investment by resident individual"

"Employee Benefit Scheme" means any compensation or incentive given to the directors or employees of any entity which gives such directors or employees ownership interest in an overseas entity through ESOP or any similar scheme.

Here, the scope of an 'employee benefit scheme' as regulated under the Foreign Exchange Management (Overseas Investment) Rules, 2022 is broader than under the Companies Act, 2013.

Hence, it is not just limited to ESOPs but also extends to schemes such as (i) restricted stock unit schemes (RSUs), (ii) employee stock purchase schemes (ESPS); (iii) stock appreciation rights schemes (SARs); (iv) phantom stock schemes, (v) general employee benefits schemes (GEBS); (vi) retirement benefit schemes (RBS); etc
The Companies Act, 2013 only expressly recognises and regulates an 'employee stock option scheme'.

Section 2(37) of the Companies Act 2013 defines 'employee stock option' as "the option given to the directors, officers or employees of a company or of its holding company or subsidiary company or companies, if any, which gives such directors, officers or employees, the benefit or right to purchase, or to subscribe for, the shares of the company at a future date at a pre-determined price".

Hence, it is not just limited to ESOPs but also extends to schemes such as (i) restricted stock unit schemes (RSUs), (ii) employee stock purchase schemes (ESPS); (iii) stock appreciation rights schemes (SARs); (iv) phantom stock schemes, (v) general employee benefits schemes (GEBS); (vi) retirement benefit schemes (RBS); etc.

ii. As per *rule (2) sub-rule (j) of Foreign Exchange Management (Non-Debt Instruments) Rules, 2019* "ESOP" *means 'Employees' stock option' as defined under the Companies Act, 2013 and issued under the regulations by the Securities and Exchange Board of India;*

Reporting requirements under Foreign Exchange Management Act:

i. ***In case of issue of shares to employees of Indian Company by the Overseas Entity:***

In case of issuance of shares to resident individual, who is an employee or a director of an office in India or branch of an overseas entity or a subsidiary in India of an overseas entity or of an Indian entity in which the overseas entity has direct or indirect equity holding reporting of the same is to be done in "Form OPI" [Regulation 10 (3) of Foreign Exchange Management (Overseas Investment) Regulations, 2022 and Para 22 - Overseas investment by resident individuals of Foreign Exchange Management (Overseas Investment) Directions, 2022 issued vide notification dated August 22, 2022

The "Form OPI" is to be reported to the AD Bank within sixty days from the end of the half-year in which the issuance of shares is made as of September or March-end.

OPI as per Section 2 (s) of Foreign Exchange Management (Overseas Investment) Rules, 2022 is defined as "Overseas Portfolio Investment" or "OPI" means investment, other than ODI, in foreign securities, but not in any unlisted debt instruments or any security issued by a person resident in India who is not in an IFSC:

Provided that OPI by a person resident in India in the equity capital of a listed entity, even after its delisting shall continue to be treated as OPI until any further investment is made in the entity.

Further, the obligation of reporting shall be of an office in India or branch of an overseas entity or a subsidiary in India of an overseas entity.

ii. ***In case of an Indian company issuing employees' stock option to persons resident outside India who are its employees/directors or employees/directors of its holding company/joint venture / wholly owned overseas subsidiary/subsidiaries:***

The Indian Company shall file *"Form ESOP"* within 30 days from the date of issue of employees stock option to its employees/directors who are persons resident outside India [Sub-regulation 4 of Regulation 4 of Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019 issued vide notification dated 19th October, 2019].

Further, as per the recent clarification by Reserve Bank of India as part of the amended guidance on foreign investment reporting and management system the reporting of cashless ESOP and Stock Appreciation rights to the employees/directors who are persons resident outside India of the Indian Entity is also required to be reported in Form ESOP within 30 days from the date of grant of ESOP.

Furthermore, the reporting for ESOP in the above case does not get complete. On allotment of shares pursuant to the grants exercised by the employees/directors who are person's resident outside India, the reporting is to be done by filing form FCGPR within 30 days of the allotment of the shares.

Practical challenges while filing/submitting Form ESOP/OPI:

i. There is no clarity with respect to reporting in Form OPI for issuance of Phantom Stock to Resident Employees by the Overseas Entities through phantom stock schemes.
ii. For cashless ESOP/EBS which do not involve remittance of funds from India, while Form OPI reporting would still apply, disclosure of 'remittance amount' becomes irrelevant. Further, how to determine and disclose investment details in terms of USD and INR in this scenario requires adequate clarity.
iii. Form ESOP does not provide separate tabs for mentioning the details of the employees to whom the grant is made, and the reporting is done, the details can only be provided as an attachment to the form ESOP.
iv. It is not possible to report multiple grants in one Form ESOP even if the date of grants is of the same date.

This article is published on Taxmann. The link for the same

https://www.taxmann.com/research/fema-banking-insurance/top-story/105010000000026332/employee-stock-option-under-foreign-exchange-management-act-experts-opinion

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NEWS UPDATES AND AMENDMENT FOR THE MONTH OF APRIL 2025

Sr. No.	News Updates	Link
	TOPIC	
1	**Merger**	Experts call for clarity as MCA's fast-track merger proposal expands in scope https://legal.economictimes.indiatimes.com/news/corporate-business/experts-call-for-clarity-as-mcas-fast-track-merger-proposal-expands-in-scope/120250358
2	**SEBI**	SEBI bats for 'optimal regulation,' likely to revamp norms https://cfo.economictimes.indiatimes.com//news/governance-risk-compliance/sebi-bats-for-optimal-regulation-likely-to-revamp-norms/120222963
3	**NFRA**	NFRA pushes audit committees for stronger audit oversight and risk management https://cfo.economictimes.indiatimes.com/news/tax-legal-accounting/nfra-pushes-audit-committees-for-stronger-audit-oversight-and-risk-management/119839945
4	**SCORES**	SEBI resolves over 4,000 complaints through SCORES in March https://www.dailyexcelsior.com/sebi-resolves-over-4000-complaints-through-scores-in-march/#google_vignette
5.	**SA 600 for LLP Audit**	Explainer: What AASB's draft SA 600 means for LLP audits involving multiple audits. https://cfo.economictimes.indiatimes.com//news/tax-legal-accounting/explainer-what-aasbs-draft-sa-600-means-for-llp-audits-involving-multiple-auditors/120299839
	Amendment	**Particulars**
1.	**SEBI LODR (Amendment) Regulations 2025**	One of the major change is that now entities with only debt listed will be high value debt as against equity listed companies being considered as HVD. Also HVD limit is increased to 1000 crore as on March 2025. There is a six months' period to comply. https://www.sebi.gov.in/legal/regulations/mar-2025/securities-and-exchange-board-of-india-listing-obligations-and-disclosure-requirements-amendment-regulations-2025_93156.html

VIEW SHARED IN MEDIA- FOR THE MONTH OF APRIL 2025

Sr. No.	Topic for Media Comment	Link
1.	Rights Issue	Makarand M Joshi, founder partner MMJC and Associates, a corporate compliance firm said, "Under the old timeline funds raised through preferential allotment during 22-23 and 23-24 were Rs 83,832 crores and Rs 45,115 crores. During same time (i.e. FY 23 and FY 24) funds raised through right issue were Rs 6,751 crores and Rs 15,110 crores (SEBI annual report 2024.) Hence it is seen preferential allotment was preferred way of fundraising." He added, "Now it needs to be seen if the rights issue would be a preferred way of raising funds as compared to preferential allotment as per revised timeline." https://www.moneycontrol.com/news/business/markets/rights-issue-to-be-faster-from-today-process-to-be-completed-in-23-days-12987279.html