BEFORE THE SECURITIES APPELLATE TRIBUNAL MUMBAI

Appeal No. 34 of 2011

Date of Decision: 6.6.2011

SRM Energy Limited
601, Pressman House,
70A, Nehru Road, C.T.S. No.76 & 87,
Vile Parle (East), Mumbai. …… Appellant

Versus

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

2. Arihant Capital Markets Limited
   3rd Floor, Krishna Bhavan,
   67, Nehru Road, Vile Parle(East),
   Mumbai. …… Respondents

Mr. Pesi Modi, Advocate with Mr. Anant Updhayay, Advocate for the Appellant.

Mr. Shiraz Rustomjee, Advocate with Mr. Ajay Khaire, Advocate for Respondent No.1.
None for Respondent no.2.

CORAM : Justice N. K. Sodhi, Presiding Officer
P. K. Malhotra, Member
S. S. N. Moorthy, Member

Per : Justice N. K. Sodhi, Presiding Officer

Whether the unsecured loans advanced by the promoter group could be adjusted against allotment of shares to them in the rights issue is the solitary question that arises in this appeal. The brief facts of the case are as under:-

2. The appellant was incorporated as a public limited company in the year 1985 under the name and style of Hitkari Fibers Limited. Its shares are listed on the Bombay Stock Exchange. Spice Energy Pvt. Ltd (for short SEPL) is another company incorporated under the Companies Act, 1956 and promoted by the Rastogi family of Delhi which owns more than 80 per cent shares in this company. Some time around December, 2007, SEPL received a ‘Letter of Facilitation’ from the Government of Tamil Nadu for setting up a coastal imported coal based Thermal Power Plant in

Cuddalore for 1000 MW capacity which was subsequently enhanced to 2000 MW in December, 2008. SEPL then received all the regulatory clearances for the power project. The Spice Energy Group which had promoted SEPL formed another private limited company under the name and style of SRM Energy Pvt. Ltd. as a special purpose vehicle for implementing the aforesaid power project. The total cost of the project was ₹ 9,438 crores. Looking at the size of the investment required to implement the project and based on the interest evinced by certain strategic investors at that time, the Spice Energy group decided to implement the power project through a listed entity so as to provide the strategic investors with an exit option. The group also decided to channelize the investment through a Global Depository Receipt issue. SEPL then took over Hitkari Fibers Ltd. in March, 2008 by acquiring 71.19 per cent of its shares and the remaining 28.81 per cent shareholding is widely held by around 5,400 public shareholders. SEPL took over the management and control of the appellant which was then known as Hitkari Fibers Ltd. This was done after complying with the provisions of the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations 1997. At the time of the takeover, Hitkari Fibres Ltd. was incurring losses and its net worth had also been completely eroded. As against the paid up capital of ₹ 3.06 crores, its accumulated losses were ₹ 6.47 crores as on March 31, 2008. The shares of Hitkari Fibres Ltd. were not getting traded on the stock exchange for a long time and it had never declared dividend. SEPL after taking over the company decided to discontinue with its then existing business and focused only on the proposed power plant. After the takeover of Hitkari Fibres Ltd. by SEPL, the special purpose vehicle formed for the purpose of implementing the power project viz., SRM Energy Pvt. Ltd. was merged with Hitkari Fibers Ltd. This was done in pursuance of a scheme of amalgamation framed under sections 391 and 394 of the Companies Act. In terms of the scheme of amalgamation, the name of the company was also changed from Hitkari Fibers Ltd. to its present name i.e. SRM Energy Ltd which is now the appellant before us. As already observed above, the funds for the proposed power project had been planned through a Global Depository Receipt issue which did not come through for reasons with which we are not concerned. Due to the failure of the Global Depository Receipt issue and the negative net worth of the appellant company, it was facing difficulty in arranging the funds for the project. It was in these circumstances that SEPL, the promoter of the appellant stepped in with its funds in the interest of the appellant company and its shareholders and kept lending its own funds from time to time as and when required by the appellant for implementing the power project. As on August 12, 2010, SEPL had lent to the appellant a sum of ₹ 4052.05 lacs which was standing in its books of account. We have on record a certificate from the statutory auditors of the appellant company showing that a sum of ₹ 4052.05 lacs was due to SEPL as unsecured loans and this fact is not in dispute. It is also on record that as on December 31, 2010, a sum of ₹ 4160.89 lacs was the amount of unsecured loans standing in the books of the appellant company which amount had been advanced by SEPL.

3. With a view to mobilize further funds for the power project, the appellant company came out with a rights issue and decided to issue shares on rights basis to its shareholders. On July 8, 2010 the board of directors of the appellant passed a resolution deciding to issue shares on rights basis and sought the approval of the shareholders by a resolution through postal ballot. It was, inter alia, stated in the notice that the rights issue was for funding the implementation of the power project. On August 13, 2010 the shareholders of the appellant passed a unanimous resolution through postal ballot approving the rights issue. Since SEPL, the promoter of the appellant, was holding 71.19 per cent shares on the date of the rights issue, its entitlement in that issue worked out to 4,19,25,000 shares amounting to ₹ 4192.50 lacs. As already noticed above, SEPL had already brought in funds to the extent of ₹ 4052.05 lacs till August 12, 2010 which were shown as unsecured loans in the books of the appellant. According to the appellant, there was an oral understanding between it and the promoter (SEPL) at the time of providing funds from time to time that if and when the appellant came out with a rights issue, the unsecured loans would be adjusted against the share price. SEPL by its letter of August 13, 2010 authorised the appellant company to adjust the unsecured loans hitherto provided to the appellant towards its entitlement in the proposed rights issue making it clear that if there was

any short fall, the same would be subscribed by the promoter (SEPL). On August 17, 2010, the appellant company through its merchant banker filed with the Securities and Exchange Board of India (hereinafter called the Board) a draft letter of offer for the rights issue which was to be sent to the shareholders. The appellant company had decided to issue rights shares in the ratio of 65 equity shares for every 10 fully paid up equity shares held by an existing equity shareholder on the record date. It was specifically mentioned in the draft letter of offer that the unsecured loans lying in the books of the company and due to SEPL shall be adjusted towards the price of the shares as per the entitlement of the latter. The draft letter of offer was sent to the Board in terms of Regulation 6 of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations 2009 (for short the Regulations). On receipt of the letter of offer, the same was examined by the Board and the Assistant General Manager, Corporation Finance Department, Division of Issues and Listing acting on behalf of the Board informed the merchant banker that "**You are advised to ensure that unsecured loans of promoter and promoter group are not adjusted against allotment of shares against their right entitlements and also against shares to be allotted to them as a result of renunciation or unsubscribed portion**". Feeling aggrieved by this direction, the appellant has come up in appeal.

4. We have heard the learned counsel for the parties who have taken us through the record. The primary argument of Shri P.N. Modi learned counsel for the appellant is that there is no provision in any law nor in the Regulations which prohibits the adjustment of unsecured loans against the price to be paid for the shares allotted in rights issue. He pointed out that SEPL which is the promoter of the appellant company had been advancing loans from time to time which are shown in the books of account of the appellant as unsecured loans which could be adjusted against the price to be paid by the promoter for the shares allotted in the rights issue. The argument is that the unsecured loans due to the promoter could be treated as share application money and the Board was not justified in directing the appellant not to make such an adjustment. Learned counsel referred to clause (5)(VII)(G)(2) of part E of Schedule VIII to the Regulations and contended that the same permits adjustment of money

brought in advance by the promoters which is deployed in the project towards their entitlement in the rights issue. It was strenuously argued by the learned counsel for the appellant that the shares proposed to be allotted in accordance with the provisions of section 81(1) of the Companies Act and that all the necessary disclosures having been made, the impugned direction given by the Board was not called for. Mr. Shiraz Rustomjee learned counsel for the Board, on the other hand, contended that the unsecured loans advanced by the promoter had a condition attached thereto that they could be converted into equity as and when the appellant came out with a rights issue and since these loans do not comply with the stringent conditions prescribed by the proviso to section 81(3) of the Companies Act, the loans of the promoter could not be converted and the Board was right in giving such a direction in the impugned communication. The argument is that only such loans can be converted into equity which satisfy all the conditions of section 81(3) of the Companies Act including those in the proviso thereto and the loans which do not satisfy all these conditions are not convertible at all. Since the answer to the rival contentions depends on the interpretation of section 81 of the Companies Act, the relevant part thereof is reproduced hereunder for ease of reference:-

"Further issue of capital

81. (1) Where at any time after the expiry of two years from the formation of a company or at any time after the expiry of one year from the allotment of shares in that company made for the first time after its formation, whichever is earlier, it is proposed to increase the subscribed capital of the company by allotment of further shares, then,-

(a) such further shares shall be offered to the persons who, at the date of the offer, are holders of the equity shares of the company, in proportion, as nearly as circumstances admit, to the capital paid-up on those shares at that date;

(b) the offer aforesaid shall be made by notice specifying the number of shares offered and limiting a time not being less than fifteen days from the date of the offer within which the offer, if not accepted, will be deemed to have been declined;

(c) unless the articles of the company otherwise provide, the offer aforesaid shall be deemed to include a right exercisable by the person concerned to renounce the shares offered to him or any of them in favour of any other person; and the notice referred to in clause (b) shall contain a statement of this right;

(d) after the expiry of the time specified in the notice aforesaid, or on receipt of earlier intimation from the person to whom such notice is given that he declines to accept the shares offered, the Board of directors may dispose of them in such manner as they think most beneficial to the company.

Explanation : In this sub-section, "equity share capital" and "equity shares" have the same meaning as in section 85.

(1A) Notwithstanding anything contained in sub-section (1), the further shares aforesaid may be offered to any persons whether or not those persons include the persons referred to in clause (a) of sub-section (1) in any manner what-soever –

(a) if a special resolution to that effect is passed by the company in general meeting, or

(b) where no such special resolution is passed, if the votes cast (whether on a show of hands, or on a poll, as the case may be) in favour of the proposal contained in the resolution moved in that general meeting (including the casting vote, if any, of the chairman) by members who, being entitled so to do, vote in person, or where proxies are allowed, by proxy, exceed the votes, if any, cast against the proposal by members so entitled and voting and the Central Government is satisfied, on an application made by the Board of directors in this behalf, that the proposal is most beneficial to the company.

(2) ……………………………….

(3) Nothing in this section shall apply -

(a) to a private company; or

(b) to the increase of the subscribed capital of a public company caused by the exercise of an option attached to debentures issued or loans raised by the company –

(i) to convert such debentures or loans into shares in the company, or

(ii) to subscribe for shares in the company :

Provided that the terms of issue of such debentures or the terms of such loans include a term providing for such option and such term –

(a) either has been approved by the Central Government before the issue of debentures or the raising of the loans, or is in conformity with the rules, if any, made by that Government in this behalf; and

(b) in the case of debentures or loans other than debentures issued to, or loans obtained from, the Government or any institution specified by the Central Government in this behalf, has also been approved by a special resolution passed by the company in general meeting before the issue of the debentures or the raising of the loans.

(4) to (7) ……………………………………..………………………."

A bare reading of section 81(1) makes it clear that when it is proposed to increase the subscribed capital of a company by allotment of further shares, the normal rule referred to therein needs to be followed. This normal rule is that further shares must be offered to the existing body of shareholders of the company in the same proportion in which they already hold shares of the company. The underlying object of this normal rule is to maintain the balance of voting rights and control in the company. It is for this reason that section 81(1) mandatorily requires that further shares **shall** be offered to the existing shareholders in the same proportion to the capital paid up on those shares on the date of offer. Section 81(1A), however, carves out an exception to the aforesaid normal rule and enables the company to offer further shares to a chosen few who may or may not be its shareholders. When offer is made to this select group of persons, the section requires, as a condition precedent, that the general body of shareholders must pass a special resolution in a general meeting authorizing and permitting the said allotment. A special resolution is one which is passed by a majority of three fourth shareholders. The underlying object of this requirement is that the shareholders who are going to waive their right and entitlement to such further shares must agree to do so and if three fourth of them agree, that decision would bind the entire body of shareholders. It is pertinent to note that when the normal rule as aforesaid is resorted to, there is no requirement for the shareholders to pass any resolution, special or otherwise, because none of them is going to be deprived of the further allotment. It is only when the company decides to deprive them of the further allotment that a resolution from them is required.

5. The opening words of section 81(3) make it clear that cases which fall under this provision shall not be governed by section 81(1) and section 81(1A). A reading of this provision makes it clear that it carves out yet another category/exception for a preferential allotment to which section 81(1) and section 81(1A) shall not apply. Section 81(3) would apply where a company has raised loans or issued debentures and those loans/debentures have a stipulation attached thereto that the lender will be entitled to exercise an option to convert those loans/debentures into shares or subscribe to the shares of the company. The proviso then imposes further restrictions requiring the terms of the loan to be approved by the Central Government before the raising of the loan or such terms have to be in conformity with the rules made by the Central Government in that behalf and if the loan has been obtained from a person other than the government or a specified institution a special resolution approving the same has to be passed by the company in a general meeting before the loan is raised.

6. Now coming to the case in hand, it is common ground between the parties that the unsecured loans of SEPL, the promoter of the appellant do not meet the requirements of section 81(3) of the Companies Act. This being so, the said provision is not applicable. It is also not the case of either party that a preferential allotment of

shares has been made to a select group of persons under section 81(1A). It is the case of the appellant and we agree with Mr. Modi that the present case falls squarely under section 81(1) of the Companies Act. Shares have been offered by the appellant to all the existing shareholders in the same proportion in which they held shares on the date of the offer. In other words, the normal rule referred to above has been followed which will not result in changing the balance of voting rights and control in the company. It is not in dispute that SEPL held 71.19 per cent shares of the appellant on the date of the offer and its entitlement under the rights issue works out to 4,19,25,000 shares for which it had to make the payment. It is also common case of the parties that unsecured loans to the tune of ₹ 4160.89 lacs advanced by SEPL were lying in the books of account of the appellant as on the date of offer. The unsecured loans were payable on demand and SEPL could have demanded from the appellant the immediate return of those loans and then paid the money back to it towards the price of the shares allotted to SEPL in the rights issue. It did not go through this ritual and instead, requested the appellant to adjust the amount of unsecured loans towards the price of the shares allotted to it. In other words, SEPL requested and made payment to the appellant by adjustment in the books of account. Payment by adjustment in the books of account is a well recognized mode by all accounting standards and we find no fault with this mode being adopted. All that SEPL has done is that it received shares in the rights issue and made payment by adjustment of the unsecured loans which were payable on demand. In the strict sense of the term, it is not a conversion of a loan into equity. The learned counsel for the Board pointed out that by making payment in this manner, the promoter has converted its loans into equity which is not permissible and that the debt equity ratio of the company has undergone a change. So what if the debt equity ratio has altered. This is precisely what the appellant wanted. The debt equity ratio has improved and this may enable it to get further loans from financial institutions but this does not mean that the promoter loses its right to make payment for the shares by way of adjustment of its unsecured loans. The methodology adopted was only a mode of payment for the shares received in the rights issue and since all the necessary disclosures have been made by the appellant in the offer document(s), we are satisfied that in the circumstances of this case section 81(1) of the Companies Act alone is applicable. In this view of the matter we cannot uphold the direction issued by the Board requiring the appellant not to adjust the unsecured loans advanced by the promoter towards the price of the shares allotted in the rights issue.

7. For the view that we have taken, it is not necessary, in the circumstances of this case, to decide the other issues raised by the learned counsel for the parties.

In the result, the appeal is allowed and the impugned communication dated February 8, 2011 in so far as it directs the appellant not to adjust the unsecured loans of the promoters against allotment of shares in the rights issue set aside. There is no order as to costs.

Sd/-
Justice N.K.Sodhi
Presiding Officer

Sd/-
P.K. Malhotra
Member

Sd/-
S.S.N. Moorthy
Member

6.6.2011
Prepared & Compared By: RHN

After we pronounced the order in the Court today, the learned counsel for the respondent prays that we should stay the operation of our order for a period of 6 weeks to enable the respondent Board to file an Appeal to the Supreme Court. No irreparable loss is likely to be caused to the Board even if our order is reversed in Appeal. The prayer is untenable and, therefore, declined.

Prayer for stay declined.

Sd/-
Justice N.K.Sodhi
Presiding Officer

Sd/-
S.S.N. Moorthy
Member

6.6.2011
Prepared & Compared By: Pmb