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Corporate Democracy

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ABSTRACT

Sections 241 and 242 of the Companies Act, 2013 in India are playing a very key role in addressing corporate governance concerns by providing a legal support against "oppression" and "mismanagement" within companies. Sections are protective mechanisms, granting legal recourse to stakeholders and shareholders against acts harmful to their interests or that of the company. The concept of Indoor management and constructive notice are associated with these issues are discussed in this paper. Sections 241 and 242 uphold the fundamental questions of fairness, transparency, and accountability, thereby contributing to increase the corporate governance benchmark in India. These provisions are discussed in association with corporate governance, fostering transparency, accountability, and fairness in the management comprising of majority and minority stakeholders. The aggrieved party can approach the NCLT or high judiciary in order to get the justice, which is discussed in this paper through landmark judgments, thereby reinforcing confidence in India's corporate sector.

Keywords: *Companies act, 2013, Oppression, Mismanagement, Tata sons case, Corporate governance, Indoor Management, Constructive Notice, Foss v. Harbottle, Supreme Court, SEBI Takeover code.*

I. INTRODUCTION

The Constitution of India is established to protect and safeguard the rights of the citizens of the country and also extends to the rights and dignity of foreign citizens. The Constitution of India especially focuses on the protection and safeguarding of the rights of minority and suppressed classes of people by way of fundamental rights and giving their remedies by way of writs as per Articles 32 (Supreme Court) and 226 (High Court) of the Constitution of India. In the same way, in the business world, the rights of minority shareholders are protected as per the provisions stated in the constitution of companies and the Companies Act, 2013, where reliefs and remedies are also available in case of breach of any provision.

Section 241 establishes the National Company Law Tribunal (NCLT) as a forum for shareholders to seek redressal in cases where the company's affairs are conducted in a manner prejudicial to their interests or against the company's interests at large. This section empowers

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aggrieved shareholders to file petitions before the NCLT, enabling the tribunal to investigate and remedy situations of oppression or unfair prejudice *(1).*

Complementing this, Section 242 allows stakeholders to approach the NCLT if they believe that the company's affairs are being conducted in a manner prejudicial to public interest or the company itself. This section empowers the NCLT to pass orders to rectify the situation, taking measures to regulate the company's conduct or, if necessary, ordering the purchase of shares or interests of any members to address issues of mismanagement *(3).*

(A) Meaning and definitions

"Section 2 (20) of the Companies Act, 2013" means a company incorporated under this Act or under any previous company law"

The Companies Act, 2013 is a very vital act in India that governs the existence and management of companies. While the Act's primary objective is to provide legal provisions for the incorporation, appointment of key managerial personnel (KMP), dispute resolution, governance, and functioning of companies, it also caters to the problems of investors in the company on an equal footing with all the minority or majority shareholders, thereby resolving the issues related to oppression of minority shareholders and mismanagement of the top management.

II. MINORITY AND MAJORITY SHAREHOLDERS

In the case of a company's ownership, the minority and majority shareholders are determined by the size of the ownership stakes held by individuals or groups of shareholders in the company.

1) Minority Shareholders: Minority shareholders are those who have a shareholding of around 20%–25% or less in shares. They have a small percentage of holdings; hence, they do not have very high voting rights, which means they do have voting rights but are not that influential. Therefore, their voice and voting regarding policy in the management meeting or among the board is not a make-or-break stand. The stakes must be protected.
2) Majority Shareholders: Majority shareholders, on the other hand, have a shareholding of more than 50%, which gives them a controlling stake in a company. As they have a large number of shares, their votes are very influential and can make or break a decision. They have management ownership of the company and can control its assets. Therefore,

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influencing the strategic decisions regarding the appointment of directors and hiring key managerial personnel The governance of the company is on their shoulders.

3) Associate shareholders: they have a shareholding of 25% to 49.99% in a company, which is less than 50% of shares. Their voting may not be individually influential, but combining it with that of minority or majority shareholders will create a win-win situation for the party they are supporting.

III. OPPRESSION OF MINORITY SHAREHOLDERS

Oppressive, in simple words, means using excessive force or power to get a job done with unjust enrichment. Here, majority shareholders are controlling the strategic functioning of the company, such as decisions, policies, norms, etc.; therefore, they misuse their power and position to unfairly disregard the rights and interests of the minority shareholders or stakeholders.

Mismanagement means a prejudicial, dishonest, or inept manner in the functioning of the company's affairs, such as decision-making, appointment, fraud, etc. Majority shareholders may indulge in misrepresentation, manipulation of financial records, or misuse of other non-monetary assets of the company that could undermine the actual value of the company and decrease the worth of minority shareholders.

Certain activities of oppression and mismanagement are as follows:

1) Exclusion from Management: Due to their low bargaining power and position, the decision-making and voting are highly influenced by the major group, and as they are large in number, they could dominate the whole process itself.

2) Dividend Withholding: As the majority shareholders have a high number of shares, they can afford to not take the dividends as the share is also appreciating, but the minority shareholders will be happy to get dividends as their shares are low, so the dividend increases the return.

3) Dilution of Ownership: as the ownership rights of the company are in the hands of majority shareholders, they can influence and manipulate the norms; therefore, the minority shareholders could face a problem of capital restructuring and could forcefully buy out the minority shareholder's shares, so they need to be protected from oppression. Majority shareholders may issue more shares to dilute the stakes of minority shareholders.

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4) Unfair Related-Party Transactions: Majority shareholders may make agreements and contracts with suppliers and vendors that benefit the majority shareholder's interests. causing financial harm to others. Can enter into the selling and buying of a business unit that suits their interests.

5) Misuse of Corporate Assets: Majority shareholders may misuse the resources of the company for their own personal benefits and personal usage.

To safeguard minority shareholders from oppression, the Companies Act, 2013 in India has sections 241 and 242 that permit minority shareholders to file complaints with the National Company Law Tribunal (NCLT) if they think their rights are being oppressed. The NCLT has the power to order and take appropriate action to address the oppression, which may include directing changes in the management or purchasing shares at a fair price.

The resolutions are categorised into three kinds, which are as follows:

1) Board Resolutions: here, directors of the company can make any decision except those stated in the company act or in any other provision to be taken by the stakeholders of the company.

2) Special resolutions: 75% of the members are required to vote to pass a resolution.

Ordinary Resolutions: 51% of the members are required to vote to pass a resolution.

IV. Provisions related to oppression and mismanagement as per the Companies Act, 2013

Sections 241-246 of the Companies Act, 2013 deal with it. It deals with scenarios where the decisions or operations of a company are being done in a way that is oppressive and against the will or consent of the minority shareholders or members, or is not in favour of the interests of the whole company.

Any stakeholder or shareholder of a company can file a complaint with the National Company Law Tribunal (NCLT) for relief if it is proved that the company's decisions or operations are oppressive in nature *(2).*

The NCLT can hear and pass orders to rectify the scenario, including the power to regulate the company's functioning, order the purchase of shares, or even wind up the company.

Section 242: Powers of the Tribunal - The NCLT has the authority to make orders, including the appointment of an administrator or receiver, regulating the functioning of the company, and even ordering the winding up of the company if required. May also direct the company to

purchase the shares of any shareholder or investor or order a relief that NCLT thinks is appropriate and satisfies the situation.

This section states the procedure for filing an application with the NCLT. It states the necessary documents and the format in which the application should be made.

Consequence of termination or modification of certain agreements: states that any change, modification, alteration, or termination of an agreement between a company and its managing director, whole-time director, or KMP or manager without the consent of the NCLT may be declared null and void.

Its objective is to protect the interests of the company and its shareholders by ensuring that important agreements involving key managerial personnel will not be changed, modified, altered, or terminated without proper inquiry or inspection.

These provisions state the mechanisms to face situations of oppression and mismanagement in companies and offer reliefs to protect and safeguard the interests of the parties (minority shareholders) who are affected by them.

Section 241 also allows the NCLT to make interim orders in the case of an application or complaint. The tribunal has the discretion to pass appropriate judgements or orders to safeguard the interests of the company or prevent further oppression or mismanagement while the application is being heard.

Section 245 of the Act permits the shareholders or members of a company to apply to the NCLT for relief in cases of oppression or mismanagement. The application can be made on some particular grounds, and the NCLT has the power to pass appropriate orders to provide relief.

Section 246 of the Act states the penalties for non-compliance with the orders of the NCLT. Any individual or company failing to comply with the tribunal's orders may be punished with imprisonment, a fine, or both.

V. DOCTRINE OF INDOOR MANAGEMENT AND CONSTRUCTIVE NOTICE

(A) Doctrine of Indoor Management:

The doctrine of indoor management is related to third-party dealings, where the party who is dealing with the company assumes that the internal management of the company is duly following the compliance stated by the statutory bodies and is abiding by the legal provisions related to the company. The person will not inquire about any irregularities in the company's management, as he or she thinks it is working efficiently and effectively *(5).*

If the third party is entering into a transaction with the company in good faith and without any mala fide intention or knowledge of any irregularities in the internal management, then their transaction or dealing with the company will not be considered invalid in the event of any problem in the company's management.

Exceptions to this principle are as follows:

1) In case the third was aware he or she was not protected by this doctrine,
2) If the third party indulges with the intention of committing fraud,
3) The third must have been done through the company's public documents, such as the Memorandum of Association (MOA) and Articles of Association (AOA), to claim the protection.

This doctrine does not overlook the problems in the company but just protects the innocent third party against any fraud or mistake done by the company without informing him or her.

(B) Doctrine of constructive notice:

Under the doctrine of constructive notice, some facts, information, and documents are deemed to be known or in the knowledge of the person dealing with the company. This principle serves the third party's interest to protect the transaction or dealing and to exercise caution before entering into a venture, agreement, or contract with the company.

If this doctrine is not followed, then the third party cannot claim any relief or remedy in the event that the company's internal management faces management or legal problems. This doctrine acts as an exception to the doctrine of indoor management.

The public documents of the company, like the Memorandum of Association (MOA) and Articles of Association (AOA), should and must be inspected by a person dealing with the company in order to have a venture, agreement, contract, etc.

The doctrine of constructive notice assures that third parties know about the legal and managerial framework in which a company operates and are presumed to have full awareness of the company's powers and limitations as stated in its constitutional documents (MOA and AOA). It establishes a level of clarity and transparency in transactions and dealings involving the companies.

VI. WHAT IS THE SEBI TAKEOVER CODE?

SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (aka SEBI Takeover Code, 2011) The Securities and Exchange Board of India (SEBI) has introduced norms and

guidelines for the acquisition of equity and preference shares and also for management control of the companies. The SEBI Takeover Code, also called the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, states the legal provisions, rules, and process for acquiring a considerable stake in a listed company in India.

The aim of the SEBI Takeover Code is as follows:

- Transparency and the non-use of unfair means against the shareholders during takeovers by the acquirer company.
- Safeguarding the interests of minority shareholders and preventing oppression and mismanagement.
- To stop any grey practises or fraudulent activities in the takeover process.

As per the SEBI Takeover Code, an acquisition of shares or voting rights above a certain threshold gives the acquirer the obligation to ask for an open offer from the public shareholders of the target company. The threshold limit is set at 25% of the shares or voting rights of the target company. If the acquirer company or entity goes beyond this threshold limit of 25%, then it is mandatory for them to make an open offer to buyout the extra or additional 26% stakes in the target company's shares from the public shareholders. Therefore, now the acquirer company or entity can have a total of 51% stakes and can enjoy control of the target company without any hindrance.

The SEBI Takeover Code states the guidelines regarding the open offer, pricing, disclosures, timelines, etc. The main focus is on the minority shareholders, who make a decision after evaluating their profit or loss in that deal.

(A) Salient features of the SEBI takeover code

The SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, also called the SEBI Takeover Code, 2011, monitor the acquisition of shares and control of listed companies in India. The salient features of the SEBI takeover code are as follows:

- Threshold limit: The SEBI takeover code has set a threshold limit of 25% of shares or voting rights as the strike point to make a public offer in a listed company. This is a mandatory provision.
- Pricing: The SEBI Takeover Code states rules to set the price at which the open offer will be made to the public shareholders. Normally, in the case of a takeover, the acquirer company or entity offers the public shareholders a price higher than what is in the market for that share, so that the public shareholders are ready to sell their shares to the acquirer

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company with any loss incurred.

- Disclosures and announcements: The SEBI takeover code states the time, deadline, and accurate disclosures by the acquirer and acquiree company. The acquirer company or entity has to announce their motive to buy the shares in the acquiree company, the price to be offered, the timeline, etc.; moreover, disclosure of non-manipulative and fair information is required.
- Exemptions: The SEBI Takeover Code states some exemptions from the open offer in certain special situations. The acquirer company can exclude and exempt the open offer to the public in cases of preference share allotment and acquisition of shares in the target company to recover its debt, etc.
- Safeguard of Minority Shareholders: The SEBI Takeover Code also protects the interests of minority shareholders and safeguards them from oppression and mismanagement in the process of takeovers, especially hostile takeovers. The code gives the shareholders a chance for safe and fair pricing and exit.
- Escrow Mechanism: The SEBI Takeover Code states that the acquirer company or entity has to create an escrow account that deposits the funds to meet the open offer requirements as a separate account so that transparency and monitoring of the funds are available without any negligence or fraud.
- Compliance: The SEBI Takeover Code states a strict deadline-oriented process for all the stages of the takeover process, and non-compliance of deadlines will attract hefty penalties for the defaulters.

(B) Process of SEBI takeover code

The process involves various types of legal and managerial frameworks that are to be followed. They are as follows:

- Triggering Event: When the acquirer company hits the 25% threshold limit, then the process of notification for the Takeover Code is initiated.
- Public Announcement: The target company and acquirer company or entity have to publicly inform the media about their intention to acquire the target company. They have to notify all the regulatory bodies and stakeholders about the issue so that they can make an informed decision.
- Appointment of officials: the acquirer company or entity has to appoint a manager who will take care of this whole takeover process. The manager shall independently see the

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whole process of appointing a particular person or manager for this sole purpose. Thus, it is mandatory as per the provisions of the SEBI Takeover Code.

- Letter of Offer: The manager appointed to supervise the Takeover Code prepares the letter of offer, in which he or she has to mention the information regarding the open offer, the offer price, the terms and conditions of the deal, relevant details of the acquirer company or entity, and other disclosures of documents required. The letter of offer should be dispatched within 15 working days of the public announcement.
- Opening and Closing of the Offer: The open offer should be open for 10 working days (minimum) and 15 working days (maximum), and there shall be no direct or indirect condition that hinders the free and fair acceptance or rejection of the offer.
- Settlement of Securities: The acquirer company or entity is required to settle the transactions related to the open offer within 10 working days (maximum) from the date of open offer closure.
- Reporting: The acquirer company or entity has to submit the relevant documents revolving around the takeover. SEBI has specified certain forms and e-applications that are to be submitted post-open offer so that the regulator has a full idea of the process. The annual statements of both companies or entities are also to be submitted with all the entries of the transaction in the takeover process.

(C) Public Announcement (PA) and Detailed Public Statement (DPS)

Regulation 14 of the SEBI (SAST) Regulations, 2011 (SEBI Takeover Code, 2011) states the requirements relating to the notification process of a public announcement (PA) and a detailed public statement (DPS) with regards to the acquisition of shares or voting rights in a listed company.

1) Moving beyond the 25% threshold limit with a motive to acquire the shares or voting rights of the target company requires a mandatory public announcement or notification in the media regarding the issue.
2) PA shall be made within four working days from the date the companies or entities are willing to exercise their contract to acquire shares or voting rights.
3) PA to be published in at least one English national daily newspaper with wide circulation and in any one newspaper in the regional language where the registered office (as per the ROC and MOA) of the target company is located.
4) PA shall clearly state all the details, like quantity of shares, percentage of shares,

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deadlines, mode of payment, offer price, etc., of the offer for the easement of the stakeholders.

5) Acquirer company or entity to submit a draught of PA to the Securities and Exchange Board of India (SEBI) seeking their permission before its publication.

6) Apart from PA, a DPS shall also have all the information and detailed disclosures regarding the acquirer company or entity, the target company, the offer price along with its size, institutions, investors, financial groups, or individuals involved in this dealing, so that no shell company or illegal funding can be done. Therefore, a source of funding is a must. Apart from the quantitative details, the qualitative details like the future plans, key managerial personnel, and the future mission and vision of the acquirer company are also to be mentioned, so that the current stakeholders of the target company can decide to continue or quit the company.

7) It is the responsibility of the acquirer company or entity to send a copy of the DPS to the target company, stock exchanges, and regulators involved in the process.

(D) Penalties as per the provisions of the SEBI Takeover Code, 2011

SEBI has quasi-judicial powers as well, through which it can punish the violator or violators by way of imposing a monetary fine, suspending the voting rights, putting restrictions, and in extreme cases, cancelling the whole takeover process, asking for additional documents for further clarification, or temporarily or permanently prohibiting the acquisition. A penalty of ₹ 25 crore or three times the amount of profits made due to non-disclosure or misleading or false disclosures, whichever is higher. Penalties imposed for non-convention of orders can either impose a fine, suspend voting rights, or cancel the takeover. For non-compliance, which can be either monetary fines or suspension of voting rights or restrictions on takeover stakes as per the discretion of SEBI.

VII. RELEVANT CASE LAWS

1. Tata Sons vs. Cyrus Investments Pvt. Ltd., Supreme Court, 2021:

Cyrus Mistry, a member of the Pallonji Mistry family, was appointed as the Chairman of Tata Sons in 2012.

In October 2016, the board members of Tata Sons unexpectedly discharged Mr. Cyrus Mistry from the post of chairman, the reason being performance-related issues in the company. Cyrus Mistry alleged oppression and mismanagement in the decision-making process of Tata Sons and claimed that he was wrongfully discharged from his post. Mistry alleged that he was not

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provided with the liberty to lead the Tata group and that some decisions taken by the Tata Sons board were not aligned with the interests of minority shareholders. He states that the problems related to corporate governance practises and decision-making in relation to some of the business units of the Tata group, including Tata Motors and Tata Steel, are mismanaged.

After Mr. Cyrus Mistry was removed, he filed a petition with the National Company Law Tribunal (NCLT) in December 2016, asking for reliefs and remedies for oppression and mismanagement under Section 241 of the Companies Act, 2013.

The NCLT dismissed Mistry's petition in July 2017, stating that Tata Sons was a private company and the complaints did not fall under the area of oppression and mismanagement.

Cyrus Mistry then appealed to the National Company Law Appellate Tribunal (NCLAT), which ruled in December 2019 that his discharge was illegal and that it was an act of oppression against minority shareholders.

The NCLAT ordered the reinstatement of Cyrus Mistry as the Chairman of Tata Sons with immediate effects, but Tata Sons appealed to the Supreme Court of India.

In March 2021, the Supreme Court of India set aside the NCLAT order, overriding the reinstatement of Cyrus Mistry as the Chairman of Tata Sons. The Supreme Court held that Cyrus Mistry's removal was not illegal, oppressive, or mismanaged and dismissed his complaints of mismanagement.

The court stated that the board of directors had the right to remove the chairman and did not find any lapses in the procedures. The Cryus Mistry alleged that their group, being the minority shareholders with around 18 not find any lapses in the procedures. The Cryus Mistry alleged that their group, being the minority shareholders with around 18% of the shares, was not granted the right to vote and that decisions were taken solely based on the majority shareholders. But the Tata Sons stated that out of 18ctors had the right to remove the chairman and did not find any lapses in the procedures. The Cryus Mistry alleged that their group, being the minority shareholders with around 18% of the shares, was not granted the right to vote and that decisions were taken solely based on the majority shareholders. But the Tata Sons stated that out of 18%, only around 2% of Cyrus's group is in equity shares, and the remaining 16% is in preference shares, which do not have any voting rights. Therefore, the case is not related to oppression and mismanagement but to the hiring of an employee by the employer; hence, Cyrus's group lost the legal battle to Tata Sons.

As the Hon'ble Supreme Court of India stated, this is indeed an employer-employee issue and not an oppression and mismanagement case *(4).*

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2. Foss v. Harbottle, Court of Common Pleas, England, 1843

Foss v. Harbottle is one of the landmark lawsuits in English company law that introduced the principle known as the proper plaintiff rule or majority rule. It states the general rule that when a wrongful act is done to a company, the company itself is the proper entity to take legal action seeking relief, remedies, and redress, rather than individual shareholders.

The plaintiffs in the case were minority shareholders of a company known as Victoria Park Company who complained that the company's directors had committed fraud and mismanagement, which led to monetary damages to the company. They fought a legal battle against the directors on behalf of the company.

The Hon'ble Court stated that the minority shareholders did not have the right or authority to bring the suit. The court further stated that when a wrong is committed against a company, the company itself is the proper party to bring a lawsuit, as it is a separate legal entity that has been damaged. The court further stated that the majority of shareholders, acting at a general meeting, could ratify or authorise the actions of the directors. therefore preventing the minority shareholders from filing a suit against the directors of the company.

The judgement in Foss v. Harbottle gives the principle that individual shareholders cannot file a lawsuit on behalf of the company for wrongs done to it unless they can demonstrate that the wrongdoing is within exceptions to the rule, like instances of fraud, ultra vires acts, or acts that need a special resolution. This principle has become a foundational and fundamental part of the company across the globe. The exception to this rule stated that a mechanism for shareholders to seek redress when the company's management did not act in the company's best interests.

3. Royal British Bank v. Turquand, 1856, 6 E&B 327:

The articles of the company permit the borrowing of money on bonds, which needs a resolution to be passed in the general meeting. The directors successfully acquired the debt, but we weren't able to pass the resolution in the general meeting. They also defaulted on the repayment of the loan, and the company was held liable; hence, the lawsuit was filed. The shareholders did not acknowledge, consider, or accept the claim due to the absence of the resolution. The Hon'ble Court stated that the company shall be liable because the persons dealing with the company are entitled to assume that all required and necessary compliance has been successfully passed with regards to the internal management. Thus, the doctrine of indoor management was upheld, and the company had to repay the debt.

4. Anand Bihari Lal V. Dinshaw & Co., 1946, 48 BOMLR 293

Here, the plaintiff knew and accepted the property of the company, which was transferred by the accountant. But the plaintiff did not inspect or inquire about the authority of the accountant to transfer the property. The Hon'ble Court held that as the plaintiff has neither inspected the public documents of the company nor asked for any copy of the Power of Attorney to confirm the authority of the accountant, the transaction is fully void. The doctrine of constructive notice was upheld in this judgement.

5. Oakbank Oil Co. v. Crum, 1882, 8 A.C. 65

Here, the doctrine of constructive notice was given an additional interpretation by the Hon'ble Court that the inspection of public documents of the company, such as the Memorandum of Association (MOA) and Articles of Association (AOA), does not merely mean a reading of them but a proper understanding of the documents to claim any relief or remedy under the doctrine of indoor management in case of any issue faced by the company.

6. SP Jain v. Kalinga Tubes, Supreme Court

In this case, the plaintiff files a complaint for oppression against the minority shareholders, which involves a lack of fair dealing and honesty with the minority shareholders about their proprietary rights as shareholders of the company. The Hon'ble Court stated that the issues must damage the petitioner in his or her capacity as a shareholder and not as a director or creditor of the company. Only then will the oppression and mismanagement provisions be applied.

7. Dale and Carrington Investment Pvt. Ltd. v. P. K. Prathapan: here, the Hon'ble Court stated that increasing the capital of a company with the sole aim of gaining control over the management can be termed oppression.

VIII. CONCLUSION

In conclusion, the Companies Act, 2013, is like the constitution of a company. The Memorandum of Association (MOA), which is related to the outside stakeholders of the company, should be read and understood by the third party before entering into any dealing, venture, or transaction with the company. The Articles of Association (AOA), which are related to the internal norms and protocols of the company, should also be read and understood by both internal stakeholders like the employee, etc., and outside stakeholders like the investors, etc., so that they are aware of the policies of the company and could also see if the company's vision and mission are aligned with their interests and goals or not, and to even go a further mile and inspect the profit and loss statements and balance sheet of the company, the auditor's reports, and other books of accounts in order to find out the effectiveness and efficiency of the resources

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of the company both in monetary and non-monetary terms.

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