

Opening closed doors again

Futile it might be, but the action against 'vanishing companies' matters, as it could serve as a deterrent and guide reforms

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It's been almost a decade since hundreds of companies did the vanishing act after raising a sizeable amount of money from the Indian public. After a very long lull, investigations are moving forward again. The Ministry of Company Affairs, which inherited this festering wound, has initiated action against the promoters and directors of 114 errant companies, the list of which will be published in newspapers soon. Prosecution proceedings have been launched against 107 companies, FIRs filed against 100. It comes late in the day, but it is better than nothing -- at least, it will serve as a deterrent to potential offenders and provide a basis for tightening existing laws.

Vanishing act

Between April 1992 and March 1996, as many as 4,057 public equity/Convertible issues were made, raising Rs 54,250 crore. Unfortunately for investors, many of these companies had no intention of setting up any business, their promoters just siphoned off public money. The case of 'vanishing companies', in truth, was more a case of vanishing funds, caused not only by hundreds of small companies but also by several large ones, who not only priced their issues aggressively but also misused issue funds.

Till 1998, there was no official recognition of this fraud. Subsequently, no regulator was willing to take responsibility for action. It was only in early-2001 that a high-level committee, comprising officials from the DCA and Sebi, identified 229 such companies. Predictably, all of them were small companies: the total amount raised by these 229 companies was just Rs 1,002 crore; only five of them had made a public issue of more than Rs 10 crore. After further enquiries, this number got reduced to 114, as some of these companies hadn't vanished, as was alleged.

The reason for the smaller-than-expected list was the way the committee defined vanishing companies for identification. A listed company was termed as a vanishing company if it met one or more of these three conditions:

- Had not complied with listing/filing requirements of stock exchanges and Registrar of Companies (RoC) for two years
- No correspondence had been received by stock exchanges from the company for "a long time"
- The stock exchange inspection found no office of the company at its registered office address

The conditions outlined failed to recognise that though companies may vanish, promoters can't as the state machinery can track most of them down. Even if one was to accept that individuals have vanished, then how does one locate them to prosecute them? What vanish, in fact, are funds.

Significantly, the definition also ignored the key issue: misuse of funds. A large number of companies that didn't use the funds for earmarked purposes -- for example, money raised to set up a paper factory being used to speculate in stocks -- escaped being branded defaulters. Since these companies changed the issue objectives with shareholder approval, they are considered to be complying with the law. But in most such cases, shareholder approval was a farce, as the promoters either had a majority shareholding or slipped through resolutions in board meetings that are beyond small investors.

Checks and balances

There are lessons to be learned from this rip-off, and we should learn them, but the focus should be on the future. To make an example, the MCA should expedite prosecutions already launched and mete out substantive punishment to such 10-15 large companies who misused issue funds. It's also good news that the MCA is currently conducting a survey of listed companies that vanished between 1998 and 2001, the report of which is expected by November and which should lead to more action.

Besides deterrents, the laws need to get more stringent and more punitive. We need a more meaningful definition of a 'vanishing company'. The existing law that provides for imprisoning promoters and directors for making false statements in an issue prospectus should be enforced. Additionally, new laws on fixing personal liability of promoters, action against auditors for certifying wrong financial statements, distributing unlawful earnings and compensating investors need to be enacted. Investors like to see the guilty being punished. What really matters to them is getting their monies back in case of a fraud.

Imperative also is a framework to monitor the end-use of funds and disclose the same to investors. If a company changes its issue objectives after its issue, it should be required to give an exit option to its small shareholders, who are normally not able to participate in general meetings, where such resolutions are approved. In case of new issues, stock exchange officials should be required to visit the plants/offices of such companies at least twice a year for physical verification. They should post a status report on their websites and warnings of all corporate defaults. Small investors are willing to manage the risks inherent in equity, what they are unwilling to put up with is the risk of fraud.

Vanishing companies and you

If you are an aggrieved investor, register your complaint on the ministry of company affairs website (www.dca.nic.in). More numbers will lend strength to the government's case and create pressure for action

Chances of getting back and money are next to nothing. But don't tear your share certificates yet. Who knows, the government might announce a payback scheme some day

Be wary of investing in IPOs of promoters without a good track record.