

Remedies available against Misrepresentation in Prospectus: An Analysis under Indian Companies Act

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1. Introduction

Prospectus are the most important aspect of the company affairs and have a very important part in it. Prospectus plays a very vital role for shareholder or debenture holder. It is document of a company and on the faith of it (Prospectus) any person get involved with the company's Share or subscribe the share and debentures.

Prospectus means an instrument which the public to share their money with company through shares and debentures. It is the best way to collect the capital for the company and remained from ever in the main practice of the company. It is only for a public company and not for a private company. It is provided in Section 3(1) (iii) of the Companies Act. Private company has to raise their capital privately.

Prospectus must be issued to the public. It is also a very important thing relating to it. It means that the Prospectus should not be presented privately but issued to the Public. In *Nash V/s Lynde* we have seen that a Prospectus passed through the hands of the company's person marked 'strictly confidential' and by the solicitor of the company is passed through to only one person. The court held on this that there had been no issue to the public. How much person constitutes public? It is very difficult to say exactly but it depends on the circumstances of each and every case. In different cases the court has given different views.

2. The contents of the Prospectus

Some legal requirements are must while issuing the Prospectus like its must be dated (Section 55), it must be registered in the office of the registrar, expert consent to be obtained while issuing the same. And Schedule II also be specified in the Prospectus. Which contains the objects and signatories and description, occupations of the signatories? It also contains the number and class of the shares and nature of it. Further Reports to be set out of Part II of the Schedule II, which contains the report by the auditors, reports by the accountant, shares in other company etc. and Part III of the Schedule II also included in it.

'Statement in lieu of Prospectus' is a term which says that while the promoters of a company are confident of the raising the capital of the company privately from their relatives and friends then, there is no need to issue a 'Prospectus'.

3. Remedies against misrepresentation in prospectus

Besides damages for deceit and fraud, the company may also be used for damages provided it is shown that the fraud was committed by the directors within the scope of their authority i.e. with the authority of the company. The company is also liable if the Prospectus is issued by the promoters and

ratified by the Board which adopts the issue, for the Prospectus is the basis of the contract for share.

Thus the first remedy against the company is to rescind a contract and claim the money back. The allottee, however must act within a reasonable time. He shall lose his right to rescind if he attempts to sell the shares or attends a general meeting of the company or receives dividends from the company.

4. Who is entitled to remedies ?

The right to claim damages for the loss sustained by reason of any untrue statement in a Prospectus is available only to a person who has subscribed, for shares or debentures on the faith of the Prospectus containing untrue statements. The shares must have been directly acquired from the company by allotment. A subsequent purchaser of shares in open market has no remedy against the company or the directors or promoters.

However, where a Prospectus is issued with the object of inducing persons to buy shares in the open market, any person who buys on the basis of false representation in the Prospectus, has a right of action for fraudulent misrepresentation.¹

In a public inters litigation case the plaintiff filed a writ against the company alleging that company has issued Prospectus containing false statements which might mislead the public injury. The plaintiff averred that had no direct interest in the matter and were not them cheated. A single judge of the Bombay High Court dismissed the case on the ground of locus standi holding that the plaintiffs themselves had no cause of action.²

5. Remedies available to aggrieved subscriber

A person who has subscribed for share or debentures on the faith of a Prospectus which contain untrue statements of material facts or which by omission of material facts are as a whole misleading, may have remedies, which are given below:

1. Against the company
2. Against the directors, promoters or persons who have authorized the issue of the Prospectus.
3. Against expert.

1. Remedies against the company : The deceived shareholder may claim :

¹ Peek V/s Gurney. (1873) 43 LJ Ch 19; Andrews V/s Mockford. (1869) 1 QB 372

²Kisan Mehta V/s Universal Luggage Manufacturing Co. Ltd., (198) 63 Comp Cas. 398.

- a. Rescission of the contract : The rules here are the ordinary rules of misrepresentation applicable to contract generally.
- b. Damages whether the statement is a fraudulent or an innocent one: this by itself without rescission cannot be obtained, since a person cannot complain that he was defrauded into becoming and yet remain a member and
- c. The return of his purchase money.

To Exercise rights against the company, the subscriber must prove:

- a. That the Prospectus was issued by the company or by someone with the authority of company by the Board of Directors, for instance.
- b. That he is an allottee: only an allottee entitled to rescind his contract, a person who has bought shares on the market on the basis of the Prospectus has no rights against the company.³ However, where it is shown that a Prospectus was issued merely as a part of a large scheme to create a false market (in commercial Parlance, "rigging the market") in shares or debentures and to induce investors to buy them from existing holder at higher prices in reliance of fast statement in the Prospectus, the purchaser in the market would be able to sue the person responsible for the issue for damages, for the purchasers had been induced to do the very thing the Prospectus had intended they should do.⁴
- c. That the misrepresentation (whether fraudulent or innocent) was material and one of facts: statements of opinion of exaggerated views of advantages of a company are not enough to upset a contract to take share, but if, taking the whole Prospectus together there was really a misrepresentation, the contract may be set aside, though each statement by itself literally true.⁵
- d. That he was induced to take shares by reason of this misrepresentation : It need not, and normally cannot be shown that it was the sole fact relied upon, but it must have been one of the facts relied upon.

Subscribing for shares as a result of a Prospectus is not bound to verify the accuracy of the statements contained in it, and will be entitled to avoid the contract, if they turn out to be untrue, even though he had the means of discovering the inaccuracy. ⁶"A contract to take shares (on the faith of the Prospectus) has become closely akin to one which is uberrimae Fidei" (Cheshire and Fifoot's Law of contract, 9th edition at P. 282).

The Right of rescission will be lost if:

- (a) The subscriber fails to act promptly after discovering the true facts: though voidable, the contract is valid rescinded, and a share who discovers that he has been deceived is bound to elect forthwith whether he will rescind his contract or not, for, his name being on the register, he is being held out as a member and a contributor to the assets, undue delays in

repudiations after knowledge of the misrepresentation may amount to ratification.⁷

- (b) He does anything after notice of the misrepresentation which is inconsistent with the right to repudiate, or signifies affirmation of the contract expressly or by implication, as when he accepts a dividends⁸ or other benefits in respect of the shares, or exercise voting rights⁹ or attempts to sell the share¹⁰ makes further payments in respect of them¹¹ or does not repudiate the shares or secure the removal of his name from the register within a reasonable time, but a transfer of parts of the shares before the discovery of the misrepresentation does not preclude relief as to the rest. ¹² Any such acts done before the notice of the misrepresentation will not affect his right to rescind and the right is not affected by his attending a meeting of the company opposing a winding up petition as a share holder after he has taken proceeding for rectification. ¹³
- (c) The parties cannot be restored to their original position. ¹⁴
- (d) The company goes into liquidation: here the rights creditors are involved and law always favors creditors at the expense of members.

2 Remedies Against Directors or Promoters :

The deceived subscriber may claim from the director, promoter or other person responsible for the issue of the Prospectus:

- (a) Damages for Fraud under the general law, if he can prove:
 1. That the Prospectus contained a material misrepresentation of facts.
 2. That the person or person sued where responsible for the issue for the Prospectus
 3. That the misrepresentation was made fraudulently, i.e. knowingly, or without belief in its truth, or recklessly, not carrying, whether it be true or false. ¹⁵
 That he took shares on the faith of the Prospectus and suffer loss as a natural consequence.

This remedy therefore requires the plaintiff to prove not only to prove not only the responsibility of the defendants for the Prospectus but also his fraudulent intent or recklessness. Even though he is in error in so understanding. ¹⁶

(b) Compensation under Section 62: In view of the difficulty to prove fraudulent intent on the part of the persons responsible for the Prospectus section 62 provides statutory remedy which

⁷ Clough V/s London and North Western Railway Co. (1871) LR 7 X 26, Aarons Reefs Ltd. V/s Twiss (1896) AC 273, HL.

⁸Scholey V/s Central Railway Company of Venezuela (1868) LR 9 EQ 266 N

⁹Sharpley V/s Louth and east Coast Railway Company (1876) Ch. D 663

¹⁰ Re Hop and Malt Exchange and Ware house Company V/s Ex P. Briggs (1866) Lr 1 EQ 483

¹¹ Re Dunlop Truffault Cycle etc. Manufacturing Company V/s P. Shareman (1896) 66 LJ ch. 25

¹² Re Mount Morgan (West) Gold Mines Ltd. (1887) 56 LT 622

¹³ Re Metropolitan Call Consumer Association V/s Edward (1891) 64 LT 561

¹⁴Houlds worth V/s City of Glasgow Bank (1880) 5 App Cases 317, HL

¹⁵ Derry V/s Peek (1889) 14 App Cases 337

¹⁶Akerhielam V/s De Mare (1959) AC 789, PC

³ Peek V.s Gurney (1873) LR 6 HL 377

⁴ Andrews V/s Mockford (1896) 1 QB 372

⁵ Greenwood V/s Leather Shod wheel Company (1990) 1 Ch. 421

⁶ Aaron's Reefs Ltd. V/s Twiss (1896) AC 273, HL

is much more reliable. Once the statement is proved to be untrue it is then up to the defendant to show, if he can, that he reasonably believed that the statement was true, and so escape liability

(c) Damages for non-compliance with section 56: As mentioned earlier section 56 which lays down the matters to be stated and the report to be set out in a Prospectus has been interpreted as conferring, by inference a right of action for damage against persons responsible for the issue of Prospectus who fail to perform the statutory of disclosure. That section exempts director and other person from liability in certain cases and in *Re South of England National Gas & Petroleum Co. Ltd.*,¹⁷ It was held that in other persons injured by the failure of the director.

3. Remedies Against Experts:

The Deceived subscriber may claim from an expert:

- (a) Damages: The same principal apply in the case of a fraudulent statement made by an expert just as in the case of a statement made by the director in a Prospectus and the person induced to take shares will be entitled to damage accordingly.
- (b) Compensation: an expert, who has given his consent o a statement in a Prospectus, may be liable as a person who has authorized the Prospectus within the meaning of section 62, but only in respect of an untrue statement purporting to be made by him as an expert.

6. Can stranger bring action for fraudulent prospectus:

In a recent case (*Kisan Mehta V/s Universal Luggage Company Ltd.*),¹⁸ the plaintiffs filed a suit against the different company alleging that the company had issued a Prospectus containing false statement which might mislead the public and result in public injury and sought and injunction restraining the company from taking any action who recovered to the issue or allotment of equity shares or debentures. The plaintiff brought the suit as the public and result wrong, they themselves having no direct interest in the matter. A single judge of the Bombay High Court dismissed the suit on the ground:

1. That the plaintiff themselves had no cause of action.
2. That it was open to a subscriber to take action in addition to that contemplated under sec. 62 & 63 for deceit and misstatement, but not for any other person who was not interested in the company at all.
3. That the plaintiff had no known cause of action nor was there any sure foundation for any innovative action.

The plaintiff themselves were not cheated nor was there any compulsion on the public to accept the offer of company. Investors had their own calculation and the court could not circumscribe them.

It may be pointed that as far back as in 1814 in England, "Rigging the market "was considered as an offence against

the public.¹⁹ Lord Ellen Borough CJ observed in *R v/s De Berenger*²⁰

that, "the purpose itself mischievous, it strikes at the price of a vendible commodity in the market and it gives it a fictitious price, by means of false rumors, it is a fraud leveled against all the public, it seems to be also not to be necessary to specify the person who became the purchaser of stock."

Some forms "rigging the market" may be statutory offences, or may entail civil liability. Although usually committed by the directors, "rigging the market" may also be committed by others : promoters, shareholder, stock brokers, merchant bankers. The rules of the stock exchange contain special provision against "rigging the market".

7. Conclusion

Despite the defects of unnecessary diversity and a considerable measure of uncertainly, the protection now afforded to investors it extensive. But their real protection is initial screening and thanks to issuing houses and to discipline of the stock exchange, this screening does take place and is generally effective. Hence it is largely to extra-legal techniques that the investors owe their present relative immunity from sharp practice. But it is must never be forgotten that had it not been for the legal sanctions, civil and criminal, the extra-legal techniques might never have been protected. So, it is urgently needed that to make the provision in approach of the public and spread all their rights relating to this.

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¹⁷ *Re South of England National Gas & Petroleum Co. Ltd.* (1911) 1 Ch. 573

¹⁸ *Kisan Mehta V/s Universal Luggage Company Ltd.* 1 (1988), 63 Comp. Cases. 398

¹⁹ *R v/s De Berenger* (1814) 3 M & S 67: 105 ER 536 (KB)

²⁰ *Ibid.*

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