

Economic Times  
17/08/2005

# Court In An IPO Bind

**I**N ANY public offering, the company issues an offer document in the form of a prospectus as per Section 56 of the Indian Companies Act, 1956. As this information is the main source for investment decisions, it may also be the focus of litigation if shareholders suffer losses in the future on account of wrong statements, false proclamations and negligent pronouncements. The exposure following initial public offerings (IPOs) for companies worldwide has historically been very large. For example, in '01 there were about 138 class actions filed against companies for claims arising out of IPOs in the US alone.

A company can proceed on its public issue only after getting observations from Sebi. However, the submission of an offer document to Sebi does not mean that the offer is cleared or approved by Sebi. The lead manager certifies that the disclosures made in the offer document are adequate and in conformity with Sebi guidelines. If adequate care is not taken in drafting the prospectus it can lead to error, breach of trust and duty, misleading statement, act, omission or neglect. This has serious implications for those associated with the prospectus, which include the following.

■ Section 62 and 63 of the Companies Act impose civil and criminal liability respectively for mis-statements in the prospectus. Since an investor subscribing to the issue places faith in the prospectus,

he can bring action for damages against the directors and persons responsible for non-disclosure.

■ Sec 68 provides a penalty for making false, deceptive or misleading statements to induce persons to subscribe.

■ Sec 62B provides a penalty for making false statements in the prospectus, knowing such statement to be false. For omission of material facts in the prospectus, directors are liable to pay damages to persons who have suffered due to this.

■ A person at fault may also attract civil liability for misrepresentation or fraud under sec 17 & 18 of the Contract Act, 1872.

Sebi Guidelines '00 entail incorporation of the Issuer's Absolute Responsibility clause in the prospectus. This penalty for violation could bar the persons concerned from accessing the capital markets for a certain period.

The onus is on the defendant to prove that either the statement was immaterial or that he believed it to be true. Significant defence costs thus need to be incurred before one can be proved innocent.

The IPO is likely to result in a large, diverse group of new shareholders. Statistically, shareholders' suits provide the vast

## IPO LITIGATION

majority of claims against directors and officers worldwide. The mix of shareholders is important, as these might include for-

**Companies can be prosecuted by disgruntled investors after an IPO. Here a public offering of securities insurance cover may come handy**

aign investors and local retail investors each with varying expectations. If these are not met, claims will sometimes follow.

### Does it happen in India?

The belief that such litigation does not arise in India is changing. Here are a few cases being heard by Indian courts:

■ Debentures were allotted under a prospectus which stated that they would be converted into shares. Instead, the

company redeemed them. As such it could be deemed that the prospectus carried a misstatement.

■ Inadequate disclosure in the offer document for buy-back of shares at the time of delisting.

■ Utilisation of funds was much lower than what was projected in the prospectus

■ Company did not use funds for purpose raised.

■ Projects referred to in the prospectus were not implemented

Prevention is always better than cure. Still, it is necessary to exercise adequate care and take every precaution. Risk transfer via an appropriate insurance cover is an option worth serious consideration. Normally, the Directors and Officers liability insurance (D&O) policy excludes risks emanating from the issuance of a prospectus. This necessitates either removing the relevant exclusion from the D&O policy or obtaining a stand alone Public Offering of Securities Insurance (POSI) cover.

**Benefits of a stand-alone POSI**

A POSI cover is an insurance cover for the wrongful acts of a company and its directors arising from the issue of a prospec-

tus. It is taken out as protection against the liability imposed on the offering company or its directors and officers. Directors can incur personal liability for a prospectus under Sebi guidelines. It is common on a flotation for directors (including non-executives) to give personal warranties and indemnities about the prospectus to the underwriter or sponsor of the flotation. The liability under these warranties is personal, may be joint and several and, where given by the directors in a personal capacity, may not be the subject of indemnity from the company. Coverage can be extended to intermediaries associated with the issue like lead managers and merchant bankers. This insurance cover pays for defence costs and settlements up to chosen limits. As with other liability insurance, criminal, intentional and malicious acts are outside the scope of the policy.

A stand-alone POSI provides coverage for directors, officers and the company. It also leaves the regular D&O policy limits unaffected if there is a claim under POSI. The lead time for analysing and placing the risk is longer compared to other lines of business. So, exploration for this policy must commence early so that the cover is in place before the start of the road show.

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The views expressed are personal