BEFORE APPELLATE BENCH NO. III

In the matter of

Appeal No. 60 of 2003

Service Industries Textile Limited
38-E Empress Road, Lahore……..…….…. Appellant

Versus

Commissioner (Company Law) SEC ……..…….Respondent

Date of Impugned Order	December 08, 2003
Date of Hearing of Appeal	January 12, 2003

Present:

For the Appellant

1. Mr. Noman Akram Raja,
   Advocate High Court

2. Ralph Nazirullah,
   Company Secretary

For the Respondent

1. Mr. Ashfaq A. Khan,
   Director (EMD)

2. Mr. Mubasher Saeed,
   Joint Director (EMD)

ORDER

This order will dispose off the present appeal filed under section 33 of the Securities & Exchange Commission of Pakistan Act, 1997 by Service Industries Textile Limited (the 'Appellant Company') against the order dated December 08, 2003 (the 'Impugned Order') passed by Commissioner (Company Law).

1. Brief facts of the case are that the Appellant Company was served a notice dated February 07, 2003 under Section 265 of the Companies Ordinance 1984 (the 'Ordinance') whereby it was asked to show cause as to why an Inspector should not be appointed to investigate the affairs of the Company. The background and the allegations against the Appellant Company leading to the show cause notice are recorded in the Impugned Order, which we need not produce here. The Appellant Company submitted a response dated April 04, 2003 to the show cause notice. The Commissioner (Company Law) after giving the Appellant Company an opportunity of hearing, proceeded to pass the Impugned Order whereby an Inspector was appointed under Section 265 of the Ordinance. Being dissatisfied with the findings of the Commissioner (Company Law) in the Impugned Order, the Appellant Company preferred the instant appeal before us.

2. The appeal documents were filed before the Appellate Bench Registry on December 23, 2003 by the counsels of the Appellant Company. The Appellate Bench Registry identified certain deficiencies in the appeal documents in accordance with the Securities & Exchange Commission of Pakistan (Appellate Bench Procedure) Rules, 2003 which were removed by the counsels on December 30, 2003. On January 01, 2003, the Appellate Bench fixed the appeal and the stay application for hearing on January 12, 2003 and accordingly a hearing notice No.60(33)B-III/EnfD/2003 dated January 02, 2003 was sent to the counsels through courier service. However, on January 07, 2003 the Appellate Bench

received an *ex parte* order dated January 05, 2003 passed by the Hon'ble Lahore High Court, Rawalpindi Bench in writ petition No. 29 of 2004 filed by the counsels of the Appellant Company. The counsels in their petition had contended before the Hon'ble High Court that the Appellate Bench had failed to take up the Appellant Company's appeal and stay application and prayed for suspension of the Impugned Order. In its order dated January 05, 2004, the Hon'ble High Court was pleased to suspend the operation of the Impugned Order pending the taking up of the appeal and the application by the Appellate Bench. In addition, the High Court directed the Appellate Bench to take up the matter for hearing within 7 days of its order. Although the Appellate Bench had already taken up the matter and sent a hearing notice dated January 02, 2003 via courier, it seems that this information was withheld from the High Court by the counsels when it passed its order on January 05, 2003. Anyhow, the Impugned Order remained suspended on the orders of the High Court till the date of hearing on January 12, 2004. As the inspector appointed by Commissioner (CLD) had suspended his work on the orders of the High Court, the Appellant did not press the application for interim relief before us on the date of hearing on January 12, 2003.

3. On January 12, 2004, Mr. Nomaan Akram Raja the counsel for the Appellant Company appeared before this Bench along with Mr. Ralph Nazirullah the company secretary. Mr. Ashfaq Ahmed Khan, Director EMD and Mr. Mubasher Saeed, Joint Director EMD represented the Commissioner (Company Law).

4. In its appeal, the Appellant Company has contended that the Impugned Order was passed by the Commissioner (Company Law) in complete disregard of the relevant laws and the facts of the case, and is based on surmises and conjectures. Mr. Nomaan Akram Raja argued that appointment of inspector under section 265 of the Ordinance is one of the harshest provisions of the Ordinance and

should be exercised sparingly and only when there are compelling reasons for it. He stated that the appointment of inspector signals the demise of a company. Mr. Raja contended that the Commissioner had based his decision of appointment of inspector solely on one central issue, that is, the sale by the Appellant Company of certain obsolete machinery in year 1999. The machinery which consisted of 18,700 spindles and having a book value of Rs.120 million was sold by the Appellant Company for Rs.27 million only. He stated that this machinery was not just obsolete, but was rather scrap as it had been installed sometime in the late 1960s. He contended that the book value of Rs.120 million was a result of a re-valuation done in 1995 on the basis of a 'going concern' when the machinery was still operational. Whereas when the machinery was sold in 1999, it was worth only Rs.27 million. He argued that with the sale of this obsolete machinery, the performance of the Appellant Company had in fact improved and therefore this was a good decision taken by the management. He stated that the accumulated losses of the Appellant Company have been reducing year by year and the Appellant Company was making a turn around. He argued that the appointment of inspector has halted this improvement. He stated that the suppliers of the Appellant Company had stopped providing credit and the banks have halted negotiations on new financing, which was in the pipeline. He produced before us evidence of an irrevocable Letter of Credit opened on December 31, 2003 by National Bank of Pakistan in favor of a Chinese company for import of 11,000 new spindles for the Appellant Company.

5. He further argued that the sale of the machinery had been authorized by the Board of Directors of the Appellant Company and approved by the shareholders in the Annual General Meeting. He stated that the finding of the Commissioner (Company Law) in the Impugned Order that the old machinery was not replaced by new machinery was incorrect and he produced before us a list of machinery which had been replaced. He also contended that the finding in the Impugned

Order that no revaluation of the assets had been done by the Appellant Company since 1995 was erroneous as a revaluation had been conducted as recently as 2002. He stated that all these facts had not been produced before the Commissioner (Company Law) by the management due to inadvertence or negligence and resultantly the Commissioner had appointed the inspector. He stated that had these facts been brought forward at that time, there is a good chance that the Commissioner would not have appointed the inspector. He prayed that the Impugned Order may either be set aside or remanded back to the Commissioner (Company Law) so that these facts may be produced before him.

6. Mr. Ashfaq Ahmed, appearing on behalf of Commissioner (Company Law) contended that the Appellant Company had failed to obtain the approval from the shareholders for the sale the machinery. He argued that sale of 18,700 spindles out of the total of 40,000 spindles amounted to a sizable disposal of assets by the Appellant Company, for which the management needed the consent of the general meeting under section 196(3)(a). He stated that as this amounted to special business, it should have been included as the agenda in the notice of the meeting. He argued that the Appellant Company should have revalued the machinery prior to its disposal. There is also no documentary evidence available to prove that efforts were made by the management to obtain best possible price from the market for the machinery. He added that both ends of the transactions were doubtful as the Appellant Company sold 18,700 spindles having a book value of Rs.120 million for Rs.27 million and then purchased from the same person certain machinery for Rs.27 million. He further contended that even the auditors of the Appellant Company have qualified the transaction of sale of machinery and the appropriateness of the price fetched by the sale. He stated that the Appellant Company had itself agreed before Commissioner (Company Law) to the appointment of the inspector. He added that the Appellant Company was taking a self contradictory stance. On one hand it

complains of stalling of new credit negotiation, whereas an irrevocable letter of credit was opened by National Bank of Pakistan as recent as December 31, 2003. Mr. Mubasher Saeed pointed to the scope of work for the inspector laid down in the Impugned Order. He stated that in addition to the sale of the machinery, the inspector is required to report on a number of other issues, which are as important in nature.

7. We have heard both the parties in detail and also perused the documents and the record. The counsel for the Appellant Company has argued that the sole reason for appointment of inspector in the Impugned Order is the issue of sale of machinery by the Appellant Company. Although we agree that this may have been the culminating cause, however in our opinion there are a number of concerns which necessitated a fact finding exercise to establish that the affairs of the Appellant Company are being run in accordance with sound business principles and a prudent manner and not to the detriment of the shareholders. Since 2001 the Appellant Company has admittedly not laid down its annual account before the shareholders. It has also not filed its quarterly accounts as required by law. This itself is a grave violation of the rights of the shareholders guaranteed by law. The serious reservations about the transparency of the sale transaction which have been raised in the Impugned Order as well as in the report of the auditors could have been avoided if the Appellant Company was keeping its shareholders properly informed. The accounts of 2001 depict a sorry state of the affairs of the Appellant Company. The accumulated losses for the year ended September 30, 2001 stand at Rs.422.072 million resulting in negative equity of Rs.342.580 million. Its current liabilities exceeded the current assets by Rs.167.767 million. Resultantly the Appellant Company has not declared any dividend for several years. The auditors have expressed their concern on the preparation of these accounts on the assumption of the Appellant Company being a going concern. In these circumstances, we are unable to accept the

contention of the counsel for the Appellant Company that this is a mere difference of opinion between the management and the auditors.

8. On the issue of sale of machinery, Mr. Nomaan Akram Raja argued that the difference between the book value and the actual sale price of the machinery is a result of two factors, firstly the time difference between the valuation and the sale, resulting in devaluation, and secondly that the valuation in 1995 was done on a going concern basis when the machinery was operational. However, in our opinion these facts themselves raise concerns about the way the Appellant Company is being run. The auditors have already expressed their concern on the price differential, which can only be verified by an independent investigator. Had the valuations of the machinery been done on a more regular basis as recommended by IAS 16, it would not have resulted in the huge revaluation reserve on the fixed assets amounting to Rs.364.834 million. Also, it was only prudent that the Appellant Company should have revalued the machinery before the sale transaction. It would have also verified the Appellant Company's claim that the machinery was not operational when it was sold. Such verification can now only be sought from an independent investigator.

9. The counsel has challenged the finding given in the Impugned Order that no revaluation has been done since 1995. However, we are unable to understand how the revaluation purportedly done in 2002 can help bring transparency to the sale of machinery which was completed in 2001. Besides any document evidencing the revaluation conducted in year 2002 would carry weight if they formed part of the audited annual accounts presented before the shareholders. Unfortunately, the Appellant Company has not prepared its audited accounts for the relevant year. Similar is the case with the list of machinery replaced by the Appellant Company. Although the counsel has produced the list before us now, which apparently was not produced before the Commissioner (Company Law),

we fail to understand how these facts can be verified by us or the Commissioner (Company Law) in the absence of audited accounts. Again, one sure way of verifying the truth is by the appointment of an independent investigator.

10. The counsel has also challenged the finding of the Commissioner (Company Law) that no approval of shareholders was obtained by the Appellant Company before the sale of the machinery. He has produced the minutes of the AGM held on March 31, 2000. However, on the other hand it is admitted by the Appellant Company that the agreement for the sale of the machinery was executed on October 12, 1999, which is about 5 months prior to the approval given by the shareholders. It is also admitted that the actual sale of machinery had commenced in year 1999 before the approval. The sale of machinery amounted to disposal of a sizable part of the assets for which an approval was required under clause (a), sub-section (3) of section 196 of the Ordinance. This item should have been on the agenda of the meeting as the approval could not have been obtained as part of the ordinary business of the meeting as done by the Appellant Company. This amounts to a violation of law and carries serious consequences as specified in sub-section (4) of section 196. In case if any loss has been caused to the company as a result of this sale transaction, the directors of the Appellant Company are individually and severally liable for such loss. It therefore remains to be seen whether any loss has actually been caused by the sale transaction and such finding also can be verified only by an independent investigator.

11. The counsel has argued that the performance of the Appellant Company has been improving ever since the sale of old machinery and the losses have been decreasing. However, he has quoted figures up to year 2001. There is no criterion before us here to verify whether this claim is still correct today, as the Appellant Company has not filed its accounts after 2001. Besides Mr. Ashfaq Ahmed has rightly pointed out that years 2000 and 2001 were better years for the whole of

textile industry and majority of spinning units earned good profits in those years. More importantly, this decrease in losses may well be on account of the alleged rebate of Rs.71.1 million arising from restructuring arrangement with certain financial institution reflected in the accounts for the year ended 2001, which item has been qualified by the auditors. All these claims therefore, need to be verified. Notably what needs to be verified in the interest of the shareholders is whether the sale of the machinery could have fetched a better price. The Commission may not be in a position to judge this, however the price differential, the manner in which the sale transaction has been executed and the opinion of the auditors all point towards the need for an independent investigation. We have also taken into consideration the fact that the management has not been able to produce any documentary evidence before Commissioner (Company Law) or us that serious efforts were made to obtain best possible price for sale of the assets of the Appellant Company.

12. In view of all these circumstances, we are unable to agree with the counsel that the Impugned Order has been passed in disregard of the relevant facts and law on the subject. The facts *prima facie* point to the supposition that the affairs of the Appellant Company are not being managed in accordance with sound business principles and prudent commercial practices, thus necessitating a fact finding exercise to confirm or reject these charges. It is the view of this Appellate Bench, which has been expressed previously that the appointment of inspector is a fact finding exercise and not a penal action. And this action is necessary in view the interest of the shareholders. It was held in the case of *Chanra Prabha (Smt.) v. Hotel Shweta (P.) Ltd. (1995) 4 Comp LJ 540*, that an order of investigation is not an end in itself, it is only a means to find out a full facts of the acts complained of. It is nothing but an exploratory measure to be proved or disproved with reference to facts later on ascertained.

In light of the above findings we uphold the Impugned Order dated December 08, 2003 passed by Commissioner (Company Law). This appeal is accordingly dismissed.

(ETRAT H. RIZVI)
Commissioner (Insurance)

(SHAHID GHAFFAR)
Commissioner (Securities Market)

Announced in Islamabad on January 21, 2004