Before Abid Hussain, Executive Director

In the matter of

Jubilee Spinning & Weaving Mills Limited

Number and date of notice:	CSD/ARN/292/2016-3720-26 dated March 21, 2016
Date of hearing:	May 25, 2016
Present:	Mr. Rashid Sadiq, CEO, RS Corporate Advisory (Pvt) Limited (Authorized Representative)

ORDER

UNDER SECTION 208 READ WITH SECTION 476 OF THE COMPANIES ORDINANCE, 1984

This order shall dispose of the proceedings initiated against the Chief Executive and Directors (the "respondents") of Jubilee Spinning & Weaving Mills Limited (the "Company") through Show Cause Notice dated March 21, 2016 (the "SCN") issued under the provisions of Section 208 read with Section 476 of the Companies Ordinance 1984 (the "Ordinance").

2. Brief facts of the case are that Cresox (Pvt.) Limited ("CPL") is an associated company of the Company under Section 2(2) of the Ordinance as Mr. Tariq Shafi and Mr. Usman Shafi are directors in both the Company and CPL. Examination of annual audited accounts of the Company for the year ended June 30, 2015 revealed that the Company has extended loan to its associate, CPL in the form of abnormal trade debt of Rs.143.87 million out of which Rs.141.36 million is past due receivable for more than one year. It appeared that, *prima facie*, abnormal trade credit had been extended by the Company without authority of special resolution and return in contravention of

sub-section (1) Section 208 of the Ordinance. Consequently, SCN was served upon the respondents on March 21, 2016 to show cause as to why penalty may not be imposed under Section 208 of the Ordinance.

3. The respondents vide letter dated March 30, 2016 submitted reply to the SCN in which it was stated that the Company has not extended any loan to CPL, its associated company, as assumed in the SCN. The Company was engaged in manufacturing of Cotton Yarn and selling it to various customers including CPL, which is engaged in manufacturing of socks and exporting to international market USA, Canada & Europe through its major customer Renfro Corporation, USA as per Joint Venture agreement. Since 2011, CPL is suffering liquidity problems due to heavy operational losses suffered because of exit of its major foreign customer in the month of September 2010 and due to increase in prices of cotton yarn which CPL could not pass on to its customers. As per latest update, CPL is still striving to sustain in international marketing through reaching prime wholesaler and retailer in USA, Canada and Europe by cost reduction drive and financial support of major shareholders. Therefore, the management of CPL has shown its willingness to pay its all outstanding debts to the Company in near future. Further, it was stated that it is wrong construction of the legal provision contained under Section 208 that the credit allowed to CPL was "abnormal". The delay in payment does not change the nature of the transaction from normal to abnormal and convert it automatically into loans and advances as has been stipulated in the impugned SCN.

4. Later on, vide letter dated May 24, 2016, received from Mr. Rashid Sadiq, CEO, RS Corporate Advisory (Pvt) Limited (the "Authorized Representative), it was stated that the Company has never extended loan to CPL in any form and the Company has never extended abnormal trade credit to CPL. Further, submissions were made by the Company as described briefly here below:

a. It is submitted that CPL, an associated company is engaged in manufacturing of socks and exporting them to international markets like United States of America, Canada and Europe through its major customer Renfro Corporation, USA as per a Joint Venture Agreement. However, CPL has suffered huge operational losses due to the exit of its major foreign customer and is, hence, suffering liquidity problems since then. CPL has consequently suffered heavy losses and is struggling to keep its market position despite enormous increase in prices of cotton yarn which CPL has not passed on to its current customers. Moreover, as per the latest update,

CPL is striving to sustain in the international market through reaching prime wholesalers and retailers in U.S.A, Canada & Europe by cost reduction drive and continuing financial support from its major shareholders. The Company denies that it had ever extended loan to CPL. It has in fact sold the cotton yarn produced by the Company to CPL for utilization as one of the raw materials for the manufacture of socks for its international customers. Due to the financial hardships being faced by its associated company and keeping in view the Company's long term interests, a longer repayment period has been allowed to CPL to repay the balance amount which already has reduced from Rs.143.87 million as mentioned in the SCN to Rs.89 million as of to-date. Despite its enormous financial difficulties, the management of CPL has assured the Company of repayment of the entire outstanding trade debt to the Company in the near future. You will kindly appreciate that the Company has not extended any loan to CPL as mentioned in the SCN. No fund has been transferred from the Company to CPL nor has it been alleged in the SCN. Section 208, therefore, is not attracted in this case.

b. It is firmly denied that the Company has extended any abnormal trade credit. The Company has in fact sold the cotton yarn produced by the Company to CPL which the Company could not pay timely due to financial distress mainly because of the exit of its major customer, Renfro Corporation, USA. Therefore, there is no extension of abnormal trade credit by the Company. It is wrong construction of the legal provisions that the credit allowed to associated company was 'abnormal'. It is also submitted that SECP has issued the Companies (Investment in Associated Companies or Associated Undertakings) Regulations, 2012 (the "Section 208 Regulations") and before that S.R.0 865 dated December 06, 2001 was issued which required the information to be contained in the statement under Section 160 (1) (b) of the Ordinance for special business related to investments in associated undertakings to be transacted under Section 208 of the Ordinance. Section 208 Regulations and SRO nowhere requires the information to be provided in case of abnormal trade credit. SECP has also never issued any instructions to the regulatees as to what will be construed by SECP as abnormal trade credit as this has not been defined anywhere in the Ordinance or rules and regulations framed there under.

c. The Company has not paid any amount whatsoever to CPL. No special resolution was required when the Company sold cotton yarn to CPL as there was no prohibition under the

Ordinance for making sales to or purchases from associated companies. If an associated company could not make repayment of normal trade credit on time, it could not be construed that it is an investment under Section 208 of the Ordinance. The sponsors and directors hold over 75% of the total share capital of the Company and they could easily pass a special resolution if it was intended to make an investment by way of loan to CPL. Therefore, it is not legally sustainable that a special resolution is required for amounts due from CPL.

d. It has not been disputed by the SECP that the supply of cotton yarn by the Company to its associated company is a trade credit and not investment within the meaning of the expression 'investment' as defined under Section 208 of the Ordinance. The term 'abnormal trade credit' has neither been defined in the Section 208 of the Ordinance nor in the Section 208 Regulations issued under Section 2A of Section 208 of the Ordinance. The only objection appears to be that the amount which is due from CPL has not been paid for a longer period of time. SECP may please appreciate that an extension or delay in time for the payment of an outstanding trade credit does not change the nature of the transaction itself as arbitrarily assumed by the SECP in the SCN. Therefore, the amount recoverable from CPL is not an investment and, therefore, Section 208 of the Ordinance is not attracted.

e. We respectfully submit that regulation 8 of Section 208 Regulations envisages even rescheduling of loans or advance extended to an associated company by passing a special resolution of the shareholders of the investing company. It has been provided that if an associated company fails to repay the loan or advance, the same could be rescheduled with the approval of special resolution. In the case of normal trade credit, the board of directors is the authority to extend the period of payments to ensure full recovery of amounts. Therefore, the delay in payment of normal trade credit should not be construed to mean as an investment in associated company.

f. It is further submitted that the transactions with associated undertaking were carried out at arms' length basis. The trade transactions for supply of cotton yarn were carried out meticulously under arrangement with the CPL without an undue favor. It is further submitted that according to the Section 208 of the Ordinance investment in "associated companies or associated undertakings" is prohibited only in the case where it is not in the nature of normal trade credit. It is evident from a bare perusal of Section 208, that sales cannot be treated as either

investments, advances or loans. The amount receivable from CPL is neither a loan nor an advance and therefore does not fall within the ambit of Section 208. Therefore, the requirement of the passing of the special resolution under sub section (1) of Section 208 of the Ordinance was not applicable in this case.

g. It is submitted that the provisions of Section 208 (3) of the Ordinance specifically provides that if default is made in complying with the requirements of Section 208 of the Ordinance, every director of the company who is "knowingly and willfully in default" shall be liable to be fined. Therefore, the imposition of penalty under Section 208 (3) is subject to the determination that the default was made "willfully" and "knowingly". The words "knowingly and willfully" require proof of knowledge, intention and willful action. The term "willfully" as used in different statutes and judicial precedents means "deliberate or intentional act". It connotes a conscious act signifying something more than a mere omission, default or inaction on the part of a person who is under an obligation to do something. You will kindly appreciate that the non-compliance pointed out by you was not caused knowingly and willfully.

h. The sponsors/directors of the Company have provided over Rs. 86 million interest free loan to the Company to support its financial requirements. They also hold over 75% shareholding in the Company. Further, CPL's sponsors / directors have also provided interest free loan of Rs.695 million to CPL to support its financial requirements. You will kindly appreciate that they had provided huge funds for the survival of these companies.

i. The decisions of the Commission in the following decided cases under Section 208 of the Ordinance have been referred to by the authorized representatives.

- Pak German Prefab Limited dated January 2, 2003 – the proceedings were dropped against the directors when it was concluded that the balance receivable from the associated company was a result of construction contract which established that ordinary sale/purchase or service transaction between associated companies falls within the purview of normal trade credit.
- Kohinoor Power Limited Dated October 2, 2000 – it was held that where the credit has been accumulated due to inability of the customer to pay and not due to unwillingness of the directors of the company and where efforts are being made for the recovery of outstanding balance, the objective of section 208 stands

achieved and proceedings were dropped.

- Exide Pakistan Limited dated September 17, 2007/Dewan Salman Fibres Limited dated March 3, 2000 – before proceedings are initiated in terms of SCN under Section 208 of the Ordinance, the Commission must allow a company time to recover the entire outstanding/receivable amount for the associated company.
- Fazal Cloth Mills Limited Dated October 7, 2010 - It was ruled that lenient view may be taken of the default of transfer of funds to the associated companies in view of the compliance history of the company thus no fine was imposed.
- Bestway Cement Limited dated April 15, 2016 – it was ruled that although the company has violated Section 208 of the Ordinance, the respondent have admitted oversight on their part and obtained shareholders' approval by providing complete information as required under the law. The self-realization and corrective measures taken for the avoidance of future errors are reassuring. Lenient view was taken and thus no fine was imposed on directors.
- Jubilee Life Assurance Company Limited dated July 2 2014 – the company and its directors were let off with warning only for breach of Sections 208 by exceeding the limit of investment in associated companies.

5. The respondents were provided with a hearing opportunity on May 2, 2016 that was postponed to May 16, 2016 on request of the respondents which was further adjourned to May 25, 2016 on their request. On May 25, 2016, the hearing was attended by the Authorized Representative on behalf of respondents and reiterated the stance taken earlier and stated in the written submissions. The case was discussed at length in the hearing. It was observed that the Company is providing unduly long credit period to its associated company. This practice does not seem to be 'Normal Trade Credit' in accordance with requirements of Section 208 of the Ordinance. It was further informed that the directors are authorized for transactions keeping in view the best interest of the Company and especially in transactions with associated companies, the directors should be doubly careful while making decisions and caution has to be taken to ensure that the interest of the shareholder is not jeopardized in any manner. It was decided in the hearing that the Company will ensure immediate recovery of the long outstanding trade debts from CPL. Subsequent to the hearing, a letter was received from the authorized representative

dated June 24, 2016 wherein it was confirmed and stated that the Company undertakes to fully recover the balance due from the associated company by September 30, 2016. Later vide letter dated August 18, 2016 the Commission enquired about the status of the balance due from the associated company. The Company vide letter dated December 20, 2016 informed that the Company has so far brought down the receivable from the associated company to Rs.63.775 million from Rs.143.87 million. The associated company is not in a position to immediately pay the balance amount due to severe liquidity constraints. However, it intends to repay the balance amount within a period of three years. It was requested in the reply from the Company that in view of the above efforts and the recovery of substantial amount out of the total receivable from associated company to drop the proceedings against the directors of the Company.

6. Before proceeding further, it is necessary to advert to the relevant provisions of law:

- Provisions of Sub-section (1) of Section 208 of the Ordinance provides that a company shall not make any investment in any of its associated companies or undertakings except under the authority of special resolution which shall indicate the nature, period and amount of investment and terms and conditions attached thereto provided that the return on investment in the form of loan shall not be less than the borrowing cost of the investing company;

  Explanation: The expression "investment" shall include loans, advances, equity, by whatever name called, or any amount which is not in the nature of normal trade credit.

- Provisions of Sub-section (3) of Section 208 of the Ordinance provides that if default is made in complying with the requirements of this Section, every director of a company who is knowingly and willfully in default shall be liable to fine which may extend to ten million rupees and in addition, the directors shall jointly and severally reimburse to the company any loss sustained by the company in consequence of an investment which was made without complying with the requirements of this Section;

- In terms of the Commission's notification SRO 1003 (I)/2015 dated October 15, 2015, the powers to adjudicate cases under Section 208 of the Ordinance have been delegated to Executive Director (Corporate Supervision).

7. I have analyzed the facts of the case, relevant provisions of the Ordinance, and the arguments put forth by the authorized representative in writing and during the hearing and observed that:

- CPL is an associated company of the Company in term of Section 2 of the Ordinance.
- The expression "investment" has also been explicitly explained by the section 208 stating that it shall include loans, advances, equity, by whatever name called, or any amount which is not in the nature of normal trade credit. The Company had not given any documents reflecting that any recovery proceedings were initiated against CPL thus the company has extended extra ordinary time for recovery of trade debts from its associated company, thus making the receivable an abnormal trade debt.
- In financial year 2014 out of total sales of Rs.332.942 million, sale of yarn to CPL was Rs.292.163 million and receivable from them was Rs.178.429 million. In financial year 2015 total sale of the company was only Rs.14.876 million as compared to receivable from CPL stood at Rs.143.872 million. This shows that despite the financial crunch and low activity undue benefit was given to CPL by providing abnormal trade credit to CPL due to which shareholders of the company suffered.
- Even if the events that led to inability of the associated company to pay the amounts due to the Company were beyond the control of the Company and its management, it was the responsibility of the directors and management of the Company to place the matter before the shareholders for their consideration and approval. They were also required to take immediate steps to recover the due amounts including the protective measures like obtaining security, mortgage of property or to go into litigation to recover the amounts outstanding. I have observed that respondents have taken steps for recovery of outstanding funds and reduced the balance of Trade Debts due from CPL to Rs.22.12 million as on June 30, 2016 but subsequent to the issue of SCN.
- The respondents during the hearing assured that they will recover the outstanding amount on immediate basis. Further, the historical data of the Trade Debts of the Company and the balance of trade debts from CPL have been analyzed for the past five years detail of which in is given below:

Head of Account	Balance as on June 30, 2016	Balance as on June 30, 2015	Balance as on June 30, 2014	Balance as on June 30, 2013	Balance as on June 30, 2012
Total Trade Debts	24.98	147.251	181.830	185.750	91.341
Trade Debts (CPL)	22.12	143.872	178.429	182.909	91.125
Percentage of Total	88.56%	97.71%	98.129%	98.471%	99.763%

- From above it is established that the trade credit provided to associated company was abnormal trade credit and fall under provisions of Section 208 of the Ordinance.
- The cases referred by the respondent are not relevant as each case was decided on its merits.

8. For the foregoing reasons, I am of the opinion that the provision of Section 208 of the Ordinance has been violated by the respondents. The matter relating to transactions with associated company involve inherent conflict of interest on the part of the directors of the Company, who being the common directors are the direct/indirect beneficiary of the benefits passed to the associated company. One of the form of preferential treatment is extending trade debts of longer period as compared to other customers of the company. Such directors, being vested with the powers by the shareholders, and due to being in management, are in a position to control the decisions conferring the benefits to the associated company. The law has been so designed to put appropriate safeguard against the misuse of such powers on the part of the interested directors by vesting the exercise of the powers granting such preferential treatment to associate in the hands of shareholders to be exercised in a general meeting. The need for such safeguard arise only due to the inherent sensitivity attached to the relationship of associates involved in a transaction where associated company can be benefited from the listed company on the cost of shareholders. The law therefore requires the directors not to decide upon the fate of such transaction where the associate might be the beneficiary but to take such decision to the shareholders. Through this the shareholders, being the provider of the capital, act in an informed manner over their stakes involved in the company and also oversee any conflict of interest on the end of interested directors. Further, compulsory/forced lending/transfer of funds/investment due to the default by the associated company in timely payment of trade debts also needs to be ratified from the shareholders. In case of persistent default, the responsibility to act in the benefit of the company is much higher on the part of the directors, as they can use their influence over the associate in much better way. Therefore, in my view, in the cases where there are common directors between the transacting parties, appropriate protocols should be put in to place to protect the interest of the shareholder and to limit common director's influence on a company's decision to enter into a transaction. It has been argued by the respondents that at the initial stage the transactions were in an ordinary course of business. However, I am of the view that as soon as the transaction which were though normal trade credit but has now become

abnormal trade credit, whatsoever be the reason, the matter must be placed before the shareholders for their approval.

9. However in view of the recovery of funds at the time of hearing and subsequent reduction of amount receivable from Rs.143.872 million as on June 30, 2015 to Rs.22.12 million as on June 30, 2016, I am inclined to take a lenient view of the default. I, hereby, warn the respondents to be careful in future and ensure meticulous compliance of law. I further direct the respondents under Section 473 of the Ordinance, that return as required under Section 208 of the Ordinance, be charged on abnormal trade credit allowed to CPL. The mark-up be calculated on outstanding balance from the time it became overdue till the date of its recovery and same be brought in to the books of accounts of the Company accordingly and recovered from CPL. Respondents shall also submit a confirmation of compliance of this directive to the Commission within 60 days of this Order.

Abid Hussain
Executive Director

Announced:
March 21, 2017
Islamabad