



SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN

[Islamabad]

Before Tahir Mahmood, Commissioner (Company Law Division)

In the matter of

Fazal Cloth Mills Limited

(Under Section 208 read with Section 476 of the Companies Ordinance, 1984)

Number and date of notices: EMD/233/119/2002
Dated March 12, 2010

Date of Final Hearing: July 12, 2010

Present on behalf of the Company: (i) Mr. Imtiaz Rashid Siddiqui,
Advocate Supreme Court
Imtiaz Siddiqui & Associates

Order

This order shall dispose of the proceedings initiated against the directors including the Chief Executive (the "respondents") of Fazal Cloth Mills Limited ("FCML") through show cause notice dated March 12, 2010 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 note 44.1 to the annual audited accounts (Transactions with related parties) of the FCML for the year ended on June 30, 2008 disclosed fund transfer of Rs.220 million. On enquiry FCML informed that Rs 200 million was transferred to Pak Arab Fertilizer Limited ("PAFL") as an advance against investment and Rs.20 million to Amir Fine Export (Private) Limited ("AFEL") for the purchase of yarn. Subsequently, an amount of Rs. 240 million was also transferred to PAFL during the year 2009 as disclosed in the accounts for the year ended June 30, 2009 as "Fund Transfer for Equity Shares". The record of FCML available with the Securities and Exchange Commission of Pakistan (the "Commission") revealed that the shareholders of FCML had passed following special resolution in Extraordinary General Meeting ("EOGM") held on December 20, 2006 for making equity investment in PAFL. The contents of the said resolution are reproduced below for ready reference.

NIC Building, 63 Jinnah Avenue, Islamabad.



SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN
Enforcement Department

Continuation Sheet - 2 -

“Resolved to make an equity investment of Rs 1,000 million (Rupees One Thousand Million Only) by acquiring ordinary shares, as recommended by the Board of Directors, in Pak Arab Fertilizers (Private) Limited, an associated undertaking of the Company. The investment will be made over the next three financial years starting from current financial year. The proposed investment of Rs 1,000 million shall comply with the requirements of section 208 of the Companies Ordinance, 1984.”

In view of the above, it was noted that the shareholders approval was only for making equity investment in PAFL and FCML was not authorized to extend advances to PAFL. Moreover, during the period when advances were extended to PAFL no offer for issuance of shares was made by PAFL. Therefore FCML by extending advance to PAFL violated the mandate given to them by shareholders through resolution passed in EOGM held on December 20, 2006. In case of AFEL it was noted that the advance of Rs.20 million extended to AFEL was not in the nature of normal trade credit and approval of shareholders for making such advance was not found on record.

3. Consequently, a show cause notice (“SCN”) dated March 12, 2010 was issued to the respondents to explain within 14 days as to why action under Section 208 of the Ordinance may not be taken. On request of respondents extension up to April 10, 2010 was granted for submission of reply to the SCN. The reply to the SCN was received on April 16, 2010, through M/s Imtiaz Siddiqui & Associates (“Authorized Representative”) appointed to plead the case on behalf of the respondents. The reply submitted by the Authorized Representative was not found satisfactory.

4. In order to provide an opportunity of personal hearing, the case was fixed on June 08, 2010. On the date of hearing, Mr. Asif-ur-Rehman appeared and requested for adjournment of the hearing. The hearing was adjourned and re-fixed for on July 12, 2010. On the date of hearing Mr. Imtiaz Rashid Siddiqui of M/s Imtiaz Siddiqui & Associates appeared before the undersigned on behalf of all the respondents.

5. Submissions made in writing and as well as verbal at the time of hearing by the Authorized Representative are summarized below:

Funds transfer to PAFL;

- a As per the mandate of SRO # 865 (I)/2000 dated 06.12.2000 issued by the Commission for the purpose of section 208 of the Ordinance, proper details of the proposed investment was disclosed as per statement under section 160 (1) (b) of the Ordinance.



SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN
Enforcement Department

Continuation Sheet - 3 -

- b It was in the stated perspective that the shareholders, on the stated basis passed the special resolution in the EOGM. In pursuance thereof, a sum of Rs 200 million was disbursed, to PAFL, on 16.04.2008; however, an immediate consensus on fair value of shares based on discounted cash flow valuation method was found lacking as well as unanimity could not be achieved viz calculation of purchase price of the stated shares of PAFL.
- c In addition, the projected cash flow of FCML which were to become the source of finance for the sanctioned investment, were not confidence inspiring. The Board of FCML, being conscious of volatile textile environment, decided to defer the investment for the moment.
- d Accordingly on request, PAFL returned the amount and also agreed to pay a mark-up of Rs 4.7 million. It may be stated that the aforesaid was duly disclosed in the annual accounts for the period ended 30.06.2008. It is also pertinent to mention that item no. 4, notified as special business in the 43rd Annual General Meeting of FCML, duly manifest the same. A disclosure to that effect was made in the statement under section 160 (1) (b) of the Ordinance.
- e In addition to the aforesaid, since the investment could not be made till the holding of the 44th AGM of FCML on October 31, 2009, thus a full disclosure thereof was again made as appearing at page-9 of the Annual Report 2009.
- f Indeed as will be seen from the above, it is duly substantiated from the record that the amount of Rs. 200 million was not extended as a loan nor there was any conduct of the Board of FCML whereby it could be asserted and or inferred that the shareholders mandate was violated.

Funds Transfer to AFEL;

- g As regard the transaction with AFEL the FCML submission dated 15.06.2009 categorically stated that the transaction with AFEL was an advance against purchase of yarn and that the same was in accordance with normal trade credit. A copy of contract executed between FCML and AFEL has also been forwarded. The said utilized amount viz purchase of yarn, was received up and mark-up was accordingly charged.
- h In the presence of the aforesaid documentary evidence as well as the record of FCML, there cannot be any basis to assert and or assume that the transaction is not a normal trade credit.
6. Before dilating upon the contentions raised in response to the SCN, I consider it appropriate to refer to the relevant requirements of law given as under:

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.

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.

7. I have analyzed the facts of the case, provisions of Sections 208 of the Ordinance, arguments put forth by the respondents in writing and explanation given during the hearing, I observed as under:

- (i) I do agree that the approval obtained from the shareholders was in compliance with Commission's notification SRO # 865 (I)/2000 dated 06.12.2000 and clause (b) of sub-section (1) of section 160 of the Ordinance. However, the said approval was only for making equity investment in PAFL.
- (ii) Since the approval of the shareholders was for equity investment only therefore FCML should transfer the funds only at the time of issuance of shares by PAFL. However, FCML advanced Rs. 200 million in April 2008 and received back at the close of the year i.e. June 30, 2008. Again FCML issued an amount of Rs 200 million on July 02, 2010. In view of the aforesaid FCML infact made short term investment in PAFL in the nature of advance for which authority of special resolution was not obtained from the shareholders in compliance with Section 208 of the Ordinance. Thus the advances made to PAFL were not in compliance with the provisions of Section 208 of the Ordinance and mandate given by the shareholders.
- (iii) Examination of minutes of relevant BOD meetings of the FCML has revealed that the BOD did not discuss this important issue of huge investment and FCML again transferred an amount of Rs 200 million to PAFL on July 02, 2008. The FCML infact making short term investment as disclosed in their reply dated August 03, 2010.
- (iv) As regards the argument that there has been no loss to the shareholders as FCML has received markup on loans and advances, it has been noted from the record that FCML accrued markup of Rs. 4,776,274, Rs. 32,975,222 on funds transferred in the year 2007-08 and 2008-09 respectively. However, no markup was charged on the amount of Rs 200 million and Rs 50 million issued on September 28, 2009 and December 15, 2009 respectively. This clearly depicts that FCML has provided benefit to PAFL by financing /transferring interest free funds of Rs.250 million as discussed above. Moreover, interest charged was also less than the cost of short term borrowing availed by the FCML Thus the shareholders of FCML have suffered loss on account of these advances.



SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN
Enforcement Department

Continuation Sheet - 5 -

- (v) In the absence of an offer of shares from PAFL the plea of FCML that the advances were issued for purchase of shares is not justifiable.
- (vi) It transpires that the advances extended by FCML to PAFL are in the nature of running finance or an ever green line of credit at lower interest rate. It can be substantiated from the consistent huge outstanding balances with PAFL.
- (vii) In order of equity investment/instrument Para 16 of IAS 32 specify the criteria and condition which in present scenario has not found complied with, which defines:

Quote

When an issuer applies the definitions in paragraph 11 to determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met:

- (a) *The instrument includes no contractual obligation:*
- (i) *to deliver cash or another financial asset to another entity; or*
- (ii) *to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.*
- (b) *If the instrument will or may be settled in the issuer's own equity instruments, it is:*
- (i) *a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or*
- (ii) *a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose the issuer's own equity instruments do not include instruments that have all the features and meet the conditions described in paragraphs 16A and 16B or paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the issuer's own equity instruments.*

Unquote

- (viii) As regards the advances issued to AFEL appearing in the accounts of FCML from July the review of the current accounts and copy of contract revealed that the amount was transferred for purchase of yarn, advance was received back and mark up was charged on amounts transferred on February 02, 2008, However, FCML failed to charge mark-up on Rs 2 million and 1.2 million transferred on December 12, 2006 and January 31, 2008 respectively. FCML had failed to provide a satisfactory response in the written submission and also at the time of the hearing. Neither have they provided supporting documentations to substantiate their contention that the advance was in the nature of normal trade credit.

8. As discussed above, it is evident that respondents have failed to comply with provisions of Section 208 of the Ordinance in respect of advance extended by the FCML to its associated companies. Due to transfer of funds / unauthorized advances, loss has been caused to FCML. The intent and purpose of the Section 208 is to protect against diversion of a company's funds to pass on undue benefits to associated companies or undertakings at the cost of the shareholders of such



SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN
Enforcement Department

Continuation Sheet - 6 -

company. Due to this reason authority of special resolution of shareholders of a company is mandated by the law for making any investments, loans, advances etc. to associated companies or undertakings.

9. The directors owe fiduciary duties to the company they serve and its shareholders. The fiduciary must treat all the shareholders whether sponsors or the general public, fairly. They must discharge their statutory obligations in good faith with fairness and honesty. In the instant case respondents have failed to exercise reasonable care to ensure compliance with the mandatory provisions of law and have not respected the mandate of the shareholders. Therefore the respondents have breached their fiduciary duties, which they owe to FCML and its shareholders. The respondents' infact have acted as financier by providing funds to associated concerns to fulfill their financial requirements at the cost of shareholders of FCML.

10. For the foregoing reasons, it is established that the respondents have violated the provisions of Section 208 of the Ordinance and are liable for the penalties as prescribed by Sub-section (3) of Section 208 of the Ordinance. However, keeping in view the compliance history of the Company, I am inclined to take a lenient view. I therefore, instead of imposing penalties, hereby strictly warn the directors of the Company to be careful in future. I hope that the directors would react positively to this lenient view and would ensure compliance with the requirements of law in future.

Tahir Mahmood
Commissioner (Company Law Division)

Announced
October 07, 2010
Islamabad