SAMVĀD: PARTNERS

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THE COMPANIES AMENDMENT BILL, 2016 – AN AMELIORATIVE MEASURE (OR, OTHERWISE?)

The Companies Amendment Bill, 2016 (the "**2016 Amendment Bill**"), introduced by the Ministry of Corporate Affairs ("**MCA**") in the Lok Sabha (the lower house of Parliament in India) on 16th March 2016 and pending before the said house , proposes to amend a number of provisions of the Companies Act, 2013 (the "**2013 Companies Act**") on the basis of the recommendations of the Companies Law Committee (the "**Committee**") contained in its report dated 1st February 2016 (the "**Report**"). On the basis of information available on the official website of the Rajya Sabha (the upper house of the Indian Parliament), it appears that the 2016 Amendment Bill was also introduced in the Rajya Sabha by a private member on 26th February 2016, which is pending before the said house.

The latest information available on the official website of the Lok Sabha states that the 2016 Amendment Bill has been referred to the Standing Committee of the Department of Finance headed by Mr. Veerappa Moily ("**Standing Committee**") and a Standing Committee meeting is proposed to be held on 25th May 2016 to discuss the 2016 Amendment Bill. It is hoped that the Standing Committee will enter into a detailed review of the proposed changes with a view to to amend the 2013 Companies Act, more in tune with the needs and the emerging requirements of Indian commerce, industry, regulators and all other stakeholders. This 2016 Amendment Bill appears to be an attempt at corrective action by the Government, considering the confusion that the phased introduction of the 2013 Companies Act has created in the market and industry due to the unreasonableness and impracticality of several of its provisions, in light of the complete overhaul of the Companies Act, 1956 (the "**1956 Act**").

The 2016 Amendment Bill proposes numerous changes; and, while the legislation is yet to complete its passage through Parliament (which may result in it being further modified before being adopted), we feel, however, the need to highlight and provide an overview analysis of the critical proposals or changes contained in the bill. These are, in our opinion, the proposals aimed at amending those sections dealing with the concept of 'Control'; private placement of securities; inter-corporate loans; and, inter-corporate investments. This Update covers these issues.

I. 'Control' & Its Inter-play with Types of Companies: Section 2(6) (*Definition of 'Associate Companies'*) read with Section 2(27) (*Definition of Control*).

a. Background

The 2013 Companies Act defines an "Associate Company" to mean – in relation to another company – one in which such other company has 'significant influence'. Further,

‘significant influence’ is defined to reference the *control* of a minimum 20% of the total share capital or business decisions of the other entity, under an agreement.

‘Control’ is defined under the 2013 Companies Act to include – (i) the right to appoint the majority of the directors of the other entity; or (ii) to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner. This definition was introduced in the 2013 Companies Act for the first time (the 1956 Act did not have any such definition). It is a definition that has, interestingly, been taken from the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (the “**Takeover Code**”) issued by the Securities and Exchange Board of India (“**SEBI**”). Furthermore, the concept of ‘persons acting in concert’ (or ‘PAC’) is peculiar to the Takeover Code and, to that extent and within that context, was thought not to justify a presence in the companies law. However, the intention behind the 2013 Companies Act in including such a definition of ‘Control’ in the companies statute was to align both sets of laws and regulations (in particular with the existing laws, including the Takeover Code), in order to avoid multiple interpretations and overlap.

b. Proposed Changes

It is proposed to widen the definition of ‘control’ as a parameter to determine ‘significant influence’ under the definition of ‘Associate Company’ – by extending the concept of ‘associate companies’ to cover even ‘control of *or participation*’ [emphasis added] in business decisions under an agreement. The 2016 Amendment Bill also seeks to replace the 20% threshold with that of ‘total voting power’ not just ‘total share capital’.

Finally, the proposed amendments seek to fill a lacuna in the 2013 Companies Act – that had provided that ‘associate companies’ include ‘joint venture’ companies, without defining what the term ‘joint venture’ meant. The 2016 Amendment Bill now seeks to insert a definition of ‘joint venture’ as meaning “joint arrangements whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement”.

c. Analysis

The inclusion of a broader definition of ‘control’ to cover even ‘participation in business decisions under an agreement’ in the definition of an ‘Associate Company’ will have a specific, notable consequence on ‘related party transactions’ under the 2013 Companies Act. A ‘related party’ includes an ‘Associate Company’ and the related party restrictions under Section 188 of the 2013 Companies Act would, as such, apply to entities which fall within the wide ambit of ‘control’ under the Act; and, hence subject to greater regulation of a relationship which, on balance, may not be regarded as a ‘related party’ one. It is felt that if the more subjective part of the definition of ‘control’ – namely, the control of the management or policy decisions of an entity – is itself too uncertain and capable of varying interpretations and the reaching of diametrically opposite conclusions in its application to specific factual instances; that is now proposed to be widened to include even ‘participation’, which is even more loose and capable of including business relationships that ought not to construe entities as “Associate Companies”.

The MCA has tried to imitate SEBI on the concept of 'control' while failing to adopt the essence and ambit of such concept which has been clarified by SEBI over a period of time in a number of precedents including the *Jet Etihad* matter, where SEBI held that only a right to nominate a board member without any affirmative voting rights and rights which are in the nature of minority protection rights, shall not constitute 'control'. The Committee, as evident in the Report, has deliberated this aspect; however the same has, unfortunately, not been carried out in the 2016 Amendment Bill.

Therefore, even an NBFC or similar lender with a board nominee or non-strategic institutional investors with protective rights may be considered to 'control' a company (in the way the definition of an "Associate Company" will pan out as proposed) and all such restrictions including those with respect to 'related party transactions' under Section 188 of the 2013 Companies Act would apply, which may not necessarily be the intention of the MCA, especially if it wishes to align with SEBI laws, which are far more advanced. In the light of the same, it would have been appropriate for MCA to create an exception with respect to minority protection rights in the definition of 'control'.

Finally, for the same reason, it remains to be seen how the proposed concept of 'joint control' in the proposed definition of "joint venture" pans out – joint ventures may not always have 'joint control' of their arrangements translating into such rights to the net assets of the venture, but could give one party (or the other) different controlling or majority rights, while saving minority protection rights as, ideally, being those beyond the pale of constituting such rights a "joint venture".

II. <u>Private Placement of Securities</u> – <u>Section 42</u>

a. <u>Background</u>

Section 42 deals with the 'private placement' of all kinds of securities by companies and requires the offer and acceptance to be made in certain forms and subject to the terms and conditions prescribed under the 2013 Companies Act and, in particular, Rule 14 of the Companies (Prospectus of Securities) Rules, 2014.

b. <u>Proposed Changes</u>

Although it is proposed to substitute Section 42 in its entirety, there are only certain noteworthy major or principal changes, as follows:

1. It is proposed to do away with private placement offer Form PAS-4.

2. A dual penalty clause for failure to file returns of allotment, is proposed to be introduced – (i) A general penalty clause for accepting monies in contravention of Section 42, imposing a penalty of the lower of the total amount raised via such private placement or INR 2 Crores; and (ii) specific penalty of INR 1,000/- for each day during which the default continues up to a maximum of INR 25 Lakhs. Liability in both instances is sought to be imposed on the Company, the promoters and the directors.

3. A dual penalty clause for private placement offer made to more than 200 persons, is sought to be introduced. Proposed Section 42(11) states that notwithstanding the penalties (as in # 2 above), a private placement offer to more than 200 persons shall be deemed to be a public offer.

4. Inclusion of "*issue of securities*" sought in the definition of 'Private Placement'.

5. Currently, Section 42 is subject to the provisions of Section 26 of the 2013 Companies Act, which deals with prospectuses to be issued in case of a public offer; that will no longer be expressly the case going forward, if the proposed changes are adopted.

c. Analysis

The removal of the requirement of Form PAS-4 is a positive step in the light of the same being a very cumbersome procedure.

The dual penalty clause for failure to file returns of allotment, as indicated above, is a cause for concern as the reason for introduction of a separate penalty clause for return of allotment is unclear. If the intention was to limit the penalty for return of allotment, in view of the same being a less critical offence, then such an exception should have been reflected in the general penalty clause.

The dual penalty clause for 'deemed public offers' attempts to punish both the defaulter for issuing securities to more than 200 person by imposition of penalty; as well as requiring such persons to comply with the public offer requirements under the 2013 Companies Act. This indicates that the MCA has taken a serious note of the occurrence of such offences, considering the penalty in such a case would be a minimum of INR 2 Crores, at any given point; and, where a return of allotment default occurs, the applicable additional penalty shall also apply.

It is unclear why "*issue of securities*" has been included in the definition of 'Private Placement' considering, in any case the process would involve an offer and acceptance in the prescribed forms.

As Section 42 and Section 26 are independent sections dealing with different kinds of offers, such a provision stipulating that the latter was subject to the former was redundant and the same is been done away with in the 2016 Amendment Bill, which is welcome.

III. Loans etc. to Directors etc. – Section 185

a. Background

This provision has come to be regarded as one of the most draconian sections introduced in the 2013 Companies Act. Section 185, read with the allied rules, imposes (amongst others), a restriction on the grant of a loan from a holding company to its subsidiary company, except in the following cases –

(a) Where the subsidiary is a wholly-owned subsidiary and the loan is used for its (i.e., the wholly-owned subsidiary's) principal business activities.

(b) In case of a private limited company (subject to certain conditions), including the stipulation that no body corporate shall have invested in the share capital of such company in order to avail the exemption from Section 185. Therefore, a private company with any foreign investment could not avail this benefit, which did not help the situation. We draw reference to Notification No. GSR 464 (E) dated June 05, 2015 ("**Exemption Notification**"), in this regard.

b. Proposed Changes

The 2016 Amendment Bill proposes to prohibit grant of loans to – (A) a director of the lending company, director of its holding company and the partner or relative of such directors; (B) firms in which such director or relative is a partner.

All other restrictions have been eased, subject to passing of a special resolution and utilization of such loans only for principal business activities by the subsidiaries.

The 2016 Amendment Bill proposes to delete the 'savings' provision at the beginning of Section 185 – the provision that states Section 185 will apply unless, or save as, otherwise provided elsewhere in the statute.

c. Analysis

A holding company would therefore, irrespective of being a public or private company and without conditions imposed on the nature of its shareholding, be able to grant loans to its subsidiaries subject to the passing of a special resolution and the subsidiary utilizing such amount for its principal business activities. This may be a cause for concern because if the end-use of the loan is still restricted to the 'principal business activities', it appears that, in case of loans required by the subsidiaries for purpose other than for its 'principal business activities', holding companies may have to continue the current practice of amending its objects in its memorandum of association to include 'grant of loans to subsidiaries', in order to have such loans granted in the 'ordinary course of business' – and, as such, claim an exemption under sub-section (3) (b) of the proposed to be amended Section 185, which exempts companies providing loans/ guarantees / securities in the ordinary course of business, provided the specified rate of interest is charged. But again, if the MCA intended to permit such an exception, it would have been reflected in the proposed amendments as contained in the 2016 Amendment Bill. But, that is not so and, therefore, this practice of amending the objects clause may prove to be risky.

It is pertinent to note that the Exemption Notification must be amended to reflect the above relaxations under the (proposed to be amended) Section 185 – in that, confusion should not be caused that public companies under the (proposed to be amended) Section 185 enjoy more liberty than private companies under the Exemption Notification.

The 'savings' provision, in any case was redundant, since any saving would make the very purpose of Section 185 redundant. Further, it would also be interesting to note that since loans to previously restricted parties (including subsidiaries) would now be permitted, subject to conditions, the deletion of the 'savings' provision would be necessary for the conditions under

Section 185 to apply, considering that inter-corporate loans are also permitted under Section 186 of the 2013 Companies Act, which is more liberal than Section 185.

IV. Inter-corporate investments – Section 186

a. Background

Section 186 of the 2013 Companies Act deals with loans and investments by a company subject to certain conditions and thresholds where (subject to conditions contained therein) – (i) companies are not permitted to make investments beyond two layers of investment companies; and (ii) no loan/ security/ guarantee/ acquisition may be made exceeding 60% of (paid-up share capital + free reserves + securities premium account) or 100% (free reserves + securities premium account), whichever is higher.

There have been overlaps between Section 185 and Section 186 in respect of inter-corporate loans (including security or guarantee) especially in the context of a holding company granting loans to its subsidiary. This is because Section 186 exempts holding companies from compliance with the thresholds with respect to loans granted to its subsidiaries. The provisions of Section 186 were initially proving to be redundant, since Section 185 had prohibited loans to subsidiaries. However, with the rules and the Exemption Notification coming into effect, loans to subsidiaries in certain cases (as elucidated above) were permitted.

b. Proposed Changes

1. The restriction on investments up to two layers of investment companies, is sought to be deleted.

2. The thresholds on the grant of loans / security/ guarantee/ acquisition would now (it is proposed) apply not just to the value of such transactions, but to the sum of the value of such existing transactions and any proposed new transaction involving these aspects.

3. Inclusion of "investment made" by a banking company/ insurance company/housing finance company/ companies "established with the object of and engaged in the business of financing industrial enterprises or infrastructural activities under the exemption provided under Section 186 (11) of the 2013 Companies Act.

4. Proposed extension of the exemption under Section 186(11) to companies "established with the object of and engaged in the business of financing industrial enterprises".

5. Proposed extension of the exemption under Section 186(11) to any investment made by an investment company.

6. Proposed modification of the definition of "Investment Company" under the explanation to the section to include a deeming provision that: (i) where a company's assets in the forms of investments in shares, debentures or other securities constitute not less than 50% of its total assets; or (ii) if its income derived from investment business constitutes not less than 50% as a proportion to gross income; such company shall be deemed to be

principally engaged in the business of acquisition of shares, debentures or other securities.

c. Analysis

The proposed deletion of the restriction on investments up to two layers of investment companies, would prove positive especially for structures involving project companies and investment companies in its layers, considering in such scenarios, it would be difficult to restrict the structure to two layers.

A calculation based on the proposed revised threshold limits in # 2 above would be restrictive. For instance, where a company may enjoy liberty to provide loans to subsidiaries (subject to certain conditions) under Section 185 but now in view of bringing down the threshold limits under Section 186, such entities would have to apply the applicable interest rates as mandated under Section 186, upon crossing the stipulated thresholds.

The proposal in # 3 above appears to have been included with the intention to bring within its ambit equity-linked debt (upon conversion to equity), considering these days debt with an option to convert to equity, has become more popular than ever. This of course, also includes other investments made by such companies and not just equity-linked debt.

The exemption in # 4 above is applicable to companies engaged in the business of "financing of companies" which is defined under the rules to include – in relation to an NBFC registered with SEBI – one engaged in the business of providing loans/ guarantee/ security for due repayment of any loan availed in the ordinary course of business. Therefore, with the proposed amendment, the exemption shall not extend to the aforementioned companies, but only to companies established with the object of, and engaged in, the business of financing *industrial enterprises*. Further, please note that the company has to be 'established' with the object of engaging in such business. It appears that no amendment to the company's memorandum of association would suffice, in order to avail this exemption.

Under the proposed provision in # 5 above, companies in the business of acquisition of securities shall be exempt from the Section 186. However, with the proposed amendment, the exemption extends to an 'investment company', which would have been a positive move, had the MCA not restricted the definition of 'investment company' as elucidated below.

The definition of 'investment company', as in the proposed amendment, would be similar to that of the determination of financial activity as the 'principal business' for the purpose of NBFCs. This proposed amendment in the law may cause concern since the determination would be more restrictive and the same cannot be dealt with purely by an amendment to the company's memorandum of association, which has been the usual practice for determination of the business of the company.

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As with most legislative changes in this country, ameliorative measures appear to come in fits-and-starts. Consequently, it is not surprising that while the 2016 Amendment Bill

addresses and rectifies many operational anomalies as well as procedural bottle-necks, many of the concerns expressed about the structure of the 2013 Companies Act being flawed in theory as well as in actual application, remain unaddressed despite the Committee's Report highlighting many of these aspects. Having said that, still, the 2016 Amendment Bill may be welcomed as a positive move, but with the hope that many more such corrective measures follow quickly enough if the Government's avowed objective of ensuring that the ease of doing business in India is translated into a concrete reality soon.

This is an update for general information purposes only and does not constitute legal advice. Should you have any queries please write to us at infosamvad@samvadpartners.com.