Mergers and acquisitions in the new era of Companies Act, 2013

February 2014
Foreword

The new Companies Act, 2013 has sought to streamline and make M&A more smooth and transparent. It appears that the New Act can help to deal with the challenges and complexities that the current procedures faces in relation to procedures that were contemplated under the old Act. The New Act has incorporated various provisions to tackles the problems actually faced during the process of mergers, by taking into consideration the practical aspects of the process. The newly added provisions have made it easier for companies to implement ‘Schemes of Arrangement’ (Mergers & Acquisitions, de-merger, corporate debt restructuring etc) and at the same time impose checks & balances to prevent abuse of these provisions.

It is an attempt to fine tune the process by making it more efficient and in-tune effective. The new law allows an Indian company to merge with a foreign company, making cross-border mergers and acquisitions easier. The new law also disallows reverse merger of a listed company with that of an unlisted one. The New Act no doubt has some ambiguities attached to it, which would need to be sorted out in order to reduce any complexity in the process. It would need to reduce reliance on rules to be specified later and also ameliorate provisions that contrive other legislations.

Against this backdrop, ASSOCHAM is actively involved in showcasing related programmes to bring updated knowledge and policy guidelines for the industry and all stakeholders. ASSOCHAM, jointly with Ernst & Young LLP is bringing out this compilation for the benefit of participants and practitioners.

I wish all the best and success for the conference and assure that such knowledge based events shall continue to be held for the benefit of all segments of the industry and commerce.

D.S. Rawat
Secretary General
ASSOCHAM
Being the Chairman of M&A Council of the Associated Chambers of Commerce & Industry of India (ASSOCHAM), I am delighted to organize the National Conference on “New Mergers & Acquisitions Era under the Companies Act, 2013”.

There are pragmatic reforms for Merger and Acquisitions under Companies Act, 2013, which could make merger, acquisitions and restructuring easier for companies. Introduction of novel concepts fast track merger for Small Companies and Holding and its wholly owned subsidiary Companies, Cross Border merger (removing the restriction on only transferee company being Indian company) under this Act are expected to increase internal restructuring and Cross Border restructuring. Further exit opportunity to the dissenting shareholders is expected to reduce litigation & frivolous complaint and representation of Income Tax Department, Sectoral Regulators would safeguard their interest, though at the cost of prolonged process.

This is the first significant change to merger and amalgamations regime in the last six decades, with the previous Companies Act having been in place since 1956. The Ministry of Corporate Affairs has also prepare roadmap for Companies Act, 2013 and in this direction in its recent circular given chance to Income Tax Department and other Sectoral Regulators to make their representation on Merger and Amalgamation in line with the provision of Companies Act, 2013.

I hope this National Conference gives rich insight and adequate knowledge to all the interested stakeholders. We shall be happy to receive comments /suggestions of the readers for making our future endeavors better.

With warm wishes

Pavan Kumar Vijay
Chairman, M & A Council
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Managing Director
Corporate Professionals
Corporate law has undergone a radical change with the introduction of the Companies’ Act, 2013 in India during this era of major economic overturns. Pursuant to receiving the final nod from the President in August 2013, the enactment of the Companies’ Act, 2013 has been a significant step in the path of adapting with laws suitable for our times. The provisions enacted in the new legislation bring India at par with its global peers from a corporate law perspective on several fronts.

A bright spot in the history of India’s legislative initiatives, the new Act aims to improve transparency and accountability in India’s corporate sector. It retains the fundamental provisions of the earlier Act while incorporating stronger and progressive new provisions.

In the recent past, India’s economy has outperformed the West on its growth and attracted large inflows of foreign funds. Economists predict that the West will soon begin heading northwards. In this environment, Indian investors will get significant exposure to global economies. Furthermore, with opening up of international opportunities, companies can look at scenarios where strategic alliances take simpler routes, and global consolidation and fund-raising are required. Global integration and cross-border mergers are now permitted, which is an excellent change from the earlier environment in which only foreign companies were welcomed in India. The challenges faced by many corporate organizations in listing their businesses abroad if their entire business value is housed in India will now be reduced due to cross-border mergers, which will enable them to set up overseas listing vehicles.

The introduction of Class Action Suits, the concept of arms’ length pricing in related party transactions, the focus on Corporate Social Responsibility, recognition of inter-se shareholder rights, opening of doors to outbound mergers, fast-track mergers, an increased focus on governance and protection of minority shareholders are important initiatives for organizations to move toward global best practices. This paper elaborates on the key provisions of the corporate law affecting mergers and acquisitions.

The new Act prescribes rules for implementation of its provisions. However, the Rules are at the draft stage at present. It is hoped their implementation will help Indian corporate laws achieve parity with international ones and smoothen the transition from the Companies Act, 1956 to the Companies Act, 2013. It will also help organizations gauge whether Indian corporate laws are focusing northwards.

I wish to acknowledge the contribution made by my EY tax colleagues and their untiring efforts in preparing an extensive in-depth comprehensive study on this subject.

We hope this booklet will provide relevant insights and adequate knowledge to all stakeholders in the M&A arena and we wish the conference great success.

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Companies Act 2013: M&A landscape
The Companies Act, 1956 had almost reached its retirement age after having been in existence for more than five-and-a-half decades. It was essential that robust and young corporate laws were introduced in the system. This journey began in 2008, when the Companies Bill, 2008 was first introduced in the Lok Sabha. However, it hit a road-block on its introduction in August 2008 and had to be withdrawn due to dissolution of the Lok Sabha. The Bill was re-introduced in Parliament in 2009 and was subsequently sent to the Standing Finance Committee. After considerable deliberation with stakeholders, the Committee presented its report to the Lok Sabha in August 2010. Taking into consideration the recommendations of the report, a revised version of the Bill was again referred to the Committee in 2011 with the inclusion of certain new provisions.

The Bill was passed by both the houses of Parliament between December 2012 and August 2013. The President signed on the dotted line on 29 August 2013, providing his much awaited consent to the 29 chapters, 470 clauses and 7 schedules comprising the Companies’ Act, 2013. This marked a landmark event in the history of Indian corporate law.

The Ministry of Corporate Affairs has opted for phased transition from the Companies Act, 1956 to the new legislation. As on date, 98 sections of the new Act have been enacted. Provisions relating to these sections replace erstwhile legislation, while those of the Companies Act, 1956 are still in effect for the non-notified sections. However, it is pertinent to note that implementation of a significant portion of the provisions of the new Act will depend on its prescribed rules, which are yet to be formalized. We expect these to be finalized in the next few months.

The much needed new Act will make acquisitions, certain mergers and restructuring easier for companies, empower private equity investors to enforce various restrictions in agreements and check the malpractices of promoters by increasing transparency in their operations. The Act also has the potential to trigger a spate of domestic and cross-border mergers and acquisitions, and make Indian organizations more attractive to investors.

Keeping all this in perspective, we seek to provide a “sneak peek” into the key provisions of the Companies Act, 2013, which could have a bearing on mergers and acquisitions.

The new Act proposes that the National Company Law Tribunal (NCLT) will assume the jurisdiction of High Courts in context of restructuring schemes. We need to wait and watch how this transpires in coming days. However, a commendable step in the direction of simplifying courts' approved merger / amalgamation/compromise processes include relaxation of mandates in the case of mergers of small enterprises, holding companies and their wholly owned subsidiaries, etc., where the approval of NCLT will not be required. This liberalization will ease the burden of regulatory authorities and do away with lengthy implementation timelines, especially in these times when a strengthened focus on business is the key.

The minimum thresholds of 10% and 5% for shareholders and creditors objections, respectively, are expected to eliminate the frivolous objections of small shareholders who oppose deals under the guise of shareholder activism. Meetings of creditors may be dispensed with if 90% of creditors (in value) give their consent to this. This amendment is welcome in view of courts being inconsistent on the matter of dispensation of meetings for creditors. However, the need for affidavits may become onerous.

While SEBI has introduced provisions to regulate the accounting treatment for listed companies, the new Act also brings the accounting treatment of unlisted ones under the radar of the regulatory authorities. The NCLT cannot sanction a scheme unless a certificate from the auditor is submitted, stating that the accounting treatment is correct. In this scenario, there ought to be reduced accounting flexibility in the case of unlisted companies, pursuant to a scheme of arrangement. This requirement for an auditor’s certificate is also extended to the capital-reduction process.

Similarly, while SEBI has introduced the concept of e-voting for listed companies as a part of its modernization process, the Companies Act, 2013 has extended this to unlisted companies as well. This is expected to increase the participation of shareholders and creditors in arrangements, and thereby protect the rights of all stakeholders.

The law also provides that notice of every scheme should be sent to various interested regulatory authorities such as the RBI, the CCI and the Income Tax department, requesting their representation. This would have an impact on timelines and could increase attention paid and scrutiny by the authorities. The new provisions also require that a copy of the valuation report is annexed to the notice sent to shareholders and creditors for meetings. Thereby, the Companies Act, 2013 aims to protect shareholders’ rights and enable increased scrutiny of schemes by the concerned regulators. It also aims to increase transparency and reduce the scope for unconventional practices, particularly where valuation and accounting considerations are involved.

The merger of a listed company into an unlisted one will allow the latter to remain unlisted, as long as the shareholders of the merging listed company are offered an exit opportunity. Whether such an option could be explored as an alternative to or in addition to the Delisting Guidelines is a matter that needs to
be appropriately addressed. Payment of the value of shares and other benefits needs to be in accordance with pre-determined price formulae or according to their prescribed valuation. This can be a welcome step if other regulations are aligned with it.

Pooling of assets under a single company in any jurisdiction is achievable. Global integration and cross-border mergers are now permitted – the older law only welcomed foreign companies into India. However, a foreign company must be based in a notified jurisdiction. This makes it possible for an Indian company to restructure its shareholdings and migrate its ownership to an international holding structure, and thereby increase its access to foreign markets. However, the extent to which this provision will be beneficial will depend on which jurisdictions are notified for cross-border mergers under the Act. Furthermore, other regulations such as the Foreign Exchange Management Act and the Income Tax Act will need to be in tune with this provision to make it practically feasible.

Currently, companies are not prohibited from holding treasury stock. Companies are utilizing such treasury stock to control their voting rights and manage their cash flows due to this relaxation. On account of a merger or compromise under the new legislation, no company can hold shares in the names of trusts, either on its own behalf or of its subsidiaries. The new legislation may have been introduced to negate the advantage available to a company to indirectly hold shares to provide it access to voting power and/or liquidity. This is in sync with the motive of the new legislation to enable increased transparency and accountability in the corporate sector, but could be “hit” in genuine cases of acquisition, followed by mergers, due to writing off of goodwill on account of the “Pooling of Interest” method of accounting required to be followed in such cases.

Investors will now be better empowered to enforce agreed on rights on specific matters by the inclusion of entrenchment provisions in Articles of Association. Furthermore, the law provides for a cooling off period of one year between two buy-backs for a company. A provision, which would find favor with most shareholders, would be dispensation of the requirement of mandatory transfer of profits to reserves before declaring dividends. The higher the dividend pay-out, the happier the investors! Similarly, granting of general voting rights to preference shareholders, where a company has defaulted in its pay-out of dividends for more than two years, would garner strong support.

Private companies in India could issue shares with differential voting rights without any restrictions under erstwhile corporate laws. However, the Companies Act, 2013 prescribes certain conditions such as the past track record and size of the issue of private companies to issue shares with differential voting rights. While the corresponding section is currently not notified, it may be interesting to evaluate the validity and enforceability of the differential rights attached to shares issued under erstwhile corporate law, since they were not subject to any restrictions.

The sale or transfer of the whole of an undertaking or substantially most of it by a company now requires a Special Resolution, as opposed to an ordinary one under erstwhile laws. Furthermore, the terms “undertaking” and “substantially whole of the undertaking” have now been specifically defined in the new Act, thereby eliminating the ambiguity currently existent in the laws. The requirement for a special resolution on sale or transfer of an undertaking now extends to private companies. This once again underlines the motive for strong corporate governance brought out by the new Act.

A cooling off period of one year between two buy-backs has been prescribed, even in the case of shareholder-approved buybacks, limiting the number of buy-backs for a company. Repatriation of cash through a buy-back may not always be the optimal solution with the amendment mentioned above, coupled with the introduction of Buy-back Tax in Income-tax laws. Such an amendment could significantly affect the plans of MNCs looking to repatriate cash. Furthermore, now, even a buy-back under a scheme of arrangement will need to be compliant with conditions prescribed under core provisions. This will curb the loophole exploited by companies under the current law.

Multi-layered companies have become a matter of concern for regulators and investors. Certain scams were eye-openers, in which a web of companies comprised the investment vehicles that made the task of identifying the beneficiaries difficult for law enforcement agencies. The new Act restricts investments through more than two layers of investment companies, with resolutions. Shareholders holding more than 90% of the equity shares of companies are to notify their intention of buying the remaining equity shares of minority shareholders. The Act also provides for timeline- and valuation-related requirements for purchase of shares from minority shareholders.
certain exceptions such as in the case of outbound acquisitions in which the targets have subsidiaries beyond two layers or where there are more than two investment companies to meet statutory requirements. The restrictions of multi-layered structures (purely for investment purposes) may pose an additional hurdle for corporate and investee companies while raising funds, and they may have to revisit their funding strategies. The new provisions will bring in transparency in shareholding and funding structures. However, genuine corporate structures and business transactions will also be covered by them, and this may curb the ability of companies to organize their operations efficiently. Currently, it is also unclear whether past transactions will need to be restructured to comply with the new legislations.

The Act brings into perspective other issues such as insider trading, which has now been put down in black and white, as compared to its absence in erstwhile corporate laws. Although SEBI’s rules currently have provisions for insider trading, these only relate to listed companies. The introduction of provisions relating to insider trading is a huge step in the right direction in protecting shareholders’ interest. However, at the same time, there is a need to analyze how this will affect sharing of non-public price-sensitive information by the management of unlisted investee companies with potential investors during their due diligence processes.

In line with its theme of fairness in thought and conduct, the new Act requires any preferential allotment of capital being made by a company to be fairly valued by a registered valuer. This will ensure that existing shareholders are not diluted on a non-fair basis.

In the Act’s effort to give an increased impetus to corporate governance, restrictions relating to inter-corporate loans/investments/guarantees are now also imposed on private companies and holding subsidiary relationships. Such provisions may create operational hindrances in genuine business cases.

Additionally, related party transactions now need to be undertaken at arms’ length by companies. Related parties and related party transactions have been specifically defined in the new regulations. In the event a related party transaction is not at arms’ length and exceeds the specified amount, the company requires the consent of its board of directors and shareholders to undertake such a transaction. However, irrespective of its arms’ length price, a director’s report of a company has to disclose each related party transaction and the justification for entering these. Such provisions largely function as a watchdog in relation to excessive related party payments made by organizations and related party transactions that may hinder the progress of these companies.

The Companies Act, 2013 introduces the concept of class action suits in India. While there is a threshold on the minimum number of shareholders or depositors required to initiate such class action suits, this initiative will enable stakeholders to seek compensation, not only from a company but also its directors, auditors and expert advisors for any unlawful or wrong conduct. This concept has international following and has now made its presence felt in India. However, its effectiveness will depend on the manner in which it is implemented.

The Companies Act, 2013 brings about another radical change in the definition of “subsidiary.” In erstwhile corporate law, a holding-subsidiary relationship was established between two companies on the basis of an enterprise’s equity holding in its subsidiary. According to the new laws, a holding company and its subsidiary’s relationship is dependent on the former exercising control over half of the total share capital, which includes shares other than equity shares. Given this scenario, the ambit of companies being considered as subsidiaries will be significantly affected due to which additional compliance may be required. Furthermore, structuring of investments vide usage of preference shares also needs to be re-evaluated, keeping in perspective the amendments mentioned above.

Furthermore, provisions of the Bill, such as the minimum requirement of Independent Directors and for rotation of auditors is a fast march toward an investor-friendly India.

The Companies Act, 2013 seems to be opening up new and simple avenues for mergers, acquisitions and restructuring operations in India. It is expected that the new legislation will reduce shareholders’ litigation and propagate their rights. It endeavors to make restructuring a smooth and transparent procedure. While it has been a long wait, the law has taken steps forward to give a new dimension to corporate restructuring. The Act seeks an alignment with other laws such as Income Tax and exchange control provisions to facilitate its efficient implementation. The Rules, which are yet to be finalized, will also play a crucial rule in this.

We aim to provide you a quick glimpse into key M&A provisions of the new Companies Act, 2013. Many of its key provisions are elaborated on in the following chapters, to provide you with an in-depth understanding on the new rules of the game.
Chapter 2

Companies Act 2013: impact on transactions
Introduction

The Companies Act, 2013 (2013 Act) has seen the light of day and replaced the 1956 Act with some sweeping changes including those in relation to mergers and acquisitions (M&A). The new Act has been lauded by corporate organizations and lawyers for its business-friendly corporate regulations, enhanced disclosure norms and providing protection to investors and minorities, among other factors, thereby making M&A smooth and efficient. Its recognition of inter-se shareholder rights takes the law one step forward to an investor-friendly regime. While the 2013 Act is appreciated by many, it poses some practical difficulties for companies in structuring their transactions.

This article focuses on some of the sections (notified or not notified), which may have an impact on how M&A transactions are undertaken and structured in India.

Restriction on multi-layered structures (not notified)

In the 1956 Act, there are no provisions regarding restrictions on multi layered structures. Accordingly, several multi-layered structures have been set up for holding investments in operating entities to suit business or commercial needs.

However, the 2013 Act has imposed a restriction of two layers for investment companies. “Investment companies” have been defined as enterprises whose principal business is acquisition of shares, stocks, debentures or other securities.

Diagrammatic representation of the provision

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Existing
Promoter Hold Co
  ↓
Group Hold Co
  ↓
Investment No 1
  ↓
Investment No 2
  ↓
Target Co

New
Promoter Hold Co
  ↓
Group Hold Co
  ↓
Investment No 1
  ↓
Investment No 2
  ↓
Target Co
```

The requirement mentioned above does not affect the following:

- A company from acquiring another enterprise that is incorporated outside India if it has investment subsidiaries beyond two layers according to the law of the particular country
- A subsidiary company with investment subsidiaries for meeting statutory requirements

The rationale behind this change could be to limit diversion of funds and possible tax avoidance through the webs of complex corporate structures. However, this change could have an impact on structuring downstream foreign investments through holding companies in India. Furthermore, the requirement for demonstration of the operations of subsidiaries leads to operation- and compliance-related costs.

Furthermore, there is no guidance in the 2013 Act on determination of the principal business of an investment company in defining it. This has been the subject of debate under the legal regime of non-banking financial companies governed by the RBI. In the absence of any statutory clarity in this regard, deal structures will need to be looked into carefully to ensure their compliance with this restriction. Private equity investors prefer to invest in holding companies to realize increased returns from the entire group through a single investment rather than multiple investments in subsidiaries. This reduces flexibility in structuring investments, and particularly affects sectors such as infrastructure and mining, where it is common to have multiple subsidiaries to implement projects and raise funds. There is no clarity on whether existing structures will be required to comply with the new regime.

For this provision not to become a deterrent for M&A, the regulator should consider allowing exceptions for genuine multi-layered corporate structures.

Evolution of concept of “control” (notified)

The 2013 Act defines the term control as under:

Control ' shall include the right to appoint the majority of directors or 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.
The definition in the 2013 Act is broader and seeks to suggest that a company may control another organization through other mechanisms as well, e.g., management rights or voting agreements. The definition of control is closely linked with that of promoter and provides that a person with control over the affairs of a company is regarded as its promoter.

The definition of control under the 2013 Act is similar to its definition under the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (SEBI TOC) and Foreign Direct Investment policy such that the essential elements among various laws are now aligned. The definition of control and the jurisprudence surrounding this under the SEBI TOC has been developed to protect minority shareholders and provide an exit to them in the event of change of control.

In light of the similarity in the definition of control under the SEBI TOC and the 2013 Act, the jurisprudence of control under the former is likely to be applied under the new Act. However, the scope of the term control under the SEBI TOC is not clear in itself. While the Securities Appellate Tribunal (SAT) had decided that affirmative voting rights granted to investors would not amount to control due to out of court settlements between the parties, the Supreme Court has left the question open in its Subhkam Ventures ruling by stating that the SAT’s order will not have any precedent value, since Subhkam Ventures did not appoint its Director on the board and exited most of its investments.

Deal-making with respect to unlisted companies is likely to be affected, especially with regard to negotiation of shareholders' agreements, due to the prevailing uncertainty around what constitutes control. Affirmative voting rights under a shareholder's agreement can be an effective tool for safeguarding investments or investors' interests. Such rights are negotiated and decided on in shareholders' agreements, which are subsequently incorporated into the articles of association of target companies. Accordingly, investors who have secured certain rights, which provide them a degree of control over “management or policy decisions,” either by way of their representation on boards or their veto rights, may be regarded as having control of such companies, and can be classified as promoters, and the Indian companies would become their subsidiaries for all disclosure purposes.

Careful consideration should be given to obligations and liabilities associated with the position of a promoter and holding company (i.e., a related party) under the 2013 Act when negotiating rights and powers in a company by investors under the shareholders' agreement.

**Recognition of “entrenchment” (not notified)**

Another new development in the 2013 Act is its recognition of entrenchment provisions in the articles of association of a company. The purpose of shareholder agreements is to secure certain rights for shareholders, which have not otherwise been made available to them under the law. For example, an investor holding 20% shares in a company may want a say in an alteration of an investee's articles, which affect its rights in the company. However, the consent of the investor may not be required since the law only mandates a special resolution (three-fourth majority of shareholders present and voting) for any alteration made in the articles to be approved. In such a situation, the shareholder agreement may mandate an affirmative vote of all shareholders for any such alteration to be approved. While inclusion of such rights has been the norm in most shareholder agreements, under the 1956 Act, there are no specific provisions for their entrenchment in the articles of association of a company, and accordingly, there is ambiguity around the enforceability of agreements between two or more persons as regards the share transfers of a public company.

Once clause 5(3) of the 2013 Act is notified, the articles of a company may have provisions for entrenchment such that certain specified provisions of the articles may be altered, although only on the satisfaction of conditions or procedures that may be more restrictive than those applicable in the case of a special resolution.

The introduction of entrenchment provisions paves the way for the use of structures with adequate protection for diverse groups. Although they can contractually obtain these rights, incorporating these in their articles of association will make these more binding.

**Acceptability of contractual rights (notified)**

It is common practice for transacting shareholders to enter arrangements involving “put and call” options and other pre-emption rights including ROFR, tag along /draft along, etc. While transfer restrictions are enforceable in the case of private companies, their enforceability in relation to the shares of a public company has not been established conclusively.

Historically, this practice has been subject to scrutiny, since such arrangements involving listed and unlisted public companies were restricted under the Securities Contract Regulation Act, 1956 (SCRA). The 1956 Act provided that the shares and any interest in it of a public company are freely transferable, and therefore, any restrictions on
the transferability of shares cannot be enforced against it. Conflicting judgements prevail, leading to further ambiguity.

Clause 58(2) of 2013 Act seems to provide a respite to such commercial practices and prescribes that a contract or arrangement between two or more persons in respect of transfer of securities will be enforceable as a contract.

Furthermore, SEBI and the RBI have issued separate notifications permitting put and call options on shares, CCDs, etc., subject to fulfilment of certain conditions.

The amendments mentioned above settle this issue, and thereby provide legal sanctity or validity of the restrictive rights of the parties in relation to transfer of securities of a company.

Change in treatment to private companies and its impact on M&A

Since the overarching theme of the 2013 Act seems to be protection of minorities, it has resulted in curbing the flexibilities available to private companies under the 1956 Act. Various provisions introduced in the statute effectively nullify the advantages of incorporating a private company over a public one. Some of these may impact M&A.

Private placement (not notified)

Under the 1956 Act, preferential allotment conditions were applicable to public or private companies, which were subsidiaries of public organizations. Under the 2013 Act, these conditions are also extended to private companies. A special resolution is required for any preferential allotment of shares, with the pricing being determined by a registered valuer. In addition to the above, cumbersome requirements (including issuance of a private placement offer letter and filings with the registrar of companies) will have to be adhered to by private companies, even in the case of standalone placements that constitute an offer or invitation to offer.

Given that most private companies are closely held, it should be possible to ensure their uninterrupted operations, except for the compliance-related requirements that need to be factored in their transaction timelines.

Differential voting rights (DVR) (not notified)

The 1956 Act permitted a private company to issue shares of various classes, each of which could have different rights in terms of dividend, voting or any other special rights, without needing to satisfy any stipulated conditions, since DVR rules did not apply to a private company.

As the law stands today, the 2013 Act provides that private companies will also have to comply with the rules to be framed by the Government in this regard in order to be able to issue shares with differential rights. There are concerns on the validity and enforceability of the differential rights of the shares of private companies issued under the 1956 Act, especially since such issuances of shares were not subject to any conditions.

Restriction on insider trading (notified)

Clause 195 of the 2013 Act captures the essence of SEBI's Prohibition of Insider Trading Regulations, 1992, but extends its applicability to unlisted companies. According to the clause, no director or key managerial personnel of a company should engage in insider trading, e.g., subscribing, buying, selling or dealing in securities, if such a person is reasonably expected to have access to any non-public, price-sensitive information in respect of the securities of a company or its procurement processes, or communicate, directly or indirectly, any non-public price-sensitive information to any person. This restriction is likely to have an impact on deal structuring, since almost every deal involving an unlisted company involves sharing of information by directors or key managerial personnel, or subscription or sale of shares by promoters, who normally function in an executive capacity within a company.

One possible argument against the applicability of the clause (mentioned above) for private companies could be that for the purposes of the 2013 Act, “securities” has the same meaning as that given to it as in the SCRA, which only applies to marketable securities and it is a settled position in law that the securities of a private company are not marketable. One needs to wait and watch whether this argument will be found convincing by the regulator. A clarification by MCA would be useful.

Subsidiary of a foreign company (partly notified)

Section 4(7) of the 1956 Act sets out that a private company, which is the subsidiary of a foreign company (which if it was incorporated in India would have been a public company), will be considered a private company that is a subsidiary of a public one, and is subject to the same regulatory compliance standards as that applicable to a public company. Clause 2 of the 2013 Act, through various sub-clauses, attempts to incorporate section 4 of the 1956 Act. However, there is ambiguity surrounding the status of subsidiaries of foreign companies in India. According to the MCA’s general circular No. 16/2013, dated 18 September 2013, Section 4 stands repealed. This is a matter that needs clarification, since it will be necessary to understand the status of a private company incorporated in India by foreign corporate organizations.
Transfer of undertaking (notified)

Under the 1956 Act, an ordinary resolution of shareholders was sufficient for public companies to sell/lease or otherwise dispose of whole or substantially the whole of the undertakings. However, there is ambiguity regarding the definition of the terms “undertaking” and “substantially the whole of undertaking.”

In attempting to define an “undertaking,” the 2013 Act has introduced the additional restriction of a minimum threshold, which should not be read independent of the primary requirement – that the transfer in question is in actuality that of an undertaking. The 2013 Act defines the following terms as:

- **“Undertaking”** to mean one in which investment in the company exceeds 20% of its net worth according to its audited balance sheet of the preceding financial year or an undertaking that generated 20% of the company’s total income during the previous financial year.
- **“Substantially the whole of the undertaking”** in any financial year to mean that 20% or more of the value of the undertaking according to its audited balance sheet of the preceding financial year.

The shareholders of all companies are required to pass special resolutions for such disposals, irrespective of whether these are private or public organizations.

The following illustrations depict the interpretation in relation to compliance with rules pertaining to special resolutions being obtained in light of the definitions of “undertaking” and “substantially the whole of the undertaking” under 2013 Act.

**Case 1: Special resolution**

A Co has two units, Unit A (generating 80% of its total income) and Unit B (generating 20% of its total income). A Co intends to transfer part of Unit B (comprising 20% of the value of Unit B) to B Co.

Based on an initial interpretation of Clause 180 of the 2013 Act, the transfer mentioned above would require a special resolution in spite of the fact that a part of a unit of A Co, which generates only 4% of its total income, is to be transferred.

**Case 2: No special resolution**

A Co has two units, Unit A (generating 81% of its total income) and Unit B (generating 19% of its total income). Unit B is to be transferred to B Co.

Based on an initial interpretation of Clause 180 of the 2013 Act, the transfer mentioned above does not require a special resolution in spite of the fact that a unit, which generates 19% of the total income of A Co, is to be transferred.

Apart the materiality test mentioned above, which was introduced in the definition of undertaking, the unit or part of the unit intended to be transferred will still have to fulfill the requirement of being an “undertaking.”

In various cases in the past, courts have interpreted undertakings as the business or activity of companies as a whole. Furthermore, they have opined that transfer or sale of shares cannot be interpreted as the transfer of an undertaking, even if the controlling interest in a company is transferred or when the shares transferred are the only assets or a substantial portion of the assets of the company. The aspects mentioned above have still not been clarified under the 2013 Act.

It has been seen that a significant number of transactions typically follow a two-step process wherein the sellers “push” the business intended to be divested into subsidiaries, and thereafter sell their shares to potential investors. In such cases, the first step of transfer of a business from a holding to a subsidiary may be regarded as a related party transaction, and there are strict provisions in relation to consent being obtained through special resolutions by a holding and a subsidiary. These will need to comply with the provisions pertaining to related party transactions once these are notified. This may have an impact on the flexibility of conducting transactions involving transfers of undertakings.

This provision has been notified, and therefore, transactions involving transfer of undertakings are required, to ensure compliance with the provisions given above.
Conclusion

While the 2013 Act is a step in the right direction for India Inc. and investors, it may be worthwhile for the regulators to pay heed to concerns being voiced by lawyers and corporate organizations and incorporate the required amendments while notifying rules and issuing clarifications. Furthermore, the 2013 Act seeks to align other laws such as Income Tax and Exchange Control provisions to facilitate its efficient implementation. Only time will tell whether the 2013 Act will be successful in making M&A easier and more efficient or be a legislation, which is open to interpretation, leading to further disputes and litigation.
Chapter 3

Companies Act 2013: mergers, compromises and arrangements
Introduction

The Companies Act, 2013 appears to be opening new and simple avenues for mergers, acquisitions and restructuring operations in India. While the Act retains the old provisions, it also adds robust and progressive new ones. Changes made in it are likely to have a positive impact on the manner in which corporate structuring is undertaken in India due to numerous procedural changes.

The 2013 Act seeks to simplify the overall process of acquisitions, mergers and restructuring, facilitate domestic and cross-border mergers and acquisitions, and thereby, make Indian firms relatively more attractive to PE investors. While some of the changes to look for at the conceptual level include merger/demerger processes, cross-border and fast track mergers between small companies and holdings, subsidiaries and provisions relating to minority shareholders' protection and exits, among others, a lot still needs to be done in terms of provision of increased clarity on some critical areas and the overall interplay of the 2013 Act with other laws.

However, pending notification of the sections and rules in relation to restructuring and absence of transitional provisions has led to concern within industry and professionals engaged in restructuring in the corporate world. The 2013 Act provides for the constitution of the National Company Law Tribunal (NCLT) as the single authority for all schemes relating to restructuring. However, there is no clarity on the time that will be taken for the NCLT to be constituted and become operational. Practical difficulties are expected in implementation of provisions relating to restructuring till the MCA provides clarity on these issues.

This article looks at some key provisions relating to mergers, compromises and arrangements in the 2013 Act and provides a quick impact analysis of these.

A. Fast-track merger (“short form” mergers)

As in some overseas jurisdictions, the 2013 Act has introduced the new concept of fast-track mergers and demergers. These provide the option of a simplified and fast-track merge/demerger process, which can be used for the following and is an option for companies:

- Merger of two or more specified small companies
- Merger between holding company and its wholly owned subsidiary
- Such other classes of companies as may be prescribed

In this case, the merger will have to be approved by Central Government and there will be no requirement to approach NCLT.

Approval process

Under this process, the schemes approved by the boards of directors of companies will need to be sent to the Registrar of Companies (RoC) and the Official Liquidator (OL) for their suggestions or objections within 30 days. The scheme will then be considered in the meetings of shareholders or creditors, along with their suggestions or objections, and will have to be approved by the following classes of persons:

- Shareholders holding 90% of the total number of shares at a general meeting
- Majority creditors (representing nine-tenth in value) in a meeting convened with 21 days' notice

Currently, under the 1956 Act, the criterion of “present and voting” is essential for the conduct of shareholders' and creditors' meetings. However, the similar concept of “present and voting” has not been included in the 2013 Act, and there is no clarity on whether voting through a postal ballot will now be an acceptable mechanism. This requires clarity from the Ministry.

After the approval mentioned above, the scheme will have to be filed with the OL, RoC and the Central Government. In the event of there being “no objection,” this will be deemed as approved. However, in the event of objections from the RoC or OL, the scheme may be referred by the Central Government to the NCLT for it to consider the scheme under the normal process of a merger. In this case, the NCLT can either mandate that the scheme is to be considered a normal merger or it may confirm the scheme by passing an order to this effect. Therefore, a company is at risk of the process being considered a normal merger process instead of a fast-track merger.

In addition to the above, both the companies (transferor and transferee) will need to file a declaration of solvency with the RoC.

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1 A small company is a private company that meets either of the following requirements:

- Its paid-up capital does not exceed INR5 million (or higher amount, as may be prescribed, and should not be more than INR 50 million).
- Its turnover (according to its last profit and loss account) does not exceed INR20 million (or a higher amount, as may be prescribed, which will not be more than INR200 million).
Among the various features of fast-track mergers of companies, one is the exemption from the need to obtain auditors’ certificates of compliance with applicable accounting standards. This is a welcome step that will result in reduction in the administrative burden, timelines and costs of smaller companies that fall within threshold limits. However, on the flip side, there is no clarity on whether fast-track mergers will be allowed prior to NCLT becoming operational. Moreover, under existing tax laws, there is no need for a company to seek the approval of a court to prove the tax neutrality of a merger or demerger. However, clarity in this regard will be required in the case of fast-track mergers involving non-court approved schemes.

B. Cross-border mergers

With businesses no longer limited by borders, cross-border M&A transactions present significant opportunities for economic gain and increased shareholder or investor value. Various factors influence the spurt in recent cross-border mergers and acquisitions, including the ever-increasing need of companies to tap new markets and set up global operations in these, achieve cost reduction and synergies and secure natural resources. Cross-border M&A is also supported by technological advancements, low cost financing arrangements and robust market conditions, which have made deal-makers confident and think more creatively about their global growth strategies. The flow of transactions could be inbound (non-residents investing in India) or outbound (Indian businesses making investments abroad).

Current laws only permit inbound mergers (foreign companies merging with Indian ones) and not the other way round. The 2013 Act proposes to allow both – inbound and outbound cross-border mergers between Indian companies and foreign ones. It provides for the merger of an Indian company into a foreign one, whether its place of business is in India or in certified jurisdictions (to be notified by the Central Government from time to time), subject to the NCLT’s and RBI’s approval.

The consideration of a merger, which will also be subject to the approval of the RBI, could either be in cash or depository receipts, or partly in cash and partly in depository receipts. The provisions mentioned above could have a far-reaching impact that will facilitate cross-border transactions and increase their flexibility. Cross-border mergers could have ground-breaking significance in plotting India on the global M&A landscape, since corporate deals have fallen through or failed to meet their desired objectives in the past due to the lack of such provisions in the 1956 Act.

Enabling of cross-border mergers is expected to help Indian companies in more ways than one, including in the following:

- Restructuring their shareholdings, wherein they can migrate ownership to an international holding structure
- Facilitating listing of entities, which may have Indian assets in overseas jurisdictions
- Providing exit routes to current investors in overseas jurisdictions

However, corresponding amendments are required in existing laws including the Income Tax Act, Exchange Control Regulations (relating to ownership of real estate in India, sectoral caps, definitions of overseas holdings, etc.), security-related laws (change in rules regarding dual listings), etc.

Currently, tax laws do not provide any tax-neutral provisions to enable such cross-border mergers. The debate on whether cross-border mergers should be taxable or not is an interesting one, since in some mergers, companies may be moving some value outside India. If they are operating companies, they will need to move out their Indian operations before the mergers, to avoid operational and tax-related complications. Furthermore, the impact of payment of cash/depository receipts or any other modes on the tax neutrality of the amalgamations will need deep analyses.

A key aspect to look for will be notification of the “specified jurisdictions” for cross-border mergers and the amendment of Exchange Control Regulations. This may restrict the scope of outbound mergers as well as inbound ones, which are currently allowed from any jurisdiction that allow cross-border mergers under their domestic laws. Moreover, the requirement of approval from the RBI is expected to play a major role in such cross-border mergers.

C. Demergers defined

The draft rules released by the MCA clarify that the term “demerger” is to be included within the compromise or arrangement defined in the 2013 Act. As opposed to the 1956 Act, the Rules provide a clear definition of the term. It defines a demerger in relation to companies and includes transfers,
pursuant to the scheme of arrangement by a “demerged company” of one or more undertakings to any resulting company in such a manner as provided in section 2(19AA) of the Income Tax Act, 1961 (IT Act), subject to it fulfilling the conditions stipulated therein and shares allotted by the “resulting company” to the shareholders of the demerged company against transfer of its assets and liabilities.

Furthermore, the Rules provide for the accounting treatment for the demerger till a specific accounting standard has been prescribed for it, which is in accordance with the conditions stipulated in section 2(19AA) of the IT Act. The rules prescribe that the difference in the value of assets and liabilities in the books of a demerged company will be credited to its capital reserve or debited to its goodwill. Moreover, the difference in the net assets taken over and shares issued as consideration will be credited to the capital reserve (excess) or debited to goodwill (deficit) in the books of the resulting company. As compared to the IT Act, which ignores revaluation of assets for the purpose of determining book value, the rules of the 2013 Act enable a company to ignore any revaluation or write-off of assets, only of the preceding two financial years. A certificate from a Chartered Accountant will also be required to be submitted to the NCLT to the effect that the accounting treatment is in compliance with the conditions so prescribed.

Although the rules are at the draft stage as of date, one can look for guidance for accounting for demergers in them. The rules give clarity to the way forward for them. This is expected to restrict alternative accounting methodologies used in the past by corporate organizations in the past to account for reserves arising due to demergers within the scheme.

D. Treasury shares

Indian promoters of companies, including listed ones, have in the past used the route of issuing treasury stocks to consolidate their holdings in companies to raise funds and as an avenue to control voting rights. Promoters have followed the practice of transferring the shares of their subsidiary companies to trusts and issuing shares of holding companies pursuant to the mergers of wholly owned or partially owned subsidiaries with holding companies, instead of canceling such shares. Past precedents include Escorts, Mahindra & Mahindra and Jaiprakash Associates.

However, the 2013 Act restricts a transferee company from holding shares in its own name or in the name of a trust. Any inter-company investments between companies involved in mergers need to be mandatorily canceled in this event.

The provisions given above should result in greater transparency and reduce the scope of unconventional or ambiguous practices, particularly where valuation and accounting considerations are involved. This change is also in line with the 1956 Act, which prohibits a company from owning its own shares.

A related concern is how treasury stock holdings already created under the 1956 Act will be treated in the future – whether they can continue in the same manner or they need to be unwound.

E. Mergers of listed companies with unlisted ones

The 1956 Act does not contain any specific provision governing the merger of a listed company with an unlisted one. It is generally assumed that shares issued pursuant to the merger of a listed company with an unlisted one (or vice versa) need to be listed on the stock exchanges where the transferor company was listed. There have been cases, even in the present scenario, where the resulting company has continued to be unlisted after the demerger. Recent precedents include the schemes of demerger of Wipro Ltd. and Sundaram Clayton Ltd.

The 2013 Act sets out formal guidelines and provides an option to a transferee company to remain unlisted till it is listed or applies for listing, provided the shareholders of the merged listed company are given an exit opportunity. It also provides that provision should be made by the NCLT for an exit route for the shareholders of a transferor company who decide to opt out of the transferee company by making payment amounting to the value of the shares and other benefits, in accordance with a pre-determined price formula or after a valuation report is produced (which should not be less than the value prescribed by SEBI's regulations).

An analysis of the new provisions brings to light attempts made to codify the existing practice while providing more clarity on valuation requirements. While, prima facie it seems that shareholders deciding to opt out can exercise this option even if the transferee company is listed, this requires lucidity.

A specific provision in the 2013 Act will encourage companies to explore this option as an alternative or in addition to the Delisting Guidelines. It will be interesting to see the interplay between SEBI’s delisting regulations (and revisions, if any) and these provisions, especially in light of the requirements of delisting regulations, where minority shareholders effectively determine their own exit price (which is generally at a significant premium). One would expect the provisions between SEBI and MCA to be aligned while coming into force.

Practical questions may also arise on the applicable date for valuation of shares (e.g., the appointed date, the effective date, etc.) and procedures for compensating shareholders if the NCLT process consumes considerable time. Further clarity will
also be required in the event of any dispute on the exit price determined on the basis of the valuation (e.g., where SEBI’s price is not a true reflection of the true intrinsic value of a listed company) and the redressal mechanism for such disputes.

Capital gains and other tax implications in the hands of exiting shareholders, the tax neutrality of the scheme of arrangement (if more than 25% of the shareholders opt for the exit route), etc., will need to be evaluated prior to corporate organizations following this route.

F. Minority buyout

The 2013 Act has introduced an exit mechanism for minority shareholders with the intent of reducing litigation with minority shareholders. The Act grants access to the acquirer or person acting in concert or a person or a group of persons becoming registered shareholders of 90% or more of the issued equity share capital of the target company (listed or unlisted) by virtue of amalgamation, share exchange, conversion, securities or for any other reason. Such an acquirer, person or a group of persons will notify minority shareholders about their intention of buying the remaining equity shares. In addition, minority shareholders may also offer their shares suo-motto to majority shareholders.

As provided in the draft rules, the price mechanism for the minority buy-back in the case of a listed company will be the price according to SEBI’s regulations, but this needs to be carried out by a registered valuer. Whereas, for an unlisted company, various factors are taken into consideration, i.e., the highest price paid for an acquisition during the last 12 months and the fair price of shares to be determined after taking into account valuation parameters as prescribed. In addition, an registered valuer will provide a valuation report to the board of directors of a company, justifying the methodology of arriving at such a price. On the other hand, the shares of minority shareholders need to be acquired by majority shareholders and not by the company and will entail outflow of funds in the hands of the majority shareholders.

The provisions virtually recognize minority squeeze out as a legal option. This has been undertaken by corporate organizations through various corporate restructuring means in the past. However, there is not much clarity on whether this is a mandatory exit mechanism and a scenario where one minority shareholder desires to exit would the acquirer be forced to buy out all.

G. Other key changes to the process of compromise or arrangement

The 2013 Act provides that a notice for a meeting for the
institutional shareholder takes up the cause. However, it provides a safeguard against frivolous litigations by shareholders with negligible stakes (which happens in many schemes), thereby avoiding unnecessary delays.

- The 2013 Act also empowers the NCLT to dispense with meetings of creditors if at least 90% of the creditors in value agree and confirm this by affidavit, thereby reducing the discrepancy in practice followed by different High Courts while granting their approval on the basis of consent letters obtained. However, there is the absence of an explicit provision for dispensation from shareholders’ meetings.

- The 2013 Act also requires the valuation report for the share swap ratio to be sent along with the notice for the meeting to all stakeholders, as is currently applicable to listed companies, thereby opening doors for larger scrutiny on the share swap ratio by shareholders, even in the case of unlisted companies.

The road ahead

The 2013 Act provides that until the Government notifies a date for transfer of all matters, proceedings or cases sent to the NCLT, the provisions of the Act in regard to the jurisdiction, powers, authority and function of the current Company Law Board and the Company Court will continue to apply. The 2013 Act does not provide for any transitional provisions to govern the restructuring in progress at the time of notification of such a date.

Furthermore, if the restructuring currently ongoing under the 1956 Act is to be continued under the 2013 Act, any non-conformity of the portion of the process completed under the 1956 Act with the provisions of the 2013 Act is a question that remains unaddressed. For example, an ongoing scheme of a merger envisages the creation of treasury stock, would this need to be deleted, and the swap ratio to be reworked if the relevant section governing treasury stock becomes effective prior to the final sanction of the scheme by the court.

The implementation of the 2013 Act will also require updates in other laws to link these with the new provisions. Laws including Stamp Duty (the conveyance rate provided for orders under section 391–394 of the 1956 Act), Exchange Control regulations (for holding of real estate, sectoral limits, etc.) and tax laws (definition of mergers, demergers and other conditions for tax neutrality) will need amendments prior to notification of sections relating to merger provisions, to provide the effect of benefits envisaged by the 2013 Act.

Conclusion

To conclude, the overall impact of the 2013 Act on mergers, compromises and arrangements is to introduce certain simplistic and forward-looking concepts, and also codify in law certain concepts (such as dispensation, statutory auditor certificates and demerger accounting), which were followed in practice, but not contained in law. As of now, the full impact of the law is not very clear, since many matters will be governed by rules, which will be formalized once feedback from stakeholders is received by the MCA and incorporated in the final rules to be issued.

On the whole, the 2013 Act is a step toward bringing greater transparency and accountability in the age-old procedures of M&A, thereby visibly making the Indian Corporate Law relatively friendlier and more acceptable in the global arena.
Companies Act 2013: capital structuring and other M&A related aspects
The capital structures of companies have drastically changed over the years with the innovation and introduction of a new class of financial instruments and securities. Earlier, companies were mainly funded and managed by small groups of known individuals. In contrast, today, raising funds from external sources to expand the business has become a norm. Most businesses run by major business houses have entered various diversified businesses through their divisions, subsidiaries and other associated entities. Capital structuring has become essential in order to raise capital for diversified businesses and to improve the returns.

The Companies Act, 1956 (Old Cos Act) was drafted in an era where the size and structure of business organizations of today was a distant dream. Therefore, the complexity of the transactions being entered was not foreseen by the Old Cos Act. With the advent of the Companies Act, 2013 (New Cos Act), the Ministry has tried to set guidelines and govern these ever-growing entities by bringing domestic legislations at par with those practiced around the world.

There are two basic forms of capital – equity and debt capital. Furthermore, variations are possible, based on the commercial understanding between the borrowers and the lenders in the form of compulsorily convertible debentures or preference shares, hybrid instruments, etc. Each financial instrument has its own benefits and drawbacks, and a substantial portion of management time is invested in designing appropriate capital structures in terms of the risk or reward payoff for stakeholders. The methods to achieve the appropriate capital structure often result in management resorting to strategies such as private placements, buyback, capital reduction and issuance of bonus shares, which have their own set of implications or considerations. This article captures some of the key amendments that have been brought in by the New Cos Act in relation to capital structuring and related aspects including buyback of shares, issue of bonus shares, capital reduction and others.

**Buy-back of shares**

Buy-back refers to purchase of its own shares by a company from its existing shareholders. This is generally undertaken by a company when it has a significant amount of cash, there are no viable projects on the table and it is interested in disbursing cash to its shareholders in the form of dividends. The way out for management is buying back its own shares. Buy-back may also be undertaken for other reasons such as maintaining the market price of shares, an increase in promoters' stakes, etc. Buy-back may be of the following types:

- Buy-back of up to 10% of total paid-up capital plus free reserves approved by the board of directors
- Buy-back of up to 25% of the total paid-up capital plus free reserves approved through a special resolution at the general meeting of the company
- Buy-back through a court-approved Scheme of Arrangement

Under the Old Cos Act, a buy-back approved by a board of directors was only possible after a period of 365 days had lapsed from the date of the preceding buy-back offer. As regards a buy-back approved by shareholders, it was possible to adopt a view that multiple buy-backs were permissible in the same financial year as long as the total buy-back in that specific year did not exceed 25% of the paid up equity capital of the company. However, the New Cos Act has curtailed this freedom offered to companies by mandating maintenance of a gap of at least one year between two buy-backs under any of the routes. Furthermore, buy-back of shares undertaken as part of a court-approved Scheme of Arrangement will also need to adhere to conditions prescribed under buy-back provisions. The Old Cos Act prohibited a company from undertaking buy-back if it had defaulted in repaying deposits, redeeming preference shares or debentures, paying dividends, etc., till the time default persisted. However, under the New Cos Act, a company that has defaulted (as above) is prohibited from buying back its shares for a further period of three years after the default is remedied.

**Capital reduction**

“Capital reduction,” a commonly used tool for increasing shareholder value and realigning capital structure, has also been subject to certain stringent provisions under the New Cos Act.

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3 Section 77A in Old Cos Act and Section 68 in New Cos Act
4 Conditions detailed in section 77B of Old Cos Act and section 70 of New Cos Act; section partly notified by the Ministry
5 Section 101-105 of Old Cos Act and Section 66 of New Cos Act
The New Cos Act, emphasising on the importance of repayment of deposits accepted by a company from the public, prohibits an organization with arrears in its payment of deposits or interest on such deposits (accepted either before or after commencement of the New Cos Act) from undertaking capital reduction.

The procedure for undertaking capital reduction has been made more onerous by mandating the NCLT\(^6\) (which receives applications from companies undertaking capital reduction) to forward these to the Central Government (CG), the Registrar, SEBI (in the case of listed companies) and creditors, and take into consideration representations made by them. The CG and others are required to make their representations to the NCLT within a period of three months from the date of receipt of notice, failing which their assent will be presumed.

Furthermore, submission of a certificate from a company’s auditor, confirming that the accounting treatment for such reduction is in conformity with the specified Accounting Standards, has been made a pre-requisite for seeking the NCLT’s approval of the capital reduction scheme.

Additionally, it has been made mandatory for a company to publish the order of the NCLT sanctioning capital reduction in the manner directed.

**Variation of shareholders’ rights\(^7\)**

The provision with respect to a variation in shareholders’ rights under the New Cos Act has undergone little change vis a vis the Old Cos Act. Provisions seeking the written consent of at least three-fourths of the class of shareholders, whose rights are being affected, or by way of a special resolution passed at a separate meeting of such a class of shareholders are here to stay, with the additional requirement of seeking consent from at least three-fourths of such other classes of shareholders if variations in the rights of one class of shareholders affect the rights of any other class of shareholders.

**Issue of shares with differential voting rights (DVR)\(^8\)**

An alternative to variation of shareholders’ rights is issue of DVR shares, which are like ordinary equity shares, but are different in that they provide the shareholders fewer voting rights than those of ordinary shareholders. A company can issue DVR shares (not exceeding 25% of its share capital), only if it has been profitable for three years preceding the year in which it has decided to issue DVR shares, and it has not defaulted in filing its annual accounts and returns for the period. Furthermore, the articles of a company should authorize issue of DVR shares or the company should have obtained its shareholders’ approval in a general meeting by passing a special resolution (by postal ballot in the case of listed companies) for issue of such shares.

Under the Old Cos Act, restrictive conditions relating to issue of DVR shares were not applicable to private companies unless these were subsidiaries of public companies. A private company was free to issue shares with DVR, in accordance with the regulations specified in its articles of association. However, the New Cos Act has widened the purview of the provisions to all companies, thereby securing within its scope issue of DVR shares, even by private companies.

**Issue of bonus shares\(^9\)**

The Old Cos Act does not have any specific provision that deals with the issue of bonus shares, although the concept of bonus shares is referred to at many places. This led to varying practices followed by companies for issuance of bonus shares. However, the New Cos Act has introduced a section (with a view

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\(^6\) The New Cos Act, in order to provide swifter ruling in cases related to companies, proposes setting up of the National Company Law Tribunal (NCLT), which will assume jurisdiction of the High Court on corporate law-related matters.

\(^7\) Section 106-107 of Old Cos Act and Section 48 of New Cos Act

\(^8\) Section 85-86 of Old Cos Act and Section 43 of New Cos Act

\(^9\) No provisions for issue of bonus shares in Old Cos Act, governed by section 63 of New Cos Act
to bringing about uniformity), which permits a company to issue fully paid-up bonus shares.

In the case of listed entities, SEBI's Issue of Capital and Disclosure Requirement regulation, 2009 requires that a bonus issue is made from free reserves built from genuine profits or share premium collected only in cash and prohibits capitalization of revaluation reserves. Furthermore, the Institute of Chartered Accountants of India (ICAI), in its guidance note on “Availability of Revaluation Reserve for Issue of Bonus Shares,” states that a company is not permitted to issue bonus shares out of the reserves it has created by revaluation of its assets. Similar requirements are also included in Accounting Standard 10 issued by ICAI.

Recently, the RBI permitted Indian companies to inter alia issue bonus redeemable or non-convertible preference shares from their general reserves under a scheme of arrangement to non-resident shareholders. This, coupled with the provision enacted under the New Cos Act, are forward-looking provisions that will find favor with investors.

The New Cos Act, walking the line set by the guidelines mentioned above, has incorporated a new section, which provides for issue of fully paid-up bonus shares out of its free reserves, or its security premium account or capital redemption reserve account, subject to compliance with certain conditions such as authorization by the articles, approval provided in a general meeting, etc. Furthermore, companies have been prohibited from issuing bonus shares by capitalizing on their revaluation reserves or in lieu of dividends.

Private placement

The New Cos Act formally introduces the concept of private placement, which, under the Old Cos Act, was conducted with the support of various provisions. Under the New Cos Act, “private placement” has been defined to mean any offer of securities or an invitation to subscribe to the securities of a select group of persons by a company through issue of a private placement offer letter, which satisfies prescribed conditions. These provisions are applicable for private and public companies. Any offer that is not in compliance with this clause will be deemed a public offer and applicable provisions applicable will apply to it.

The New Cos Act provides that an offer of private placement of securities can be made to a maximum of 50 persons or a higher prescribed number in a financial year (the Draft rules prescribed a limit of 200 persons in a financial year). However, qualified institutional buyers, as defined under SEBI's Issue of Capital and Disclosure Requirement and employees under the Employees' Stock Option Scheme, have been excluded while computing the maximum limit. The Draft rules also prescribe limits on the number of private placements that can be made in a year and intervals between each such placement. As in the case of public offers, a company can only collect subscriptions through cheques, demand drafts or banking channels and should keep these in a separate bank account.

A direct consequence of the recent dispute between the Sahara Group and SEBI has been a clarification that an offer should only be made to persons whose names have been recorded by a company prior to inviting subscriptions. Furthermore, a company making an offer or issuing an invitation through private placement will need to allot its securities within 60 days from the date of receipt of the application money, failing which this will need to be repaid to the subscribers.

Considering that private placement by private companies can be made to a large number of investors, many unlisted public companies may consider becoming private.

Furthermore, tightening the noose on companies for raising funds in a fraudulent manner, the New Cos Act states that no fresh offer or invitation can be issued unless their allotments with respect to previous offers or invitations have been completed, withdrawn or abandoned by them. Moreover, companies raising funds through private placement will not be allowed to release any public advertisements or utilize any media, marketing or distribution channels or agents, to inform the public about such offers.

10 Section 67 of Old Cos Act and Section 42 of New Cos Act
Loans to directors/subsidiaries

Taking note of misuse of rules relating to loans advanced to directors and persons in whom directors are interested, the New Cos Act mandates stringent regulations relating to advance of such loans and levies a heavy penalty in the case of non-compliance.

The New Cos Act has withdrawn the exemptions available to private companies under the Old Cos Act in this regard, thereby making it nearly impossible for directors to divert funds for their personal use by such means. This provision is among the few sections that has been notified by the Ministry.

Under the Old Cos Act, such loans or guarantees could be provided with the approval of the Central Government. The New Cos Act has taken away this shield from companies. However, exceptions have been made in the following situations:

1. Loans to managing or whole-time directors as part of service conditions committed to him or her or in pursuance of schemes approved by companies’ shareholders through special resolutions
2. Loans or guarantees provided in the ordinary course of business by a company and the rate of interest on such loans not being less than the bank rate declared by the RBI

The New Cos Act includes restrictions on advancing of loans or guarantees to directors and “to any other person in whom a director is interested.” The expression “any other person in whom a director is interested” includes any body corporate, whose board of directors, managing director or manager acts in accordance with the directions or instructions of the board or of any director of the lending company. A literal reading suggests that this expression may cover subsidiary companies.

It may be noted that the Old Cos Act had specifically exempted any loans or advances granted to wholly owned subsidiaries from applicable restrictions. This exemption has been removed under the New Cos Act, which seems to suggest that loans cannot be advanced to subsidiaries that do not have completely independent management. If this view is correct, it is likely to create significant hardship for many companies, especially where support of a holding company is sought as a pre-requisite by lending institutions.

A clarification from the Ministry of Corporate Affairs on this is eagerly awaited by India Inc. in view of the ambiguity relating to loans advanced to subsidiaries.

Companies’ loans and investments

Like the existing Old Cos Act, the New Cos Act also prohibits a company from giving loans or guarantees to, providing security in connection with a loan to any other body corporate or acquiring the securities of any other body corporate exceeding the higher of the following:

a) 60% of its paid-up share capital, free reserves and securities premium
b) 100% of its free reserves and securities premium

Under the Old Cos Act, the restriction above was only applicable in connection with provision of loans/guarantees/securities on behalf of another body corporate. The New Cos Act extends this restriction to any person or entity. Furthermore, prior approval through a special resolution passed at a general meeting is mandated where the specified limits given above are likely to be breached.

The loans/guarantee/security provided by private companies or holding company to/on behalf of its wholly owned subsidiary have also been brought under prescribed investment limits under the provisions of the New Cos Act. This will create hardships for many subsidiary companies, which are significantly dependent on their parents for financing. In many cases, loans given by parents to their subsidiaries are substantial and may breach the 60% or 100% limits when the New Cos Act is effective.

A company will now be required to make full disclosure of such loans/guarantees/securities and the purpose of their utilization by the recipient in its financial statements.

Additionally, the New Cos Act requires a lending company to charge interest on a loan advanced, the minimum rate whereof has been linked to the prevailing yield on government securities.

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11 Section 372A of Old Cos Act and Section 186 of New Cos Act
Revival and rehabilitation of sick companies

Over the years, corporate legislation in India has been criticised for not addressing the concerns of creditors. One of the key changes brought about by the New Cos Act is simplification of the procedure for rehabilitation and winding up of sick companies.

The coverage of the Sick Industrial Companies Act, 1985 (SICA) is limited to industrial companies, while the New Cos Act covers the revival and rehabilitation of all companies, irrespective of their sectors. The criterion for erosion of 50% of a company’s net worth for declaring it sick and approaching the Board for Industrial and Financial Reconstruction has been dispensed with in the New Cos Act – the revised criterion is “inability to pay 50% of the outstanding secured debt” within 30 days of service of notice by secured lenders. Any secured creditor fulfilling the criteria given above or a company may suo moto file an application with the NCLT for being declared a sick organization on the same grounds.

Conclusion

While some conditions for regulation of capital structuring, including offers of securities made by private companies, are warranted in view of some recent cases, the current set of regulations seem too cumbersome and restrictive, especially for private companies. On the other hand, this ensures discipline and corporate governance, which appear to be the need of the hour.
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Today, ASSOCHAM has emerged as the fountainhead of Knowledge for Indian industry, which is all set to redefine the dynamics of growth and development in the technology driven cyber age of 'Knowledge Based Economy'. ASSOCHAM is seen as a forceful, proactive, forward looking institution equipping itself to meet the aspirations of corporate India in the new world of business, and is working towards creating a conducive environment of India business to compete globally.

ASSOCHAM derives its strength from its Promoter Chambers and other Industry/Regional Chambers/Associations spread all over the country. ASSOCHAM has been a significant contributory factor in the emergence of new-age Indian Corporates, characterized by a new mindset and global ambition for dominating the international business.

Website: www.assocham.org

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