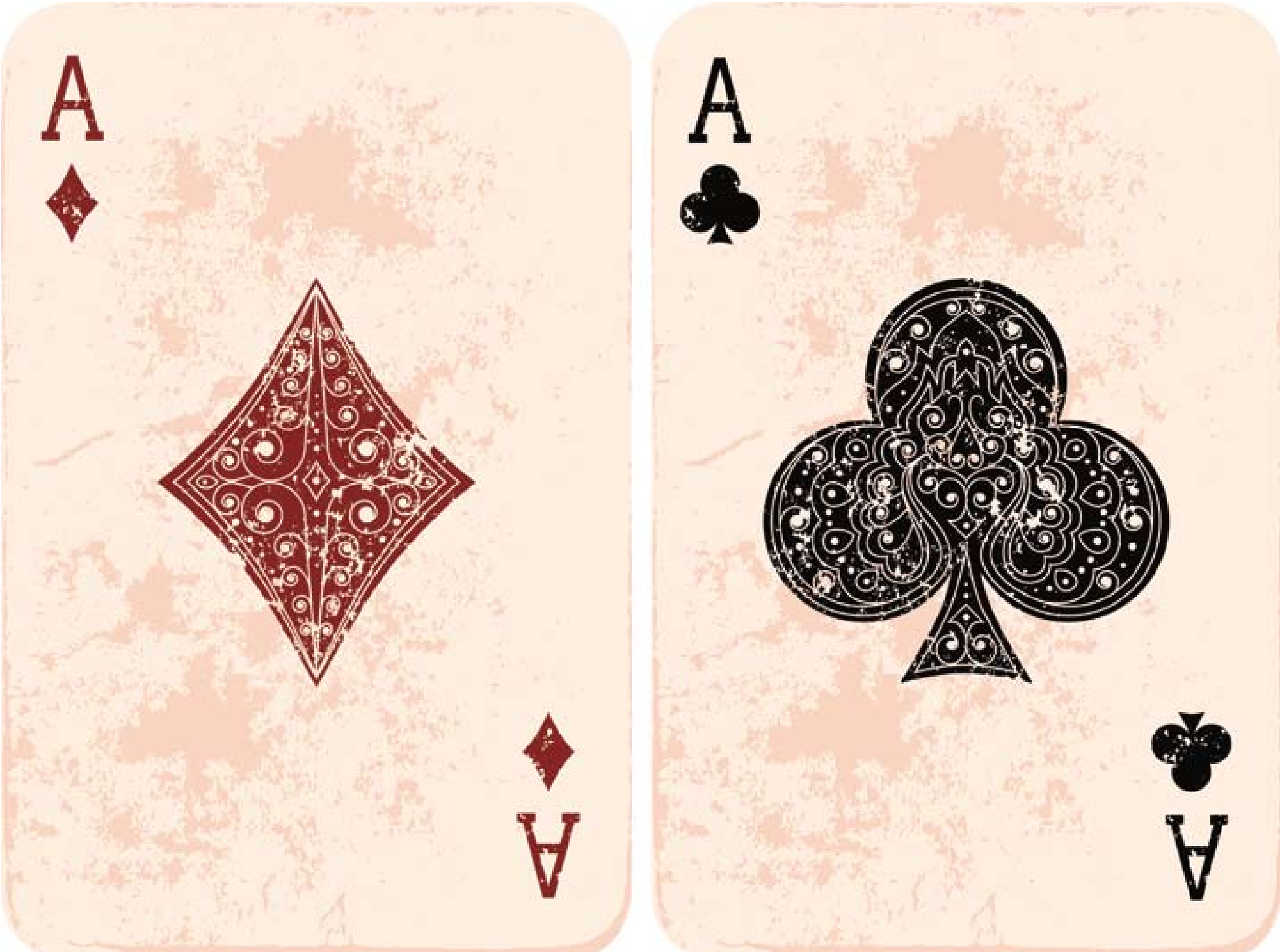


Playing by new rules

While in many respects India's new Companies Act has come up trumps, doubts remain over its implementation

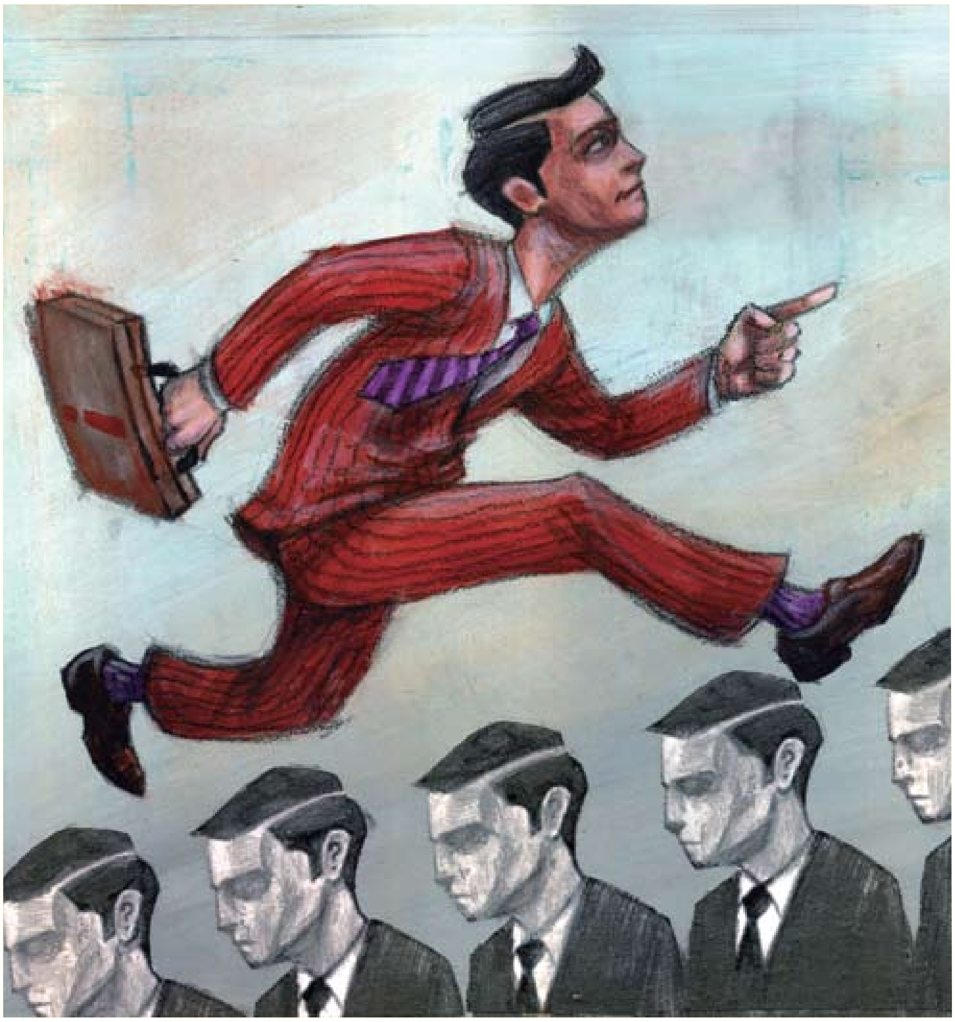
Aparajit Bhattacharya and Harvinder Singh report

Companies operating in India can expect a greater focus on increased regulations and corporate accountability. Governance is at the heart of the Companies Act, 2013, which was notified in the Gazette of India on 30 August. The act appears to keep pace with the changes in the Indian economy and effectively frames dynamic, abstract concepts into concise and crisply worded legislation.

The act is an umbrella legislation, as it largely relies on subordinate rules for the implementation of its provisions and for day-to-day governance. The subordinate rules are being framed and are being made available; as yet there is no timeline for this. As a result, a complete picture of the impact of the new act would only be available when the Ministry of Corporate Affairs publishes the subordinate rules. In the meanwhile, two sets of draft rules that cover 24 chapters have been issued.

A fair hand

In a bid to create a robust corporate law framework while strengthening existing concepts, the act introduces several new concepts. These include a one person company (OPC), provisions for corporate social responsibility (CSR) for certain classes of companies that will be measured and evaluated, and the mandating of at least one woman director for certain classes of companies, as well as one resident director for all companies.



SOLO MISSION: The Companies Act, 2013, offers Indian businesses the chance to set up a one-person company.

Limiting structures

The act also places restrictions on the making of downstream investment. As a result, such investments can be made through a maximum of only two layers of investment companies. However, there are multiple areas in relation to the concept of two layers of investment companies that are not addressed in the act.

A restriction on investment layers may potentially have a negative impact on the ability of companies to undertake innovative business and corporate structuring. In addition, while the stated intention of limiting multi-tiered structures is to prevent the diversion of funds and to bring in more transparency in the utilization of funds, it is unclear how this can be achieved by limiting corporate structures. Meeting transparency requirements could have been achieved through enhanced disclosure requirements rather than by restricting corporate structuring opportunities.

As regards M&A activity, it will now be permissible for an Indian company to merge with a foreign company in certain jurisdictions, which are yet to be announced. This will make cross-border mergers and acquisitions easier. The new law also simplifies mergers between two or more small companies (with a paid up share capital less than 5 million or turnover less than ₹20 million) or between a holding company and its wholly owned subsidiaries, which will now need no court intervention.

The act also places strong emphasis on accountability, with mandatory provisions regarding the rotation of auditors, strengthening the independence of independent directors and highlighting the relevance of minority shareholders in related party transactions.

Innovative laws

Several jurisdictions, including the UK, the EU, Singapore and certain countries in the Gulf, have already adopted the concept of a single member company, with the intention of simplifying the procedural aspects of incorporating a company. With the introduction of the concept of an OPC, it will now be possible to incorporate a similar entity in India.

However, there are grey areas with regard to OPCs. While the act is unclear about whether a body corporate can become the sole member of the OPC, a deterring factor in relation to the incorporation of an OPC will be the incidence of a 30% corporate tax (plus surcharge) under the present tax regime. As such, unless the Income Tax Act, 1961, is amended, a single person entity that is structured as an OPC would pay higher tax than a sole proprietorship, which under slab rates pays tax at rates ranging from 10% to 30%. In addition, sole proprietorships are not liable for any minimum alternate tax and dividend distribution tax.

More changes necessary

However, other regulations will have to be amended in order for other laws that affect companies to be consistent. These include the Foreign Exchange Management Act, 1999, and the Income Tax Act, 1961, which currently do not recognize cross-border mergers, but will need to be amended to be consistent with the changes brought about in the new Companies Act.

Private equity, angel and strategic investors will be relieved now that the ambiguity on the enforceability of certain protective covenants, such as on the transferability of shares, tag along, drag along and the right of first offer and refusal rights, has been removed.

Certain conflicting judicial precedents regarding transfer of securities have also been laid to rest, as the act provides that any contract or arrangement for transfer between two or more persons shall be enforceable. Further, an investor who is in control of the company i.e.

has the right to appoint the majority of the directors or has the right to control the management or policy decisions, by virtue of shareholding or management rights or shareholders agreements or voting agreements irrespective of its actual shareholding in the company, will qualify as a promoter. This will entail greater accountability.

Showing you care

The provision for mandatory CSR spending introduced in the act is radical and may also be the first of its kind in the world. Companies that have a net worth of at least ₹5 billion, or turnover of at least ₹100 billion, or net profit of at least ₹50 million during any financial year will now be obliged to spend 2% of their average net profits made during the three immediately preceding financial years towards CSR activities. However, the act does not provide penalties for non-compliance and companies are only required to provide a disclosure of the reasons for non-compliance in their annual report.

In addition, the act does not define specific CSR activities. The only obligation it imposes is for companies to earmark the funds, form a committee, formulate a CSR policy, and spend the cash. As such, it appears to be a benign provision, which will allay the initial fears that had been expressed by the corporate world.

Fixing flaws

Various scams and frauds – including that at Satyam in 2009 – that rocked the corporate world showed that the Companies Act, 1956, was inherently flawed in relation to the audit provisions. Not only was an overhaul of the entire auditing standards and systems necessary, but there was also need for greater accountability on the part of the auditors.

URGENT REPAIRS: Corporate scams such as that at Satyam revealed the inherent flaws of the previous Companies Act.

The act provides for appointment of auditors for five years, although there are requirements that the shareholders ratify their appointment at the annual general meeting. In addition, shareholders have the power to rotate an auditor partner and his team at such intervals as desired by the shareholders. This will ensure that every five years there will be a new watchdog to look at a company's records. This should minimize any chance for collusion between the auditor and the management.

Power to shareholders

The act focuses on the protection of shareholders' rights and interests. It includes provisions for class-action suits, which were to-date unheard of in India. It gives the shareholders and depositors of a company the right to claim damages or compensation from the company, its directors, auditors and experts or consultants. Damages can be claimed from directors, auditors or experts for any fraudulent, unlawful or wrongful act or omission or conduct, including for any improper or misleading statement made in the audit report. Liability under such suits will be unlimited.

These provisions re-emphasize the fact that the core construct of the act is to increase accountability and allocate responsibility. While the benefits of such provisions are clear, it will play an important role in introducing sufficient checks and balances to ensure that only genuine actions are entertained by a National Company Law Tribunal (NCLT), which will replace the Company Law Board.

The NCLT is expected to also assume the jurisdiction of the high court in relation to restructuring, mergers, amalgamations and windings up. The idea of the NCLT was first introduced in 2002 as part of an amendment to the Companies Act, 1956, but never made operational. Presumably the NCLT will now become a reality as it has a significant role to play in the new act.

On 12 September, as a first step towards implementation of the new Companies Act, the Ministry of Corporate Affairs notified 98 of the act's 470 sections. These are sections that can be implemented without the support of any subordinate rules.

Although the new act poses some implementation challenges, it is undoubtedly expected to usher in sweeping changes with regard to the future governance, audit and accountability of corporations in India. The strong emphasis on increased regulation, increased accountability and clear allocation of responsibility appears to be aligned not only with evolving global trends, but also with the demanding requirements of the current dynamic domestic economic environment.

Companies looking to get to grips with the new Companies Act will do well to heed the words of Pope John Paul II, who said: "the future starts today, not tomorrow". ■

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