Between the lines...

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Highlights

I. Downstream investment in violation of FDI Policy illegal: Bombay High Court

The Bombay High Court issued its ruling in ***IDBI Trusteeship Services Ltd. v. Hubtown Ltd.,*** in relation to a foreign investment structure that involved compulsory convertible debentures (**CCDs**) issued by an Indian company to a foreign investor, the proceeds of which were in turn used by the Indian company to invest in optionally convertible debentures (**OPCDs**) of two wholly owned subsidiaries operating in the construction and development sector. The judgment was issued in relation to a summary suit and winding up proceedings filed by an Indian debenture trustee (plaintiff) against Hubtown (defendant) for a guarantee issued in favour of the plaintiff.

In November 2009, a Netherlandcorporation NederlandseFinancierings – Maatschappiji Voor Ontwikkelingslanden N.V. ("FMO") (foreign investor) acquired equity shares and subscribed to CCDs issued by an Indian company, Vinca Developers (**Vinca**), for a total consideration of INR 418 crore. The equity shares comprised 10% of the equity share capital of Vinca and upon conversion of the CCDs, the foreign investor would hold approximately 99% shareholding in Vinca. Until such conversion, Hubtown and its promoters held 90% of Vinca.

The investment made by FMO in Vinca in the form of three CCDs was used by Vinca to purchase OPCDs issued by Amazia Developers Pvt. Ltd. (**Amazia**) and Rubix Trading Pvt. Ltd. (**Rubix**), two wholly-owned subsidiaries of Vinca that were involved in the development of townships in India. The OPCDs had a fixed interest rate of 14.5% per annum and Hubtownhad issued a corporate guarantee to secure the liability arising under the OCDs. In 2012, the debenture trustee invoked the guarantee for default of OPCDs by Amazia and Rubix. Subsequently, it filed a summary suit and commenced winding-up proceedings against the guarantor for the recovery of dues under the OPCDs.

The defendants challenged the invocation of guarantee inter-alia on the grounds that enforcing of guarantee is against public policy as the guarantee was for a downstream investment which was against the laws of India, FDI Policy and

FEMA regulations.

The Bombay High Court held that the transaction was a colourable device and part of an illegal structure that provided an assured return to the foreign investor and violated the FDI regulations in India. While rendering the judgement, the Court did not accept the argument of the Defendant that that downstream investment by a “foreign owned or controlled company” is only permitted through equity or compulsorily convertible instruments and not through non-convertible or optionally convertible instruments.

Source: Bombay High Court, Ordinary Original Civil Jurisdiction, Summons for Judgment No. 39 of 2013, in Summary Suit No. 520 of 2013

VA View

This judgement should caution the foreign investors, who try to circumvent the FEMA regulations, which do not permit assured returns to equity investors, by adopting colourable devices. In such a case the Courts will view the transaction as a whole by transcending beyond the form and into the substance.

II. Government notifies Companies Amendment Act, 2015

The President has given his assent to the Companies (Amendment) Act, 2015(“the Amendment Act”) and the same has been notified in the official gazette on 26th May, 2015.All sections of the amendment act have been made effective from 29th May, 2015 except the sections relating to Section 143 (related to 'fraud') and 177 (related to omnibus approval by audit committee) of the Companies Act, 2013 (‘2013 Act’). Ancillary amendments also issued in Companies (Registration Offices and Fees) Rules, Companies (Registration of Charges) Rules, Companies (Declaration and Payment of Dividend) Rules, Companies (Incorporation) Rules and Companies (Share Capital and Debentures) Rules.

With the object of easing the way business is done in India, the Amendment Act has introduced certain changes which are highlighted below:

- The Companies Act, 2013 (2013 Act)prescribed the minimum paid - up share capital of INR One Lakh for a private company INR Five Lakhs for a public company. The Amendment Act deleted the abovementioned numerical value as minimum paid up capital for a private and a public company. With the deletion of the minimum paid up capital threshold, it also empowers the Ministry of Corporate Affairs (**“MCA”**) to regulate the minimum paid up capital of either of these two companies by way of amendment/ modification in the Chapter I rules. MCA has not proposed any minimum paid up capital limit for the companies.
- The concept of Common Seal, which is a “relic” as far as global laws are concerned, has been done away with. Accordingly, Section 9 and other provisions of the Companies Act, 2013 has been amended. Since, use of Common Seal is now optional, if company doesn’t have common seal the authorization (or power of attorney) given to any attorney to execute other deeds on its behalf (in any place either in or outside India) under Section

22(2) or the issue of share certificate under Section 46(1) shall be made by two directors or by a director and the Company Secretary, wherever the company has appointed a Company Secretary.

- Section 11 of the 2013 Act has been deleted. By virtue of this deletion, companies can directly commence their business immediately upon incorporation without waiting to get their bank accounts opened and receiving the subscription monies and filing any declaration with the RoC.
- Board resolutions passed by the Directors under section 179 and rules thereto and filed with the Registrar of Companies shall not be available for inspection by any person.
- No company can declare dividend unless carried over previous losses and depreciation not provided in previous year or years are set off against profit of the company for the current year. This provision was inserted in the Rules, without being part of the Act. So the gap, as regards the drafting has been rectified.
- All shares in respect of which dividend have not been paid or claimed for seven consecutive years or more shall be transferred by the company in the name of Investor Education and Protection Fund (**IEPF**) and in case any dividend is paid or claimed in any year during the said period of 7 years, the shares shall not be transferred to IEPF.
- The 2013 Act mandated that if the auditor(s) of a company has reason to believe that an offence of fraud has been committed against the company, by officers or employees, he must report the matter to the Central Government. The Amendment Act has amended this provision, which now requires that only those frauds which are above a prescribed monetary threshold must be reported to the Central Government by the auditor. Frauds below the threshold will be reported to the Board or the Audit Committee, if any.
- Companies must disclose details of such frauds in the Board's report.
- The Amendment Act amended section 212(6) to impose restrictions on the grant of bail only in case of offences relating to fraud under section 447 of the 2013 Act.
- The 2013 Act mandated that a company cannot enter into any related party contract on certain matters without the consent of the Board of Directors and if those matters exceeded the prescribed monetary thresholds, then prior approval of the company by a special resolution was required. The requirement of obtaining approval by a special resolution has been amended with that of an ordinary resolution. This change needs to be mirrored by SEBI in clause 49 of the listing agreement.

  The Amendment Act also brought in the concept of exempting the transactions with wholly owned subsidiaries from the requirements of section 188(1) and by this move this section is been brought in line with the provisions of clause 49 of listing agreement.
- Loans can be made by a holding company to its wholly owned subsidiary company or it can give guarantee or provide security in respect of any loan made to its wholly owned subsidiary company. Also, any guarantee may be given or security may be provided by a holding company in respect of loan made by any bank or financial

institution to its subsidiary company. However, these loans are to be utilized by the subsidiary company for its principal business activities.

- Winding up matters shall be heard by two member bench of NCLT, and not by three member bench.
- The Amendment Act has inserted a new provision vide section 76A which states that in case a company accepts, invites or allows another person to accept or invite on its behalf any deposit which is in contravention to the provisions specified in the Act or rules under it or fails to repay the deposit or any interest, either in part or whole, within the time specified in the Act, or further time allotted by a Tribunal, it shall be subject to certain penalties. If it is proved that the officer of the company, who is in default, has contravened such provisions knowingly or willfully with the intention to deceive the company or its shareholders or depositors or creditors or tax authorities, he shall be liable for action for fraud.
- The 2013 Act empowered the central government to establish or designate special courts for the purpose of providing speedy trial of offences under the Act. The Amendment Act has amended this provision to limit the constitution of such benches only for the trial of offences where punishment is imprisonment of two years or more. All other offences are to be tried by a metropolitan or first class judicial magistrate.

Source: http://www.mca.gov.in/Ministry/pdf/AmendmentAct_2015.pdf

VA View

Government has brought changes in Companies Act, 2013 with a view to promote ease of doing business in India, aligning Indian corporate laws with global practices and rectifying drafting errors which were there at the time of enactment of Companies Act, 2013. These pro-active steps on part of the Government will go a long way to ease the doing of business in India.

III. SEBI's guidance on voting agreements under Takeover Code

SEBI has issued an informal guidance on inter-se transfer of shares between promoters and voting agreements under the Takeover Code. This was issued upon request by the promoters of Cipla Limited, one of India's leading pharma companies.

The promoter and largest shareholders of Ciplaare Dr. Y.K. Hamied and his family members. Until now, all the family members had exercised their voting rights individually and no proxies were appointed to vote on behalf of any member. As part of a voluntary and consensual family understanding, the promoter family proposed to enter into a voting agreement wherein the family would operate jointly as a single consolidated unit and exercise their voting rights as per the direction of Dr. Y.K. Hamied, and after his death or in the event of his incapacity, by Mr. M.K. Hamied.

Thereafter, the family shall act as a joint unit subject to the direction of the member of the family having the largest shareholding among all family members. In addition to these clauses, the said agreement also provided for preemptive rights in case any family member chooses to transfer his shares.

The promoters approached SEBI to understand whether the voting agreement as contemplated above would amount to an acquisition of shares or voting rights under the Takeover Regulations and therefore trigger mandatory open offer requirements.

SEBI stated that the family members are already disclosed as part of the promoter group and they are "persons acting in concert". The voting agreement "implies that Mr. Y.K. Hamied would be the single largest holder of voting rights in the target company". This would have triggered the mandatory open offer obligation but since the voting agreement is between family members, it would be exempt under Regulation 10(1)(a)(ii) read with 10(1)(a)(iv) of the Takeover Regulations subject to fulfillment of certain conditions stated therein.

Source: http://www.sebi.gov.in/cms/sebi_data/pdffiles/30987_t.pdf

VA View

This informal guidance in case of Cipla, has clarified that succession planning in terms of control over the company amongst the promoters/promoter group will not trigger Takeover Regulations. Such arrangements between family members, promoter group or other parties can be entered into subject to exemption from SEBI.

IV. Snapshot of the Foreign Direct Investment Policy

The Government of India has issued Consolidated FDI Policy Circular of 2015 [FDI Policy Circular] on 12 May 2015 which subsumes all press notes/clarifications/press release in relation to foreign direct investment [**FDI**] issued by Department of Industrial Policy & Promotion, Ministry of Commerce & Industry, Government of India [**DIPP**], which were in force as on May 11, 2015 and reflects the FDI policy as on date. The key updations made in the FDI Policy Circular are highlighted below:

Railway

For railways infrastructure, 100% under Automatic Route is permitted in construction, operation and maintenance of the following: (i) Suburban corridor projects through PPP, (ii) High speed train projects, (iii) Dedicated freight lines, (iv) Rolling stock including train sets, and locomotives/coaches manufacturing and maintenance facilities, (v) Railway Electrification, (vi) Signaling systems, (vii) Freight terminals, (viii) Passenger terminals, (ix) Infrastructure in industrial park pertaining to railway line/ sidings including electrified railway lines and connectivity to main railway line and (x) Mass Rapid Transport Systems. Proposals involving FDI beyond 49% will be considered on a case to case basis.

Insurance

In insurance sector, sectoral cap has been raised to 49% from 26%, with upto 26% under Automatic Route, and upto 49% under Government Route. The aggregate holdings by way of total foreign investment in its equity shares by foreign investors, including portfolio investors, cannot exceed 49% of the paid-up equity capital of the Indian insurance company.

Defense

FDI under defense sector is permitted upto 49% under government route, up from 26%.FPI investment is also permitted. Portfolio investment by FPIs/ FIIs/ NRIs/ QFIs and investments by FVCIs together is limited to 24% of the total equity of the investee/ joint venture company. Chief Security Officer (CSO) of the investee/ joint-venture company should be resident Indian citizen. Investee/ joint-venture Company should be structured to be self-sufficient in areas of product design and development. The investee/ joint-venture company should also have maintenance and life cycle support facility of the product being manufactured in India. Proposals for FDI beyond 49% (formerly 26%) with proposed inflow in excess of INR 2000 crores (formerly 1200 crores), which are to be approved by Cabinet Committee on Security will not require further approval of the Cabinet Committee on Economic Affairs (CCEA).

Pharmaceutical

FDI up to 100% under the automatic route is permitted for manufacturing of medical devices.

Depository Receipt

Depository Receipts will be governed by the new Depository Receipts Scheme, 2014 issued by Reserve Bank of India on December 15, 2014.

Issue of shares

Under the FDI Policy 2015, the price of the shares issued will be determined as per the fair valuation of shares by a SEBI registered Merchant Banker or a Chartered Accountant as per any internationally accepted pricing methodology on arm’s length basis, where the shares of the company are not listed on any recognized stock exchange in India.

Acquisition of shares under scheme of merger or amalgamation

FIPB approval would not be required in case of ESOPs or mergers and acquisitions taking place in sectors under automatic route.

Approvals

FIPB would consider proposals with foreign equity inflow of and below INR 2000 crores, up from the earlier limit of INR 1200 crore. The recommendations of FIPB on proposals with total foreign equity inflow of more than INR 2000 crores would be placed for consideration of Cabinet Committee on Economic Affairs (CCEA). No fresh approval will be required for any additional foreign investment beyond the approved investment limits subject to the condition that the approved foreign equity percentage is maintained.

Filing of FC-TRS for the transactions on the stock exchanges

It has been clarified that in cases where the non-resident investor, including an NRI, acquires shares on the stock exchanges under the FDI scheme, the responsibility of filing FC-TRS with the AD Category-I bank would be that of the investee company and not of transferor or transferee.

Source: http://dipp.nic.in/English/policies/FDI_Circular_2015.pdf

VA View

Issue of FDI policy by Government of India is an annual routine affair. The Government is opening more and more sectors and is taking steps towards hassle free entry of investors. The increasing of threshold limit for proposals to be placed before CCEA is a welcome step.

V. Tidbits

1. A Constitution Bench ruling of the Supreme Court in the matter of Madras Bar Association v. Union of India and Another has upheld the constitutionality of the provisions of Companies Act 2013 relating to National Company Law Tribunal subject to certain conditions regarding qualifications, term and structure of the committees. This allows setting up of a body, meant to replace the Company Law Board (CLB), the Board for Industrial and Financial Reconstruction (BIFR) and the Appellate Authority for Industrial and Financial Reconstruction (AAIFR). As a result of this judgment, the remaining provisions of the Act may now be notified.

   Source: http://supremecourtofindia.nic.in/FileServer/2015-05-14_1431595075.pdf

2. The Finance Act, 2015 has amended the test of determination of residence of offshore companies in India. A company shall be said to be resident in India if its Place of Effective Management, in that year, is in India ,i.e, the concept of Control or Management (wholly in India) is replaced with Place of Effective Management.

   "Place of Effective Management" means a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole, are in substance made.

   Source: http://www.incometaxindia.gov.in/Pages/acts/finance-acts.aspx

3. The Institute of Chartered Accountants of India (ICAI) issued a guidance note on Accounting for Expenditure on Corporate Social Responsibility Activities covered under section 135 of the Companies Act, 2013 in accounting for its corporate social responsibility (CSR) expenses.

   - To ensure transparent financial reporting, this guidance note requires a company to debit (charge) its profit and loss account (P&L Account) with the CSR expenses incurred by it during the year. Further, such expenses are to be shown as a separate line item in the P&L account.

   - Any shortfall in meeting the minimum CSR requirements need not be provided in the P&L Account. Similarly, any excess spent over the minimum CSR requirement cannot be carried forward and adjusted in the next fiscal.

- Programmes or projects or activities, that are carried out as a pre-condition for setting up a business, or as part of a contractual obligation undertaken by the company or in accordance with any other Act, or as a part of the requirement in this regard by the relevant authorities cannot be considered as a CSR activity within the meaning of the Act. Similarly, the requirements under relevant regulations or otherwise prescribed by the concerned regulators as a necessary part of running of the business, would be considered to be the activities undertaken in the 'normal course of business' of the company and, therefore, would not be considered CSR activities.
- An asset whose control has been transferred by the company for purposes of CSR will be charged as expenditure in its Profit and Loss Account. For instance, the expenditure incurred on a school building and transferred to the Gram Panchayat for running and maintaining the school.

Source: http://www.icai.org/post.html?post_id=8918

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