

## Indian Companies Act 2013: The Story So Far

### Introduction

It has been a long time in waiting but India finally enacted its new Companies Act 2013 (the “Companies Act”) at the end of August 2013. The Companies Bill was passed by the Lok Sabha (the Lower House of the Parliament of India) on 18 December 2012 and in the Rajya Sabha (the Upper House of the Parliament of India) on 8 August 2013. It received Presidential Assent on 29<sup>th</sup> August 2013 thereby creating the Companies Act 2013.

The new Companies Act, replaced the old Companies Act 1956, which although amended approximately 25 times was still considered to be out of date and inadequate compared to the legislation regulating companies in many other jurisdictions. It took four years to implement the Companies Act since it was first introduced as a Companies Bill in 2009 but not all of its provisions will come into force immediately as a number of them require the Indian Government to draft rules and regulations for their implementation.

Some of the provisions of the Companies Act 2013 that did not require any additional rules or regulations for their implementation were brought into force on 12 September 2013, following a notification by the Ministry of Corporate Affairs. However, these provisions only represented 98 out of the 470 sections of the Companies Act and it has caused confusion because businesses still have to look at both the old Companies Act and the new Companies Act to interpret the current law. Many have argued that the whole of the Companies Act should have been brought into force at one time, whilst others believe that a step by step approach provides businesses with time to get to grips with the new provisions.

The draft Companies Act Rules (“Rules”) which are required for the implementation of some of the provisions have been issued for public comment. These have been issued in two phases, with feedback on the 1<sup>st</sup> Phase Rules to be submitted by 10 October and feedback on the 2<sup>nd</sup> Phase Rules to be provided by 23 October.

We have set out below a brief summary of some of the key changes that are coming into force, including clarifications provided by the draft Rules.

### Key changes being implemented

**Financial Year** - The financial year of every company must be end on 31 March every year, which is the same period as is required for tax reporting purposes. An Indian company which is a holding

company or a subsidiary of a foreign company requiring consolidation outside India will have an option to apply to the National Company Law Tribunal to follow a different period as its financial year. Existing companies have two years to align their financial year with the new requirements.

**One Person Company and Small Company** - The Companies Act introduces the concepts of a one person company and a small company which will not have to comply with certain requirements relating to reporting, board meetings and other procedural matters. A small company is defined as a company other than a public company which has either (a) a paid up share capital of no more than INR 50 lakhs (c. US\$80k); or (b) turnover which does not exceed INR 2 Crore (c. US\$320k) or such higher amount as may be prescribed but not more than INR 20 Crore (c. US\$3.2m). However, these provisions will not apply to a holding company or a subsidiary, a charity or a body corporate governed by any special Act.

The draft Rules further provide that in respect of a One Person Company, the shareholder must be a natural person who is an Indian citizen and resident in India. They further state that a person can only incorporate a maximum of five One Person Companies.

**Dormant Company** - The Companies Act recognises the concept of a “dormant company” which can be formed for a future project or to hold an asset or intellectual property, provided it has no “*significant accounting transaction*” which in summary means any transactions other than transactions relating to the maintenance of the company and compliance with law.

**Entrenchment Provisions** - Companies can now include entrenchment provisions within their articles of association. An entrenchment provision is a provision which can only be amended or removed by a vote of such number of shareholders exceeding that number that would be required for a special resolution. As a result, minority protection provisions such as veto rights, or drag - along and tag-along rights, can now be included within articles of association without fear of their amendment or removal by a special resolution, thereby providing rights to minority investors which could previously only be reflected in a shareholders’ agreement. The adoption of any entrenchment provisions must be notified to the Register of Companies within 30 days.

**Corporate Social Responsibility (“CSR”)** - CSR will be made mandatory for Indian companies with a net worth of INR 500 crores (c.US\$80m) or more, or a turnover of INR 1,000 crores (c. US\$160m) or more, or net profits of INR 5 crores (c. US\$800k) or more during any financial year. Such companies will be required to establish a CSR committee to formulate a CSR policy and to recommend expenditure of CSR projects. The company is required to spend at least 2% of the company’s average annual net profits over the preceding three financial years on social and charitable causes annually in accordance with its CSR policy.

The draft Rules state that for the purposes of the first CSR reporting, the net profit shall be the average of the annual net profit of the company for the preceding three financial years ending on 31 March 2014.

Any company subject to these provisions which does not comply with this requirement must provide the reasons for not doing so in its annual financial statements.

**Auditor Rotation** - Under the previous Companies Act auditors were appointed on an annual basis and held office until the conclusion of the next AGM. Under the new Companies Act auditors must hold office until their sixth AGM (i.e. 5 years), although the appointment still needs to be ratified at each AGM. Furthermore, listed companies and companies belonging to prescribed classes of companies may not appoint or reappoint their auditors for (i) more than two consecutive five year terms if the auditor is an audit firm; or (i) for more than one term of five consecutive years if the auditor is an individual. Following retirement from a company an auditor may not be reappointed for a further five years.

The draft Rules state that the prescribed classes of company referred to above are all companies excluding small companies and one person companies. The draft Rules further state that any period prior to the commencement of the Companies Act shall be taken into account in determining the five or ten year consecutive terms.

**Directors** - Under the previous Companies Act, a public company, or any private company which was a subsidiary of a public company, could only have a maximum of 12 directors. Any increase required an approval from the Central Government. Under the new Companies Act the number of directors that any Indian company can have has been increased to 15 directors. This can be increased further by the passing of a special resolution.

Certain classes of companies “as may be prescribed” must now have a female director, although there is a transitional period in which to comply with this.

According to the draft Rules, the classes of companies shall be every listed public company, who will have one year from commencement of the provision to comply; and every other public company having a paid up share capital of INR 100 Crore (c. US\$16m), or a turnover of INR 300 Crore (c. US\$50m), who will have three years from commencement of the provision to comply.

Every company must now have a director who resided in India for 182 days or more in the previous calendar year.

The directors duties have now been codified. They state that a director of the company shall (a) act in accordance with the articles of the company; (b) act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and the protection of the environment; (c) exercise his duties with due and reasonable care, skill and diligence and shall exercise independent judgement; (d) not involve himself in a situation in which he may have a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company; (e) not achieve or attempt to achieve any undue gain or advantage either to himself or his relatives, partners or associates; and (f) not assign his office.

Board meetings by telephone conference are now explicitly permitted under the new Companies Act.

**Independent Directors** - One-third of the number of directors of every listed public company must be independent directors. Certain classes of public (non-listed) companies will also have to appoint such number of independent directors as may be prescribed.

According to the draft Rules, such companies will be public companies having a paid up share capital of INR 100 Crore (c. US\$16m); or a turnover of INR 300 Crore (c. US\$50m); or which have in aggregate, outstanding loans or borrowings or debentures or deposits, exceeding INR 200 Crore (c. US\$30m). Also note that once appointed the draft Rules state that the obligation to maintain an independent director continues during the director's tenure, even if the share capital, turnover or borrowings fall below the limits referred to above.

The new Companies Act also prescribes what attributes a person must have to be an independent director. These include that an independent director must (a) be a person of integrity and possess relevant expertise and experience; (b) not be a promoter of the company, or its holding, subsidiary or associate company; (c) not be related to promoters or directors in the company, its holding company or associate company; (d) have no pecuniary relationship with the company, its holding company or associate company, or their promoters or directors, during the two previous years or the current year (e) have no relatives that have such a pecuniary relationship (subject to certain thresholds); (f) not be or have been in a key managerial position with the company or an employee; (g) not be a chief executive officer of any non-profit organization that receives 25% or more of its receipts from the company; and (h) must not be a holder, individually or together with his relatives, of 2% or more of the voting shares of the company. A nominee director cannot be an independent director.

Companies have one year from commencement of these provisions to implement these changes.

Every independent director must give a declaration when he commences office and at the first board meeting in each financial year that he meets the criteria for an independent director.

Independent directors shall hold office for a term of up to five consecutive years and shall then be up for re-appointment for a further term of five consecutive years. No independent director may hold office for more than two five year terms, but may be re-appointed after three years following retirement.

Independent directors are not entitled to stock options. It is unclear how previously granted stock options will be dealt with.

**Related Party Transactions** - Under the previous Companies Act, the approval of Central Government was required before a company could enter into certain related party transactions.

Under the new Companies Act directors can approve the entry into by the company of related party transactions provided that certain financial conditions are not exceeded.

These conditions are set out in the draft Rules which prescribe that a special resolution is required if a company has a paid-up share capital of INR 1 Crore or more (c. US\$160k) and is proposing to enter into a contract with a related party, or if the transaction to be entered into with a related

party (a) exceeds the higher of 5% of the annual turnover or 20% of the net worth of the company (as per the last audited financial statements of the company, and is in relation to the sale, purchase and supply of goods and materials, the selling or buying of property, the leasing of property, the availing or rendering services, or the appointment of an agent for the sale or purchase of goods, services or property; (b) relates to an appointment to any office with a monthly remuneration exceeding INR 1 lakh (c. US\$1.5k); or (c) is for remuneration for underwriting any subscription of any securities or derivatives exceeding INR 10 lakh (c. US\$15k).

**Loans to Directors** - The new Companies Act contains restrictions on advancing any loan to any director or to “*any other person in whom the director is interested*”. For these purposes, persons in whom the director is interested includes (a) any private company of which such director is a director or member; and (b) any body corporate, the board (or the managing director or manager) or which is accustomed to act in accordance with the instructions of the board of the lending company.

Although, similar provisions were contained in the old Companies Act, the old Act also included an exemption for loans from holding companies to its subsidiaries. This exemption has not been carried forward into the new Companies Act meaning that a holding company will no longer be able to give a loan, or guarantee or provide security on behalf of its subsidiary if they have common directors.

Note that this provision is now in force following notification on 12 September 2013.

**Investments** - The new Companies Act introduces a new requirement that a company cannot make an investment through more than two layers of investment companies (being a company whose principle business is the acquisition of shares, debentures and other securities). However, this will not apply to the acquisition of companies outside of India if the target has investment subsidiaries beyond two layers according to the laws of that jurisdiction, or to any subsidiary from having any investment company for the purposes of meeting any requirement of any law for the time being in force.

**Mergers and Amalgamations** - Under the new Companies Act, mergers between two or more small companies (as defined) and between holding companies and their wholly owned subsidiaries will no longer require the prior approval of the National Company Law Tribunal, subject to compliance with certain other prescribed procedures. Mergers of Indian companies with companies from certain other jurisdictions to be determined from time to time by the Central Government are also permitted on a similar basis. No further guidance has been provided in the draft Rules.

Provisions have also been introduced permitting an acquirer of 90% or more of the issued share capital of the target company to compulsorily acquire the minority shareholding at a price to be determined by a registered valuer.

**Class Actions** - Class action law suits will be introduced in the Companies Act 2013, so that members may, if they are of the opinion that the management or the affairs of the company are being conducted in a manner prejudicial to the interests of the company, or its members, file an application before the National Company Law Tribunal on behalf of the members, seeking one of

the orders set out in the Companies Act, such as to restrain the company and its directors from committing certain acts, to declare a resolution altering the memorandum and articles of association as void, or to claim compensation against the company or any of its directors, its auditors, or any expert for improper acts, including fraudulent, unlawful or wrongful acts.

The draft Rules have prescribed that the number of members of a company having a share capital that can bring such a claim shall be not less than 100 members or not less than 10% of the total number of its members, whichever is less, or any member or members holding not less than 10% of the issued share capital of the company.

## Summary

The new Indian Companies Act is a positive step towards modernising India's company law and aligning it to global standards. It has given increased decision making powers to the company, and introduced provisions giving minority shareholders additional rights and protections. The introduction of one person companies and small companies should alleviate some of the administrative burdens that small businesses have to bear, but larger companies should prepare themselves for further administrative burdens as a result of changes in the appointment of auditors and directors.

Further clarity will be required as the provisions of the Companies Act come into force and we will watch with interest as this area of law develops.

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