CLIENT UPDATE

INDIA'S NEW COMPANY LAW REGIME

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On August 30, 2013, India enacted the Companies Act, 2013[1] (the "New Act"), which has replaced the Companies Act, 1956 ("Old Act"). Not all the provisions of the New Act will come into force immediately as a number of them require the Government of India to draft rules and regulations for their implementation. This process is likely to take place over the next several months.

The New Act is seen as an important step in bringing Indian company law closer to global standards. It regulates areas ranging from incorporation to fundraising, corporate governance, mergers, auditor rotation and investor protection. The main highlights of the New Act are:

INCORPORATION

- Private companies may be incorporated with up to 200 members, up from the existing limit of 50 under the Old Act. However, a private company which is a subsidiary of a public company will be regarded as a public company, even if incorporated as a private company.

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[1] Notified as Act No. 18 of 2013 in the Gazette of India, Extraordinary, Part II, Section 1, dated 30th August 2013.

- A company will be regarded as a holding company of another, if the former *holds or controls* more than 50% of the *total share capital* of the latter, *i.e.*, equity (voting and otherwise) and preference share capital. This is significantly wider than the test under the Old Act where only ownership of equity shares was considered and will have an impact on the determination of related-party transactions, inter-company loans, etc.
- The New Act, while simplifying certain requirements for incorporation, has introduced new concepts of "One Person Companies" and "Small Companies" that will enjoy dispensation from requirements relating to reporting, board meetings and other procedural matters.
- The concept of a "dormant company" which can be formed for a future project or to hold an asset or intellectual property has been introduced.
- An investment structure that involves more than two layers of "investment companies" in India is now prohibited, subject to two specific exceptions: (i) allowing Indian companies to acquire offshore companies, which, in turn, have subsidiaries beyond two levels; and (ii) in cases where a company needs to have more than two layers of investment companies in order to comply with law. An "investment company" has been defined as one whose principal business is the acquisition of securities. The suggested rationale behind this change is to limit tax avoidance through multiple holding company structures. On the flip side, this change will have an impact on structuring down-stream foreign investment through holding companies in India. It reduces flexibility, particularly impacting sectors such as infrastructure and mining where it is common to have multiple subsidiaries for implementing projects and fund-raising. Also, there is a lack of clarity on the fate of existing structures, and whether, they will be required to comply with the new régime.

SHARE CAPITAL AND FUNDRAISING

- In the case of public companies, a contract (such as a shareholders' agreement) restricting the transfer of shares will now be enforceable, resolving uncertainty created by prior judicial decisions.
- Companies will be restricted from issuing shares at a discount, except in the case of "sweat equity" shares. "Sweat equity" shares are equity shares issued to directors or employees at a discount or for consideration other than cash, in return for their know-how, intellectual property or other value addition to the company.
- For equity fund raising on a private placement basis, enhanced regulation requiring the offer document to be filed with the regulators, depending on the number of offerees and/or the value of the offer, have been introduced.

- For public fund raising (for example, initial public offerings), stricter disclosure requirements and other investor protection measures have been introduced.

MERGERS / AMALGAMATIONS

- The National Company Law Tribunal will be set up as an exclusive forum to decide on matters related to mergers, demergers, arrangements and amalgamations. This forum is expected to increase efficiency as court approval (and the lengthy delays associated with going to court in India) will no longer be required.
- In an attempt to make mergers less time consuming and less expensive, mergers between holding companies and their wholly owned subsidiaries or between two or more small companies (as defined in the New Act) will no longer require prior court / tribunal approval.
- Mergers of Indian companies with companies incorporated in certain yet-to-be specified foreign jurisdictions will be permitted.
- If a listed company merges with an unlisted company, the surviving company will be given the option to remain unlisted. However, the listed company must provide its shareholders with an opportunity to exit for cash.
- In an effort to eliminate unmeritorious litigation in relation to a scheme of arrangement, only those dissenting shareholders or creditors holding at least 10% of the share capital or 5% of the total outstanding debt will have the right to object.
- A person or group of persons acquiring 90% or more of the issued equity share capital of a company, may now acquire compulsorily the minority shareholding of the company at a price to be determined by a registered valuer.

CORPORATE GOVERNANCE AND CORPORATE SOCIAL RESPONSIBILITY

- Appointment of at least one director who is a resident of India, *i.e.*, has been present in India for at least 182 days in the previous calendar year, will be made mandatory for all companies.
- The maximum number of directorships of one individual of public companies will be reduced to 10 from the current 15.
- Public companies will now be required to have independent directors on their boards, with public listed companies required to have at least one-third independent directors. A code of conduct for such directors has been prescribed in Schedule IV of the New Act which lays down the role, duties and manner of appointment of independent directors.

Furthermore, such independent directors may not be given any stock options and their term in office cannot exceed two five-year terms. In addition, nominee directors will no longer be regarded as independent. These measures are seen as efforts to encourage and clearly demarcate the role of independent directors, who, due to the promoter driven nature of Indian business, were often seen as mere figureheads. A prescribed code of conduct could, however, inhibit people from taking up independent directorship for fear of being held directly accountable.

- The New Act has codified the duties of directors, including, the duty to act in good faith, avoid any direct or indirect conflict of interests with the company and to exercise due diligence and reasonable care in decision-making.
- Board meetings by video-conferencing will now be explicitly permitted.
- Corporate Social Responsibility ("CSR") will be made mandatory for a company with a net worth of INR 500 crores (approx. US$100 million) or more, or a turnover of INR 1,000 crores (approx. US$200 million) or more, or net profits of INR 5 crores (approx. US$1 million) or more during any financial year, giving rise to a requirement to spend at least 2% of the company's average net profits of the preceding three financial years on social and charitable causes annually.
- Related party transactions will now require shareholder approval by three-fourths majority where certain prescribed thresholds are exceeded. Related parties, which include key managerial personnel and group companies, are prohibited from voting on such matters.

AUDITOR ROTATION AND INDEPENDENCE REQUIREMENTS

- The New Act provides for mandatory auditor rotation for listed and other prescribed companies every five years depending on whether the auditor is an individual or a firm. In addition, there will be a cooling-off period of five years after completion of such a term during which the auditor cannot be re-appointed.
- Approval of the appointment of the auditors by the shareholders at every annual general meeting of the company will be made mandatory.
- A company's auditor will not be permitted, directly or indirectly, to render any internal audit, investment advisory, management or similar services to the company, its holding company or any subsidiary.
- In the wake of recent accounting scandals, the auditor will be required to immediately report to the central government if it has reasonable suspicion of any offence involving

fraud which is being or has been committed against the company by its officers or employees.

INVESTOR PROTECTION

- "Class action" lawsuits will be introduced for the first time in India, whereby any class of members or depositors, in specified numbers, may initiate proceedings against the company if they are of the opinion that its affairs are being carried out in a manner unfairly prejudicial to the interests of the company, members or depositors.
- Fraud will be made a new ground for seeking the winding up of a company.

CONCLUSION

The New Act contains some significant changes to the current company law regime and its objective of providing greater transparency and better investor protection are praiseworthy. The New Act, along with other recent reforms in foreign direct investment and the recent pro-arbitration stance of the Indian judiciary, are steps in the right direction to renew investor confidence in India. However, the devil still remains in the detail, and the government has a lot to do in terms of framing effective rules and regulations under the New Act. Pending enactment of such rules, it is too early to predict the success of the New Act.

Please note that this firm is not qualified to advise on Indian law. This update is based on information that has been published in the press and from other sources in the public domain.

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Please do not hesitate to contact us if you have any questions.

September 6, 2013