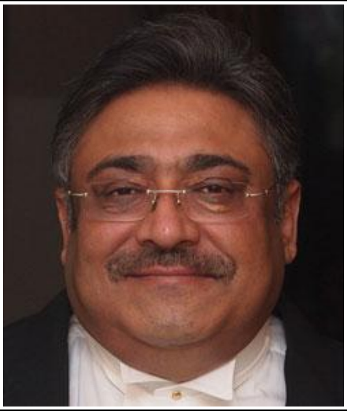
Companies Act, 2013 – a new landscape for fund-raising



Rajiv K.Luthra
Founder & Managing Partner
Luthra & Luthra Law Offices

Introduction

Like all game changers, the Companies Act, 2013 ("**2013 Act**") has gotten a fair number of heads to roll across the entire range of the corporate legal spectrum. With radical strides galore, ranging from enhanced corporate governance norms, greater scrutiny of related party transactions to allowance of class action suits, the 2013 Act seems set to permanently re-define the contours of Indian corporate laws.

Reflecting the wave over the last few years of active regulation on securities offerings by Indian companies, the 2013 Act significantly revamps the manner in which equity and debt capital markets may be tapped by the Indian issuers. To this end, Chapter III of the 2013 Act and the rules issued thereunder govern public offerings and private placements of securities by Indian companies. Chapter III both re-packages numerous provisions of the Companies Act, 1956 ("**1956 Act**"), and introduces new dictates that companies will now be subject to in their fundraising avatars. This article highlights and discusses a few of these key changes, boon or bane alike.

What works

Clarity on 'public offering' and increased reach of private placements

Perhaps where Chapter III of the 2013 Act scores most over its predecessor is in its much-needed clarity on the concept of a 'public offering'. The 2013 Act designates a public offering to include an initial public offer, a further public offer, or an offer for sale of securities to the public, by way of a prospectus. Furthermore, Part II of Chapter III and the rules enacted thereunder go on to define a 'private placement' to mean an offer of securities to persons not exceeding 200 in aggregate (excluding Qualified Institutional Buyers ("**QIBs**"), and employees being offered securities through a stock options scheme), in a financial year. Any offering that is not within the contours of Part II is now deemed to be a public offering. This is a welcome improvisation – not only does it lend clarity to the earlier, and at-best, nebulous proviso to section 67(3) of the 1956 Act, but also seeks to nip fiascos like *Sahara Real Estate* in the bud.

Furthermore, the exclusion of QIBs from the cap of 200 for private placements in a financial year will enable listed issuers heave a sigh of relief, who can now avail of the Qualified Institutions Placement route for fund-raising without having the erstwhile 'rule of 50' breathing down their necks.

Variation in issue proceeds

Reflecting its underlying theme of accountability, the 2013 Act permits a public issuer to alter the end-use of proceeds of its offering from what it has averred in the underlying prospectus only through a special resolution by its shareholders in a postal ballot. Once such a special resolution is passed, the promoters or the controlling shareholders of an issuer must accord all dissenting shareholders an opportunity to exit. Bold and investor friendly – this provision should ensure that issuers think twice before reneging on their end-use representations to investors, and that incidents like the one in December 2011 where Securities and Exchange Board of India ("**SEBI**"), the securities market regulator, was constrained to come down heavily on as many as seven issuers and three merchant banks for facilitating misuse of public offering proceeds, are a thing of the past.

Enhanced disclosure requirements on promoters and directors

Disclosure requirements pertaining to the directors and promoters of issuers have been significantly enhanced under the 2013 Act. Significantly, a prospectus for a public offering will now require to include details of litigation and legal action taken against the promoter of the issuer during the last five years, as well as details of the remuneration paid out, and other shareholding interests of directors of the issuer in its subsidiary and associate companies. Such enhanced disclosure norms should go a long way to ensure that investors are well in the know about some of the most significant shareholders and functionaries of companies in which they wish to throw in their financial hats. Further, the 2013 Act seeks to haul up directors of issuer companies more than its predecessor by requiring all directors who are 'officers in default' to be jointly and severally liable to refund subscription amounts to investors in a public issue along with interest, when such issue has been unable to garner the stated minimum subscription amount and subscription monies have not been refunded by the issuer within prescribed time periods.

Liability on public offering documents

The 2013 Act is palpably more gung-ho than its predecessor in terms of the liabilities associated with a prospectus. Four bold strides in the 2013 Act are notable in this regard. First up, civil liability on statements made in a prospectus is now triggered by a wider spectrum of 'mis-leading statements' as opposed to the narrower 'untrue statements' in the predecessor legislation. This is a fairly significant change, and mirrors the famous 'SEC Rule 10b5' on securities fraud promulgated by the US Securities and Exchange Commission. Second, criminal liability for mis-statements in a prospectus has been equated with the liability accruing from 'fraud', by virtue of which mis-statements now attract both imprisonment as well as a monetary fine, and if such fraud involves public interest, a mandatory minimum punishment of three years has been prescribed. Third, and perhaps the most frightening of all – if proven that a prospectus had been issued with an intent to defraud or any other fraudulent purpose, key personnel of the issuer, such as its directors, promoters, experts (whose statements have been included in the prospectus) and every other person who had authorised the issue of the prospectus are to be held personally responsible, without any limitation of liability, for losses incurred by investors who have subscribed to such prospectus. Finally, the 2013 Act expressedly ascribes civil liability to 'experts'. Directors and promoters may not, however, disclaim civil liability on expert statements in the prospectus, if found misleading.

Additionally, the 2013 Act empowers a group of persons or any associations of persons affected by any misleading statements or the inclusion or omission of any matter in the prospectus to file a suit. No minimum number of persons required for filing such a suit has been prescribed. It has also been stated that 'any other action' may be taken imposing civil or criminal liability on the persons responsible for such misleading statements in a prospectus.

All of this encompasses a robust liability regime, one that should ensure exercise of greater due diligence and adoption of more checks and balances by issuers and their key functionaries seeking to tap public markets.

Valuation of shares for further issuances by registered valuer

Section 62 of the 2013 Act and the rules framed thereunder suggest that an issuer makes an offering of its securities to persons other than its members (which would typically cover public offerings as well as private placements) must price these securities in accordance with the report of a registered valuer. The requirement of registered valuer sign-off is however, exempted for shares issued on a 'preferential' basis by a listed company. While public offerings can be priced through various methods prescribed by SEBI, the relevant SEBI regulations did not contain suitable checks and balances on determining whether a particular method for pricing a public offering was justifiable. The 2013 Act attempts to bridge this lacuna by providing for any such valuation to be ratified by the report of a registered valuer. This is a welcome move and will hopefully act as a deterrent to issuers wanting to price their securities at unjustifiable levels.

What doesn't work

Disclosure of the sources of promoters contribution

A fairly onerous new disclosure diktat under the 2013 Act requires a prospectus for a public offering of securities to disclosure the sources of 'promoter's contribution'. Issuers are now required to state the source of funds of their promoters which financed the purchase of securities constituting promoters' contribution. This provision is a little extreme at best – tracing the source of funds for promoter shares held for a long period of time by the promoters may be neither practicable nor verifiable. Disclosing such details in a prospectus will be a challenge, and as the directors of the issuer also take liability in respect of the prospectus, it could prove to be a hurdle in fair and accurate disclosures.

Restriction on variation of objects

While, the restrictions imposed under the 2013 Act on issuers attempting to change the end-use of offer proceeds is a welcome one, this provision fails to dot the i's completely by being silent on whether it applies in a situation where an issuer does not change the end-use of funds raised, but varies deployment of offer proceeds within the stated end-uses. Given that the 2013 Act is silent, this provision could potentially saddle issuers who obtain public funds for large projects (such as power or infrastructure) with the hassle of obtaining a special resolution and providing exit options to the dissenting shareholders for any alteration in the deployment of proceeds in case of time or cost overruns in the underlying project, without there being change in the end-use of proceeds.

Offerings by foreign companies

The provisions of Chapter XXII of the 2013 Act read with section 42 envisage a particularly puzzling situation in relation to issuance of stock options by companies incorporated outside India. Chapter XXII directs a company incorporated outside India not to make an offering of its securities in India to the public unless it complies with the regulatory regime governing public offerings by Indian companies, including, unless it issues a prospectus which is duly registered with the Registrar of Companies, and includes the requisite disclosures therein. While section 42 exempts shares offered by an Indian company to employees in pursuance of a stock options scheme from being calculated for the 200 investor limit, such exemption does not extend to include stock options offered by companies incorporated outside India to Indian employees. In this unique case of possible overreach, the 2013 Act actually regulates offshore incorporated companies more onerously than Indian ones – stock options may therefore not be offered by companies incorporated outside India to more than 200 of its Indian employees without pushing the public offer button.

Additionally, the over-reach extends even generally under Part II of Chapter III – given that issuances by foreign incorporated companies of securities has not been exempted from this part, the issue of even one security in India by an offshore company will now have to pass muster of the 2013 Act provisions governing private placements in India, including, the requirement to have a prior offering document designated as a private placement offer letter.

Some other creases

Apart from the larger issues highlighted above, the 2013 Act has its fair share of smaller creases that one hopes, will be ironed out as more issuers attempt to access the capital markets under the new legal framework.

One significant melting pot of creases appears in the cluster of rules under the 2013 Act on issuance by companies of non-convertible debentures ("**NCDs**"). Such rules prescribe, *inter alia,* a maximum of tenor of 10 years for secured NCDs (the window relaxed to 30 years for entities 'setting up' infrastructure projects); that NCDs can be secured only through specific movables; disallowing share pledges as acceptable security for NCDs; and that for partly convertible debentures ("**PCDs**"), a redemption reserve be created only in respect of the non-convertible portion of the PCDs. These rules don't augur too well, and particularly for entities such as non-banking financial companies ("**NBFCs**") that typically utilise the NCD route for long term financing. A maximum tenure of 10 years makes little sense, particularly if the underlying issuer offers adequate security that does not depreciate over the tenure. The 30 year exemption for issuers 'setting up infrastructure projects' is fuzzy, at best, particularly since it does not clarify if NBFCs who are infrastructure lenders can avail of this window. Requiring movable security cover to be specific also, does not help NBFCs, since such companies with no real immovable assets would typically charge their entire pool of receivables through floating charges to secure NCDs will now be require to charge specific movable assets. Finally, while the 2013 Act does cover PCDs in terms of the requirement to maintain redemption reserves, it does not cover optionally convertible debentures – issuers of which will have to grapple with the question of whether or not to create a debenture redemption reserve, given that the 'debentures' are can be either redeemable or convertible at the option of their holders.

While the requirement for a special resolution for undertaking each tranche of private placement has been relaxed to a one-time special resolution for NCDs, since the 2013 Act requires special resolution to mention the justifications behind the "price" at which securities will be offered, an omnibus resolution covering numerous tranches of NCDs over a year may be required to mention some basis of the coupon rates at which they are offered. Given that coupon rates for NCDs are heavily driven on market indices such as the Repo Rate and the Government Securities Rate, it could be difficult for issuers of NCDs to indicate even a coupon range for all of its NCD issuances in a year at the time of passing of the special resolution.

Finally, with regard to foreign direct investment – rules under the 2013 Act require the conversion price of a convertible security issued on a preferential basis to be determined upfront. Apart from being on the restrictive side, this conflicts with extant norms governing foreign direct investment in India, which require only the conversion formula of convertibles offered to foreign investors to be determined up-front, and not the issue price itself.

Conclusion

With a new government in the centre, investment appetites being whetted once more, and reports in the press indicating that numerous issuers who were waiting out the pre-election storm are now raring to give the capital markets a go, the 2013 Act seems set to be truly put to the test. While the legislation has all the looks of having its heart at its right place, particularly in relation to greater transparency and investor protection, it is still in its infancy, and does encompass elements that could potentially hinder faster and easier access to money markets. One can only hope that emerging jurisprudence, regulatory clarifications and market practice even out these few kinks so that the Indian corporate milieu can indeed boast of having access to liquid markets, a diverse investor base, and a watch-dog legislation that oversees the interests of all relevant stakeholders.