AGAMA
LAW ASSOCIATES

Compliances with Companies Act, 2013 – Part V

The Companies Act, 2013 seeks to create a major overhaul in the functioning of the corporates in India. The Act subjects private companies to a greater control and compliances and withdraws many of the exemptions available to private companies under the Companies Act, 1956. One such area is compliances relating to issue or offer of securities by private companies.

Further Issue of Share Capital (Section 62)

Further issues

Section 62 dealing with further issues of shares is the new avatar of Section 81 of the previous Companies Act. Section 62 is protector of rights of existing shareholders in that it offers the right of pre-emption or the anti dilution right to investors in a company. The earlier Act exempted private companies from the provisions of this section and rightly so. There is no such exemption under the Companies Act. Certain chanes are proposed vis-à-vis provate companies by the new Government, details of which are available here. However the law as it stands today, is set out below.

Rights Issue

As under the previous Companies Act, existing shareholders have the right to be offered first any subscription to additional capital in the Company. However, under the previous Companies Act, the shares had to offered to existing shareholders only after the initial capitalisation phase had ended, which the law placed at 2 years from the date of incorporation or the first issue of shares. This helped companies to capitalise and infuse funds without the dagger of compliance hanging on their heads. Now, even a private company shall from first day of incorporation offer its shares to all exisitng shareholders before issuing shares to any person. In most cases, the promoters incorporate a company with the minimum paid up capital needed under law i.e. INR 1 lakh and thereafter infuse funds over a period of time.

Unless the articles of the company otherwise provide, in the case, where existing shareholders do not accept the offer or renounce, the directors should dispose of such shares in a manner "non dis-advantageous" to the shareholders and the company. It is very difficult to construe what not disadvantageous means.

Issue of ESOPs

The approval of shareholders by way of separate resolution shall be obtained by the company in case of issue of sweat equity shares or ESOPs. The company shall make the prescribed disclosures in the explanatory statement annexed to the notice for passing of the resolution as prescribed under Companies (Share Capital and Debentures) Rules, 2014 ("**Share Capital Rules**"). In a recent proposal of the Ministry of Corporate Affairs, this requirement of special resolution for issuance of ESOPs was proposed to be done away with. It will need to be seen how far the other compliances as required under the Share Capital Rules are done away with.

The companies granting option to its employees pursuant to Employees Stock Option Scheme will have the freedom to determine the exercise price in conformity with the applicable accounting policies.

In addition to the special resolution, the Companies (Share Capital and Debenture) Rules, 2014 require certain other requirements as well of an unlisted company including inter alia the following:

a) Restriction on quantum of sweat equity shares to be issued at 15% of existing paid up share capital or value of INR 5 crore whichever is higher, with a total cap of 25% of paid up share capital at all times,
b) Lock-in of 3 years on the sweat equity issued,
c) Valuation of intellectual property to be made by a registered valuer, and
d) Treatment of sweat equity as part of compensation package of the concerned employee.

Preferential offer

Under the previous Companies Act, a preferential offer was governed by Section 81 (1A). Shares may be offered to persons who are not members of the company if such issue is authorised by a special resolution. Even under new Companies Act, the position is the same. However, this provision has been made applicable to private companies as well.

Certain compliances are required for such preferential issues:

1) A special resolution needs to be passed,
2) Requisite disclosures in the explanatory statement to be annexed to the notice of the general meeting pursuant to section 102 of the Act *inter alia* with respect to the following:
    a. object of the issue,
    b. price band,
    c. basis of price and report of registered valuer,
    d. intention of promoters/ KMP to subscribe to the offer,
    e. change in control purusant to the preferential allotment,
    f. details of allotment in the previous year.

Rule 13(1) of the Share Capital Rules provides that an issue under Section 62(1)(c) shall also comply with the conditions laid down in section 42 of the new Companies Act dealing with private placement of securities.

Private Placement of Securities (Section 42)

Private placement has been defined to mean any offer of securities or invitation to subscribe to securities to a select group of persons by a company through issue of private placement offer letter.

Typically, the provisions of private placement was necessary to allow listed companies or public companies to obtain additional capital withtout having to go to the public under a further public offer or a rights issue as the case may be.

Any placement by a private company would by definition need to be a private placement without the law imposing such additional restrictions on private companies.

In order to qualify as a private placement under the new Companies Act, companies need to ensure that :

- Offer of securities or invitation to subscribe to securities cannot be made to persons (excluding QIBs and employees subscribing to shares under an ESOP scheme) *exceeding 50* or such higher number as may be prescribed in a financial year.
- Offer or invitation shall be made to not more than *200 persons* in aggregate in a financial year.

As to the rationale for these provisions being made applicable to private companies there is no answer.

A private company by definition (Section 2(68)) cannot invite the public to subscribe to any securities of the Company. The articles of association will contain restrictions in this behalf. The issues that arise from application of this section to private companies can be seen in the following:

i. Any offer or invitation not in compliance with this section shall be deemed to be a public issue;
ii. Monies cannot be collected in cash and can only be collected through normal banking channels;
iii. Allotment of securities shall be within 60 days from the date of receipt of application monies, otherwise application monies shall be refunded within 15 days from the expiry of 60 days;
iv. Monies received under this section shall be kept in a separate bank account in a scheduled bank and shall not be utilised for any purpose other than for adjustment against issue of shares or repayment on non-allotment of securities.

Consequences of Non-Compliance

Section 62 is in the nature of shareholders rights and not so much in the nature of compliance. The section is a mandatory provision, and not a compliance provision. Any issue of shares in breach of the section will be illegal, and therefore, liable to be quashed. Other remedies available to shareholders shall be in the nature of suing for oppression and mismanagement or seeking rectification of registers.

The real meance is Section 42 (10) which prescribes penalty for non-compliance whereby the company, its promoters and directors shall be liable for a penalty which may extend to the amount involved in the offer or invitation or INR 2 crores, whichever is higher and the company shall refund all monies to subscribers within 30 days of imposition of penalties.

That private companies are required to comply with Section 42 as well as Section 62 to increase the issued, subscribed and paid up capital (other than by way of a rights issue) is the position of law today. But this position is unitelligible in its application to private companies.

Surprisingly removal of the application of this section to further issues by private companies finds no mention in the proposal issued by the new government in relaxations to private companies. A lot of thought needs to be applied to infusion of capital until any relaxation is provided by the Government.