Private Equity Regulation under Companies Act: Comment on Prevailing Provisions under Companies Act, 2013

Abstract

The Companies Act 2013 has largely consolidated the law regulating public companies but as a consequence has imposed a severe compliance burden on private companies. Private Equity and Venture capital is considered as the fourth wheel of the industry and fuels growth in the economy by infusing professionalism into typical management owned firms. Over the years PE/VC levels have shown an upward trajectory and constant increase is essential to fund the startup industry in India that has started to show some decline. The complicated process of private placement in the Act and imposition of liability on Non-Executive directors places an unnecessary compliance burden that shall cause the investment levels to stagnate if the law continues to be enforced in its current form. Investors have found innovative and questionable strategies to bypass norms for regulation that threaten to hurt the legislative intent of the Act. India needs to understand the importance of Private Equity and the law needs to cement investor confidence. This paper traces the growth of the Private Equity industry in India over the last few years and highlights the relevant provisions under the companies Act that act as deterrents to investments. Much of the scholarship on the Act focuses on public companies whereas the private companies that comprehensively outnumber the public companies are swooped into the regulatory ambit under certain sections, hurting their scalability prospects without achieving any directly measurable public interest outcomes.

Introduction

Hundreds of thousands of companies are the gatekeepers of the mass wealth of our nation and successive governments have recognized these growing enterprises as the torchbearers of economic progress and development. All companies, at some point of their operational cycle, need to raise money from the market to sustain, scale up or diversify. Raising money from the market is one of the most essential features that the law seeks to regulate in public investor interest. With an increasing number of industries on the one hand and increase in the Non-Performing Assets (NPA) on the other, there is a need to examine the marketplace to ensure the balance is maintained on the spectrum by protecting the investors and promoting business. Availability of funds for private and public unlisted companies through non-debt instruments is a market with immense scope for better investment potential and return.

As per the last published statistics of MCA the number of active private companies at nine Lakhs (Approx.) is fifteen times more than the total public companies registered in India. Out of the said number of companies about 7,19,796 companies filed returns in the recently published statistics report for assessment year 2014-15 by the Income Tax Department. Private Limited companies form the major chunk of those returns and thus the governments of developing nations accord a sublime role to these organizations to contribute more than a third of the total Gross Domestic Product.There is a need to develop a market that is conducive for attracting investment without management losing ownership control in SMEs and gaining institutionalized investor support.India opened up its doors to liberalization in 1991 and with the latest series of reform on GST, make in India and digitalization, we seek to cement our place in the world economy as one of the most favorable emerging market to get profound returns to investment.

Need for Venture Capital & Private Equity

At this point it is important to highlight the difference between Venture Capital and Private Equity, whilst they fall under the same category of private placement under Section 42 of the Act, venture capital is usually used to fund innovative startups at their inception stage and Venture capitalist help the business in the initial years to stabilize. They often lack the capacity and the resources to help firms prosper once they have stabilized. Private Equity is an advanced stage of private placement, wherein the investors identify large established companies and invest to get a seat at the director's table to bring professionalism to previously management owned companies. The forte of a PE investor is often scalability, while the VC resources to assist his portfolio companies exhaust after the first few million

dollars in gross revenue, a PE fund manager has plans to scale a 100 million dollar business to perhaps a Billion Dollar Empire.

Venture Capitals for Start-Ups often referred to as seed funds; attract lesser degree of regulatory control as they invest in the businesses much before it organizes itself in the form of a business organization (Partnership/company/proprietorship). This gives the portfolio manager leeway to structure the investment in a manner suitable to the industry and his portfolio's security. In cases when the seed fund invests in the subsisting business, it usually is organized and registered as a Private Company under the Companies Act, owing to its higher creditworthiness and limited liability. Thus the major part of the paper will focus on the investments made by VC and PE funds in existing private limited and public unlisted companies.

Investment Levels in India

Most reports upon the levels of Private Placement in India focus upon the Private Equity, as about ninety percent of all deal making is done with foreign capital at about 24 Billion USD. IIM Bangalore has concluded a survey from a plethora of sources that track the Private Equity deal-making in India, although their report makes little to no demarcation between Venture Capital and PE. Venture Capital investments in India are largely undocumented and thus I am unable at this moment to comment upon any broad statistics of VC deals in India. Although two recent reports published by KPMG and Bain & Co put the combined value of VC and PE deals concluded in 2016 at a whopping USD 25 Billion excluding the real estate sector. As impressive as that sounds, what truly is encouraging for a young population in India is that estimates put the VC/PE-GDP ratio in India at less than 2% that is significantly lower than those of developed nations like the United Kingdom at over 4%.

Private Companies always are the most preferred form of investment especially for the overseas investor, thus an appraisal of the new Companies Act is important and analyze the completely revamped Section 42 of Private placement after the Sahara debacle.[1] A close look to provisions of rights issue and director liability also shows the impact the law has on investor confidence and sentiment.

Recent Regulatory Changes under Companies Act of 2013

Private Placement and Rights Issue

[1]Sahara India Real Estate Corporation Limited & Others v. Securities and Exchange Board of India & Others, [2012] 174 Comp CAS 154 (SC).

Under the Section 67 of the 1956 Act, the case law had abundantly made it clear that any offer being made to people in excess of 49, ceases to be a private offer and is tantamount to regulatory burden as a public offer.[2] Section 42 of the current Act has broadly increased the said gambit to 200 persons. Whilst this is a welcome move for companies looking to raise money without subjecting itself to the regulatory cost of a public company, the Act in essence somewhat smudges the regulatory compliance difference between a public unlisted and a private company by placing very high standards of legal control on all private companies regardless of the number of shareholders.

The legislative intent to introduce the term private placement in the current Act instead of 'not public issue' was to curb the menace created by brokers and underwriters to pass off call for public offerings in newsprint/advertisement etc. as private issue by specifically prohibiting the same under 42(8). The new Act has prescribed standard forms through which a private placement offer is to be made including the designation of a separate bank account with a scheduled bank. Requirements such as secretarial procedure (E.g.: Filing of PAS-4 and PAS-5 form with SEBI within 30 days) and valuation reports are impediments to investment for sophisticated investors. Any contravention or deviation from the elaborate and complex procedure laid out in Section 42 attracts a minimum risk of penalty at INR 2 crores regardless of the amount of offer or invitation unless it is more than 2 crores. Additionally, 42(4) of the Act creates a discrepancy as any offer made in excess of 200 persons is to be deemed as a public offer under Section 23, then such an offer becomes punishable under Section 450 in addition to 42(10), for violation of Sections 25-20 (relating to offering and prospectus). Thus, owing to a form of corporate double jeopardy wherein the company will be punished both as a private and public company creating an additional deterrent for the investor.

In light of the complexities notified by the present Act, investors have found a way to bypass the regulations by exploiting Section 62 of the Act. A significant investment in private firms is by way of private placement disguised as rights issue by virtue of existing shareholders designating their rights to a person of their choice by statement of right under 62(a)(ii). The said process of bypass may still not be enough to stimulate investor confidence as it assumes an underlying regulatory risk of decertification as it goes against the legislative intent and is repugnant to the object of Section 42. Additionally, all shares when originally issued under Section 42 with a right for assignment or renunciation amounts to domestic concern and

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[2]Toubro Infotech and Industries v. Securities And Exchange Board of India, No. 2004 55 SCL 243 SAT.

donot require registration with Roc (Letter No. 8/81/56-PR dt. 04/11/1957 issued by Department of Company Law Administration).

Director Liability

As discussed earlier, the VC/PE managers play an active role in the growth of the company by becoming an active part of the management policy and company vision. It is due to the influx of professional management, the company is able to achieve greater net revenue levels or turn around its dying fortunes as the case may be. The previous companies act left the term non-executive director undefined and the duties of all directors were to be generally determined under common law. However the current act has laid out the detailed statutory duties imposed upon the directors. Additionally, Section 149(12) holds even non-executive directors responsible for acts done by the company and presumes that they had the knowledge of the said acts during their time on the board.

This creates a profound complication for PE/VC fund managers. While they intend to actively assist in the management of the company and contribute directly to getting better returns on their investment, they are increasingly skeptical about the possibility of getting sucked into the ambit of litigation and liability for acts that they had no control or knowledge of in the ordinary course of business. The act in essence has reserved the onus of proof by removing the distinction between an Executive and Non- Executive director. The legally safe alternative for the portfolios is to create a "Board Observer" position that does not classify as a key managerial position (KMP) under proviso to Section 149(12). However, under Section 197(13)[3] the company is allowed to take out insurance policies to indemnify directors and this provision gives legal sanctity to such insurance contracts between the insurances companies and the company by not categorizing it as being against public policy (Statutory Inclusion). The terms of the insurance are usually suited to provide indemnification (by "holding harmless") to the non-executive and executive directors. Also, 2013 Act has not made any demarcation between the duties imposed upon executive and non-executive directors by virtue of Section 166 read with Sec. 2(34).

But, the said insurance policy is seldom adequately providing complete indemnification to the PE investor appointed director;additionallyit places the cost of premium on the company. While the company absorbs the cost as part of the cost to raise funds from investors, there is an unnecessary burden of additional compliance imposed upon the Non-ED directors

[3]Nikhil Inamdar, SudiptoDey, and DevChatterjee, *Spotlight on Accountability of Non-Exec Directors, Business Standard Column,*BUSINESSSTANDARD, (April 6, 2018), http://www.business-standard.com/article/opinion/spotlight-on-accountability-of-non-exec-directors-113102000679_1.html.

especially in case of private limited companies. The JJ Irani Committee reportwhilst making its recommendations had the interest of the shareholders and the 'benefit of members as a whole' in consideration that is the general public. However in case of a private company funds are subject to direct investor oversight, making such a mandatory provision of the law hurtful to investor sentiment. Thus the current predicament of the law provides a less attractive investor environment than the 1956 Act wherein the regulatory burden on private companies was significantly less, especially with regard to the obligations of non-executive directors, openly encouraging active investor participation without risk of misplaced liability exposure.

Conclusion

This concludes the list of perceived anomalies in the prevailing company legislation that is an impediment to positive investor sentiment in the hugely underutilized PE/VC market of Private Limited Companies (PLCs). In observing the PE/VC market of any economy on a year-on-year basis, there are two equally important aspects that can determine the prevailing market sentiment. (i) Total value of the Deals concluded, (ii) Total volume of the deals concluded, thereby indicating the average deal size. In 2017, while the total value of deals concluded touched record highs (Courtesy of SoftBank and Tencent), the volume of deals fell by a stark 23%. Such a decline was accompanied by a record exit in over 259 deals amounting to more than USD 12.5 Billion Dollars.If, the two indicators of a favorable market i.e. gross investment and gross exit is on a positive upward trajectory, why that is not translating into higher deal volume is a cause for concern for India. Exit of capital has been one of the longest investor caveatsin the Indian market but that has shown great progress over the last few years.

Therefore, there ought to be other regulatory deterrents that have caused the VC/PE-GDP ratio to stagnate at 1.8% even when about 36.3% population of Indiaconstitutes the typical entrepreneurial age groups of 20 to 44. A holistic appraisal of the legal framework around investment including but not limited to FDIs, DTAAs, SEBI, Capital gains etc. is needed to carefully shed the sluggish growth tendencies and reach the investment levels that India needs because Private Equity sector indeed is the fourth wheel of the economy shortly behind the PSUs, MNCs and Indian Public Corporations.