India's New Corporate Law: Challenges in Structuring Private Equity Investments

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India's corporate laws and exchange control regulations have been notoriously cumbersome in two areas critical to private equity and venture capital investments in Indian companies: capital structuring and distribution of profits. In April of this year, India's Ministry of Corporate Affairs published rules (the "Rules") to implement the Companies Act of 2013 (the "new law"), which have made a bad problem worse.

The new law replaces the previous Companies Act of 1956 (the "old law") and aims to better regulate companies in India, improve corporate governance and to prevent corporate fraud. For example, it requires more companies to appoint independent directors to their boards, imposes explicit duties and qualifications on directors and more stringently regulates related party transactions. The new law is a culmination of a historic opportunity to update and modernize corporate law in India. As with many laws in India, most of the issues with the new law are in its implementation. The new law grants extensive rule-making power to the MCA to implement the new law. Many of the provisions in the Rules are illogical, unnecessarily restrictive and overly prescriptive. The Rules applicable to capital structuring and distribution of profits illustrate the point.

Capital Structuring

For new, emerging and growth companies looking to attract capital from investors, flexibility in structuring capital to reflect negotiated risks and rewards of investment is critical. Most of those companies are likely to be privately owned by experienced shareholders. In such companies, investors often want to structure the capital so that profits can be distributed in accordance with a "waterfall" that provides for different priorities depending on the amount of cash available for distribution. Voting rights of investors and founders may also differ depending on the nature of decisions to be made. The new law permits Indian companies to issue equity shares with differential rights as to dividends, voting or otherwise, which is essential for structuring a "waterfall". However, the Rules prohibit all companies from issuing such equity shares with differential rights unless they comply with a number of onerous conditions. The old law exempted private companies from similar conditions but the Rules do not. The following two conditions imposed by the Rules make the ability to structure a typical distribution "waterfall" virtually impossible. First, the Rules state that shares with differential rights cannot exceed 26 percent of the total post-issue paid-up equity share capital. Often, the amount invested by investors is calculated based on a company's valuation, which is invariably multiple times higher than its paid-up equity share capital and the share capital issued to investors will be significantly higher than the 26 percent limit imposed by the Rules. Therefore, the 26 percent limit under the Rules destroys the ability to structure differential rights in favor of investors. The rationale for the 26 percent limit, particularly in the case of private companies, is not evident.

Secondly, according to the Rules only companies with a consistent track record of three years of distributable profits prior to the issue of shares with differential rights can issue such shares. A majority of the prime candidates for private equity and venture capital investments are likely to be companies that have losses because they are in their early stages of growth and are investing in continued growth. The Rules prevent them from obtaining much-needed investments on the only terms that may be available to them. Again, the rationale for this condition is not clear.

Given these restrictions, the only alternative under the new law is to structure priority payments to investors by issuing preference shares. However, preference shares have a number of limitations, including:

- First, under India's foreign exchange regulations, preference shares issued to non-resident investors cannot be redeemed. Conversely, preference shares must be compulsorily converted into equity shares in order to qualify as equity rather than debt, which is subject to more onerous regulations. In other words, non-resident preference shareholders cannot really have a preference over equity shareholders in receiving a return of their capital.

- Second, the return on preference shares issued to non-resident investors cannot exceed the prime rate announced by the State Bank of India plus 3 percent.

- Third, preference shareholders have the right to vote only on matters directly affecting their rights. This restriction significantly limits the voting rights customarily given to investors in private equity and venture capital transactions.

- Fourth, the new law requires that the proportion of voting rights of preference shareholders in relation to the voting rights of common equity shareholders should equal the proportion of paid-up capital in respect of preference shares and equity shares. Again, the rationale for this is not clear.

At the end of June 2014, MCA solicited public comments on a proposal to exempt private companies from a number of provisions of the new law and the proposed exemption from two such provisions appears to remove the third and the fourth limitation on preference shares identified above. However, the proposal does nothing to address any of the other obstacles to structuring a distribution "waterfall" because most of the obstacles are in the Rules rather than in the new law. The MCA proposal actually causes more confusion on this subject because it makes the enabling provision in the new law that permitted shares with differential rights and preference shares, along with the definition of preference shares and some helpful clarifications relating to it, completely inapplicable to private companies. The MCA needs to provide clarity on these issues and remove the constraints on capital structuring imposed by the Rules.

Distribution of Dividends

Under the new law, as was the case under the old law, dividends are permitted to be distributed only out of current year's profits after providing for depreciation at prescribed rates. The new law removes the problem of "trapped cash" caused by the previous requirement that up to 10 percent of a company's profits had to be retained as reserves before distributing dividends. It is now, correctly, the decision of a company's board of directors that will determine how much profit will be retained for any current or future needs.

However, if a company voluntarily decides to retain profits for a planned acquisition or future investments in the business, the Rules create significant unwarranted obstacles to distribution of such retained profits in a subsequent year. The rate of dividend out of retained profits cannot exceed the average rate of dividends over the previous three years; however, if no dividends have been distributed during such three year period, no such limit applies. The total amount that can be distributed from previous years' retained profits is capped at 10 percent of the sum of paid-up capital and free reserves. This is not an annual cap but an aggregate cap. Quite often, retained profits on a cumulative basis could be higher than the paid-up capital, and the 10 percent limit could create a bigger "trapped cash" problem than the one under the old law, which the new law evidently intended to eliminate. In addition, the balance of retained profits from previous years cannot fall below 15 percent of the paid-up capital (not including the free reserves), and distribution from retained profits can only be made after reducing the amount for any losses from prior years. If there is no requirement to retain profits in the first place, why should all these onerous restrictions apply when a company voluntarily decides to retain profits out of caution or for business planning? These restrictions may have the effect of incentivizing companies to distribute all the profits on a yearly basis rather than retaining profits for future needs. This does not appear to be the intent of the new law nor is it always in the best interest of the company or its stakeholders.

India Must Change the Rules to Attract Capital

Even before the publication of the Rules, structuring capital in India was difficult due to foreign exchange restrictions causing significant delays in executing transactions. In a rapidly changing economic environment, valuations move quickly and the expectations of founders and investors can diverge swiftly. Any material delay in completing transactions in such an environment kills transactions. With the impractical conditions imposed by the Rules, the obstacles to private equity and venture capital transactions have become almost insurmountable. This is neither the objective of the new law nor is it good for the Indian economy. The Rules contain numerous other instances of unnecessary government intrusion into the running of private companies and, in a number of respects, fail to strike the right balance between creating a flexible framework for fast-growing companies that aspire to become globally competitive and protecting investor interests. For these reasons, the Rules need to be changed immediately to attract badly-needed capital for Indian companies.

About the Author

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