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Section 4(7) Revealed

SECTION 4(7) REVEALED

☞ INTRODUCTION

Section 4(7) of the Companies Act, 1956 (the Act), in brief, can be defined as determining the holding-subsidiary relationship of two companies.

It states as under,

"A private company, being a subsidiary of a body corporate[1] incorporated outside India, which if incorporated in India, would be a public company within the meaning of this Act, shall be deemed for the purposes of this Act to be a subsidiary of a public company if the entire share capital in that private company is not held by that body corporate whether alone or together with one or more other bodies corporate incorporated outside India".

The objective behind the insertion of section 4(7) was to place a private company, which is a subsidiary of a foreign public company, at par with an Indian public company, as a subsidiary of a public company.

Thus, to simplify, the following conditions must prevail:

- The foreign parent must be a "public" company, similar to an Indian public (listed or unlisted) company;
- The entire share capital of the Indian subsidiary must be held by foreign corporations. Private companies in India are supposed to have a minimum of two shareholders. This would mean that if Section 4(7) is <u>not</u> to apply, those two shareholders MUST be foreign companies;
- Should an individual, foreign or Indian, hold even a single share, the Indian company will be considered to be a subsidiary of a public company. Accordingly, the reporting requirements of that subsidiary will have to be those of a public company, which are far more stringent than those for private companies.

In order to meet the statutory requirements of a private company, it is quite common that an Indian resident is made the second shareholder. In fact, this is the crux of a very common problem. For instance, if a foreign public company holds 99% of the share capital of an Indian company and the remaining 1% is held by an Indian nominee of the foreign company, then the Wholly Owned Subsidiary (WOS) i.e. the Indian company, will be deemed to be a public company, and will have to follow the reporting requirements of a public company under the Act.

Numerous companies forget that a single individual shareholder in the company changes the status of the company from private to public. Companies ignoring this section continue to violate the law for a long period of time, which leads to several non-compliances.

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[1] According to Sec 2 (7) of the Companies Act, 1956 "body corporate" or "corporation" includes a company incorporated outside India but it does not include – (a) a corporation sole; (b) a co-operative society registered under any law relating to co- operative societies; and (c) any other body corporate (not being a
company as defined in this Act), which the Central Government way, be 13 notification in the Official Gazette, specify in this behalf;]

Non-Compliances By WOS

The trap that such WOS fall into is a notion that they are private companies whereas, in reality, the status is that of a subsidiary of a public company. This causes multiple problems relating to reporting and statutory compliances.

Some of the significant areas that are ignored are as follows:

1. Appointment of Managing or Whole-time Director or Manager

Central Government approval is required for appointment and payment of remuneration to the Managing or Whole-time Director or Manager. An application for this purpose has to be moved within a period of 90 days from the date of the appointment[2], except where the appointment is made in accordance with the statutory guidelines[3] prescribed in Schedule XIII of the Act. Prior Central Government's sanction is also required to modify any provision relating to their appointment[4].

Non-compliance of this section leads to termination of the appointment of such managing director. Failure to vacate the office would attract a fine of Rs.5000 (approx $110)[5] for every day during which the person continues in the office.

Normally an expatriate managing director is appointed in a WOS and it is possible that the foregoing approval is ignored on the basis that a private company does not require this approval.

2. Section 293 of the Act which restricts the powers of the Board

Section 293 of the Act specifies that the Board can exercise certain powers only with the consent of the shareholders. Such powers relate to selling, leasing, remitting or giving time for payments of debts, investing or borrowing monies etc. Further, the Board cannot exceed the powers in the hope that the general body will ratify their actions.

For instance, a Director, forgetting the status of the company, borrows money exceeding its paid-up capital, without any authorization from its shareholders. This will be ultra vires their powers and the Directors may, in certain circumstances[6], be personally liable in damages to the lender, on the ground of the implied warranty given by them that they had the power to borrow.

3. Restrictions on Loans to Directors etc.

Section 295 of the Act states prior approval of the Central Government is required before any loan or guarantee can be given to any of its directors, their relatives etc.

Violation of this provision will make every person liable, who is knowingly a party to it. The penalty maybe either a fine up to Rs.50,000 (approx. $1100) or simple imprisonment for a term up to six months. The director in default would also have to vacate his office. Moreover, a loan in contravention of this section is merely void and illegal and, therefore, recoverable by the company.

4. Participation in Board meetings by interested director

Under Section 300 of the Act, directors of public companies are prohibited from voting and participating in meetings of the Board, in which they are interested.

It is a fairly normal practice to have common directors in holding and WOS companies who, however, have a tendency not to disclose their personal interest in a matter in which the holding company is involved.

In companies with a low level of corporate governance, directors do not take the provisions of this section as to participation or voting in the proceedings of the Board very seriously and do not disclose their personal interest in a matter in which the holding company is involved. Consequently, they expose themselves to monetary sanctions.

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[2] Vide section 269(2)&(3) of the Act
[3] Such as age requirements, if he is a resident in India etc.
[4] Vide section 268 of the Act
[5] 1$ = Rs.46.00 approx.
[6] The lender of the money to a company under the ultra vires contract has a right to make the director personally liable. Firbank's Executors v. Humphreys, (1886) 18 QBD 54; Garrard v. James, 1925 Ch 616

5. Inter-corporate loans and investments

Section 372A of the Act prescribes that in case the aggregate of the inter-corporate loans, and/or investments and/or guarantee given or security provided exceeds 60% of the paid-up share capital of the company, the prior approval of the shareholders is required.

By not securing the prior approval, the company and every officer of the company, who is in default, is punishable with imprisonment which may extend to five years or with fine up to Rs.50,000 (approx. $1100). The penalty by way of imprisonment is not imposed when the loan or guarantee/security provided in connection with a loan has been repaid in full and when repaid in part, such penalty is allowed to be reduced proportionately.

☞ CONCLUSION

From the above, it is clear that there are numerous areas with respect to requirements of the status of a company which, if ignored, can lead to non-compliances. A large number of companies tend to ignore these areas and unknowingly violate statutory provisions. Moreover, in closely held companies, since the penalties for such defaults and non-compliances might not seem extremely grave and critical, the shareholders themselves will not expose their errors to the statutory authorities.

However, these issues are extremely important from the following perspectives:

- WOS are usually establishments having a small capital and in case of default of continuing nature, the liability of the company could rise to a significant amount. Moreover, the Act provides for compounding of certain offences. Section 621A states that the offences punishable with imprisonment or with fine or both may be compounded. The action has to be initiated by the statutory authorities.
- In the event of any failure to comply, though the company might be silent about it and make efforts to cover-up, there could be instances of third parties who would try to gain from the default of such company. Such third parties could be either affected parties or others like a disgruntled employee.
- A consequence of these non compliances can also be realized in the event of an acquisition of the WOS. A potential acquirer of the shares (wholly or partially) or of the business of the company will conduct a due diligence. The report of such due diligence will reveal the anomalies and violations. In such situations, the acquirer may attempt to use the lacunae as a leverage during negotiations with an intent to reduce the price.

Thus, WOS companies need to be cautious of their status when the shareholding pattern changes in order to prevent the irregularities and ensuing consequences.

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