

OCTOBER 2017

RESTRICTION ON THE NUMBER OF LAYERS OF SUBSIDIARIES

1. INTRODUCTION

The Ministry of Corporate Affairs notified the Companies (Restriction on Number of Layers) Rules, 2017 (the “Rules”) on September 20, 2017. The Rules have been issued pursuant to Section 2 (87) of the Companies Act, 2013 (the “Act”), which provides the Central Government the power to cap the number of layers of subsidiaries that a company may have.

2. THE RESTRICTION

The Rules provide that a company can no longer have more than 2 (two) layers of subsidiaries. Under the Act, a ‘subsidiary’ of a company (i.e. the holding company) has been defined as a company in which the holding company, on its own or with its other subsidiaries: (i) can appoint or remove the majority of directors; or (ii) exercises, controls or owns more than half of the share capital.

Further, any company, whose board composition or share capital is controlled (as provided above) by a subsidiary of a holding company, is also considered to be a subsidiary of the holding company.

The definition of ‘subsidiaries’ under the Act is in line with the concept of ‘control’ under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011.

3. EXCEPTIONS

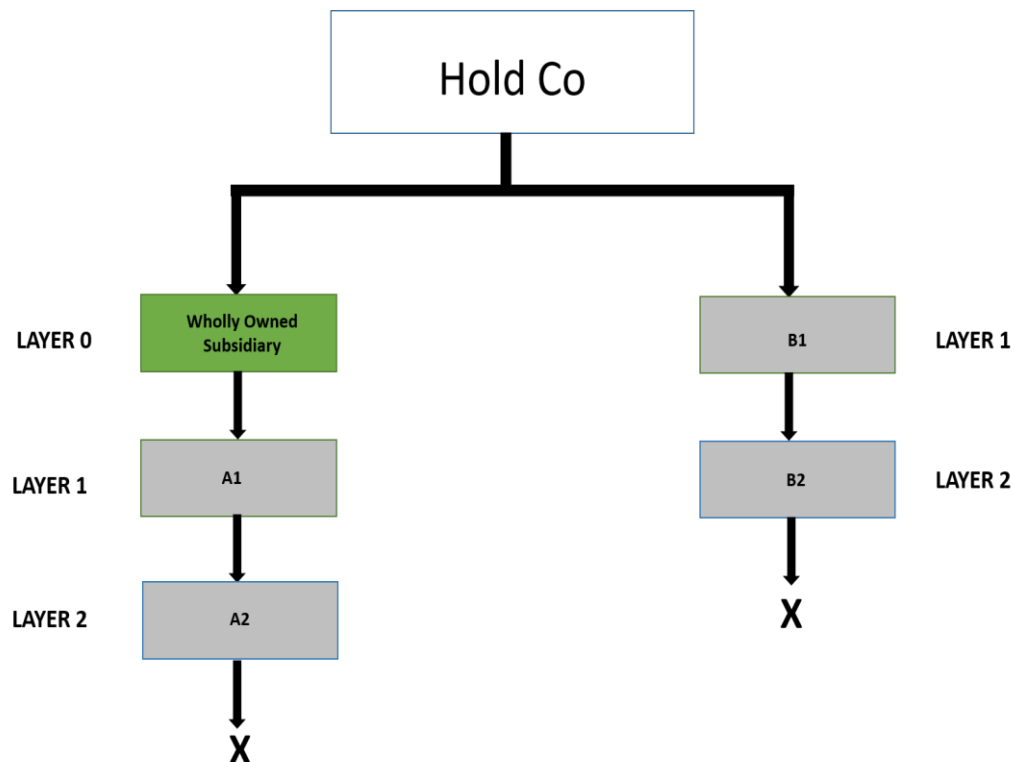
The following classes of companies are specifically exempted from the restriction on the number of layers:

- (a) a banking company;
- (b) a non-banking financial company, which is considered to be systematically important;
- (c) an insurance company; and
- (d) a government company.

The Rules do not restrict Indian companies from acquiring a foreign company with more than 2 (two) layers of subsidiaries, if such layers of subsidiaries exist in accordance with the laws of the jurisdiction of the foreign company.

In this context, it must be noted that the Rules apply to body corporates, which include companies incorporated outside India. Hence, the Rules can be read to say that a company outside India cannot have more than 2 (two) layers of subsidiaries in India as well.

For the purpose of computing the number of layers under the Rules, one layer which consists of one or more wholly owned subsidiaries does not need be taken into account.



As explained in the above structure, a layer consisting of a wholly owned subsidiary is not taken into account for the purpose of calculating the number of permissible layers. Although the language in the Rules is slightly ambiguous, the language could be interpreted to mean that the exception works vertically, and not horizontally.

To illustrate, in the structure above, B1 will be considered to be a layer, although the Wholly Owned Subsidiary is at the same level as B1.

Further, even vertically, a wholly owned subsidiary of a wholly owned subsidiary may be considered to be a layer. This is because, while a wholly owned subsidiary of a subsidiary is a subsidiary of the holding company, it is not wholly owned by such holding company.

To illustrate, in the structure above, if B2 was a wholly owned subsidiary of B1, B2 is a subsidiary of the Hold Co, but not a wholly owned subsidiary of the Hold Co. Since the exemption has only been provided to wholly owned subsidiaries, any wholly owned subsidiaries in a subsequent layer may not be exempt as a layer.

Section 186 (1) of the Act prescribes that a company is prohibited from making investments through more than 2 (two) layers of investment companies. The proviso to Section 186(1) exempts the following companies from the restriction:

- companies acquiring foreign companies with 2 (two) or more layers of subsidiaries;
- subsidiary companies having investment subsidiaries for the purpose of meeting the requirements under law.

The Rules clarify that they are not in derogation of the exceptions to Section 186 (1) of the Act.

4. REPORTING REQUIREMENTS

The Rules are prospective in nature. They have to be complied with from September 20, 2017. If any company has more than 2 (two) existing layers of subsidiaries, it is required to file Form CRL-1 with the Registrar of Companies to disclose

the details of the layers of subsidiaries. This filing is to be made within 150 (one hundred and fifty) days from September 20, 2017.

The filing does not preclude a company from complying with the Rules prospectively with respect to any new subsidiaries acquired or created by them.

5. PENALTY FOR NON-COMPLIANCE

Contravention of the Rules is punishable with a fine of a maximum of INR 10,000 (Indian Rupees ten thousand). If the offence is continuing in nature, a further fine of a maximum of INR 1,000 (Indian Rupees one thousand) may be imposed, for every day that the offence continues.

6. INDUSLAW VIEW

The restriction on the number of layers of subsidiaries was intended to clamp down on companies that are (or were) involved in illicit funding activities through shell companies. The restriction was a reaction to various scams that came to light in the time immediately preceding the Act. The reporting requirement will also provide the government with a database of all companies that possess more than 2 (two) layers of subsidiaries.

However, the Rules seem to be fairly restrictive, with the potential to impair the operational flexibility of companies to structure their group companies for strategic reasons. Since the definition of 'subsidiaries' is quite wide, corporate restructuring may prove to be challenging.

The ambiguity created by the overly broad definitions and loosely worded Rules is sure to cause an interpretative quandary. For example, in the structure outlined in Paragraph 3 above, if the board of A1 is controlled by B2, A1 will be a subsidiary of B2. This could make A1 a third layer of subsidiary of the Hold Co, though each chain of holdings as illustrated would seem to also seem to be consonant with the wording of the Rules.

The lack of clarity with respect to what constitutes a layer, or indeed examples on how the Rules are meant to work will engender debates on how the Rules are meant to operate. For example since the Rules apply to a company, it could be argued that the Rules are meant to be applied to each company. Using the logic of the previous sentence, this means that A2 and B2 in turn could have 2 more layers below them. This interpretation, however, would be inconsistent with the original intent behind prescribing a limit on layers. Perhaps a more rational way to interpret the Rules is to say that they apply only to holding companies, and not companies that are themselves subsidiaries.

With the enactment of the Rules, structuring transactions and holdings just got more complicated and interesting. We will wait to see how the interpretation of the Rules evolves in practice, and update our readers as issues develop and find resolution.

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