Capital reduction and Buyback – Regulatory Overview

ICSI WIRC – 14 August 2023

Opinions expressed are solely my own and do not express the views or opinions of my employer

01 Overview – Reduction of Share Capital

Regulatory framework and modes of capital reduction

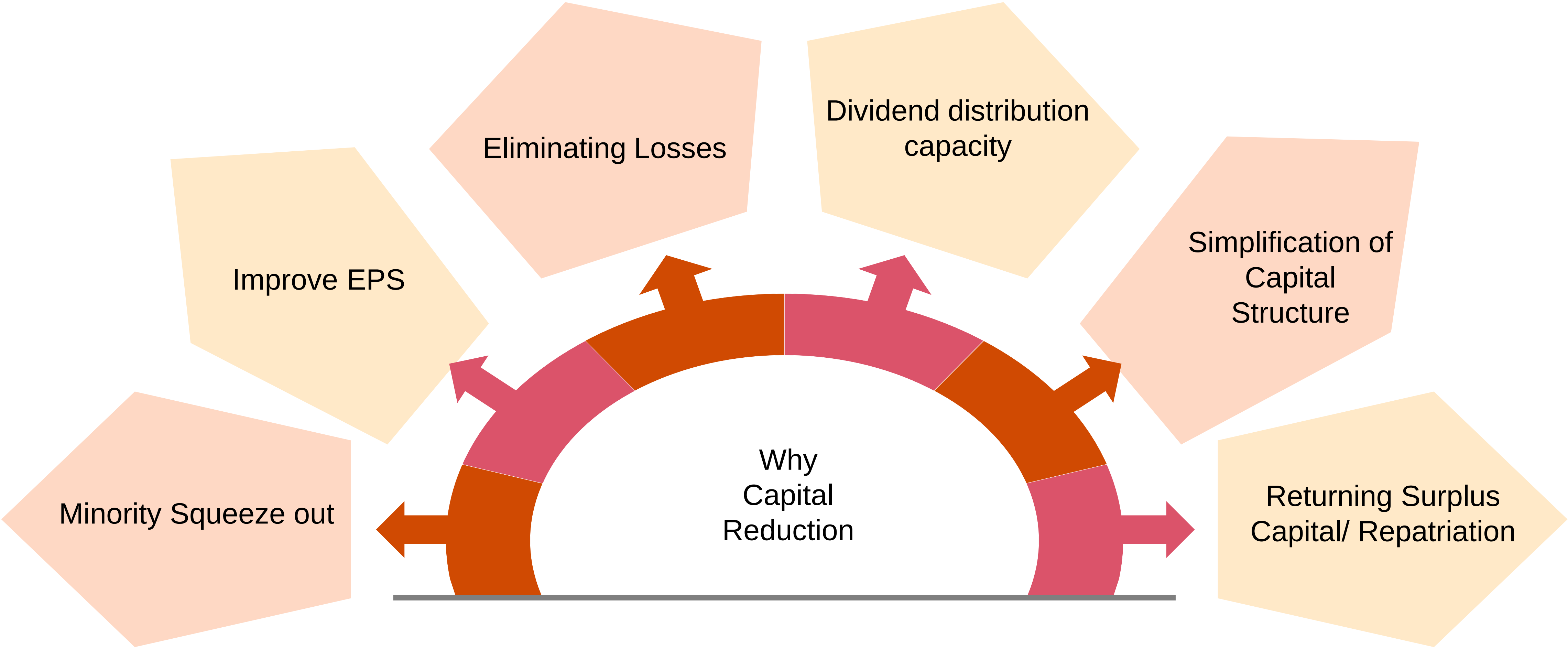
Regulatory framework

- Section 66 of the Companies Act, 2013
- NCLT (Procedure for reduction of share capital of Company) Rules, 2016

*Section 66 - Capital can be reduced in '**any manner**' and in particular by:*

- Extinguishing or reducing the liability on any of its shares in respect of the share capital not paid-up
- Canceling any paid-up share capital which is lost or is unrepresented by available assets (i.e., against accumulated losses)
- Paying off any paid-up share capital which is in excess of the wants of the company

Objectives of capital reduction



Other key considerations

What is considered as capital for the purpose of capital reduction?

- Paid up share capital
- Securities premium account (as per Section 52)
- Capital reduction (to the extent the reserves were created out of profits transferred in case of redemption of preference shares) – Section 55

Any restrictions to capital reduction?

- If a company is in arrears in the repayment of any deposits accepted by it or the interest payable thereon

02 Deep dive into some of the capital reduction modes

Wiping out accumulated losses

Before Capital Reduction

Liabilities	Amounts (INR in Crores)	Assets	Amounts (INR in Crores)
Equity Shares capital (1 crore shares of INR 100 each)	100	Fixed Assets	80
Reserve and surplus	(50)	Trade Receivables	50
Current/ Non-current liabilities	100	Current assets (cash)	20
Total	**150**	**Total**	**150**

- INR 50 Cr loss accumulated loss to be reduced from share capital of INR 100 Cr
- Reserves will become ‘Nil’ and capital will be INR 50 Cr
- Securities premium (if adequate) can also be used instead of share capital or both
- Reduction can happen either in number of shares or face value

Wiping out accumulated losses

After Capital Reduction

Liabilities	Amounts (INR in Crores)	Assets	Amounts (INR in Crores)
Equity Shares capital (50 lakh shares of INR 100 each)	50	Fixed Assets	80
Reserve and surplus	Nil	Trade Receivables	50
Current/ Non-current liabilities	100	Current assets (cash)	20
Total	**150**	**Total**	**150**

How does the company benefit in this scenario:

- Reflects the current situation of the Company, if the Company is doing well
- Company can pay dividend – as there are no accumulated losses
- If redeemable preference shares are issued, then redemption out of profits available for dividend can be possible
- DRR in case of NCDs issued are to be funded out of profits available for dividend – and this makes it possible

Repatriation of Surplus Cash to the Shareholders

Before Capital Reduction

Liabilities	Amounts (INR in Crores)	Assets	Amounts (INR in Crores)
Equity Shares capital (1 crore shares of INR 100 each)	100	Fixed Assets	90
Reserve and surplus	80	Trade Receivables	40
Current/ Non-current liabilities	100	Current assets (cash)	150
Total	**280**	**Total**	**280**

- INR 70 Cr amount is paid out to the shareholders
- 70 Cr is reduced from the capital and Cash balance will reduce to the extent of 70 Cr
- Securities premium (if adequate) can also be used instead of share capital or both
- Reduction can happen either in number of shares or face value
- Reduction can be proportionate from shall shareholders or selective

Repatriation of Surplus Cash to the Shareholders

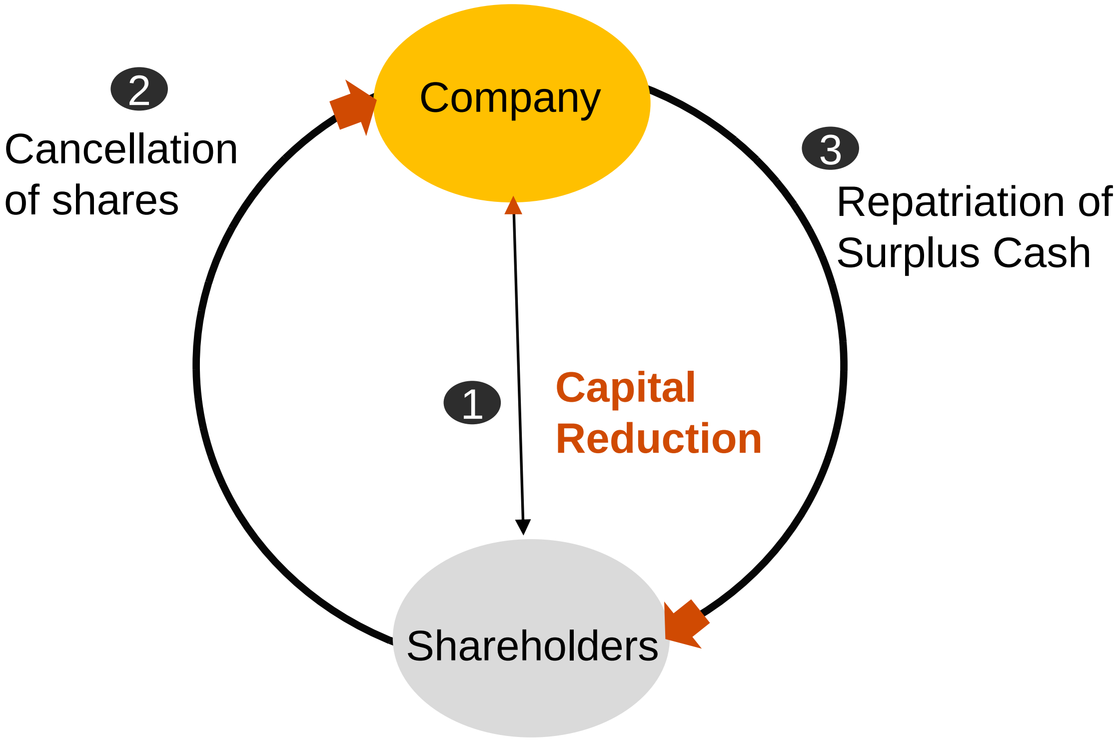
After Capital Reduction

Liabilities	Amounts (INR in Crores)	Assets	Amounts (INR in Crores)
Equity Shares capital (1 crore shares of INR 30 each)	30	Fixed Assets	90
Reserve and surplus	80	Trade Receivables	40
Current/ Non-current liabilities	100	Current assets (cash)	80
Total	**210**	**Total**	**210**

Key Consideration/ benefits:

1. Post reduction of share capital, Company to have sufficient liquid/ current assets to cover future obligations
2. Company to ensure that the interest of the creditors and all stakeholders are taken into consideration
3. Return of investment to the shareholders/ cash harvesting by parent company

FEMA implications on pay-out under capital reduction to non-resident shareholders



FEMA implications

- Consideration discharged on capital reduction should be capped to the FMV determined in accordance with a valuation report (as per internationally accepted valuation methodologies).
- Filing of FC-TRS required

03 Vexed NCLT decisions

NCLT orders on selective capital reduction

Ansa Decoglass Private Limited

- Capital of the shareholding holding 75% of the paid-up capital to be cancelled without any consideration and the equivalent amount be transferred to capital reserve
- Company had strong financial fundamentals
- NCLT rejected the petition stating that the above is not envisaged under Section 66

Rejected

Druva Data Solutions Private Limited

- The capital reduction was unanimously approved by the shareholders and no consideration was to be paid
- The Regional Director made the following objections:
  - Capital reduction is selective and unjust and unfair
  - The company was a profit-making
  - The words "in any manner" should be read with the spirit of the law
- NCLT approved the petition on the premise that capital reduction is a matter of domestic concern and decision of majority will prevail

Approved

NCLT order on pay-out when having negative net worth

Precious Energy Services Limited

- It proposed to cancel 99.85 % of Paid-up equity Share Capital by and paying Rs.77.49
- Net worth of the Company was negative, and creditors did not raise objections to the scheme
- NCLT rejected the application that the proposed capital reduction by way of return of capital to its shareholders is not in the overall interest of the Company and its stake-holders
- Company appealed to NCLAT, and the decision was overturned considering the following argument:
  - Company has sufficient cash flows for operations aspects of the business and negative net-worth is on account of depreciation on being a very capital-intensive business
  - Consideration of commercial wisdom of the parties should be not be overlooked
- NCLAT allowed the appeal and the NCLT order was set aside

Approved

04 Implementation

Implementation - things to know..

Authorisation

- Articles of Association
- Board Meeting
- Special Resolution by Shareholders

Application to be filed with NCLT

Following attachments to be filed with application

- List of creditors with Auditors certificate
- Declaration from director with Auditor certificate for no default in repayment of deposits
- Accounting treatment certificate

Directions and order by NCLT

- Directions to issue notice to RD, RoC and creditors
- Directions to issue newspaper advertisement
- Order to be passed by NCLT
- Order to be filed with RoC to become effective

Role of CS and stakeholder perspective

Things to consider..

- Consent of Creditors to reduction – managing expectations
- Ensuring overall coordination with all stakeholders, Finance team, vendors, auditors, etc.
- Scheme and documentation for the shareholders meeting should clearly indicate the purpose or the commercial rationale
- Clearly indicate the impact of the capital reduction on the employees and creditors of the Company
- Reduction should be fair and equitable

05 Overview on Buy-Back

Background & key objectives

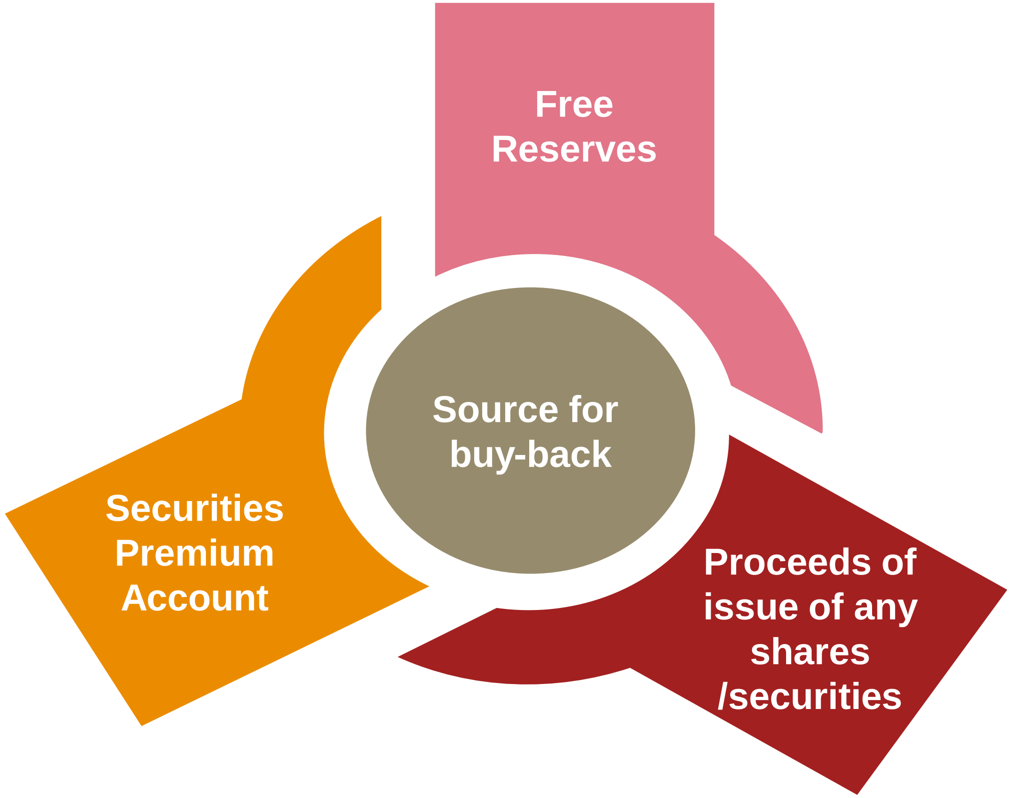
Buy-back in simple terms means 'purchase by a company its own shares or securities'

Statutory provisions governing Buy-back

- Section 68, 69, 70 of CA, 2013
- Rule 17 of the Companies (Share Capital and Debenture) Rules, 2014

- Increase in the underlying value of the share of the Company
- Enhance the Earning's per share
- To pay off excess surplus cash
- To reduce redundant capital and to avoid risk of over-capitalisation
- Exit route for shareholders

Source for buy-back



The proceeds of an earlier issue of same kind of shares or specified securities cannot be utilised for Buy-Back

- Buy-back can be from-
  - ✓ Existing shareholders or security-holders on a proportionate basis
  - ✓ Open market (applicable for listed companies)
  - ✓ Purchasing the shares or securities issued to employees through scheme of Stock Option or Sweat Equity

Key considerations

- Articles of Association should permit buy back
- Board’s approval for buy back up-to 10% of the total paid up capital and free reserves (including securities premium)
- Buy back beyond 10% and up-to 25% permissible with the approval of the shareholders by a special resolution
- Company should be able to meet its liabilities and not rendered insolvent within a period of 1 year
- Post buy back Debt – Equity Ratio required – 2 : 1
- All shares or specified securities for buy back need to be fully paid-up
- Buy back to be completed within 1 year of passing of the resolution
- Capital Redemption Reserve to be created to the extent of face value of shares bought back
- The cooling period between two Buy-back is 1 year – reckoned from the date of closure of the preceding offer of Buy-back
- Shares bought back to be extinguished/ physical destroyed within 7 days from the last date of completion of buy-back

Calculation of 25% limit

Section 68(2) *No company shall purchase its own shares or other specified securities under sub-section (1), unless—*
(a) ….
(b) ….
(c) *the buy-back is 25% per cent or less* ***of the aggregate of paid-up capital and free reserves*** *of the company:*

Provided that in respect of the buy-back of ***<u>equity shares</u>*** *in any financial year,* ***the reference to 25% in this clause shall be construed with respect to its total paid-up equity capital*** *in that financial year.*

Illustration:

- Equity share capital = 1 Crore
- Preference share capital = 1 Crores
- Free Reserves = 2 Crore

Possibility of 2 interpretations

1

- Total 25% buy back consideration as per Section 68(2)(c) = 1 Crore;
- Limit on the number of Equity Shares as per proviso = 25 Lacs

Accordingly, the Company can expend 1 Crore for the buy-back, but can buy shares of face value up-to 25 Lacs

2

- Total 25% buy back consideration as per Section 68(2)(c) = 1 Crore;
- 25% of 1 Crore (Equity Share capital) + 2 Crore (Free Reserves) = 75 Lacs

Literal reading of the proviso would mean that if Equity Shares are bought back, then only equity should be considered for calculating the overall 25% limit. So, 75 Lacs is the overall limit

Restrictions/ prohibitions on buy-back

Buy-back of its own shares or other specified securities not permitted—

- Through any subsidiary company including its own subsidiary companies;
- Through any investment company or group of investment companies; or
- If a default, is made by the company in:
    - ➢ Repayment of deposits, interest payment
    - ➢ Redemption of debentures or preference shares
    - ➢ Payment of dividend to any shareholder
    - ➢ Repayment of any term loan or interest payable thereon to any financial institution or banking company
- Company can buy back - If the default is remedied and a period of 3 years has lapsed after such default ceased to subsist

Buyback – Brief Process

Convene a Board Meeting to pass the necessary resolution

File Form *MGT-14 with Registrar of Companies (“RoC”)

Convene the General Meeting and file Form MGT – 14 for the special resolution

File the letter of offer and declaration of solvency with RoC

Dispatch the letter of offer to the shareholders/ security holders

Open a separate bank account to deposit the sum payable as consideration

Complete the verifications of the offers received within 15 days from the closure of offer

Make payment of consideration and extinguish the share certificates bought back

File the Return of Buy-back with RoC in SH – 11

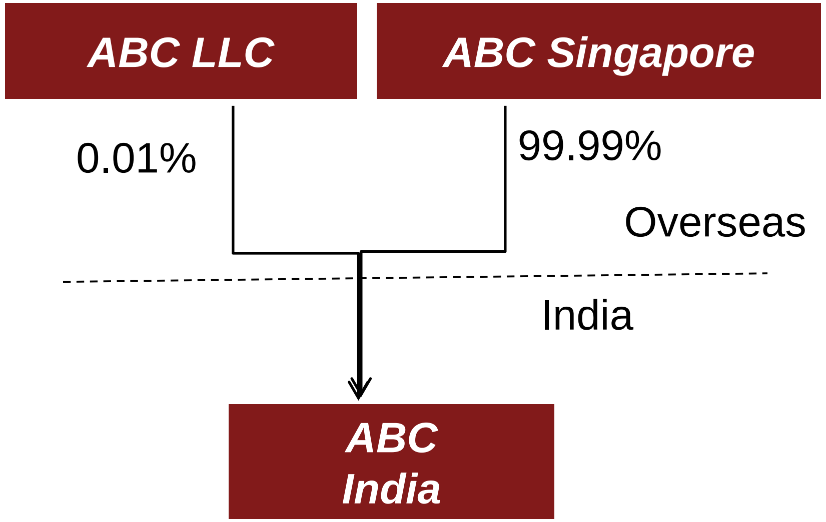
Exempted for private companies vide MCA notification dated June 05, 2015.

06 Buy-back case study

Case Study – Background

Background

- ABC Singapore Pte. Limited and ABC LLC are the shareholders of ABC India
- Considering operations have become profitable, ABC India proposes to repatriate its surplus funds and therefore proposing a buy-back of equity shares
- The shareholding structure of ABC India is below-



Particulars	As on 31 Mar 2023 (INR - Crores)
Share Capital (60,000,000 equity shares of INR10/- each)	60
P&L Surplus	1.5
Securities Premium Account	80
Total Paid up capital and free reserves	**141.5**
Total Debt	**150**
Cash Balance	**55**
Fair value per share	**90**

Case Study – Indicative workings

Maximum Equity Shares that can be bought back	
Total number of equity shares **[A]**	60,000,000 shares
Number of shares permitted to be bought back **[A*25%]**	15,000,000 shares
Maximum Permissible Limit	**Amount (INR – Crores)**
Paid-up Share Capital **[B]**	60
Free Reserves (Securities premium account + P&L surplus) **[C]**	81.50
Total **[D] = [B]+[C]**	141.50
Maximum permissible limit **[D]*25%**	35.37
Amount proposed to be repatriated **[E]**	35.37
Price at which shares would be bought back (fair value) **[F]**	90 per share
Number of shares to be bought back **[G] = [E]/[F]**	3,930,000 shares
Net cash available	**Amount (INR – Crores)**
Cash available for repatriation	55

Case Study – Post Buyback debt-equity ratio

Particulars	Amount (INR – Crores)
Post Buy Back paid-up Equity capital (Existing paid-up capital – shares bought back) **[A]**	56.07
Free Reserves (Securities premium account + P&L Surplus) **[B]**	81.50
Transfer to capital redemption reserve **[C]**	3.93
Post buy back Free Reserves **[D] = [B] – [C]**	77.57
Post buy back paid-up equity share capital and free reserves **[E] = [A] + [D]**	133.64
Total debt **[F]**	150
Post buy back debt equity ratio [F / E]	**1.12**

FAQs

Can a company do a issue of equity shares immediately after a buy back of similar equity shares?	No. A Company cannot make a further issue of the same kind of shares for a period of 6 months, except by way of bonus issue or conversion of warrants or preference shares or debentures, stock options and sweat equity.
Can a company borrow for funding the buy-back?	No
Can the company use the latest audited accounts for calculating the buy-back limits?	Yes, as long it is not older than 6 months. In the case, the audited accounts are more than 6 months old, the calculation with reference to buy back shall be based on un-audited accounts, subjected to a limited review
Do we need an auditor's certificate for buy-back?	Auditors to provide a certificate stating: • They have inquired into the company's state of affairs • The amount of the permissible capital payment (i.e., maximum consideration payable for buy-back) is in their view properly determined • Buy back is based on audited/ limited reviewed accounts, not more than 6 months old • Board of directors have formed an opinion that the company shall not be rendered insolvent within a period of 1 year

Open issues – need further clarity

Selective buy-back possible?

Need for valuation?

Can a Stock option be bought back?

07 Capital reduction vs Buy-back

Capital Reduction vs Buy-back

Particulars	Capital Reduction	Buy-Back
Limits	No limits	25% of paid-up capital and free reserves
Approvals required	Board, Shareholders and NCLT	Board/ Shareholders – depending on the limits
Timeline	8 to 10 months	2 to 3 weeks
Creditors notification	Required	Not required

Thank you!