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CONTENTS

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Readers are invited to contribute article/s for the Journal. The article should be on a topic of current relevance on Corporate Law, Tax Law, or on any other matter or issue relating to Economic or Commercial Laws. The article should be original and of around 7-8 pages in word file (approx. 2500 words). Send your articles at email id : articles@vidhimaan.com along with your student registration number. The shortlisted articles shall be published in the Journal.

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Dear Students,

The New Year stands before us, like a chapter in a book, waiting to be written and only we can help to write this story at its best with our setting goals. Friends, with the beginning of this year, when we are armoured in furthering the success of our goals, we should not forget to rejoice the brilliant milestones, we have achieved in last year.

The preceding year has been historic for the nation as well as for the Institute while registering the premier parameters of growth and development at global fora. At national level, we have witnessed the initiation of vision New India, 2022, Goods and Services Tax, remarkable appreciation in the Ease of Doing Business Index and numerous practices of settling good governance in the country.

Proudly, in shoulder to shoulder association with the government, the Institute also dedicated various initiatives towards Nation Building through Good Governance. To name a few are *celebration of the inauguration of ICSI Golden Jubilee Year, Establishment of ICSI Study Centres in Far Flung Areas, Shaheed Ki Beti initiative, Application of GST in our Course Module, Publications on Emerging Trends like Corporate Anti-bribery Code, Code on Charity Governance, Model Governance Code for Meetings of Gram Panchayats, Revised Secretarial Standards (SS-1 and SS-2), Secretarial Standard (SS-3), MoU with NSDC to impart training for GST Accounts Assistants so on and so forth.*

Along with this, the International boundaries of our accomplishment were also touched well when the Malaysian Association of Company Secretaries had expressed its desire to adopt the Secretarial Standards rolled out by ICSI as benchmark to develop their own which was duly approved by the Ministry of Corporate Affairs. Apart from this the link of ICSI's website along with logo has been placed at the official website of High Commission of India at Kenya and at Malaysia respectively in order to assist persons/companies overseas with the guidance and facilitation on setting-up business in India.

And while this is just a chapter of our accomplishment, a detailed book of our name fame and dedicated service to the nation is impending.

Friends, with celebrated milestones; the year 2017 has been Golden in the history of the Institute and I am sure that the legacy would be carried forward with the precision and hard work of all the stakeholders of the Institute.

Last but not the least, along with my best wishes for the New Year, I would say,

तुम समय की रेत पर छोड़ते चलो निशान,
देखती तुम्हें जमीन देखता है आसमां;
लिखते चलो नौजवान नित नयी कहानियाँ,
देखती तुम्हें जमीन देखता है आसमां ॥

Wishing you the Best for all your future endeavours !!!

सी एस (डॉ.) श्याम अग्रवाल
अध्यक्ष, भारतीय कंपनी सचिव संस्थान
Date: 6th January, 2017

DEFINITION OF 'PRIVATE COMPANY' – HOW TO COUNT THE NUMBER OF MEMBERS

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In this article, the author explains the mechanism of counting the number 200 of shareholders which every private company can have in terms of clause (68) of section 2 of the Companies Act, 2013

AMBIT

In a private company, a question that often arises as to how the number 200, which is the maximum number of shareholders every private company can have, can be counted. The definition of 'private company' in clause (68) of section 2 of the Companies Act, 2013 (the Act) reads as follows:

(68) "private company" means a company having a minimum paid-up share capital [* * *][1] as may be prescribed, and which by its articles,—

(i) restricts the right to transfer its shares;

(ii) except in case of one person company, limits the number of its members to two hundred:

Provided that where two or more persons hold one or more shares in a company jointly, they shall, for the purposes of this clause, be treated as a single member:

Provided further that—

(A) persons who are in the employment of the company; and

(B) persons who, having been formerly in the employment of the company, were members of the company while in that employment and have continued to be members after the employment ceased, shall not be included in the number of members; and

(iii) prohibits any invitation to the public to subscribe for any securities of the company;'

LIMIT ON THE NUMBER OF MEMBERS

In the Companies Act, 1956 by virtue of sub-clause *(b)* of clause *(iii)* of sub-section (1) of section 3 it was provided that the number of members of a private company must not exceed fifty, excluding the members who are for the time being the company's employees and who were the company's employees and acquired shares in the company while in employment. The Act has increased the number fifty to two hundred.

EMPLOYEE AND EX-EMPLOYEE SHAREHOLDER

As per the second proviso to sub-clause *(ii)* of clause *(68)* of section 2, in counting the number 200, persons who are in the employment of the company; and persons who, having been formerly in the employment of the company, were members of the company while in that employment and have continued to be members after the employment ceased, shall not be included. If a shareholder becomes an employee or vice versa, the exemption under this clause would be available even after the person has become an employee or a shareholder, as the case may be. In other words, a person who was shareholder before becoming an employee of the company as well as a person who was an employee before becoming a shareholder, would be excluded from the number 200. The essential requirement, however, is that the person holding shares of the company must be an employee of the company, that is there must be employer-employee (or master-servant) relationship between the company and the shareholder. For example, a person who has a contractual or retainer relationship for

[1] The words "of one lakh rupees or such higher paid-up share capital" omitted by the Companies (Amendment) Act, 2015, with effect from 29th May, 2015.

providing to the company certain services, such a consultant or advisor, cannot be considered as an employee of the company.

A director simpliciter who is a shareholder of the company cannot be treated as an employee, but a managing or whole-time director may be regarded an employee for the purposes of this sub-clause if the relationship between him and the company is one of employee-employer on the basis of terms of his appointment[2].

According to the definition, where two or more persons hold one or more shares jointly, they shall, for the purposes of the definition of 'private company', be treated as a single member. It may be noted that it is only for the purposes of this definition that joint shareholders are to be treated as a single member. As a general rule, every joint shareholder is a member of a company.

Every member who became a member of the company while in its employment and continued as a member after the employment ceased, shall not be included in 200. The words 'after the employment ceased' make it clear that the cause of ceasing to be an employee of the company is irrelevant; whether by superannuation, resignation or termination.

JOINT SHAREHOLDERS

According to the first proviso to sub-clause *(ii)* of clause *(68)* of sub-section (1) of section 2 if two or more persons hold one or more shares in a company jointly, they shall, for the purposes of this clause, be treated as a single member. In a public company, every joint shareholder is a member and when two or more persons agree to accept shares they constitute as many members as there are applicants. This proviso became necessary because, but for it every joint shareholder would be a member and if every joint shareholder was to be counted as a member the number might go beyond fifty [two hundred under the Act] to which the private company was restricted. Therefore, only in the case of a private company, by a legal fiction, joint shareholders are not to be considered as separate members but are to be treated as a single member[3].

In the proviso, the words 'for the purposes of this clause[4]' are significant. All that they convey is that two or more persons holding one or more shares jointly in a private company shall be treated as a single member not for all purposes but "for the purposes of this definition" only. According to this requirement, there can be fifty sets (two hundred sets as per the Act) of joint holders and joint holders of each set shall be treated as a single member and the total number of members will thus be considered to be fifty [two hundred under the Act].

It was held by the Punjab High Court[5], that if joint holders are entitled to be entered on the register in any order they choose, or to have part entered in one order and part in another, or that their joint holdings may be split up into two or more joint holdings or that two joint holders can form a quorum at a meeting, there seems to be absolutely no reason why a joint holder whose name appears on the register of members of the company and who fulfils the qualification of 'a member' under the Act should not be treated as a shareholder. There is nothing in the articles of association or in the Companies Act prohibiting a transfer of shares to a joint holder in his individual capacity. Joint holders as such are not a distinct legal entity apart from the individual owners who jointly own one or more shares. A transfer of shares whether made to an individual shareholder or to joint holders collectively is not within any statutory ban, or within the prohibition of the articles of association so long as the total number of members of the private company does not exceed fifty [two hundred under the Act].

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[2] *See Ram Prashad v CIT* [1972] 42 Comp Cas 544 (SC).
[3] *Narandas Munmohandas Ramji v Indian Mfg Co Ltd.* [1953] 23 Comp Cas 335 (Bom).
[4] *"This clause" means this definition.*
[5] *Jarnail Singh v Bakshi Singh* [1960] 30 Comp Cas 192 (Punj).

WHETHER A CASE FALLING WITHIN BOTH THE PROVISOS IS ELIGIBLE FOR EXCLUSION

A situation may arise in a private company when a member is an employee of the company and holds shares in the company jointly with one or more persons. For example, A is a shareholder and he is in the employment of the company and the shares held by him are registered in his name jointly with his three family members, C, D and E. The case apparently falls within the ambit of both the provisos to sub-clause (ii). Does this entitle the company to exclude the shares held jointly by A, B, C and D? The recent judgment of the Bombay High Court in *Darius Rutton Kavasmaneck v Gharda Chemicals Ltd.*[6] shows that the answer to the above question is in the affirmative. The Bombay High Court observed as follows :

'The company had specifically created an employee's quota of shares and had identified the employee's share certificate separately as employee's shares. The transfer of shares by these employees during their employment and thereafter was restricted under article 59(b) of the articles of association. In view of the condition imposed in section 3(1)*(iii)(b)(ii)* of the Companies Act, 1956, even the employee shareholders who continued to be members after their employment ceased were also required to be excluded categorically while computing the number of members fifty as restricted under section 3(1)*(iii)(b)*. Any such transfer made by such employee shareholder in favour of his wife or children would not make his wife or children a member to be included within the number of fifty members and such member, if any, would continue to be excluded for the purpose of computation of fifty members under section 3(1)*(iii)(b)* of the Companies Act, 1956. Even if any such employee had transferred his shares during the course of his employment in favour of his family members or even an outsider, the shares having been allotted to such an employee being allotted in his capacity as an employee that would not provide any separate or additional membership to such transferee of shares through such an employee. All such employee shareholders of the company who were transferred the shares under a specific quota, i.e., "employee quota share" or any transferee of shares claiming through such employee were transferred during the course of their employment or otherwise had to be excluded for the purpose of computation of number of members as fifty. The name of the appellant was admittedly first shareholder in all five certificates. It was also not in dispute that all the notices were sent by the company to the first shareholder and not to the joint shareholders. Under the proviso to section 3(1)*(iii)(b)*, where two or more persons hold one or more shares in a company jointly, they shall, for the purposes of the definition of "private company" be treated as a single member. The name of the appellant being the first in all the shares which were transferred in favour of himself and his family members they would thus be treated as one single member and not four members. If the joint membership of the appellant and his family members and the names of those employees and other persons claiming through those employees were deleted from the list of members of the company, the number of members would be 34 and in any case below 50. Therefore, the number of members of the company had not exceeded 50 by virtue of transfer of shares by the appellant (singly) to the appellant jointly with his children and wife.

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[6] *[2017] 141 CLA 212 (Bom)*

INSOLVENCY AND BANKRUPTCY CODE, 2016 : AN ANALYSIS WITH REFERENCES TO HOME BUYERS BOOKED APARTMENT / FLATS WITH CORPORATE REAL ESTATE DEVELOPERS

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In this article, the author highlights the anomaly in the Insolvency and Bankruptcy Code, 2016 which do not provide any relief to the persons, who booked apartment and had given advance, in the event of real estate developer not delivering the apartment at the agreed upon time. He feels this provision is inequitable and unjust. He suggests that the definition of 'liability' be incorporated in the Code on lines that have been provided in the Singapore Bankruptcy Act.

INTRODUCTION

As one of the measures which would lead to ease of doing business, the Insolvency and Bankruptcy Code, 2016 (the Code) was enacted on 11th May 2016 and received the assent of the President of India on the 28th May, 2016 and put on the Statute Book on the same day. Under the Code, a financial creditor or an operational creditor can prefer an application to the Adjudicating Authority under the Act for initiation of speedy and time bound insolvency resolution process against an operational debtor.

EXPRESSIONS 'DEBT' 'FINANCIAL DEBT', 'FINANCIAL CREDITOR' 'OPERATION DEBT' AND 'OPERATIONAL CREDITOR' EXPLAINED

The term 'operational debtor' has been defined in sub-section (8) of section 2 of the Code to mean a corporate person who owes a debt to any other person. The word 'debt' has been defined in clause (*11*) of section 3 of the Code to mean a liability or obligation in respect of a claim which is due from any person and includes a financial debt and operational debt.

The expression 'financial debt' has been defined in clause (*8*) of section 5 to mean a debt along with interest, if any, which is disbursed against the consideration for the time value of money and includes—

(a) money borrowed against the payment of interest;

(b) any amount raised by acceptance under any acceptance credit facility or its de-materialised equivalent;

(c) any amount raised pursuant to any note purchase facility or the issue of bonds, notes, debentures, loan stock or any similar instrument;

(d) the amount of any liability in respect of any lease or hire purchase contract which is deemed as a finance or capital lease under the Indian Accounting Standards or such other accounting standards as may be prescribed;

(e) receivables sold or discounted other than any receivables sold on non-recourse basis;

(f) any amount raised under any other transaction, including any forward sale or

purchase agreement, having the commercial effect of borrowing;

(g) any derivative transaction entered into in connection with protection against or benefit from fluctuation in any rate or price and for calculating the value of any derivative transaction, only the market value of such transaction shall be taken into account;

(h) any counter-indemnity obligation in respect of a guarantee, indemnity, bond, documentary letter of credit or any other instrument issued by a bank or financial institution;

(i) the amount of any liability in respect of any of the guarantee or indemnity for any of the items referred to in (a) to (h) above;

The phrase 'financial creditor' has been defined in clause (*7*) of section 5 of the Code to mean any person to whom a financial debt is owed and includes a person to whom such debt has been legally assigned or transferred to'.

The expression 'operational debt', has been defined in clause (*21*) of section 5 of the Code to mean 'a claim in respect of the provision of goods or services including employment or a debt in respect of the repayment of dues arising under any law for the time being in force and payable to the Central Government, any State Government or any local authority'. The phrase 'operational creditor' has been defined in clause (20) of section 5 to mean a person to whom an operational debt is owed and includes any person to whom such debt has been legally assigned or transferred'.

Initiation of Insolvency Resolution Process

On a careful and close analysis of the foregoing, it would be apparent that only a person who has extended financial assistance to a corporate debtor or one who has extended credit during the course of the business activities of the corporate debtor can take re-course to the provisions of the Code to initiate an insolvency resolution process, in the event of default committed by the operational debtor in the discharge of his obligations to the financial creditor or the operational creditor, as the case may be.

CAN A PERSON BOOKED APARTMENT WITH CORPORATE REAL ESTATE DEVELOPERS TAKE INITIATE INSOLVENCY RESOLUTION PROCESS IN THE EVENT OF NOT DELIVERY APARTMENT

A person who has booked a flat or apartment with a corporate real estate developer and who has given advance, from time to time, to the real estate developer before the possession of the flat or apartment booked by him is given to him cannot take re-course to the provisions of the Code, in the event of the real estate developer not delivering the flat or apartment at the time or extended time, agreed upon. The

advance given by him from time to time towards his booking of the flat or apartment is not a debt in the strict sense of the term defined in the Code even though it is so in the normal parlance. In the legal parlance the advance given is an amount given in trust to the real estate developer and not a debt within the meaning of the term 'debt' defined in the Code.

There is no provision in the Code to give preference to the repayment of such amounts given in trust or treat such persons as secured creditors. Such persons would rank as unsecured creditors, with the result that depending upon the financial position of the real estate developer they can either get back the full amount of advance or such part thereof as could be paid to them in terms of the resolution plan drawn by the insolvency resolution person. Such a course would be unequitable and unjust to them, who in most cases have invested all their hard-earned resources or life savings with a view to providing them a secured shelter t and to their immediate family members.

In a recent case such persons had to knock at the doors of the Supreme Court to get their grievances redressed. One should agree that one should not be reduced to the position of knocking at the doors of courts of law, including the highest court of the land to get their grievances redressed. They may not have time and/or the resources to do so. The law should protect, even if necessary by amending the Code, their interests.

As noticed earlier the term 'debt' has been defined to mean, inter alia, a liability. But the term 'liability' has not been defined in the Code. The writer did some research in this regard and happened to fall upon the definition of 'liability' in the Singapore's Bankruptcy Act. The said Act defines liability in the following words:

'"liability" means a liability to pay money or money's worth, irrespective of whether such liability is present or future, certain or contingent or of an amount that is fixed or liquidated or that is capable of being ascertained by fixed rules or as a matter of opinion, and includes any such liability arising—

(a) under any written law;

(b) under contract, tort or bailment;

(c) as a result of a breach of trust by the person liable; or

(d) out of an obligation to make restitution

CONCLUSION

Possibly, if a definition of the term 'liability' is inserted on the lines of the above definition into the Code by means of an amendment thereto, will go a long way to providing a legal handle to such persons who have invested their hard earned money to securing a secured shelter to them and their immediate family members.

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QUALIFICATIONS AND DISQUALIFICATIONS FOR BECOMING OR VACATING OFFICE OF DIRECTOR OF A COMPANY

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In this article, the author emphasises that vacation of office of director in one company under sub-section (1) of section 167 of the Companies Act, 2013 will not imply automatic disqualification / vacation of his office as such in other companies unless the Companies (Amendment) Bill, 2017 is enacted.

BACKGROUND

India Inc. underwent a great turmoil and was shaken badly during the last few months when *(i)* Ministry of Corporate Affairs ("MCA") struck 2,09,000 companies off registers of companies database for not filing annual returns, etc. for three years ; *(ii)* MCA identified 1,06,000 directors for disqualifications ; *(iii)* Register of Companies ('ROC') sent notices to nearly 3,00,000 companies for not filing annual returns ; *(iv)* SEBI imposed a partial trading ban on 331 firms ; *(v)* National Stock Exchange sent notices to 300 listed companies, whose directors have been disqualified ; *(vi)* Bombay Stock Exchange identified 500 listed companies, which appear to have directors disqualified by MCA ; *(vii)* crackdown on directors put companies in a bind ; *(viii)* a large number of companies lost their Boards of directors as all directors vacated their offices after having been declared by MCA as "disqualified" ; and *(ix)* fear of criminal action for fraud under section 447 of the Act fell on hundreds of shell companies, which deposited unexplained high value notes during demonetisation or operated bank accounts after their names were struck off. This was done all under the garb of strict enforcement of provisions contained in sections 164 and 167 of the Companies Act, 2013 ("the Act") relating to 'Disqualifications for appointment of directors' 'Vacation of office of directors' respectively. MCA, however, promptly provided an escape route in terms of sub-section (3) of section 167 and issued a notification on 6th October, 2017 allowing appointment of the required number of fresh directors. ROC has been given the facility to add signatory details from the back end with the approval of Regional Director.

QUALIFICATION FOR BECOMING A DIRECTOR [SUB-SECTION (1) OF SECTION 149]

There is only one statutory qualification, *i.e.*, the person should be an 'individual', *i.e.*, a natural person, as stipulated in sub-section (1) of section 149 of the Act (corresponding to section 253 of the Companies Act, 1956 'the 1956 Act'). Besides, there is no other qualification required for a person to become a director. Companies Acts in India has always been very liberal with respect to appointment of a person as director of a company. No qualification has ever been prescribed for a person to become director of a company on the basis of caste, creed, sex, education, residence, profession / business, experience, age, religion, nationality, marital / social / financial status, or otherwise. Any person from a cart puller of BPL category living in a tiny village to the wealthiest person living in smartest city of the world is eligible for appointment as director of any company. A person could be appointed as

director of a company by its articles of association, Board of directors, shareholders, court, etc. There is, however, one important non-mandatory qualification that the person should be favourite, trustworthy, supportive, known to the promoter and assuring to safeguard his interest.

DISQUALIFICATION FOR APPOINTMENT OF DIRECTOR [SECTION 164]

While there is no qualification, except being an individual, section 164 of the Act prescribes ten disqualifications barring a person from becoming / appointment as a director of a company. As per sub-section (1) of section 164 of the Act, there are eight personal disqualifications, i.e a person cannot be appointed / re-appointed as director if he –

(a) is of unsound mind,

(b) is an un-discharged insolvent,

(c) is in the process of being adjudicated as insolvent,

(d) has been convicted by a court of an offence and punished with, imprisonment for more than seven years,

(e) has been disqualified for appointment as a director by a court or NCLT,

(f) has defaulted in payment of calls in respect of shares held by him in a Company,

(g) is convicted of offence with respect to entering into related party, transactions in violation of the provisions of section 188 of the Act, or

(h) does not have a DIN.

As per sub-section (2) of section 164, there are two disqualifications relating to any of the companies, in which he is a director, i.e. if the company –

(a) has not filed financial statements or annual returns for any continuous period of three financial years, or

(b) has failed to repay the deposits or interest thereon, pay declared dividend or redeem debentures for more than one year.

The intent and effect of section 164 is that any person, who has triggered any of the above disqualifications will not be, in future, eligible for appointment / re-appointment as director of any company.

So far, MCA has been strict only for compliance of provisions of sub-section (2) of section 164 and accordingly provided in rule 14 of Companies (Appointment of the Directors) Rules, 2014 stipulating that every director shall inform to the company concerned about his disqualification under sub-section (2) of section 164, if any, in Form DIR 8 before he is appointed or re-appointed. And, on the basis of a director's written representation, the independent financial auditor certifies in the annual audit report to the shareholders that the director concerned is not disqualified (or otherwise) from being appointed as a director of the company. Thus, there does not appear to be any ambiguity or absurdity in the existing provisions of section 164 disqualifying a person from becoming director in case any of the provisions of its sub-sections (1) or (2) is triggered.

In fact, I shall make the following suggestions

in respect of compliance of provisions of sub-section (1) of section 164 :

- MCA may amend rule 14 and Form DIR 8 demanding a declaration for eligibility in terms of sub-section (1) of section 164 also. The companies do not have any modus operandi to know about triggering of any of the disqualifications prescribed in sub-section (1) of section 164. As a result, the disqualified director may be appointed / re-appointed as a director by default, under section 152 though there is a small saving clause in DIR 7 where the prospective director has to declare to the MCA that he is not disqualified, inter alia, under the provisions of section 164. But, thereafter, there is no check and balance on his disqualifications under sub-section (1) of section 164 thereafter.
- Financial auditor may confirm that directors of the company are also eligible (or otherwise) for appointment in terms of provisions of sub-section (1) of section 164.
- Secretarial audit report Form MR 3 may be amended to incorporate a clause about the company directors' eligibility/disqualifications under sub-sections (1) and (2) of section 164.

VACATING THE OFFICE OF DIRECTOR [SECTION 167]

Sub-section (1) of section 167 is also very simple and clear stipulating that "The office of a director shall become vacant" in a company on triggering any of the following eight events :

(a) he incurs any of the disqualifications specified in section 164 ;

(b) he absents himself from all Board meetings of the company in an year ;

(c) he enters into contract / arrangement with the company in contravention of provisions of section 184 ;

(d) he fails to disclose his interest in contracts with the company in contravention of provisions of section 184 ;

(e) he becomes disqualified by an order of a court or the Tribunal from continuing as director of the company ;

(f) he is convicted/sentenced by a court of any offence involving moral turpitude or otherwise ;

(g) he is removed as director of a company in pursuance of the provisions of the Act ; and

(h) he ceases to hold office/employment, which makes ex-officio director of a company.

It may be noted that these conditions / events must happen in the specific company, in which a person is presently a director and it is in that company alone that his office as director will automatically be vacated without any further action on his part. The company is, on its own, obliged to file form DIR 12 with the MCA about the 'change', i.e., vacation, in terms of sub-section (2) of section 170. An (automatic) vacation of office of director in one company will not affect the vacating director's directorships in other companies. This view is confirmed on the following two counts :

Qualifications and Disqualifications for Becoming or Vacating Office of Director of a Company

- Sub-section (3) of section 167 states "where all the directors of a company vacate their offices under any of the disqualifications specified in sub-section (1), the promoter shall appoint the required number of directors, who shall hold office till the directors are appointed by the company the general meeting. This is a short term remedy provided under the Act to the promoter of a company, whose all directors automatically become disqualified in terms of sub-section (1) of section 167, so that the company's administration and management is not jeopardised. Sub- section (3) does not come into play in case of other companies, in which such disqualifying directors are also directors.
- Clause 54 of the Companies (Amendment) Bill, 2017 inserts the following proviso to clause (a) in sub-section (1) of section 167, which reads as follows :

  "Provided that where he incurs disqualification under sub-section (2) of section 164, the office of the director shall become vacant in all the companies, other than the company, which is in default under that sub-section.".
- This is a new thought to legalise vacation of office of a director in all companies ("other than the company, which is in default") as a result of disqualification on account of non filing of annual returns etc. by one company under sub-section (2) of section 164. It implies that, presently, only the defaulting company's director vacates office under section 167 from that company alone and not from all other companies. The proviso has been added to make this situation upside down providing that, in future, the defaulting company's director will not vacate office from that company but from all other companies.

CONCLUSION

The MCA's action in disqualifying a large number of directors under sub-section (2) of section 164 from all other companies and the two Stock Exchanges sending notices to many of the listed companies, whose directors have been disqualified as aforesaid by the MCA, is arbitrary, unjust, illegal, hasty, unilateral and will fail in the test of law though it is also true that directors, especially prominent ones, are generally ignorant and lazy about legal compliances in their small companies. It may, however, be noted that in terms of clause 54 of the Companies (Amendment) Bill, 2017, a director of a company failing to comply with provisions of sub-section (2) of section 164 would have to vacate his office from all other companies. But, that shall happen in future after enactment of the Companies (Amendment) Bill, 2017 into an Act and not retrospectively. It will be befitting if MCA takes a justified lenient view in the matter before it bites the dust. It is suggested that on first page bottom in Form DIR 12, two options, namely 'vacation of office' and 'resignation', may be incorporated which is, at present, included in the option of 'cessation'.

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DUE DILIGENCE – THE LEGAL PROCESS TO INVESTIGATE

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In this article, the author makes an attempt to explain the concept of due diligence, the legal process to investigate or audit of a potential investment.

INTRODUCTION

Due diligence is an investigation or audit of a potential investment or product to confirm all facts, such as reviewing all financial records, plus anything else deemed material. It refers to the care a reasonable person should take before entering into an agreement or a financial transaction with another party. Due diligence can also refer to the investigation a seller does of a buyer to find out whether the buyer has adequate resources to complete the purchase as well as other elements that would affect the acquired entity or the seller after the sale has been completed. In the investment world, due diligence is performed by companies seeking to make acquisitions by equity research analysts, fund managers, broker-dealers, and of course by investors. For individual investors, doing due diligence on a security is voluntary, but recommended. Broker-dealers, however, are legally obligated to conduct due diligence on a security before selling it. This prevents them from being held liable for non-disclosure of pertinent information.

BREAKING DOWN 'DUE DILIGENCE'

Due diligence became common practice. Securities dealers and brokers became responsible for fully disclosing material information related to the instruments they were selling. Failure to disclose this information to potential investors made dealers and brokers liable for criminal prosecution. However, Legislature understood that complete disclosure left the securities dealers and brokers vulnerable to unfair prosecution if they did not disclose a material fact they did not possess or could not have known at the time of sale. As a means of protecting them, the statute included a legal defense that stated that as long as the dealers and brokers exercised 'due diligence' when investigating companies whose equities they were selling, and fully disclosed their results to investors, they would not be held liable for information not discovered during the investigation.

A standard part of an initial public offering is the due diligence meeting, a process of careful investigation by an underwriter to ensure that all material information pertinent to the security issue has been disclosed to prospective investors. Before issuing a final prospectus, the underwriter, issuer and other individuals involved (such as accountants, syndicate members, and attorneys),will gather to discuss whether the underwriter and issuer have exercised due diligence toward state and federal securities laws.

THE DUE DILIGENCE PROCESS

Below are detailed steps for individual

investors undertaking due diligence. Most are related to equities, but aspects of these considerations can apply to debt instruments, real estate and other investments as well.

STEP 1: ANALYZE THE CAPITALIZATION (TOTAL VALUE) OF THE COMPANY

Determine just how big the company is. The company's market capitalization says a lot about how volatile the stock is likely to be, how broad the ownership might be and the potential size of the company's end markets. For example, large cap and mega cap companies tend to have more stable revenue streams and a large more diverse investor base, both of which generally equate to less volatility. Mid cap and small cap companies, meanwhile, may only serve single areas of the market, and may have more fluctuations in their stock price and earnings. When you start to examine revenue and profit figures, the market cap will give you some perspective.

STEP 2: REVENUE, PROFIT, AND MARGIN TRENDS

When beginning to look at the numbers, it may be best to start with the revenue and profit margin (RPM) trends. Understanding a company's gross revenue, profit margins and return on equity and whether it is growing or shrinking is essential in any equity or corporate bond investment.

Look up the revenue and net income trends for the past two years at a general finance website. These should have links to quarterly (for the past 12 months) and annual reports (past two to three years). Look at the recent trends in both sets of figures, noting whether growth is choppy or consistent, or if there any major swings (such as more than 50% in one year) in either direction.

Profit margins should also be reviewed to see if they are generally rising, falling, or remaining the same. Some investors demand that a company's return on equity plus its profit margins be equal to 50 or greater – the higher the better. This information will come into play more during the next step.

STEP 3: COMPETITORS AND INDUSTRIES

Now that you have a feel of how big the company is and how much money it earns, it's time to size up the industries it operates in and who it competes with. Every company is partially defined by its competition. Compare the margins of two or three competitors. Looking at the major competitors in each line of business (if there is more than one) may help you nail down just how big the end markets for products are. Is the company a leader in its industry? Is its industry growing overall, and could its position in the field change?

Information about competitors can be found in company profiles on most major research sites, usually along with a list of certain metrics filled in for both the company you're researching and its competitors. If you are still uncertain of how the company's business model works, you should look to fill in any gaps here before moving further along. Sometimes just reading about some of the competitors may help to understand what your target company does.

STEP 4: VALUATION MULTIPLES

Now it is time to get to the nitty-gritty of price-to-earnings (P/E) ratio, price/earnings to growth (PEGs) ratio and price-to-sales (P/S) ratio and the like, for both the company and its competitors. Note any large discrepancies between competitors for further review. It's not uncommon to become more interested in a competitor during this step, but still look to follow through with the original pick.

P/E ratios can form the initial basis for looking at valuations. While earnings can and will have some volatility (even at the most stable companies), valuations based on trailing earnings or on current estimates are a yardstick that allows instant comparison to broad market multiples or direct competitors. Basic 'growth stock' versus 'value stock' distinctions can be made here, along with a general sense of how much expectation is built into the company. It's generally a good idea to examine a few years' worth of net earnings figures to make sure most recent number (and the one used to calculate the P/E) is normalized, and not being thrown off by a significant one-time charge or adjustment. Shareholders tend to be best served when the people running the company have a vested interest in the performance of the stock.

STEP 5: BALANCE SHEET EXAM

Many articles could easily be devoted to just the balance sheet, but for our initial due diligence purposes, a cursory exam will do. Look up a consolidated balance sheet to see the overall level of assets and liabilities, paying special attention to cash levels (the ability to pay short-term liabilities) and the amount of long-term debt held by the company. A lot of debt is not necessarily a bad thing, especially depending on the company's business model. But what are agency ratings for its corporate bonds? And does the company generate enough cash to service its debt and pay any dividends? Some companies (and industries as a whole) are very capital intensive, while others require little more than the basics of employees, equipment, and a novel idea to get up and running. Look at the debt-to-equity ratio to see how much positive equity the company has going for it; you can then compare this with the competitors to put the metric into better perspective. In general, the more cash a company generates, the better the investment is likely to be.

STEP 6: STOCK PRICE HISTORY

At this point, you will want to nail down just how long all classes of shares have been trading, and both short-term and long-term price movement. Has the stock price been choppy and volatile, or smooth and steady? What was the price three and six months and one, two, three, five and ten years ago? Is it rising or falling? Does this history match its profit trends? All this outlines what kind of profit experience the average owner of the stock has seen, which can influence future stock movement. Stocks that are continuously volatile tend to have short-term shareholders, which can add extra risk factors to certain investors.

STEP 7: STOCK OPTIONS AND DILUTION POSSIBILITIES

Next, investors will need to dig into the 10-Q and 10-K reports. Quarterly SEC filings are required to show all outstanding stock options as well as the conversion expectations given a range of future stock prices. Use this to help understand how the share count could change under different price scenarios. Are there any insider lock-up expirations on the horizon? Is it conceivable that the company may complete a secondary offering? While employee stock options are potentially a powerful motivator, watch out for shady practices like re-issuing of underwater options or any formal investigations that have been made into illegal practices like options backdating. With real estate, look to see if there is any inventory that could be brought to market nearby?

STEP 8: EXPECTATIONS

This is a sort of a catch-all, and requires some extra digging. Investors should find out what the consensus of Wall Street analysts for earnings growth, revenue and profit estimates are for the next two to three years. For real estate, what is the opinion of professionals regarding future price trends and interest rates? Investors should also research discussions of long-term trends affecting the industry and company-specific details about partnerships, joint ventures, intellectual property, and new products/services. News about a product or service on the horizon may be what initially turned you on to the stock, and now is the time to examine it more fully with the help of everything you've accumulated thus far.

STEP 9: EXAMINE LONG AND SHORT-TERM RISKS

Setting this vital piece aside for the end makes sure that we're always emphasizing the risks inherent with investing. Make sure to understand both industry-wide risks and company-specific ones. Are there outstanding legal or regulatory matters, or just a spotty history with management? Is the company eco-friendly? And, what kind of long-term risks could result from it embracing/not embracing green initiatives? Investors should keep a healthy game of devil's advocate going at all times, picturing worst-case scenarios and their potential outcomes on the stock.

What is the worst case scenario? If a new product fails or a competitor brings a new and better product forward, how would this affect the company? How does an investing plan manage downside risk? For real estate, how would a jump in interest rates affect the ability to carry a mortgage on a property?

CONCLUSION

Once you have completed these steps, you should be able to wrap your mind around what the company has done so far, and how it might fit into a broad portfolio or investment strategy. Inevitably you will have specifics that you will want to research further, but following these guidelines should save you from missing something that could be vital to your decision.

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KNOWLEDGE UPDATES

COMPANY LAW

Companies (Filing of Documents and Forms in Extensible Business Reporting Language) (Second Amendment) Rules, 2017

Ministry of Corporate Affairs, vide GSR No. 1480 (E) dated 4th December, 2017, has amended Companies (Filing of Documents and Forms in Extensible Business Reporting Language) Rules, 2015 by substituting Annexure III.

Relaxation of Additional Fees and Extension of Last Date of Filing Form CRA-4 under the Companies Act, 2013

Ministry of Corporate Affairs, vide GSR No. 15/2017 dated 4th December, 2017, has, pursuant to the representations received, extended the last date for filing of Form CRA-4 for the financial years starting on or after 1st April, 2016, without additional fees till 31st December, 2017.

Companies (Cost Records and Audit) (Second Amendment) Rules, 2017

Ministry of Corporate Affairs, vide GSR No. 1526 (E) dated 20th December, 2017 has amended Companies (Cost Records and Audit) Rules, 2014 ('Principal Rules'). Key amendments are as follows :

- Substitution of clause (aa) of rule 2 which now states that Custom Tariff Act heading means the heading as referred to in the Additional Notes in the First Schedule to the Custom Tarriff Act, 1975.
- In rule 3 of the Principal Rules, for the words "Central Excise Tarriff Act Heading", "Custom Tarriff Act Heading" shall be substituted.
- In the Annexure to the Principal Rules, wherever the words "CETA Heading" appears in Forms CRA-2, CRA-3 and CRA-4, the words "CTA Heading" shall be substituted.

The abovementioned amendments shall be deemed to have taken place with effect from 1st July, 2017.

Companies (Amendment) Act, 2017

The Companies (Amendment) Bill, 2017 was given an assent to by the President of India on 3rd January, 2018. The bill was passed by Rajya Sabha on 19th December, 2017 and by Lok Sabha on 27th July, 2017. The key highlights of the Act are as follows :

- Relaxation on the restriction imposed on the grant of loan by companies to its directors or related person by passing special resolution.
- Relaxation on the number of partners to be there in order to convert into a private company. It is proposed that the partnership firm to have two or partners as against seven in the present Act in order to convert into a private company.
- Proposal to make an investing company or the venture of a company a related party as under the Companies Act.
- Proposal to provide an abridged form of annual return for one person company and small company which will make annual compliance for a company simpler for small businesses. It has also made it mandatory for all companies to place a

copy of the annual return on the website of the company and provide web link for the annual report in the Board's report.

- Proposal to do away with the requirement of members to ratify annually the appointment of auditors who have been appointed for the period of five years.

  In relation to private placement many changes have been introduced some of which are as follows :

  - Filing of return of allotment within 15 days instead of 30 days
  - Money received under the private placement will not be utilized unless the return of allotment is filed with the ROC
  - The offer letter of Private Placement shall not contain any right of renunciation

- Proposal to determine the eligibility criteria for the purpose of constituting the corporate social responsibility committee and incurring expenditure towards CSR based on immediately preceding financial year instead of immediately preceding three financial years.
- Proposal to provide the Chief Executive Officer to sign the financial statements irrespective of whether he is director or not since a CEO is the key managerial personnel of the company, and responsible for the overall management of the company.
- Proposal to impose additional fees on non-filing of Annual Return under section 92 and financial Statement under section 137 which is also different based on the different classes of companies.
- Proposal to provide that if the postal ballot is required to be transacted at general meeting, that can be provided by way of e-voting.

INSOLVENCY LAW

Insolvency and Bankruptcy Board of India (Grievance and Complaint procedure) Regulations, 2017

Ministry of Corporate Affairs, vide Press Release dated 7th December, 2017, has notified the IBBI (Grievances and Complaint Handling procedure) Regulations, 2017 with the primary objective to provide for a fair and transparent procedure for disposal of grievances and complaints by the Insolvency and Bankruptcy Board of India. This regulation enables a stakeholder to file a grievance or a complaint against a service provider, namely, Insolvency Professional Agency, Insolvency Professional, Insolvency Professional Entity or Information Utility.

Guidelines for Technical Standards for Core Services

Insolvency and Bankruptcy Board of India, vide Press Release dated 14th December, 2017, has laid down technical standards for the performance of core services for the following matters under regulation 13 of the IBBI (Information utilities) Regulations, 2017:

- Standard terms of service

RNI Regd. No.DELENG/2017/71754
Posted on : 12-14 January 2018
Published on 9, 10 & 11 January 2018

DELHI POSTAL REGD. NO. DL-SW-1/4199/17-19
Place of posting : NDPSO, New Delhi
LICENSED TO POST WITHOUT PRE-PAYMENT No. U(SW)-20/2017-19

- Registration of users
- Unique identifier for each record and each user
- Submission of information
- Identification and verification of persons
- Authentication of information
- Verification of information
- Data integrity
- Consent framework for providing access to information to third parties
- Security of the information
- Risk management framework
- Preservation of information
- Purging of information

An information utility shall comply with the applicable Technical Standards, while providing services. The Guidelines are available at www.mca.gov.in and www.ibbi.gov.in.

SEBI LAW

Categorization and Rationalization of Mutual Fund

SEBI, vide Circular No. SEBI/HO/IMD/DF3/CIR/P/2017/126 dated 7th December, 2017, has issued guidelines to modify its Circular No. SEBI/HO/IMD/DF3/CIR/P/2017/114 ('Principal Circular') dated 6th October, 2017. The key highlights are as follows:

- Addition of clause (d) after clause (c) in point 8 of the Principal Circular which provides that while preparing the single consolidated list of stocks, average full market capitalization of the previous six month of the stock shall be considered.
- In respect of Sr. Nos. 3,4,6,7,8 and 9 of section B of Annexure to the Principal Circular, it is clarified that Macaulay duration shall be at portfolio stocks shall be at portfolio level and accordingly, the column 'type of Scheme (uniform description of scheme)' of the respective scheme of the aforesaid sr. nos. is modified.
- The fund manager, may, in the interest of investors, reduce the portfolio duration of the schemes with respect to medium duration fund and medium to long duration fund, upto one year, in case he has a view on interest rate movements in light of anticipated adverse situation.

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