

Companies Act Series

May 09, 2014

INDIA INC. HIT BY NEW DEPOSIT RULES!

- Acceptance of deposits by India Inc. will now be governed by stricter rules.
- Securities application money that is retained for more than 60 days without issuance of securities shall be deemed deposits.
- Stringent conditions for issuance of bonds and debentures – unsecured optionally convertible debentures shall be treated as deposits.
- Additional compliances required for deposits accepted prior to CA 2013.

The Government of India has recently notified Companies Act, 2013 (“**CA 2013**”), which shall replace the erstwhile Companies Act, 1956 (“**CA 1956**”). To help understand the changes introduced under the CA 2013, we are undertaking a series of updates on the CA 2013 (“**NDA CA 2013 Series**”) analyzing the key changes and their implications for all stakeholders by setting out the practical aspects of some of the important changes introduced by CA 2013.

For a quick look at our analyses so far on the changes brought forth by the CA 2013, please refer to our first and second hotlines in this series through this [link](#).

In this third hotline, we analyze sections 73 to 76 under Chapter V of CA 2013, along with the Companies (Acceptance of Deposits) Rules, 2014 (“**Deposit Rules**”), which lay down the provisions regarding the acceptance of deposits by companies.

BACKGROUND

Companies aim to secure finance by different cost-effective methods to suit their financial requirements. However, apart from the cost of raising capital often there are other considerations in choosing a particular method of financing over other. Raising money from venture capital, private equity firms or by way of loans from financial institutions is a common practice. However, this form of financing often curtails the freedom of the promoter / company as they have to provide some management or control of the company to the financiers. To avoid the loss of management or control, companies preferred to raise money from the public by way of invitation of deposits, although the amounts to be raised through deposits is limited to 25% of the aggregate of the paid-up capital and free reserves. Investing into fixed deposits of companies is a relatively attractive option for public or members of the company as it gives them an opportunity to earn at least 2 – 5% more than fixed deposits with banks. Like CA 1956, CA 2013 also provides the framework under which a company may accept deposits. In this hotline, we aim to briefly discuss the frame work of accepting deposits under CA 2013, the key changes brought about by CA 2013 in comparison to the regime under CA 1956 and the consequential changes.

FRAMEWORK OF ACCEPTING DEPOSITS

The basic framework for accepting deposits under CA 2013 is largely same except for certain additions provided for enhancing investor protection. CA 2013, like CA 1956, also provides that a public company can accept deposits from its members and other persons, while private companies can accept deposits only from its members (it should be noted that CA 1956 permitted a private company to accept deposits from members, directors or their relatives also).

Further, any company accepting deposits must fulfill certain criteria such as having a minimum network or a turnover. The criteria under CA 1956 and CA 2013 are briefly discussed in point 3 below.

The definition of the term ‘Deposit’ is different under CA 1956 and CA 2013, however, in principle the meaning is same except the fact that definition under CA 2013 is clearer as the definition includes any receipt of money by a company by way of deposits or loans or in any other form, subject to certain exceptions. We have further discussed the exceptions in point 1 below.

KEY CHANGES UNDER CA 2013

1. Exceptions to the definition of ‘Deposit’

Under the Deposit Rules, large number of exceptions have been retained from the Companies (Acceptance of Deposits) Rules, 1975, for example the exception for an amount received by a company from another company, amount received from foreign investors subject to the provisions of the Foreign Exchange Management Act, 1999 (“**FEMA**”) etc. still continue. However, some additional exceptions are provided under the Deposit Rules, few of them are discussed as follows:

(i) It is provided that the securities application money received by a company shall not be considered as a deposit,

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only if the securities are allotted within 60 (sixty) days of receipt of such amount or if the amount is refunded within the period of 15 (fifteen) days after the completion of this 60 (sixty) day period. Here it is pertinent to note that while FEMA provided a time limit of 180 days for allotment of securities to foreign investors, CA 1956 did not provide for any such time period.

Key Takeaway: Under CA 1956, the investors had to negotiate for a contractual protection under the investment agreements, towards allotment of securities within a stipulated time. However, now the investors (that are organized in a form other than as companies, since amount received by one company from another company is still an exception to the definition of deposits) will have an additional statutory protection. Further, this provision will require greater accountability from the companies that were adopting the practice of retaining the securities application money without allotting any securities. Also, the investor will have a second layer of protection since as per section 42, securities application money cannot be deployed by the company and has to be kept in a separate bank account.

(ii) Under CA 1956, the amount raised by bonds or debentures was not considered as 'deposits' if such bonds or debentures were secured by the mortgage of any immoveable property of the company, wherein the value of the bonds or debentures so issued shall not be more than the market value of such immoveable property, or if such bonds or debentures had an option to convert them into shares of the company. However, with CA 2013, an onerous requirement is provided wherein the bonds or debentures issued by a company should be secured by a first charge or a charge ranking *pari passu* with the first charge on the assets of the company (excluding the intangible assets) or such bonds or debentures should be compulsorily convertible into shares of the company within 5 (five) years for availing the exemption from the definition of deposits.

Key Takeaway: The companies will no longer be able to issue debentures by merely creating subsequent subordinate charges on the same property. Further, the companies will not be able to issue unsecured optionally convertible debentures (to investors that are organized in a form other than as companies) as debentures that are optionally convertible into equity are now considered as deposits. Also, since the language under rule 2(ix)¹ suggests that a charge should be created on the 'assets of the company', it is unlikely that security offered in the form of pledge of promoter shares will be considered as 'security' for the purpose of exemption from the definition of deposit. Hence, it may be difficult for a project specific company to issue optionally or non-convertible debentures without qualifying them as deposits, unless such debentures are secured by assets owned by the SPV. Further, earlier optionally convertible debentures were exempt even though such OCDs were unsecured. Under CA, 2013 only CCDs with maturity of 5 years have been exempted, raising structural issues for domestic funds which are typically set up as trusts.

(iii) Any advance amount received by a company for its business purposes is deemed to be deposits on the expiry of the 15 (fifteen) days from the date they become due for refund. Also, it is provided that an amount received by the company for supply of goods or provisions of services is required to be *appropriated* against supply of good or provision of services for within a period of 365 days, failing which it should be refunded within 15 (fifteen) days otherwise the advance amount will be treated as a deposit for the company. The ambiguity arises with the usage of the term 'appropriate', as it is not clear if the company is deemed to be compliant with this requirement merely by appropriating the money for procuring raw material etc for the supply of goods or provision of services within 365 days, or is it that the company is required to actually supply the goods or provide these services within 365 days.

Key Takeaway: Lead to greater accountability from the companies for amounts borrowed for business purposes.

2. Increased investor protection

Unlike CA 1956, the CA 2013 now provides the following safeguards to protect the interest of the depositors like the obligation of the company to provide, *inter alia*, the following additional information in the circular to the members for acceptance of deposits:

- Managements perception of the risk factors of the company;
- Terms of raising deposits (duration, rate of interest, mode of payment and repayment);
- Reasons or objects of raising the deposits;
- The details of the credit rating and the extent of the deposit insurance obtained by the company;
- Particulars of the charge created or to be created for securing such deposits (if any);
- The details of any financial interest of the directors, promoters of key managerial persons in such deposits and the effect of such interest in so far as it is different from the interest of other persons;
- Detailed reporting of any outstanding deposits, including the number of existing depositors, the amount accepted, the rate of interest and defaults, if any, in repayment of deposits;
- Detailed description of the financial position of the company. For example, as against the requirement of providing the summary of the financial position of the company for the last two years under CA 1956, the CA 2013 requires this for last three years;
- Declaration by the directors stating, *inter alia*, the following: (a) that in their opinion, based on the estimated future financial position of the company, the company will be able to meet its liabilities as and when they become due, (b) the deposits shall be used only for the purposes indicated in the circular, (c) depositors will be given a chance to exit in case of an adverse change in credit rating.

Also, CA 2013 provides that the company should (i) maintain a deposit insurance equal to the principal amount of deposits and the interest due thereon, however, the company is required to obtain an insurance for payment of interest upto INR 20,000 only in case of any default in repayment of principal amount and interest thereon, (ii) for secured deposits, create charge on the assets of the company, as a security for the deposits, wherein the total value of security by deposit insurance or by way of charge or by both shall not be less than the aggregate of the deposits accepted and the interest payable (*Note: creation of charge may not be mandatory provided the security by deposit insurance is equivalent to the aggregate of the deposits accepted and the interest due thereon. However, this position is not free from ambiguity because of the language under sub clause (d) and (f) of section 73 (2) of CA 2013*), (iii) appoint a trustee for depositors, for creating security for their secured deposits in favor of the trustee, and (iv) obtain credit rating of the company at the time of invitation of deposits from the public and shall have an

obligation to continuously obtain such ratings every year during the tenure of deposits.

Key Takeaway: CA 2013 imposes elaborate requirements on a company that takes deposits. The distinction between secured and unsecured deposits has been reduced as the deposit insurance and credit rating are required to be procured for an unsecured deposit also. This makes raising finance through deposits costly for India Inc. However, the requirements will go a long way in protecting the interest of depositors.

3. Preconditions for accepting deposits by public companies

CA 1956 required that the company should have a net owned fund of more than INR 10 million for accepting public deposits,² however, CA 2013 provides that a public company should have a net worth of not less than INR 1 billion or a turnover of not less than INR 5 billion. In addition, the public company should have (i) obtained prior consent by way of special resolution for accepting deposits and (ii) filed such resolution with the RoC. However, if the aggregate of the amount of deposits, as proposed to be accepted and existing deposits of the company do not exceed the aggregate of the paid-up share capital and free reserves (excluding temporary loans obtained in the ordinary course of business), the prior consent by way of an ordinary resolution is also sufficient for accepting public deposits.

Key Takeaway: Small or less profitable public companies may not be able to accept deposits from public (i.e. from persons other than its members) due to high net worth requirements.

4. Deposits accepted prior to CA 2013

Section 74 of CA 2013 provides, that with respect to the 'deposits' of a company accepted prior to CA 2013, the company should file a statement with the RoC, to mention the details about all the deposits and the interest due thereon. Also, the company is required to repay such deposits and the interest due, within (i) one year from commencement of CA 2013, or (ii) one year from the date when the payments are due, whichever is earlier.³ However, this obligation to repay is not applicable if the company complies with the requirements under CA 2013 and the Deposit Rules, and makes the pending payments when due. However, it remains ambiguous if the term 'deposit' under section 74 is meant to derive its meaning from CA 1956 or from CA 2013, the Deposit Rules. The ambiguity arises because explanation to rule 19 of the Deposit Rules specifically refers to CA 1956 also while referring to the term 'public deposits' thereby clarifying that the meaning of the term 'public deposits' has to be derived from within the ambit of CA 1956 and the rules therein. However, there is no such reference of CA 1956 under Section 74 of CA 2013 when the term 'deposit' is used. If it is the intention that the term 'deposit' is to be interpreted as per the provisions of CA 2013 and the Deposit Rules, it may have a huge implication under the existing investment agreements where the companies had raised monies by issuance of optionally convertible debentures or if the company has a pending allotment of securities for the securities application money.

Key Takeaway: Companies that accepted deposits prior to CA 2013 will be obligated to comply with the requirements under CA 2013. Also, failure to make payments on due dates will trigger the obligation to make the repayments before the schedule.

ANALYSIS AND CONCLUSION

CA 2013 along with the Deposit Rules call for some significant changes to the investment structures used by the private equity and venture capital firms due to restrictions regarding the securities application money and the optionally convertible debentures. The capital raising may be affected by deposit rules as a deposit, now means, receipt of money by a company and therefore should an acceptance of capital be tantamount to an acceptance of a deposit, the rules relating to acceptance will have to be complied with. The additional compliance requirements will make it difficult for the companies to raise money in a cost effective manner. However, on the contrary the added requirements introduced by the Deposit Rules like the obligation to maintain deposit insurance will be helpful in securing the monies invested by the depositors. Other than that, like most of the new legislations in India, the provision regarding acceptance of deposits bring few ambiguities, some of which are discussed above. India Inc. will have to grapple with these ambiguities till the time necessary clarifications are provided.

— Corporate Team

You can direct your queries or comments to the authors

¹ Rule 2 (ix) of the Deposit Rules

² Rule 3(1)(e) of the Companies (Acceptance of Deposits) Rules, 1975

³ Section 74(1) was notified on March 26, 2014 and is effective from April 1, 2014. Hence, it may be assumed that the term 'commencement of this Act' under section 74(1) should be considered to be the date of April 1, 2014 only.

DISCLAIMER

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