Companies Act 2013: A New Sail in LLP Regime?[1]

Introduction

The Companies Act 2013 has shaken the way business was conducted in India. The governance ecosystem of the Companies Act, 1956 ("**Old Act**"), with its *laissez faire* approach to privately held companies, is now history. The Companies Act, 2013 is driven by three key objectives: Firstly, to make the law modular and reduce the need to send amendments to Parliament; to this end, the Ministry of Company Affairs **("MCA")** has been empowered not only to clarify the law but also to make detailed provisions by way of rules in order to amplify and give effect to most of the sections. Secondly, to avoid scams such as Satyam and 2G that have rocked the country in the recent past, principles of related party transactions, raising of capital and directors' liability have been restated considerably. Thirdly, there is a strong push for shareholder democracy and this has been applied with a broad brush, regardless of the nature and size of the company.

Each of these drivers has led to anxiety amongst the business community. A modular law, while good in concept, places heavy responsibility on the MCA to address business interests while at the same time respect the company law jurisprudence which has evolved over decades. Delegated legislation carries a significant uncertainty risk of roll backs and aggressive interpretation of the provisions of the statute by the Ministry. Increasing compliances, with an emphasis on disclosures have made the way companies function in India vulnerable. This major corporate reform necessitates dusting off the Limited Liability Partnership Act 2008 ("**LLP Act**"). It has been seven years since the dawn of the LLP Act, but we have very few Limited Liability Partnerships ("**LLPs**") registered in India.

There are several reasons for the slow adoption of LLPs. When the LLP Act was introduced, the concept of taxation of LLPs was still hazy. Moreover, another significant discomfort about LLP was prohibition of Foreign Direct Investment ("**FDI**") under the automatic route.

Nonetheless, with the advent of the Companies Act 2013 ("**New Act**") and increased burden of restrictions and compliances, a gradual rise in the number of LLPs may not come as a surprise. The LLP structure's advantages of flexible governance coupled with limited liability have now been strengthened by its recognition as a pass through entity for tax purposes and its recognition as an FDI entity.

Company vs. LLP

Equity funding and sharing has become the preferred route for entrepreneurs aiming to execute their business plans and the difference between an LLP and a Company is nowhere more evident than here. Prior to the coming into force of the New Act, the most common method of equity funding in private companies was the preferential allotment route. A preferential allotment is understood to mean an issue of shares to persons, other than to the existing shareholders. Under the Old Act, a private company was only required to pass a board resolution in order to raise capital. However, under Section 62 (1)(c) of the New Act and Rule 13 of the Companies (Share Capital and Debentures) Rules, 2014, a company can issue shares by way of preferential allotment by obtaining approval of three fourth of its shareholders in general meeting. Rule 13 also states that issue on preferential basis should also comply with conditions

---

[1] **Avimukt Dar, Partner and Chitvan Bakshi, Associate. The views expressed in this article are the personal views of the authors and do not reflect the views of the Firm.**

laid down in Section 42 of the New Act. This is interpreted to mean that any preferential issue, even if to a single investor, is required to comply with the provisions applicable to a private placement. A key condition to a private placement under Section 42 is the compulsory filing with the Registrar of Companies ("**ROC**") of sensitive disclosures such as details of any litigation, related party contracts, any inquiry, inspections, investigations initiated, etc. This substantially increases the compliance and litigation risk of companies wishing to issue shares to private investors. To further add to the lengthy compliance procedure, a valuation certificate by a registered valuer is mandatory to decide the price for preferential allotment of shares by a private company.

On the other hand, contribution to the capital of an LLP is fairly simple and can be done through executing an agreement providing particulars of new partners and their contribution to the LLP. Accordingly, the existing partners need to revise the LLP agreement and register the amendment due to admission of a new partner. Moreover, concepts such as sweat equity, employee options and contributions other than **cash** are fairly straight forward since the principles of partnership follow the common law maxim of *consensus ad idem.* Indeed, the partners are free to agree to a procedure for induction of a new partner and the manner of governance of the firm.

In addition to equity, there are several other provisions in the New Act which makes management of private company compliance heavy as compared to an LLP. These are tabulated as below:

Compliance	Company	LLP
Financial Statement	Along with the filing of annual returns with the ROC, detailed public disclosures regarding financial health of the company are required.	The Limited Liability Partnership Rules, 2009 ("**LLP Rules**") provides a very simple form for filing of annual returns.
Related Party Transactions	The New Act provides for an elaborate framework within which a company can enter into inter-group and other related party transactions. This has increased the compliance burden of a private company.	In an LLP, there are no such restrictions and an LLP can enter into transactions with related individuals and entities.

Statutory Management Discussion *Board's Report* *Director's Responsibility Statement ("**DRS**")*	The Companies Act, 2013 provides for a plethora of policy disclosures to shareholders and the public, a few of which are mentioned below: ➢ Company's policy on directors' appointment and remuneration; ➢ Particulars of loans, guarantees or investments. ➢ Particulars of contracts or arrangements. and In a DRS, the directors need to declare that they have devised proper systems to ensure compliance with the legal provisions and that these are adequate and operating effectively.	In contrast, an LLP does not require its management to make a statutory disclosure of policies and particulars and leaves it to the partners to discuss these in confidence. Public disclosure is limited public disclosure to the partnership deed and annual balance sheet.
Corporate Social Responsibility ("CSR")	The New Act has introduced a CSR regime which is applicable to private companies as well.	There is no concept of CSR activities or its disclosure under the LLP Act.
Duties of Director/Partner	Under the New Act a fresh duty to stakeholders' i.e. interested persons distinct from shareholders as a whole has also been introduced. 'Act in good faith in order to promote the objects of the company for best interests of members as a whole, the company, *its employees, shareholders, community and for protection of the environment*'.	The management of an LLP does not have duties to stakeholders and their duty is limited to the firm and its partners.
Restrictions on the power of the Board	The New Act has substantially fettered the flexibility of a private company requiring shareholder consent for nearly every significant action.	LLPs are free to organise their management contractually.

Regulatory Race to the Top?

It is evident that the LLP model has fewer compliances, restrictions and disclosure requirements in comparison to a private company under the new Companies Act. The structure of an LLP provides a conducive environment to businessmen to manage their business in an ecosystem free of tedious governance compliances.

There are several tax incentives for an LLP. An LLP is taxed like a partnership firm and is not required to pay surcharge or dividend distribution tax on its income distribution.

But in spite of tax benefits and permission for FDI under the automatic route, it has been observed that very few LLPs have been registered. In stark contrast to, an enormous figure of 437,671 companies registered during 2009-2014 only 21,784 LLPs have been registered in India[2].

Although there has been a significant increase in registrations during 2013-14, one can infer that the very flexibility afforded the LLP structure renders it opaque and an investor has limited visibility in its affairs. This creates a governance risk for investors and lenders. The scalability of LLPs will therefore always prove unlikely in an ecosystem outside of medium scale business and large professional enterprises.

Conclusion

Under the new company law regime there is a high probability that instead of going through the trauma of enhanced 'corporate governance', start- ups, family run businesses and small scale enterprises may opt for incorporating LLPs. An LLP is an alternative ecosystem which enables professional expertise and entrepreneurial initiative to combine and operate in a flexible, innovative and efficient manner, and at the same time provides the benefits of limited liability. It gives its members the flexibility of organizing their internal structure as a partnership based on an agreement and provides a confidential business friendly model which could be a preferred option for closely held businesses.

Thus the New Act may certainly prove to be a 'fresh wind in the sail of the LLP' regime and professionals need to evaluate the pros and cons of limited liability partnership with greater care when advising clients.

[2] MCA Annual reports: 2009-2010,2010-2011,2011-2012,2012-2013.