

**THE RELATIONSHIP BETWEEN A PARENT COMPANY AND ITS
INDIAN WHOLLY OWNED SUBSIDIARY**

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Introduction

India is the seventh largest country in the world in size and the second most populous. Further, it is the fourth largest economy in the world and an emerging market. India has taken active steps to deregulate its economy by adopting ambitious economic reforms to stimulate foreign investment. Globalization and liberalization of the Indian economy have encouraged numerous organizations all over the world to do business with India.

Most recommended structure to invest in India

The most recommended investment structure for foreign companies entering India is to set-up either a joint venture with an Indian partner (if the foreign investor needs to collaborate with an Indian partner) or a wholly owned subsidiary (“WOS”) in India.

Other modes of investment in India include:

1. Agency

A foreign entity can, by appointing an Indian agent, obtain an indirect presence in India. Depending upon the scope of the agency agreement, the Indian agent can buy or sell the foreign principal’s products or services in India.

2. Liaison Office

A liaison office is an entity that fully owned and controlled by the foreign enterprise establishing it, and is not permitted to manufacture, trade or carry on any other commercial activity. Foreign companies establish liaison offices to liaise with their Indian customers, and to promote export and import activities.

3. Branch Office

A branch office is treated as a foreign company in India and is charged higher income tax (40% plus a surcharge as opposed to 30% [to be effective on April 1, 2005] plus a surcharge payable by an Indian company).

WOS in the form of a private company

A WOS can be defined as an entity whose entire share capital is held by foreign corporate bodies. A WOS can be formed either as a private or public company, limited by shares or guarantee, or an unlimited liability company. Considering the various exemptions available to a private company limited by shares (a “private company”) under India’s Companies Act, 1956 (the “Act”), it is recommended that a WOS be established as a private company.

1. Key advantages of a private company

A private company needs to have a minimum paid-up share capital of only Rs. 100,000 (US\$ 2300 approximately) as against Rs. 500,000 (US\$ 11800 approximately) required by a public company. (Section 3(1)(iii) of the Act).

A private company needs a minimum of two (2) directors and two (2) shareholders, whereas a public company requires a minimum of three (3) directors and seven (7) shareholders. (Sections 252 and 12(1) of the Act)

The profit and loss account of a private company can be filed separately with the Registrar of Companies (“ROC”) and need not be disclosed to the public. (Section 220 of the Act) Thus, confidentiality can be maintained.

A private company may make its own corporate rules. For example, the notice period to call a members’ meeting can be less than the statutorily specified twenty-one (21) days (section 171 of the Act); and a private company’s board of directors is not restricted from selling, leasing or otherwise disposing off the undertaking of the company, remitting or giving time for repayment of any debt due by a director, investing the compensation received by the company from a compulsory acquisition in securities (other than trust securities), borrowing moneys in excess of the paid-up capital and free reserves of the company, or contributing to charitable and other funds not directly related to the business of the company or the welfare of the employees. (Section 293 of the Act)

A private company needs to have only two (2) members to form a quorum at a shareholders' meeting, as against a minimum of five (5) members required for a public company. (Section 174 of the Act)

A holding company may grant a loan to its WOS, or give a guarantee or any security in respect of a loan made to its WOS, or acquire by way of subscription, purchases or otherwise, the securities of its WOS even for an amount exceeding sixty percent (60%) of its paid-up share capital and free reserves, or one hundred percent (100%) of its free reserves, whichever is more, without obtaining a special resolution of the shareholders in a general meeting. (Section 372A of the Act)

2. Steps to incorporate a WOS in the form of a private company

To begin with, an application, in Form 1A, must be made to the ROC along with payment of Rs. 500 (1US\$ = Rs. 43) to ascertain the name availability. After obtaining the name approval, the Memorandum of Association ("MOA") and Articles of Association ("AOA") have to be filed with the ROC, duly stamped as per the stamp duty laws applicable in the state in which the company is being incorporated. Two subscribers and one witness must sign the MOA and AOA of a private company. Along with the MOA and AOA, certain forms (including Form No. 1, Form No. 18 and Form No. 32) have to be filed with the ROC. The ROC scrutinizes the documents filed, and once satisfied, registers the Company and issues the certificate of incorporation. Usually, company incorporation takes three (3) weeks.

Regulatory restrictions

Foreign direct investment ("FDI") in India is subject to policy guidelines framed by the Government of India ("GOI") from time to time in accordance with the New Industrial Policy, 1991 (as amended). Currently, FDI up to one hundred percent (100%) under the GOI's automatic route is permitted in many sectors, namely, software development, IT-enabled services and infrastructure projects. However, sectors that require an industrial license, or in cases where foreign investment is more than twenty-four percent (24%) in the equity capital of companies manufacturing items reserved for the small scale industries sector, or if the foreign collaborator has a previous venture or tie-up in India in the same field in India, the prior approval of the Foreign Investment Promotion Board under the

Secretariat of Industrial Assistance, Ministry of Commerce and Industry, Government of India, is required.

Banned sectors (list of activities in which foreign investment is prohibited)

The GOI has specified activities or sectors in which foreign investment is prohibited. Some of these are:

Retail trading,

Atomic energy,

Lottery business,

Gambling and betting, and

Agriculture (excluding floriculture, development of seeds, animal husbandry, pisciculture, cultivation of vegetables, mushrooms, etc. under controlled conditions, services related to the agriculture and allied sectors), and plantations (other than tea plantations).

In other sectors, the GOI has either prescribed sectoral caps in respect of foreign investment or has permitted 100% foreign ownership, as explained in paragraph D above.

Corporate groups

1. Inter-company loans

The Act imposes certain restrictions and corporate compliance requirements (specified in paragraph C.1(vi) above) on public companies seeking to give loans to other companies under the same management. However, these do not apply to private companies, or where loans are made by a holding company to its subsidiary. Two (2) body corporates are deemed to be under the same management:

if the Managing Director or manager of one body corporate is the Managing Director or manager of the other body corporate;

if the majority of the directors of one body corporate constitute, or at any time within the immediately preceding six (6) months constituted, a majority of the directors of the other body corporate;

if not less than one-third of the total voting power with respect to any matter relating to each of the two (2) bodies corporate is exercised or controlled by the same individual or body corporate;

if the holding company of one body corporate is under the same management as that of the other body corporate; or

if one or more directors of one body corporate while holding, whether by themselves or together with their relatives, a majority of the shares in that body corporate also hold, whether by themselves or together with their relatives, the majority of shares in the other body corporate. (Section 370 of the Act)

2. Dominant undertakings

In order to prevent concentration of economic power and acquisition of controlling interest in the shares of a public company or a private company which is a subsidiary of a public company (as defined in section 4(7) of the Act), the Act imposes certain restrictions under sections 108A to 108I. Sections 108A to 108I of the Act apply to the acquisition or transfer of shares by, or to, an individual, firm, group, constituent of a group, body corporate or bodies corporate under the same management, who or which (a) is, in the case of acquisition of shares, the owner in relation to a dominant undertaking and there would be, as a result of such acquisition, any increase– (i) in the production, supply, distribution or control of any goods that are produced, supplied, distributed or controlled by that dominant undertaking; (ii) in the provision or control of any services that are rendered by that dominant undertaking; or (b) would be, as a result of such acquisition or transfer of shares or share capital, the owner of a dominant undertaking; or (c) is, in the case of transfer of shares, the owner in relation to the dominant undertaking.

A “dominant undertaking” is one which, by itself or along with inter-connected undertakings, produces, supplies, distributes or otherwise controls not less than one-fourth of the total goods or services produced, supplied or distributed in India

or any substantial part thereof. (Section 2(d) of the Monopolies and Restrictive Trade Practices Act, 1969)

An individual, firm, body corporate, group, constituent of a group, or bodies corporate under common management are prohibited from acquiring more than twenty-five percent (25%) of the paid-up equity share capital of a public company or a private company which is a subsidiary of a public company, without the approval of the Central Government. (Section 108A(1) of the Act) Every body corporate or bodies corporate under the same management, holding, whether singly or in the aggregate, ten percent (10%) or more of the nominal value of the subscribed equity capital of any other company shall, before transferring such shares, intimate the Central Government. (Section 108B of the Act) No body corporate or body corporates under the same management, which holds, or hold in the aggregate, ten percent (10%) or more of the nominal value of the equity share capital of a foreign company, having an established place of business in India, shall transfer any shares of such foreign company to any citizen of India or any body corporate incorporated in India except with the previous approval of the Central Government. (Section 108C of the Act)

There is no formal requirement to record a group structure in any corporate document.

Management

1. Rights of the board of directors

The board of directors of a company is entitled to exercise all such powers as the company is entitled to exercise, except for such powers, which are required to be exercised only by the shareholders in a general meeting. (Section 291 of the Act) The Act specifically provides for certain powers to be exercised by the board only at a board meeting, as for example, the power to make calls on shareholders in respect of money unpaid on their shares, the power to authorize buy-back, the power to issue debentures, the power to borrow money otherwise than on debentures, the power to invest the funds of the Company, and the power to make loans. (Section 292 of the Act)

2. Rights of shareholders

Under the Act, the shareholders of the company have wide powers. However, it is vital to note that these powers are subject to the provisions of the memorandum and articles of association of the company and the Act. Decisions of the shareholders are recorded in the form of resolutions. A resolution in a meeting of the shareholders may be passed either as an ordinary resolution (where the votes cast in favour of the resolution exceed the votes cast against the resolution) or as a special resolution (where the votes cast in favour of the resolution are not less than three times the votes cast against the resolution). In many joint ventures or WOS', shareholders enter into agreements *inter se*, agreeing to vote on corporate issues in a certain manner. Such agreements are commonly called pooling agreements. In this regard, in *Rolta India Ltd. v. Venire Industries Ltd.*, (2000) 2 Bom. CR 241; (2000) 100 Comp. Cases 19; (2000) Comp. L. J. 161, the Division Bench of the Bombay High Court held that an agreement between shareholders of a company would not bind the company, and the shareholders cannot infringe upon a director's fiduciary rights and duties. Further, shareholders cannot dictate terms to directors, unless they exercise their rights to remove directors under the Act (section 284 of the Act) or unless the provisions of the pooling agreement have been incorporated in the articles of association of the company.

3. Rights of minority shareholders

As the Act provides for a specific number of votes to pass resolutions in shareholders' meetings, minority shareholders may not always be in a position to voice their opinion. In view of this, the Act gives a powerful weapon to shareholders against companies that indulge in mismanagement, and conduct which is prejudicial to the affairs of the company and public interest. Minority shareholders can take recourse to the provisions of sections 235 to 237, as well as sections 397 and 398, and their rights in Indian companies can, thus, be substantially protected.

- (i) Under sections 235 and 237 of the Act, the Central Government can order an investigation into the affairs of a business:
 - (a) in the case of a company having share capital, when an application has been received from not less than two hundred (200) members or from members holding not less than one-tenth of the total voting power therein, and

- (b) in the case of a company having no share capital, when an application has been received from not less than one-fifth of the persons on the company's Register of Members.
- (ii) Under section 397 of the Act, the following members of a company who complain that the affairs of the company are being conducted in a manner prejudicial to public interest or in a manner oppressive to any member or members (including any one or more of themselves) may apply to the Company Law Board for appropriate reliefs:
- (a) in the case of a company having share capital, not less than one hundred (100) members of the company or not less than one-tenth of the total number of its members, whichever is less, or any member or members holding not less than one-tenth of the issued share capital of the company, provided that the applicant or applicants have paid all calls and other sums due on their shares;
- in the case of a company not having share capital, not less than one-fifth of the total number of its members.
- (iii) Under section 398 of the Act, the following members of a company, who complain that the affairs of the company are being conducted in a manner prejudicial to public interest or in a manner prejudicial to the interests of the company, or that by reason of any material change in the management or control of the company, it is likely that the affairs of the company will be conducted in a manner prejudicial to public interest or in a manner prejudicial to the interests of the company, may apply to the Company Law Board for appropriate reliefs:
- (a) in the case of a company having share capital, not less than one hundred (100) members of the company or not less than one-tenth of the total number of its members, whichever is less, or any member or members holding not less than one-tenth of the issued share capital of the company, provided that the applicant or applicants have paid all calls and other sums due on their shares;
- (b) in the case of a company not having share capital, not less than one-fifth of the total number of its members.

Transfer pricing

In 2001, detailed transfer pricing regulations were incorporated under sections 92 to 92F of the Income-Tax Act, 1961 (“IT Act”) to compute income on international transactions between associated enterprises. A company would be an associated enterprise of another, *inter alia*, if it held a majority shareholding in the other. Income arising from an international transaction is required to be computed having regard to arm’s length price. Arm’s length price means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions. (Section 92F(ii) of the IT Act) Any one of the following methods prescribed must be used to calculate arm’s length price:

- (i) comparable uncontrolled price method,
- (ii) resale price method,
- (iii) cost plus method,
- (iv) profit split method,
- (v) transactional net margin method, or
- (vi) such other method as may be prescribed.

A chartered accountant must certify arm’s length price, and records of all documents have to be preserved for a long period of time. Breaching these rules may result in the WOS being liable to tax in India on income attributed to it by the tax authorities.

Liability

1. Civil liability of officers and directors under the Act

The Act imposes personal civil liability on the directors and officers of a company for certain acts and omissions. For example, if an officer of a company does certain acts or signs certain documents without specifying the name of the company, he becomes personally liable for such acts. (Section 147(4) of the Act) Directors may be held personally liable to a company, which is in liquidation, for all losses caused to the company by reason of their having conducted the company’s business in a fraudulent manner, or by reason of any misapplication of

funds, or any misfeasance or breach of trust committed by them in relation to the company. (Sections 542 and 543 of the Act)

2. Civil liability under the IT Act

The directors of a private limited company are personally liable to pay the unpaid and irrecoverable income tax due from such company, unless they prove that they have not acted negligently. (Section 179 of the IT Act)

3. Common law liability

At common law, a director owes two types of duties to the company – a fiduciary duty, and a duty of skill and care. Pursuant to these principles of common law, a director may be personally liable to an affected third party on the ground of an implied breach of warranty as a consequence of his act, which is ultra vires the company.

4. Criminal liability under the Act

The Act is full of provisions, which impose penal sanctions against officers who are in default for a variety of violations, for e.g., the failure to file the annual accounts within the time prescribed (section 220 of the Act), or the failure to repay the amount of a fixed deposit at maturity. (Section 58A(5) of the Act)

5. Criminal liability under other statutes

Almost all modern Indian statutes which deal with environmental, industrial, economic and other welfare issues include a section which defines the vicarious liability of directors for the offences committed by the companies of which they are directors, e.g., The Water (Prevention and Control of Pollution) Act, 1974, (section 47); The Air (Prevention and Control of Pollution) Act, 1981, (section 40); The Environment (Protection) Act, 1986, (section 16); The Industries (Development and Regulation) Act, 1951, (section 24(2)); The Employees State Insurance Act, 1948, (section 86-A); The Employees Provident Funds and Miscellaneous Provisions Act, 1952, (section 14-A); The Central Excise and Salt Act, 1944, (section 9-A); The Customs Act, 1962, (section 140); The Income-Tax Act, 1961, (section 278B). However, if a director can prove that the contravention of the provisions under the various acts took place without his knowledge, or that

he acted with due diligence to prevent such contravention, he may be able to escape such vicarious liability. (*Agarwal Trading Company v. Assistance Collector of Customs*, AIR 1972 SC 648, and *Girdhari Lal Gupta v. D. N. Mehta*, AIR 1971 SC 648)

A famous cases in India where a parent was held liable for negligence is the Union Carbide case. In 1984, there was a major gas leak at Union Carbide's plant in Bhopal, India. This resulted in several deaths and injuries to thousands of local residents. Action was taken against Union Carbide in the US, and after a protracted legal battle, a settlement was reached. Therefore, foreign companies operating in India need to ensure that the Indian WOS' are well managed.

In relation to global bribery statutes, e.g., the US Foreign Corrupt Practices Act, there have been no major convictions in India. India is in the process of enacting anti-money laundering laws and also has its own anticorruption laws.

Lawyers, auditors and other professionals representing Indian companies can be held liable for professional negligence or deficiency in service. This can result in civil liabilities such as fines, disbarment, etc.

6. Indemnification and Insurance

A company may obtain insurance to protect itself against a liability, which may be incurred by it because of any act or omission of a director or officer. (Section 201 of the Act) For the same reason, a director or officer may lawfully take out an insurance policy to protect himself against potential liability, and it is lawful for the company to pay the premium on such policy. A company can indemnify the directors or officers in respect of such liability, only if officer or director is successful in the legal proceedings filed against him.

7. Conflicts between a parent and its WOS

Generally speaking, an indemnity given by a parent in respect of its WOS' obligations in India is enforceable only if the subject matter of the indemnity is not contrary to India's public policy or statutory law.

8. Lifting the corporate veil

A company is a natural person and has its own legal entity. A company's entity is totally separate from its shareholders. As such, it bears its own name and has a seal of its own. Further, its assets are separate and different from those of its members, and it can sue and be sued independently. At law, a holding company and its WOS are separate legal entities. Therefore, neither is the creator (i.e., the holding company) liable for the breaches of contracts and torts of its WOS (*see R. v. South Wales Traffic Licensing Authority, ex parte Ebbw Vale U.D.C.*, (1951) 1 All E.R. 806), nor can it sue to enforce rights that belong to its subsidiary. (*Bell v. Lever Bros. Ltd.* (1932) A.C. 161)

Notwithstanding this, the Act permits the lifting of the corporate veil, where there is an evasion of contractual and statutory obligations that would subvert public interest, e.g., non-payment of direct or indirect taxes; non-payment of statutory benefits to workmen; where the company acts as a trustee or a agent of the shareholders; where the company is a sham or engages in fraudulent acts; or where the company has assumed the character of an enemy company.

In tax cases, Indian courts have pierced the corporate veil where it has been apparent that the effective control of an Indian WOS is with a foreign parent. Therefore, care should be taken that an Indian WOS is managed in India. Further, it is rare for an entire group or conglomerate of companies to be made liable for the negligence of an Indian WOS. Typically, it is the shareholders of the company that are made liable if the corporate veil is pierced.

Conclusion

In India, it is recommended that a WOS in the form of a private limited company be established, to the extent permitted by Indian foreign exchange laws and regulations. This structure gives the most flexibility and protection to a foreign investor.