PRIVATE SUBSIDIARIES OF PUBLIC COMPANIES UNDER THE COMPANIES ACT: CRITICAL CONSIDERATIONS, SIGNIFICANCE, AND REGULATORY FRAMEWORK

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ABSTRACT

This topic explores the critical considerations, significance, and regulatory framework surrounding private subsidiaries of public companies under the Companies Act. Private subsidiaries play a crucial role in the corporate structure of public companies, offering benefits such as flexibility in operations, risk management, and tax planning. However, their existence also raises important considerations related to corporate governance, disclosure obligations, and regulatory compliance. This abstract provides an overview of the key aspects covered in the discussion, including the legal framework governing private subsidiaries, the obligations of public companies towards their subsidiaries, and the regulatory oversight and reporting requirements imposed by the Companies Act. The abstract underscores the importance of understanding the implications, responsibilities, and regulatory considerations associated with private subsidiaries to ensure compliance and effective management within the corporate structure of public companies. It discusses corporate governance exclusively for subsidiaries to avoid crisis-like situations.

INTRODUCTION

The Companies Act, 2013 governs the legal framework and regulations for companies. Under this Act, public companies often establish private subsidiaries to pursue specific business objectives, diversify operations, or manage risk effectively. These subsidiaries play a significant role in the corporate structure of public companies, offering various benefits and opportunities. However, the establishment and operation of private subsidiaries also involve critical considerations, both from a strategic and regulatory perspective. This topic explores the critical considerations, significance, and regulatory framework surrounding private subsidiaries of public companies under the Companies Act. We will delve into the reasons why public companies opt for subsidiary structures, the advantages they offer, and the potential challenges they may face. Additionally, we will examine the regulatory framework

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that governs the establishment, management, and oversight of these subsidiaries, emphasizing the legal obligations and compliance requirements imposed on public companies. Understanding the nuances of private subsidiaries is essential for stakeholders, including shareholders, investors, directors, and regulators. By comprehending the underlying principles and regulatory landscape, public companies can make informed decisions about subsidiary formation and ensure compliance with relevant laws. Similarly, investors can evaluate the risks and benefits associated with investing in public companies with private subsidiaries, while regulators can ensure adherence to legal and ethical standards. This study aims to provide a comprehensive overview of private subsidiaries of public companies under the Companies Act, shedding light on their critical considerations, significance, and the regulatory framework that governs their operations. By examining these aspects, we can better grasp the complexities and implications of this corporate structure, enabling a more informed analysis and decision-making process for all stakeholders involved.

PUBLIC COMPANIES

The establishment and functioning of a public limited company in India are regulated by the Companies Act of 2013. A public limited company offers shares to the general public and operates with limited liability. Its shares can be acquired by anyone, either through an initial public offering (IPO) or through trading on the stock market. The company is subject to strict regulations and is required to disclose its true financial status to its shareholders.

Registering a public limited company in India is an ideal business structure for entrepreneurs planning large-scale operations. The registration requires a minimum of seven members, and there is no maximum limit on the number of members or shareholders. The shares of the company can be acquired by anyone through IPOs or stock market trades, making such offerings beneficial for raising capital. Public limited companies are subject to more stringent rules and regulations compared to private limited companies. This is because the funds invested in the company belong to the public, and therefore, transparency and accountability are of utmost importance. The Companies Act of 2013 provides a comprehensive framework to govern the establishment, management, and operation of public limited companies, ensuring compliance with legal and regulatory obligations.

As per Section 2(71) of the Companies Act, 2013- "Public company" means a company which

(a) is not a private company and;

(b) has a minimum paid-up share capital as may be prescribed.

Provided that a company that is a subsidiary of a company, not being a private company, shall be deemed to be a public company for the purposes of this Act even where such subsidiary company continues to be a private company in its articles.

Here are some important considerations to bear in mind prior to incorporating a Public Company in India:[1]

Minimum shareholder and director requirements: It is essential to have a minimum of 7 shareholders and 3 directors to form a Public Limited Company in India. There is no restriction on the maximum number of directors.

Name requirement: For a Public Limited Company, the name must conclude with the term "Limited" to comply with regulatory guidelines.

Name approval by ROC: Before proceeding with the registration process, the proposed name of the company needs to be approved by the Registrar of Companies (ROC).

Digital Signature Certificates (DSC): It is mandatory to obtain DSC for all directors and subscribers involved in the formation of the company. DSCs ensure secure and authenticated online transactions.

Stringent regulations: Public Limited Companies in India operate under more rigorous rules and regulations compared to Private Limited Companies. This is primarily due to the public nature of the company and the involvement of external shareholders. Compliance with these regulations is crucial to ensure transparency and accountability.

Limited liability: The liability of each shareholder is limited. In simple words, a shareholder of a public limited company isn't personally responsible for any loss or debts of the company for any amount greater than the amount invested by them; contrary to partnerships and sole proprietorships, where the partners and business owners are jointly and severally liable for the debts of the business. However, this characteristic of a public limited company does not

[1]Public Limited Company in India, ClearTax, https://cleartax.in/s/public-limited-company-india, 28th June, 2023

offer immunity to the shareholders. The shareholders will be held responsible for their own illegal actions.

Paid-up Capital: A public limited company is required to have a minimum paid-up capital of Rs 5 lakh or such a higher amount as prescribed under the act.[2]

Prospectus: A prospectus is a comprehensive statement of the affairs of the company issued by a public limited company for its public and there is a requirement under the Act for public limited companies to issue a prospectus. However, there are no such provisions for Private Limited Companies. This is because private limited companies cannot invite the public to subscribe to their shares.

PRIVATE SUBSIDIARIES[3]

According to the Companies Act 2013, a **subsidiary** is defined as a **company** in which a foreign legal entity owns at least 50% of the total share capital. The definition also states that the **foreign company** has legal rights on the structure of the **board of directors of the subsidiary**.

The Companies Act, 2013, replaces the previous Companies Act, 1956, and introduces provisions for governing subsidiaries of domestic and overseas companies in India. According to the Act, a subsidiary company is defined as one in which the holding company controls the composition of the Board of Directors and owns more than half of the total share capital either directly or through its other subsidiary companies.

The Act introduces new filing and disclosure requirements for holding companies regarding their domestic and overseas subsidiaries. These include incorporating financial reports of subsidiaries in the prospectus for public issuance, filing an annual return with details of subsidiary and associate companies to the Registrar, submitting overseas subsidiary accounts to the Registrar, presenting consolidated financial statements covering all subsidiaries (including associates and joint ventures) at the annual general meeting, and classifying non-current investments into subsidiaries, associates, joint ventures, or special purpose entities.

[2] Public Company: An Overview and Incorporation Process, TaxGuru, https://taxguru.in/company-law/public-company-overview-incorporation-process.html, 29th June, 2023

[3] Deloitte, Governance of Subsidiaries: A Survey of Global Companies, https://www2.deloitte.com/content/dam/Deloitte/in/Documents/risk/Corporate%20Governance/in-gc-governance-of-subsidiaries-a-survey-of-global-companies-noexp.pdf, 28th June, 2023

Regarding books of accounts, the Act mandates every company, including its subsidiary companies and branch offices in India or overseas, to maintain records of its books of accounts at its registered office. Additionally, the Act requires every holding company to publish audited accounts of each subsidiary on its website and provide copies to any shareholder upon request.

In India, a subsidiary is recognized as a distinct legal entity under the applicable legislation. It operates as a separate company and is subject to the regulations outlined in the Income Tax Act, along with the benefits and provisions applicable to companies registered in India. With India becoming an increasingly popular destination for foreign companies, establishing a subsidiary is a common choice for entering the Indian market, alongside the option of operating through a branch office.[4]

When registering a subsidiary in India, it is typically done as a private limited company, requiring the appointment of at least two directors. The process of forming a subsidiary involves several steps. The directors of the company must apply for a Director's Identification Number (DIN). Subsequently, the subsidiary must follow specific incorporation procedures, such as obtaining approval for the chosen trading name from the Registrar of Companies. Once these steps are completed, the subsidiary will be issued a Certificate of Incorporation. Our consultants can provide further details on the specific documents required during the company formation process. Additionally, if investors wish to protect their brand, trademark registration can also be included as a step in the company formation procedure in India.

Overall, establishing a subsidiary in India entails adhering to the legal requirements, following the prescribed registration process, and fulfilling necessary documentation. By doing so, foreign companies can establish a separate legal entity in India that operates under the country's regulations, enabling them to effectively conduct business within the Indian market.

Subsidiaries are established to fulfil various business requirements, such as corporate structuring, innovation of products and services, regulatory compliance, tax optimization, and facilitating mergers and acquisitions. They also enable companies to expand into new geographical markets. As businesses grow and diversify, the number of subsidiaries tends to increase, leading to complex corporate structures. While there is a well-defined concept of

[4] ibid

corporate governance that outlines the principles of good governance, extending these practices and policies downstream to subsidiaries poses challenges for companies.

Ensuring effective governance of subsidiaries requires addressing two critical questions:

- How to implement sound corporate governance practices and policies in subsidiaries?
- What governance structures should be adopted to ensure efficient oversight of the entire company?[5]

Establishing a cohesive chain of oversight and governance from the parent company to its subsidiaries is a key consideration. The aim is to ensure that subsidiaries operate in alignment with the overall corporate governance framework and contribute to the company's success. This involves defining appropriate governance structures, roles, and responsibilities for subsidiaries, along with mechanisms for reporting, accountability, and decision-making. The extension of corporate governance practices to subsidiaries requires careful coordination and integration of policies, procedures, and control mechanisms. It involves defining clear lines of authority, establishing communication channels, and setting up monitoring and evaluation systems to ensure compliance and alignment with the parent company's objectives. Determining the appropriate governance structures for subsidiaries involves assessing factors such as the subsidiary's strategic importance, geographic location, and level of operational autonomy. Companies may opt for centralized governance structures where the parent company exercises significant control and oversight, or decentralized structures where subsidiaries have greater autonomy within defined boundaries.[6]

LEGAL FRAMEWORK FOR PRIVATE SUBSIDIARIES

The Companies Act 2013 introduced significant changes and regulations related to holding and subsidiary companies in India. These provisions aim to promote corporate governance, transparency, and accountability within the corporate sector. Here are some key points to consider[7]:

Definition and Classification:

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[5] ibid
[6] ibid
[7] https://taxguru.in/company-law/holding-subsidiary-company-provisionsimplication-companies-act-2013.html

- The Act defines a holding company as one that controls the composition of the board of directors or exercises control over the management and policies of another company.
- A subsidiary company is defined as one where the control or management is vested in the holding company.
- The Act also introduces the concept of an associate company, which is a company in which the holding company has a significant influence but does not control the management.

Holding Company's Obligations:

- A holding company is responsible for ensuring compliance with the provisions of the Act by its subsidiaries.
- It must prepare consolidated financial statements that include the financials of its subsidiaries and associate companies.
- The holding company must also disclose the details of its subsidiaries, associate companies, and other related entities in its financial statements.

Subsidiary Company's Requirements:

- A subsidiary company is required to comply with the provisions of the Act and maintain its own financial statements.
- It must prepare and present its financial statements, hold general meetings, and appoint auditors as per the Act's requirements.
- The Act also mandates that the financial statements of the subsidiary be audited and reported separately from those of the holding company.

Corporate Governance and Control:

- The Act emphasizes the need for transparency and accountability in the corporate sector.
- It lays down provisions related to the composition of the board of directors, independent directors, and corporate governance committees for both holding and subsidiary companies.
- The Act requires holding companies to ensure that their subsidiaries adhere to corporate governance principles and maintain high standards of accountability.

Transactions between Holding and Subsidiary Companies:

- The Act regulates transactions between holding and subsidiary companies to prevent abuse of power or undue advantage.
- It requires any transaction that exceeds specified thresholds to be approved by the board of directors and, in some cases, by shareholders as well.
- The Act prohibits certain types of transactions, such as loans or investments in companies with the same directors or substantial shareholders, without the approval of shareholders.

Compliance and Penalties:

- The Act imposes obligations on holding and subsidiary companies to comply with its provisions.
- Non-compliance with the Act's requirements may result in penalties, fines, or other legal consequences for the companies and their officers.
- It is crucial for companies to ensure they understand and fulfill their obligations under the Act to avoid legal repercussions.

IMPORTANT SECTIONS

Section 19 (1): **Subsidiary company not to hold shares in its holding company**.— No company shall, either by itself or through its nominees, hold any shares in its holding company and no holding company shall allot or transfer its shares to any of its subsidiary companies and any such allotment or transfer of shares of a company to its subsidiary company shall be void:

Provided that nothing in this sub-section shall apply to a case—

(a) where the subsidiary company holds such shares as the legal representative of a deceased member of the holding company; or

(b) where the subsidiary company holds such shares as a trustee; or

(c) where the subsidiary company is a shareholder even before it became a subsidiary company of the holding company:

Provided further that the subsidiary company referred to in the preceding proviso shall have a right to vote at a meeting of the holding company only in respect of the shares held by it as a legal representative or as a trustee, as referred to in clause (a) or clause (b) of the said proviso.

(2) The reference in this section to the shares of a holding company which is a company limited by guarantee or an unlimited company, not having a share capital, shall be construed as a reference to the interest of its members, whatever be the form of interest.

Section 186. Loan and investment by company.— (1) Without prejudice to the provisions contained in this Act, a company shall unless otherwise prescribed, make an investment through not more than two layers of investment companies:

Provided that the provisions of this sub-section shall not affect,—

(i) a company from acquiring any other company incorporated in a country outside India if such other company has investment subsidiaries beyond two layers as per the laws of such country;

(ii) a subsidiary company from having any investment subsidiary for the purposes of meeting the requirements under any law or under any rule or regulation framed under any law for the time being in force.

219. Power of inspector to conduct investigation into affairs of related companies, etc.— If an inspector appointed under section 210 or section 212 or section 213 to investigate into the affairs of a company considers it necessary for the purposes of the investigation, to investigate also the affairs of—

(a) any other body corporate which is, or has at any relevant time been the company's subsidiary company or holding company, or a subsidiary company of its holding company;

185. Loan to directors, etc.— (1) Save as otherwise provided in this Act, no company shall, directly or indirectly, advance any loan, including any loan represented by a book debt, to any of its directors or to any other person in whom the director is interested or give any guarantee or provide any security in connection with any loan taken by him or such other person. In summary, the Companies Act 2013 introduced provisions to regulate holding and subsidiary companies, aiming to enhance corporate governance, transparency, and accountability. The

Act defines these entities and imposes obligations on them regarding compliance, financial reporting, corporate governance, and control. It also regulates transactions between holding and subsidiary companies to prevent abuse of power. Non-compliance with the Act may lead to penalties and legal consequences. It is essential for companies to familiarize themselves with the Act's provisions and ensure compliance to maintain good corporate practices. For detailed information and a deeper understanding of the topic, I recommend referring to the article you provided. The Apex Court in the case of **Regional Provident Fund Commissioner v. ABS Spinning Orissa Ltd.**[8]has observed that a subsidiary company has an independent existence as against the holding company and, therefore, is not liable to clear the provident fund dues of its subsidiary company. In the present case also, the facts are similar.

SUBSIDIARIES OF PUBLIC COMPANY

According to the provision of a "Deemed Public Company," if a subsidiary company of a public company is not itself a private company, it will be considered a deemed public company for the purposes of the Act, even if it continues to be classified as a private company in its articles. To determine if a company is a deemed public company, the following points should be checked[9]:

- Subsidiary of a Public Company: Verify if the company is a subsidiary of a public company.
- Restrictions mentioned in clause 68 of section 2: Ensure that the company continues to adhere to the restrictions mentioned in clause 68 of section 2.

The date of becoming a deemed public company occurs immediately when the private company becomes a subsidiary of a public company.

In a 2006 case (Hillcrest Realty Sdn. Bhd v. Hotel Queen Road (P.) Ltd.), the Company Law Board, Delhi Bench, held that the provisions in the Articles maintaining the basic characteristics of a private company, as per section 3(1)(iii), will continue to govern the affairs of the company, even if it is a subsidiary of a public company. The Delhi CLB Bench stated that the basic characteristics of a private company should not be altered solely because it is a subsidiary of a public company, considering the fiction created by section 3(1)(iv)(c)

[8] Civil Appeal No. 6928 of 2002
[9] Deemed Public Company: Subsidiary of Public Limited Companies, TaxGuru, https://taxguru.in/company-law/deemed-public-company-subsidiary-of-public-limited-companies.html, 29th June, 2023

that it is a public company. The Bench further clarified that while the company may be a public company under other provisions of the Act, it still retains its basic characteristics as a private company.

A deemed public company, which is a subsidiary of a public company, is subject to all provisions applicable to a public company except for the following restrictions mentioned in its Articles of Association:

- Restriction on the right to transfer its shares.
- Limitation on the number of members, which cannot exceed 200.
- Prohibition on making any invitation to the public to subscribe for securities of the company.

While complying with the provisions applicable to a public company, the deemed public company can maintain these restrictions in its articles, similar to a private company. Therefore, constitutionally, the company may continue to be identified and operate as a private company, even though it acquires a public interest status due to its parentage. It is important to note that the maximum number of members in a deemed public company should not exceed 200, as per the applicable restrictions.[10]In summary, a deemed public company, despite being a subsidiary of a public company, can retain the restrictions applicable to a private company in its articles and operate under the status of a private company, as long as it complies with the provisions specific to a public company and does not exceed the maximum limit of 200 members.

ISSUES AND CHALLENGES

Related-party transactions and conflicts of interest

Related Party[11]: To understand related party transactions, it is necessary to identify the parties that qualify as related parties. The definition of related parties is provided in Section 2(76) of the Companies Act, read with Rule 3 of the Companies (Specification of definitions details) Rules, 2014. The following entities and individuals are considered related parties with respect to a company:

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[10] Deemed Public Company: Subsidiary of Public Limited Companies, TaxGuru,https://taxguru.in/company-law/deemed-public-company-subsidiary-of-public-limited-companies.html, 27th June, 2023

[11] Related Party Transactions (RPT) under Companies Act, 2013, TaxGuru, https://taxguru.in/company-law/related-party-transactions-rpt-companies-act-2013.html, 27th June, 2023

- Director or key managerial personnel or their relatives.
- A firm in which a director, manager, or their relative is a partner.
- A private company in which a director or manager, or their relative, is a member or director.
- A public company in which a director or manager is a director and, along with their relatives, holds more than two percent of the paid-up share capital.

1. Anybody corporate whose board of directors, managing director, or manager acts according to the advice, directions, or instructions of a director or manager.

2. Any person whose advice, directions, or instructions a director or manager is accustomed to follow. However, this does not apply when given in a professional capacity.

- Holding, subsidiary, or associate company of the company.
- A subsidiary of a holding company, of which it is also a subsidiary.
- An investing company or venturer of the company. "Investing company or venturer of a company" refers to a body corporate whose investment in the company would result in the company becoming an associate company of the body corporate.
- A director, other than an independent director or key managerial personnel, of the holding company or their relative.[12]

Note: The term "relative" in relation to a person includes their father, mother, son, son's wife, daughter, daughter's husband, brother, sister, members of a Hindu Undivided Family (HUF), husband, and wife.[13]

The provisions regarding related party transactions are outlined in Section 188 of the Companies Act, 2013, along with Rule 15 of the Companies (Meetings of Board and its Powers) Rules, 2014. According to these provisions, a company is prohibited from entering into any contract or arrangement with a related party, except with the prior approval of the Board or shareholders, depending on the nature and value of the transaction. The following transactions are considered related party transactions under Section 188:

- Sale, purchase, or supply of goods or materials, either directly or through the appointment of any agent.

[12] ibid
[13] ibid

- Selling, disposing of, or buying any property, either directly or through the appointment of an agent.
- Leasing of any kind of property:
- Availing or rendering of any services, either directly or through the appointment of an agent:
- Appointment of a related party to any office or place of profit in the company, its subsidiary, or associate company, with a monthly remuneration exceeding Rs. 2,50,000.
- Underwriting the subscription of any securities or derivatives thereof of the company.

Research into fraudulent practices reveals a growing prevalence of related party transactions as a mechanism for perpetrating fraud. The most common types of fraudulent related party transactions include undisclosed or unapproved purchases or sales of goods or services from related parties, where payments are made but the transactions may be non-existent. Another frequently occurring type is improper lending or investments, involving loans or investments extended to related companies or executives with improper disclosure or valuation.

In India, a similar trend is observed. A recent study found that over half of the companies involved in fraud engaged in fraudulent activities through sales and purchases with related parties or shell companies that were related parties. They also utilized loans granted to related parties, whether interest-free or otherwise, and made investments in subsidiaries. The fraudulent practices in these cases often involved fictitious sales and purchases, long outstanding dues from related party debtors and creditors, write-offs of related party advances and debtors, non-compliance with disclosure requirements, unauthorized transactions without shareholder or stakeholder approval, lack of supporting evidence and documentation for related party transactions, and diversion of loans for personal use by promoters and/or directors. The presence of related party transactions has been found to be significantly higher in fraud firms compared to non-fraud firms, indicating an association between related party transactions and heightened fraud risk. However, it is important to note that not all related party transactions are fraudulent, as they are recognized and regulated practices in corporate and taxation laws. Frauds involving related party transactions primarily occur through investments in, sales to, purchases from, and borrowings from related parties. Some key observations and examples include[14]:

Investments in related parties: Improper disclosure of investments in related parties can lead to an overstatement of assets and mislead investors. Cases such as Assam Company India Ltd (ACIL) and Inter Globe Finance Limited (IGFL) highlight suspicions of misrepresentation of financials and non-compliance with shareholding patterns.

Sales to related parties: Fictitious sales transactions to related parties create a false impression of business activity and can overstate revenue. Examples include K Lifestyle India Ltd, Arvind Remedies Limited, and Tree House Education and Accessories Limited, where transactions were misrepresented or non-existent, leading to financial misstatements and potential misuse of funds.

Purchases from related parties: Fraudulent firms may make unnecessary purchases from related parties or pay above-market prices to transfer funds borrowed from banks and lenders. Venmax Drugs and Pharmaceuticals Ltd is an example where false purchases and sales were entered into financial statements, indicating potential misrepresentation.

Borrowings from related parties: Improper reporting of loans from related parties can create a non-transparent system and inaccurate financial position estimation. Instances involving Assam Company Limited, Tree House Education and Accessories Limited, and Hit Kit Global Solutions demonstrate suspicions of misused funds, incomplete documentation, and non-disclosure of related party loans and advances. While related party transactions can serve legitimate purposes, it is crucial to adhere to statutory standards, ensure proper disclosure, and conduct regular audits to mitigate risks and prevent fraudulent activities.

- **Transfer pricing and tax implications**

Transfer pricing pertains to the prices of goods and services exchanged between companies that share a common controlling entity. This commonly occurs when a subsidiary company sells products or provides services to its parent company or another affiliated company, and the price at which these transactions occur is known as the transfer price.

[14] ibid

Entities under common control are those that are ultimately controlled by a single-parent corporation. Multinational corporations utilize transfer pricing as a means to allocate profits (earnings before interest and taxes) among their different subsidiaries within the organization. This practice helps determine how profits are distributed and attributed to various entities within the corporate structure. Transfer pricing strategies can provide several benefits to a company in terms of taxation. However, it is important to note that regulatory authorities often disapprove of the manipulation of transfer prices to evade taxes. Therefore, it is crucial to engage in effective and legal transfer pricing practices.

One approach to optimize transfer pricing involves taking advantage of the varying tax regimes across different countries. By increasing transfer prices for goods and services produced in jurisdictions with lower tax rates, companies can allocate a larger portion of their profits to those locations, resulting in potential tax savings. Moreover, companies may also reduce expenses related to international transactions by avoiding tariffs on goods and services exchanged across borders. These practices are subject to scrutiny by international tax laws governed by the Organization for Economic Cooperation and Development (OECD). Auditing firms, which are reviewed and authorized by the OECD, conduct audits of the financial statements of multinational corporations (MNCs) to ensure compliance with transfer pricing regulations.

In summary, while transfer pricing strategies can be advantageous for tax purposes, it is essential to adhere to legal and transparent practices to avoid regulatory issues and maintain compliance with international tax laws.

- **Potential misuse and abuse of private subsidiaries**

Using money from the company (public shareholders) to increase promoters' stake in the company.

To execute such transactions, the following key steps are typically involved:

Transfer of company funds: The money of the company (referred to as A) is transferred to another entity (referred to as B). Entity B can be either a subsidiary of the company or a promoter group entity.

- If B is a subsidiary, the transfer may occur through investment in B's shares or as a loan or advance to B.
- If B is a promoter group entity, the transfer usually takes the form of a loan or advance.

Purchase of company shares: Once entity B receives the transferred funds, it utilizes the money to buy shares of company A from the open market or other significant shareholders. Inclusion of shares in the Promoters' Category: Subsequently, the promoters include the shares owned by entity B in the Promoters' Category, thus disclosing a higher promoters' shareholding in company A. These steps allow the promoters to artificially inflate their shareholding in the company using the funds of company A, thereby potentially gaining more control or influence. It is important to note that such practices can attract regulatory scrutiny and potential legal consequences.

Promoter group entities, which may include subsidiaries of the company, are used as recipients of loans and advances. The company provides loans or advances to these promoter group entities, effectively transferring company funds to them. The promoter group entities, particularly subsidiaries, utilize the funds received from the company to purchase shares of the company in question. Inflating promoters' shareholding: The shares acquired by the subsidiary entities are attributed to the promoters, leading to an increase in their overall shareholding in the company. This strategy involves misusing the subsidiary entities by utilizing their financial resources to indirectly benefit the promoters, potentially leading to the consolidation of control or influence. Such practices may attract regulatory scrutiny as they can be seen as unfair exploitation of subsidiaries and potentially raise concerns about corporate governance and transparency.

The misuse of subsidiaries can occur when promoters exploit their control over subsidiary entities to gain advantages in shareholding. One such method involves using loans and advances provided by the company to promoter group entities. Through this strategy, the company transfers funds to these entities, which then purchase shares of the company, ultimately increasing the promoters' shareholding. Another way to misuse subsidiaries is by acquiring shares at a discounted price through employee stock options (ESOPs). The company transfers shares to subsidiaries at a lower price, benefiting the promoters who control these subsidiaries. These practices can raise concerns about fair resource allocation, conflicts of interest, and corporate governance.

The misuse of subsidiary companies can occur when promoters exploit their control over these entities to gain advantages in acquiring company shares at a cheaper price. One method involves the use of stock warrants, where the company transfers these warrants to subsidiary entities at a discounted price. The subsidiaries then exercise the warrants to purchase company shares at a predetermined price lower than the market value. As the promoters typically control the subsidiaries, this practice indirectly benefits them by enabling them to acquire shares at a more favorable price. This misuse of subsidiaries raises concerns regarding fairness, transparency, and potential conflicts of interest. Regulatory authorities closely monitor such practices to ensure compliance with regulations surrounding fair pricing, related-party transactions, and corporate governance. It is essential for companies to uphold transparency, proper governance, and regulatory compliance when involving subsidiary companies and utilizing financial instruments like stock warrants to maintain integrity and safeguard stakeholders' interests.

WAY FORWARD: POTENTIAL REMEDIES

This article discusses the challenges of effectively managing subsidiaries within corporate groups and the need to strike a balance between control and autonomy. The following risk areas and practical steps are highlighted[15]:

RISK AREAS[16]

Duty to the subsidiary: Directors of a subsidiary must act in the best interests of the subsidiary, even if it conflicts with the interests of the parent company. Common directors between parent and subsidiary companies can create challenges in fulfilling this duty.

Control and management: While the parent company has the right to appoint directors of the subsidiary, the subsidiary's board should be allowed to manage its affairs independently. Excessive interference by the parent company may lead to legal implications, such as being considered shadow directors or facing liability for subsidiary breaches.

[15]Managing Subsidiaries: A Balancing Act, Lexology, https://www.lexology.com/library/detail.aspx?g=2c0c7957-f6b1-43e2-b715-899d4a188ee1, 29th June, 2023
[16] ibid

PRACTICAL STEPS[17]

Avoid common directors: Minimize the overlap of directors between parent and subsidiary companies and consider appointing non-executive directors to ensure independence.

Establish clear internal group policies: Develop comprehensive group policies that extend to subsidiaries, covering conflicts, major transactions, related party transactions, borrowing, and guarantees.

Clarify subsidiary directors' roles: Ensure that directors of subsidiaries understand their responsibilities and obligations, treating their roles as more than just symbolic positions.

Separate board meetings: Conduct separate board meetings for each group company to maintain independence and facilitate decision-making.

Caution in parent company involvement: Parents should avoid giving direct instructions to subsidiary boards and carefully consider their role in approving actions, allowing the subsidiary's board to make autonomous decisions.

Arm's length transactions: An arm's length transaction is a business transaction where buyers and sellers operate independently without exerting influence over each other. It implies that both parties act in their own self-interest and are not subject to coercion or undue pressure from the other party. Arm's length transactions are conducted to ensure fairness and to provide assurance that there is no collusion between the buyer and seller. Additionally, it is expected that both parties have equal access to relevant information related to the transaction. Ensure that transactions between group entities are conducted at arm's length or seek professional advice if they are not.

Maintain proper documentation: Document and record board decisions and the rationale behind them to maintain transparency and accountability.

In conclusion, while the parent company needs some control and oversight over its subsidiaries for risk management purposes, it should respect the autonomy of subsidiary boards and avoid pressurizing directors to act against the best interests of the subsidiary. Emphasizing the independence of subsidiary boards and implementing practical measures to

[17] ibid

foster their autonomy is crucial. Apart from the above, emphasis must be laid on the overall subsidiaries' corporate governance as well.

GOVERNANCE AND MANAGEMENT CONSIDERATIONS

Gain buy-in from the holding company and subsidiaries' boards: Obtain the approval and support of the holding company board and all subsidiary boards before proceeding with the subsidiary governance framework template[18].

Conduct an audit and due diligence on all subsidiaries: Perform a thorough audit and due diligence process for each subsidiary to gather essential information and documentation[19].

Collate key information and documentation: Gather and organize important data, documents, and records obtained during the audit and due diligence process.

Establish and resource the governance team: Create a dedicated governance team with the necessary resources, expertise, and skills to implement and manage the subsidiary governance framework[20].

Set priorities, goals, and time frames: Define clear priorities, goals, and time frames for implementing the subsidiary governance framework. This helps ensure focus and accountability throughout the process.

Communicate the rationale behind the project: Clearly articulate the reasons and benefits behind the subsidiary governance framework project to relevant stakeholders, emphasizing the need for their involvement and support.

Develop a subsidiary governance framework template: Create a standardized framework template that will guide subsidiary governance practices and processes. The template should align with the overall objectives and requirements of the holding company and its subsidiaries.

When developing the subsidiary governance framework template, it is important to incorporate best practices in corporate governance across the entire group, while considering

[18]Subsidiary Governance Framework Template, Diligent Insights, https://www.diligent.com/insights/subsidiary-management/subsidiary-governance-framework-template/, 29th June, 2023
[19] ibid
[20] ibid

potential legal or regulatory barriers. To mitigate risks and ensure flexibility, it is necessary to account for variations in local laws, regulations, and customs that may require adjustments by subsidiaries to suit their respective jurisdictions. Instead of adopting a rigid one-size-fits-all approach, it is crucial to involve and encourage subsidiary boards and management in the development process. Their expertise in running the subsidiary and knowledge of local regulations will be invaluable in creating an effective framework[21].

To promote good governance, it is essential to conduct audits of subsidiary boards to assess their composition and effectiveness. Regular reviews should be planned, particularly following acquisitions or expansion efforts. Additionally, it is crucial to review the service contracts of all directors at the subsidiary level to ensure they encompass appropriate safeguards. Furthermore, remuneration policies and practices must be carefully reviewed, considering the varying norms and regulations across jurisdictions and subsidiaries. It is important to develop remuneration policies that account for these differences, taking into consideration what is deemed suitable for staff, especially senior executives[22].

To ensure compliance and accessibility of group-wide policies, it is crucial to make them easily available to all staff. This includes policies such as anti-bribery measures, codes of ethics, health and safety guidelines, and whistleblowing procedures. Lack of awareness should not be an excuse for non-compliance, so efforts should be made to enhance staff awareness and understanding of these policies. It may be necessary to update and align the policies with the subsidiary governance framework template. Maintaining a centralized repository for entity information is considered best practice as it ensures version control and consistency across the organization. In addition, it is important to consider providing overarching guidance or terms of reference for subsidiary boards. This should clarify their duties, and expectations for interaction with the parent company, and address any conflicts of interest that may arise. Defining delegated authorities and decision-making procedures is essential in these terms of reference.

To facilitate effective board meetings, guidelines for board meeting procedures should be established. This should cover aspects such as the format of agendas and board papers, proper

[21] ibid
[22] ibid

documentation of meeting minutes, and ensuring appropriate circulation of information among board members.[23]

CONCLUSION

In conclusion, private subsidiaries of public companies under the Companies Act hold a significant position in the corporate structure, offering advantages in operational flexibility, risk management, and tax planning. However, their existence also presents important considerations in terms of corporate governance, disclosure obligations, and regulatory compliance. Understanding the legal framework governing private subsidiaries, as well as the obligations and responsibilities of public companies towards their subsidiaries, is crucial for ensuring compliance and effective management within the corporate structure. Regulatory oversight and reporting requirements imposed by the Companies Act further emphasize the need for diligent management and adherence to regulatory guidelines. By prioritizing corporate governance exclusively for subsidiaries, public companies can mitigate risks and avoid crisis-like situations. Overall, recognizing the critical considerations, significance, and regulatory framework surrounding private subsidiaries enables public companies to navigate their corporate structure effectively and ensure compliance with legal obligations.

[23] ibid