

Can Limited Liability Partnership be considered Subsidiary of a Company?

Separate entities formed by an apex company (holding company) can be in the form of companies or partnership firm or limited liability partnership (LLP) or any other form, depending on the nature of business of the organization. Due to flexibility in operations and movement of funds, LLP is a preferred option by many corporates. Many times, questions are raised that whether separate entity formed in the nature of LLP can be considered as subsidiary or not? As per LLP Act, 2008, LLP is a body corporate but does not have features of a company. Hence this question arises that whether LLP would be considered as subsidiary under the Act or would LLP be excluded from the definition of 'subsidiary' and what can be implication of this interpretation for compliance of various provisions of The Act.



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INTRODUCTION

It is very common phenomenon for large corporate to have various subsidiaries. As subsidiary companies are legally separate entities, this structure is used for decreasing the holding company's liability while growing its business. One more benefit is that the law provides certain exemptions for transaction between holding and subsidiaries such as exemption provided under Section 185, 186 of the Companies Act ("the Act") subject to fulfilling prescribed conditions. However, to avoid mis-utilisation of structures, certain transactions between holding company and subsidiaries are restricted such as subsidiary cannot

hold shares of holding company, restriction on having more than two layers of subsidiaries, etc.

Such separate entities formed by an apex company (holding company) can be in the form of companies or partnership firm or limited liability partnership (LLP) or any other form, depending on the nature of business of the organization. Due to flexibility in operations and movement of funds, LLP is a preferred option by many corporates. Many times, questions are raised that whether separate entity formed in the nature of LLP can be considered as subsidiary or not? As per LLP Act, 2008, LLP is a body corporate but does not have features of a company. Hence this question arises that whether LLP would be considered as subsidiary under the Act or would LLP be excluded from the definition of 'subsidiary' and what can be implication of this interpretation for compliance of various provisions of The Act will be a subject of discussion in this article.

DEFINITION OF 'SUBSIDIARY'

In the context of any company, the term 'subsidiary' has been defined at two places – one under section 2(87) of the Act and another under the accounting standards, i.e., AS-21 and Ind AS-110. Section 133 of the Act empowers the Central Government to prescribe the standards of accounting. Accordingly, the Companies (Indian Accounting Standards) Rules, 2015 [which was introduced in 2015 for the first time] and the Companies (Accounting Standards) Rules, 2021 [which were previously in the form of the Companies (Accounting Standards) Rules, 2006 prescribed under Companies Act, 1956] are the two Rules under The Act which lay down various accounting standards to be followed by companies.

The Companies (Indian Accounting Standards) Rules, 2015 are applicable for below companies:-

- i. Companies (including NBFCs) whose equity or debt securities are listed or are in the process of being listed on any stock exchange in India or outside India (other than 'SME exchange' as referred to in Chapter XB or on the 'Innovators Growth Platform' without initial public offering in accordance with the provisions of Chapter XC of the SEBI ICDR Regulations.

- ii. Companies (including NBFCs) other than those mentioned in clause (i) above and having net worth of Rs. 250 crores.
- iii. Companies which are holding, subsidiary, joint venture or associate companies of the companies mentioned in clauses (i) or (ii) above.

The Companies (Accounting Standards) Rules, 2021 [which had been in existence since 2006] is applicable to all other companies to whom the Companies (Indian Accounting Standards) Rules, 2015 are not applicable.

Hence the accounting standards also do emanate from the Act only. Therefore, it can be said that the Act directly or indirectly recognises two definitions for 'subsidiary'.

CONCEPT OF SUBSIDIARY/SUBSIDIARY COMPANY UNDER THE ACT

Section 2(87) of the Act defines subsidiary/subsidiary company. As per definition of subsidiary under section 2(87), "subsidiary company" or "subsidiary", in relation to any other company (that is to say the holding company), means a company in which the holding company—

- (i) controls the composition of the Board of Directors; or
- (ii) exercises or controls more than one half of the total voting power either at its own or together with one or more of its subsidiary companies."

Hence one company can be called as subsidiary of other company if that other company holds more than 50% voting power in the subsidiary. If one Company (say H) holds or controls more than 50% of the total voting power of another company (say S), it makes S as H's Subsidiary.

One more way of being a holding company is by controlling composition of board of directors of the subsidiary. Clause (b) of the Explanation appended to section 2(87) provides that "the composition of a company's board of directors shall be deemed to be controlled by another company if that other company by exercise of some power exercisable by it at its discretion can appoint or remove all or a majority of the directors."

If one company (H) exercises less than half the total voting power in another company (S), but controls the composition of the board of directors of S, i.e. H has an absolute and unrestricted power to appoint or remove all or the majority of the directors of S, then H is the holding company and S is the subsidiary company. This criterion would apply regardless percentage of control by virtue of the voting power of H in S. This criterion is based on the ability to control the composition of a majority of the directors of the subsidiary.

Subsidiary may be Company or body corporate: As explained above, a subsidiary company is controlled by another company, i.e., its holding company, through control over voting power or through control over the composition of the other company's board of directors. According to clause (c) of the Explanation in the definition of 'subsidiary', "the expression 'company' includes any body corporate." The effect of this is that a subsidiary may be either a company incorporated under the Companies Act or a body corporate which is not a company. Therefore, a body corporate which is not a company can be subsidiary of a company incorporated under the Act.

¹ Section 2(87) of the Act

CONCEPT OF SUBSIDIARY UNDER THE COMPANIES (INDIAN ACCOUNTING STANDARDS), RULES, 2015

If we make a reference to the definition of 'subsidiary' and 'control' under the Companies (Indian Accounting Standards), 2015, i.e., Ind AS-110, it says that "A subsidiary is an entity that is controlled by another entity" Further 'control of an investee' is defined as "An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee."

CONCEPT OF SUBSIDIARY UNDER THE COMPANIES (ACCOUNTING STANDARDS) RULES, 2021

If we make a reference to the definition of 'subsidiary' and 'control' under the Companies (Accounting Standards) Rules, 2021, i.e., AS-21, it says that "A subsidiary is an enterprise that is controlled by another enterprise (known as the parent)" Further 'control' is defined in AS-21 as

- (a) the ownership, directly or indirectly through subsidiary(ies), of more than one-half of the voting power of an enterprise; or
- (b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from its activities."

COMPARATIVE ANALYSIS OF 'SUBSIDIARY' DEFINITION UNDER THE ACT AND THE COMPANIES (INDIAN ACCOUNTING STANDARDS), 2015 AND THE COMPANIES (ACCOUNTING STANDARDS) RULES 2021

If we refer definition of 'subsidiary' under the Act, it is rule based definition and it states that any company/body corporate can become subsidiary of another company if that another company fulfils either of the two conditions, i.e. exercises not less than half the total voting power in the first company or controls the composition of the Board of Directors of the first company. So, the definition is restrictive and it is necessary to fulfil either of the two conditions.

Whereas the definition of 'subsidiary' under Ind AS 110 as well as AS-21 is a wide one. Ind AS-110 refers to any entity whereas AS-21 refers to any enterprise, which can be extended to any entity or enterprise, and not limited to companies or bodies corporate. The term 'control' referred to in AS-21 is similar to the one referred to in section 2(87) of Act, i.e., it envisages the ownership of more than one-half of the voting power of an enterprise or control of the composition of the Board of Directors or governing body (in case of any enterprise other than company) so as to obtain economic benefits from its activities. However, unlike section 2(87) of the Act and unlike AS-21, the term 'control' in Ind AS-110 is not restricted to voting power or composition of Board of Directors but refers to right to variable returns due to involvement of the controlling entity and ability to affect those returns through the controlling entity's power.

To avoid misutilisation of structures, certain transactions between holding company and subsidiaries are restricted such as subsidiary cannot hold shares of holding company, restriction on having more than two layers of subsidiaries, etc.

Therefore, if we analyse definition under section 2(87) of the Act and AS-21 vis-à-vis Ind AS-110, the definition of 'subsidiary' under the Act and AS-21 is a restrictive one as compared to Ind AS-110.

WHETHER A LIMITED LIABILITY PARTNERSHIP ("LLP") CAN BE INCLUDED IN THE DEFINITION OF SUBSIDIARY?

A. Ind AS-110 perspective:

As per definition of subsidiary under Ind-AS-110, subsidiary can include LLPs as the definition of subsidiary refers to partnership firm and any other incorporated entity as well. Moreover, the definition of 'control' as per Ind-AS-110 states that control refers to right to variable returns due to involvement of the controlling entity and ability to affect those returns through the controlling entity's power. LLP agreement may provide that certain partners would have management rights in that LLP, which can mean that such partners would have control, as referred to in Ind AS-110, in the LLP. So if a company is a partner in an LLP and the LLP agreement provides management rights to that company, then that company can be said to have control in that LLP, irrespective of that company's stakes in that LLP. Therefore, in such cases, a company can have control over LLP and hence, as per Ind AS- 110, an LLP can be considered as subsidiary of a company.

Let's discuss whether LLP can be considered as subsidiary of company in the context of the Act?

B. The Act perspective:

Due to clause (c) of the explanation to section 2(87) of the Act, i.e., in the definition of subsidiary, a subsidiary may be either a company or a body corporate. Limited Liability Partnership is a Partnership Firm having limited liability. Further if we check the definition of 'firm' under other Acts like Income Tax Act, LLP is treated as firm, whereas if we refer LLP Act, 2008, it treats to LLP as a body corporate. Therefore, being a body corporate as per LLP Act, 2008, whether LLP can be considered as subsidiary of Company or not under section 2(87) of the Act is the question to deliberate?

If we refer definition of 'subsidiary' as provided in Section 2(87), it includes control on the basis of two factors / conditions only:-

- (i) One condition is based on composition of board.

- (ii) Another condition is based on voting power.

Further the definition of 'subsidiary' is rule-based definition and not principle-based definition. Therefore, it is mandatory to fulfil either of the conditions.

(i) Condition based on composition of board:

If we refer provisions of LLP Act, 2008, it recognises LLP as body corporate, but there is no reference to the term 'director' and it recognises concept of 'partner' and 'designated partner'. If we refer the definitions of partner and designated partner and compare it with the definition of 'director' in the Act, then these definitions cannot be compared on the basis of roles, responsibilities of director as enumerated in the Act as the basic structure of Company and LLP is not comparable. LLP is basically a partnership firm with limited liability and the concepts of Director, Shareholders, General Meetings etc., does not exist in case of LLPs. Therefore, to treat LLP as subsidiary, the first condition of holding-subsidiary relationship, i.e., control on composition of Board of Directors cannot be fulfilled.

(ii) Condition based on voting power:

The structure of LLP is totally different from company. Further with respect to voting power, the voting in LLP is defined by LLP agreement, whereas voting in a company is proportionate to its paid-up capital. In case of LLP, there is no connection of voting power with contribution made and there is no concept like Ordinary resolution and Special resolution. The concept of control by way of exercising more than half of the total voting power do not exists in LLP. Therefore, to treat LLP as subsidiary, the second condition of holding-subsidiary relationship also cannot be fulfilled.

C. Can one apply the Casus Omissus rule?:

One may feel that if a company has control, over variable returns from its involvement and ability to affect those returns, in another LLP, then not calling that LLP as subsidiary of that company may be unfair. But as discussed earlier, the definition of 'subsidiary' in section 2(87) of the Act is rule based definition and not principle based definition, and it recognises only two types of control, i.e., the control by way of voting power and /or the control by way of composition of board as the control which leads to the controlled entity to be called a subsidiary of the controlling entity.

Therefore, when section 2(87) of the Act is clear in its language, then applying casus omissus principle may not be a correct way of reading it.

What is 'casus omissus'?

Meaning of the Latin phrase Casus omissus is – "a situation omitted from or not provided for by statute or regulation and therefore governed by the common law."

Casus Omissus is an important principle of Interpretation of statutes. It is well settled that, a casus omissus cannot be supplied by the Court except in the case of clear necessity and when the reason for it is found in the four corners of statute itself. Some of the cases where this principle was quoted are given below:

“Traditional Rule is that court cannot read anything into statutory provision which is plain and unambiguous and the legislative casus omissus cannot be supplied by judicial interpretative process” [Prakash Nath Kannan v. CIT (2004)].

“The first and primary role of construction is that the intention of the legislature must be found in the words used by the legislature itself. If the words used are capable of one construction only, then it would not be open to the Courts to adopt any other hypothetical construction on the ground that such hypothetical construction is more consistent with alleged object and policy of the Act.” [Satheedevi V. Prassana 2010 AIR SCW 3754].

“Courts cannot supply words which the legislature might have deliberately omitted.” [Delhi Financial Corporation v. Rajiv Anand [2006] 131 comp cas 285(SC)]

Of course, the decision of Courts will depend upon the facts of the cases and public interest involved in the matter. But if we check the precedents, in one of the cases, where question for consideration was *“Whether amalgamation of an LLP with a company incorporated under the provision of the Act or erstwhile Companies Act was permissible under the provisions of section 230 to 232 of the Companies Act 2013?”* NCLAT has denied the merger of an LLP with a company stating that *“Companies Act, 1956 provides that any body corporate can merge into a company. However, Section 234 of The Act provides that foreign company or body corporate incorporated outside India can be merged into an Indian company and there is no such occasion to apply the principal of casus omissus.”*

Similarly, the principle of ‘casus omissus’ cannot be applied for the question of whether an LLP can be considered as a subsidiary of a company under section 2(87) of the Act?

IMPACT OF ABOVE DISCUSSION

Considering the above discussion, it can be said that LLP may not be considered as a subsidiary of a company for any of the provisions of the Act, except for the manner of consolidation of accounts prescribed in Rule 6 of the Companies (Accounts) Rules, 2014 which says that *“The consolidation of financial statements of the company shall be made in accordance with the provisions of Schedule III of the Act and the applicable accounting standards”*

The sections of the Act which impose certain conditions/restrictions based on holding-subsidary relationship will have to be evaluated to analyse the impact of this interpretation that irrespective of existence of control of a company over a LLP, by virtue of rights given in LLP agreement, the LLP cannot be considered as subsidiary of that company.

For eg: Section 19(1) of the Act says that “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.” Taking ahead the above case, the LLP will not be considered as subsidiary of the



company. Further the opening words of section 19(1) imposes restriction on ‘company’ and not any ‘subsidiary’ / ‘LLP’. This can mean that even if a company has control over an LLP (by virtue of powers given by LLP agreement), that LLP is not prohibited from holding shares in that company under section 19(1).

Further, there can be example of other sections also like section 2(76) of the Act which defines ‘related parties’ for the purpose of compliance with section 188 and section 177 of the Act. Under Section 2(76), the LLP as mentioned in above case shall not be considered as related party because it shall not be a subsidiary of the company, although as per Ind AS-24, it shall be a related party. However, for such LLP compliance of section 177 (approval of audit committee) and section 188 (approval of board of directors and shareholders in case of certain transactions) will not be required. This can mean that without taking the requisite approvals, the company can do any transactions with the LLP over which it has control (by virtue of powers given by LLP agreement). This will also defeat the basic intention of sections like 188 and 177 of the Act.

CONCLUSION

Considering the above discussion, it can be said that LLP may not be considered as a subsidiary of a company as per section 2(87) of the Act. But this will lead to absurdity in interpretation of some of the provisions of the Act in a situations where company has control over an LLP, which is otherwise than in the nature of ‘control’ which makes the other body corporate, a subsidiary of the company.

Some sections where such interpretation can lead to absurdity like section 177 and 188 of the Act are under in-house adjudication mechanism of Registrar of Companies under the Ministry of Corporate Affairs (MCA). In such situations, if the Regulator takes a different view, then there will be no judicial forum to deliberate on this interpretation and take the most appropriate view. It may be noted that the Company Law Committee Report, 2019 and earlier reports of Company Law Committee also state that, only procedural, technical and minor non-compliances, especially the ones not involving interpretation issues, may be dealt through in-house adjudication mechanism.

Therefore, there is a need to bring parity by the law makers in this provision of section 2(87) of the Act in line with the Ind AS-110 and settle this question of “whether LLP can be considered as a subsidiary under section 2(87) of the Act”. ☐