Merger Regime Under The Companies Act, 2013

Introduction

Merger is a restructuring tool available to Indian conglomerates aiming to expand and diversify their businesses for various reasons whether it is to gain competitive advantage, reduce costs or unlock values. In commercial parlance, merger essentially means an arrangement whereby one or more existing companies merge their identity into another existing company or form a distinct new entity. Company law in India is undergoing a complete overhaul and a new law was finally passed in 2013. However, only 98 sections of the new Companies Act, 2013 ("**2013 Act**") have been brought into force and the provisions relating to mergers covered in Sections 230 to 240 are yet to be notified. Until then, this court driven process will continue to be governed by Section 391-396A of the Companies Act, 1956 and the Companies (Court) Rules, 1959 (collectively referred to as "**1956 Act**").

This newsletter describes selective key changes introduced by the 2013 Act in relation to mergers, which term, in common parlance, is used interchangeably with amalgamations under Indian law. Additionally, it aims to compare those changes with the 1956 Act.

1. The Framework

Chapter XV of the 2013 Act deals with *"Compromises, Arrangements and Amalgamations."* In this chapter, the Act consolidates the applicable provisions and related issues of compromises, arrangements and amalgamations; however, other provisions are also attracted at different stages of the process. Amalgamation means an amalgamation pursuant to the provisions of the Act. In an amalgamation the undertaking comprising of property, assets and liabilities, of one (or more) company are absorbed by and transferred either to an existing company or a new company. Simply put, the transferor integrates with the transferee and the former loses its entity and dissolves without winding-up. The 2013 Act creates a new regulator, the National Law Company Tribunal ("**Tribunal**") who, upon its constitution, will assume jurisdiction (the High Courts will no longer have any jurisdiction) of the court for sanctioning mergers. Once the Tribunal is constituted, expected to be formed sometime this year, and related rules finalized, the provisions under the 2013 Act would be implemented.

Before detailing the key changes under the new law, a brief overview of the existing process will be useful. Under the 1956 Act, companies which have reached a consensus to merge must prepare a "scheme" of amalgamation/merger ("**Scheme**"). The lenders (financial institutions or banks) of the transferor and the transferee must approve[1] the Scheme in-principle, followed by the subsequent approval of the respective Board of Directors of the merging entities. If the merging entities are listed companies, then the listing agreements executed with the stock-exchanges require the company to communicate price-sensitive information to the stock exchange immediately, to seek an approval from the capital market

[1] Clearance of the lenders is essential to void any major change in the meeting of creditors convened at the instance of the company courts under section 391 of the 1956 Act

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regulator, Securities and Exchange Board of India ("**SEBI**") simultaneous with the public notification. This essentially happens after the approval of the Board to the Scheme. The next step is to apply[2] to the High Court having jurisdiction over the registered office of the company seeking an order to convene shareholders and creditors meeting. Without getting into further details of the process, the key point is that any objector amongst the stakeholders can object to the Scheme in the court proceedings.

The element of preparing the Scheme has been retained under the 2013 Act. Unlike the 1956 Act, the new regime **(a)** recognizes cross border mergers, **(b)** sets out separate procedure for merger of small companies and those of holding with wholly-owned, **(c)** prescribes thresholds for objections, and **(d)** describes mandatory filings to ensure legal compliance.

2. The Changes to the process

(a) Regulatory/Third party approvals[3]: As shareholders' and creditors' consents are essential, the 1956 Act, therefore, contemplates issue of a notice to them. The 2013 Act requires service of the notice of the merger along with documents (such as copy of the Scheme and valuation report) not only upon the shareholders and creditors but also on various regulators including the Ministry of Corporate Affairs (*through Regional Director, Registrar of Companies and Official Liquidator*),[4] Reserve Bank of India ("**RBI**") (*where non-resident investors are involved*), SEBI (*only for listed companies*), Competition Commission of India (*where the prescribed fiscal thresholds are crossed and the proposed merger could have an adverse effect on competition*), Stock Exchanges (*only for listed companies*), Income Tax authorities and other sector regulators or authorities which are likely to be affected by the merger.[5] This ensures compliance of the Scheme with other regulatory requirements imposed on the merging entities. In fact, under the 1956 Act the courts have made mergers subject to approval of the regulators. The 2013 Act prescribes a 30 day time frame for the regulators to make representations, failing which the right would cease to exist. This is a positive step because in the 1956 Act no such time frame was provided leading to considerable delays in the court proceedings.

(b) Approval of the Scheme through postal ballot[6]: The 1956 Act required presence of the shareholders and creditors in the physical meetings, either in person or by proxy, to cast vote for/against the Scheme. In the 2013 Act, the shareholders and creditors also have the option to cast vote through postal ballot while considering a Scheme. The 1956 Act did not allow this and the shareholders and creditors could only cast votes physically. This right will ensure wider participation of the shareholders and creditors, particularly for those who are scattered all over the country and who find it difficult to be either physically present or provide a proxy. Postal ballot, therefore, will offer them a greater flexibility to cast their votes.

(c) Valuation Report: Though the 1956 Act is silent on disclosing the valuation report to the stakeholders, as a matter of transparency and good corporate governance, the listed

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[2] The transferor and the transferee should make separate or joint applications to the High Court
[3] See Section 230(5) of the 2013 Act
[4] Under the 1956 Act, approval from the Ministry of Corporate Affairs is taken but subsequent to shareholders and creditors approval and before the final approval of the High Court
[5] For example, Department of Telecommunications in case of merger of telecom companies
[6] See Section 230(6) of the 2013 Act

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companies used to make available the valuation report for inspection and also during the course of the meetings. Courts also required annexing of the valuation report to the application submitted before them. The 2013 Act now mandates annexing of the valuation report to the notices for the meetings to enable ready access to the shareholders and creditors[7].

(d) Objections[8]: A bane under the 1956 Act was that it permitted the individual shareholders and creditors to raise frivolous objections to arm-twist and unnecessarily harass the companies following the meetings. Such right to object to the Scheme would no longer be available to any and every person. Objections can be raised by shareholders holding 10% or more equity and creditors whose debt represent 5% or more of the total debt as per the last audited financial statements. By raising the bar, the new law aims to ensure that the frivolous objections/litigation can be avoided.

(e) Accounting Standards[9]: As a matter of practice, frequently the Scheme provided for accounting treatment that would deviate from the prescribed accounting standards necessitating a note to this effect in the balance sheet of the company. This was frowned upon by the tax authorities. Consequently, in case of listed companies, the listing agreement was amended to provide that an auditor's certificate stating that the accounting treatment is in accordance with the accounting standards was required to be filed for seeking approval of the stock exchanges. The 2013 Act makes such prior certification from an auditor mandatory for both listed and unlisted companies.

(f) Merger of a listed company into an unlisted one:[10] The 2013 Act specifically provides for the Tribunal's order to state that the merger of a listed company into an unlisted company will not *ipso facto* make the unlisted company listed. It will continue to be unlisted until the applicable listing regulations and SEBI guidelines in relation to allotment of shares to public shareholders are complied with. Further, in case the shareholders of the listed company decide to exit, the unlisted company would facilitate the exit with a pre-determined price formula which shall be within the price specified by SEBI regulations. The Indian securities law prescribes strict enforcement of listing requirements by companies intending to get listed. SEBI had, however, eased these requirements for listed companies proposing merger by granting them exemptions from complying with the initial public offering requirements[11] on a case-to-case basis. Recently SEBI had issued guidelines[12] stating that if the Scheme provides for listing of shares of an unlisted company without complying with the initial public offering requirements, then, upon court approval of the Scheme, the unlisted company has to file a specific application seeking such exemption from SEBI. Such an application has to be filed upon, *inter-alia*, allotment of equity shares to the holders of securities of the listed company.[13] The changes under the 2013 Act are in line with SEBI requirements. The 1956 Act was silent on this aspect.

[7] See Section 232(2) of 2013 Act
[8] This is covered in the Proviso to section 230(4) of the 2013 Act
[9] This is covered in the Proviso to Section 232(3) of the 2013 Act
[10] See Section 232(3)(h) of the 2013 Act
[11] See Rule 19(2)(b) of Securities Contracts (Regulations) Rules, 1957
[12] See SEBI circular nos. CIR/CFD/DIL/5/2013 dated February 4, 2013 and CIR/CFD/DIL/8/2013 dated May 21, 2013
[13] See Part B of Annexure I of SEBI circular nos. CIR/CFD/DIL/5/2013 dated February 4, 2013

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3. The New Kinds of Mergers

Apart from the aforesaid changes, the 2013 Act provides for separate provisions for cross border mergers, merger of two small companies and that of holding with wholly-owned subsidiaries. These are described briefly below.

(a) Cross-border mergers[14]: The 1956 Act permits cross-border mergers only where the transferor is a foreign company. In contrast, the 2013 Act permits in-principle mergers between an Indian and a foreign company located in a jurisdiction notified by the central government in periodic consultation with RBI. Such a merger would be subject to RBI approval and Scheme may provide payment in cash or depository receipts or both. The payment in cash or depository receipts would facilitate exit to the shareholders of the merging entity who do not want to be a part of the merged entity. These changes reflect the legislature's intent to facilitate cross-border business. The Income Tax Act presently grants tax exemptions[15] on mergers if the transferee is an Indian company and does not recognize a situation where the transferee will be a foreign company, as contemplated under the 2013 Act. The introduction of cross-border mergers under the 2013 Act may, therefore, require corresponding changes in other laws, including foreign exchange and tax.

(b) Merger of "small companies" and holding with wholly-owned subsidiaries: Unlike the 1956 Act under which merger of all companies, irrespective of nature and size requires court approval, the 2013 Act carves out a separate procedure for small companies[16] and the holding and wholly-owned subsidiaries. Section 233 of the 2013 Act prescribes a simplified fast track procedure for their merger which requires consent of shareholders holding 90% in value and creditors representing 9/10th of debt in value as well as approval of the Scheme by the Regional Director, Ministry of Corporate Affairs in case no objections are received from the Official Liquidator and Registrar of Companies. Approval of the Tribunal is not required for such mergers. This could be good news for the merging entities who may not be required to **(i)** file documents required to be filed under the listing agreement, in the case of listed companies, **(ii)** give notice to various authorities, **(iii)** provide auditor's certificate of compliance with applicable accounting standards. However, if the Regional Director is of the opinion that the Scheme is not in the interest of the stakeholders, he may approach the Tribunal who could follow the merger procedure prescribed under the 2013 Act. This ability to transfer to the Tribunal has the potential to change fast-track to a normal merger and make such mergers less appealing.

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[14] See Section 234 of 2013 Act

[15] The Income Tax Act contains provision that mergers of companies where the transferee is an Indian company will not be subject to tax if certain conditions, namely, all assets and liabilities of the transferor become the assets and liabilities of the transferee, and at least three-fourth (in value) of the shareholders of the transferor become shareholders of the transferee, are fulfilled. If the two conditions are fulfilled, then the merger is a qualified one for the purpose of the Act and there will be no tax implications in the hands of the transferor and its shareholders

[16] See Section 2(85) of the 2013 Act which defines "Small Companies" as a private company, with a paid-up capital of maximum INR 5 million or a prescribed amount up to INR 50 million *or* with a turnover of maximum INR 20 million or a prescribed amount up to INR 200 million. It excludes (i) holding and subsidiary companies; (ii) a company or a body corporate governed by a special Act or (iii) charitable companies formed under section 8 of the 2013 Act

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4. Penalties

The penalties for contravention of the provisions under the 1956 Act were a maximum of INR 50,000 (*approximately US$ 806*[17]) which apply to the company as well as officer-in-default. However under the 2013 Act, separate penalties have been levied on the company and its defaulting officer. To bring in more accountability, quantum for companies has been increased from the aforesaid sum to a minimum of INR 100,000 (*approximately US$ 1,612*) and maximum of INR 2,500,000 (*approximately US$ 40,322*). Defaulting officer(s) will also be punishable with imprisonment up to one year or with a minimum fine of INR 100,000 (*approximately US$ 1,612*) and maximum INR 300,000 (*approximately US$ 4,838*) or both.[18] Such stringent penal provisions will not apply to mergers of small companies and that of a holding company with its wholly-owned subsidiaries unless their merger is transferred to the Tribunal and approved by it.

Conclusion

While several noteworthy changes have been proposed, corporations could perceive the need to get multiple approvals from different regulators as onerous. However, the thirty days time limit imposed on the regulators will, hopefully, ensure that they respond in a time bound manner. On the face of it, the 2013 Act offers comprehensive and better transparency ensuring protection of stakeholders' interest, while simultaneously avoiding frivolous objections. The exact time frame that the entire merger process would involve will be known once it is tested and which will happen after the Tribunal is constituted and the rules implemented. It would be fair to say that the 2013 Act seeks to streamline and make M&A more smooth and transparent. The new provisions should make it easier for corporations proposing mergers as it spears to have a good system of checks & balances to prevent abuse of these provisions.

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[17] 1$=INR 62 approximately
[18] See Section 232 (8) of the 2013 Act

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