Managing Human Resources in M&As

Most international corporations now realize that a global footprint now necessarily means having an India strategy for future growth. When expanding overseas, one critical concern that confronts corporations relates to labour – but India's socialist legacy continues, in many ways, to place enormous burdens on employers.

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India's recent surge within the global economy has been almost unprecedented. Although a relatively late starter compared with countries like China, Thailand and Brazil, India has shown remarkable growth in recent years. A statement by the Indian prime minister, Manmohan Singh, brings home this point very clearly: "Victor Hugo said no power on earth can stop an idea whose time has come ... the emergence of India as a major economic power happens to be one such idea."

The vast opportunities, exponential growth rates and current business environment are all serving to integrate India into the global economy. Most international corporations are slowly beginning to realize, and openly acknowledge, that having a global footprint means having an India strategy and presence in the country to ensure future growth. When expanding overseas, one critical issue that confronts corporations relates to labour. Human resources and their management play a unique role in the success of any industry or organization. It is important to understand that prior to the era of globalization, India fundamentally gravitated toward socialism, and the existing labyrinth of labour laws are a legacy of this socialist past that continues to be primarily pro-employee and places enormous obligations on employers. Judicial activism is also focused on protecting the interests of workers. The philosophy behind having elaborate laws is to check the exploitation and oppression of labour so as to have industrial harmony and to curb unfair labour practices, strikes, lock-outs, breaches of discipline, etc. Knowledge of labour laws is, therefore, essential for both Indian and foreign employers. Moreover, non-compliance may prove disastrous for it can subject the employer to heavy penalties and even imprisonment.

A hypothetical case

Take foreign company X, which is an original equipment manufacturer in the automotive industry and intends to establish a manufacturing unit in India. For this purpose, it intends to acquire the existing established business of Indian company Y (as opposed to creating a wholly owned subsidiary or a greenfield joint venture), and both parties agree to run the resultant joint-venture company (JVC). The existing business of Y involves diverse activities and only certain aspects of the business are supposed to be transferred to the proposed JVC. An important issue to consider in this transaction relates to the transfer of the workforce and its position in relation to the JVC. Any acquirer in an Indian acquisition needs to pay crucial attention to the specific situation of its future employees, as sometimes the financial implications of this may impact the valuation of the deal. The following addresses the human resource issues that need to be evaluated and considered in Indian acquisitions.

The difference between a factory and an establishment

At the outset, X must be aware of the legal framework within which Indian labour law operates. Section 2 (m) of the *Factories Act, 1948* defines factories whereas offices and establishments are defined in the *Shops and Establishments Act*. Establishment refers to a commercial establishment, defined as any premises wherein any trade, business or professional service, or any work in connection with, incidental or ancillary thereto, is carried out. A unit qualifies as a factory either (i) when it does not use electrical power and employs 20 or more workers engaged in a manufacturing process, or (ii) if electrical power is used for manufacturing, if it has 10 or more employees.

In the absence of social security provided by the state, an employee in India has to rely on the various benefit schemes formulated by the government and complied with by the employer that provide a safety net for their future. Consequently, if the benefits of an employee are affected by any business transfer or an acquisition, then this is potential grounds for an industrial dispute. The legislation related to employee benefits are common for both factories and establishments.

Potential problem areas

The due diligence should reveal the thorny issues that may be potential problem areas and which should be addressed and resolved at the initial stages of the deal. In the hypothetical case, the following areas would require attention.

(i) Transfer of an undertaking

Section 25 FF of the *Industrial Disputes Act, 1947* (the ID Act) provides for compensation to workmen in case of a transfer of undertakings, that is, where the ownership or management of an undertaking is transferred, whether by an agreement or by an operation of law. The section states that when there is a change in management then every employee, who has been in the "continuous service" of the company for at least one year is entitled to notice and compensation similar to a retrenched employee as per section 25F of the ID Act. Retrenchment means the termination of an employee from service for any reason other than as a punishment inflicted by way of disciplinary action excluding voluntary retirement, retirement on reaching the age of superannuation, termination due to non-renewal of the contract of employment or termination due to continued ill health. The expression "for any reason whatsoever" in the definition of retrenchment includes a situation in which an employer (for reasons of economy and convenience arising out of financial difficulties or irregularities) adopts a certain re-organizational scheme for the business and, as an inevitable consequence, discharges certain employees. Such action is a *bona fide* retrenchment.

The Supreme Court, in *Management, Mettur Beardsell Limited vs. Workmen of Mettur Beardsell Limited & Another*, held that the proviso to section 25 FF provides that payment of compensation on the transfer of an undertaking will not be applicable where employment has not been interrupted, if the terms and conditions of service are as favourable as they were before such transfer, and the acquirer is committed to pay the employees their dues as if their employment had been constant and uninterrupted by the transfer. It is also important that the employees of Y provide their written consent to accepting the terms and conditions of employment in the new company. Failure to receive this acceptance from the employees of Y may become potential grounds for dispute. Thus, the most critical aspect of this is the reference to "continuity of service", because an employee will not want the eligibility points for benefits to begin anew (see (ii)).

(ii) Transfer of an employee

As stated above, an acquirer has to ensure continuity of service. The benefits that any worker is entitled to are linked to the total number of days the individual has worked in the organization. For example, a workman is entitled to receive gratuity after completing five years of continuous service. Section 2A of the *Payment of Gratuity Act, 1972* defines continuous service as an uninterrupted period of an employee's service. This uninterrupted period includes any sick leave, accident or maternity leave. Should the employee resign and sign a fresh employment contract with the JVC, this would involve a break in the employment for reasons other than those provided in the law and would affect the rights of the workman. The law provides that if the employment is terminated due to immoral behaviour, misconduct or when, through negligence, the employee has caused damage or loss to the company, then the company has the right to forfeit the gratuity. Further, Indian jurisprudence mandates that an employer has the right by law to transfer an employee if (a) it is a condition in letter of appointment, (b) there is no *malafide* intention on the part of the management while transferring an employee, or (c) the transfer is from one branch to another under the same management.

(iii) Retrenchment

The law requires that the retrenchment of employees must be made with no *malafide* intention. The courts have imposed an obligation on the employers to ensure that, through retrenchment, (a) employees are not being victimized, (b) no unfair labour practices are being adopted, and (c) no ulterior motives or malpractice exists under the guise of a rationalization that there is an excess in the workforce. Further, it is important that the JVC should not employ new labour for the same task because, if it employs another worker in the same position after retrenching an employee, then this amounts to unfair labour practice and courts can direct a reinstatement of such retrenched employee. However, the law prescribes a procedure under section 25 F of the ID Act that outlines the conditions required for the retrenchment of an employee. If these conditions are not fulfilled, then the retrenchment is void, invalid and inoperative and such employee will remain an employee of the company. If a case for retrenchment is made, it is obligatory for the employer to follow the "last come, first go" rule, which means that the employer should retrench the person last employed in that category unless there is an agreement to the contrary or on grounds of inefficiency, unreliability or habitual irregularity. However, the employer has to prove the existence of such valid reasons in the tribunal or court if the retrenchment is challenged by the retrenched employee. Departure from such rule without any justification may lead to the conclusion that the retrenchment is the result of ulterior motives and hence *malafide*, which may amount to unfair labour practice.

The Indian Supreme Court, in *Hindustan Tin Works Private Limited vs. Employees Hindustan Tin Works Private Limited*, held that, "If the employer is found to be in the wrong as a result of which the workman is directed to be reinstated, the employer cannot shirk his responsibility of paying the wages which the workman has been deprived of by the illegal or invalid action of the employer". The Court further held in the same case that if the employer terminates the service illegally and the termination is motivated, as in this case, to resist the workman's demand for a revision of wages, the termination may well amount to unfair labour practice. In such circumstances, reinstatement being the normal rule, it should be followed with full back wages. This view was upheld in the recent case *JK Synthetics vs. KP Agrawal*.

Consequently, if the JVC decides that retrenchment may be necessary, it must follow the prescribed procedure under the ID Act and give the benefits due to an employee before retrenching.

(iv) Contract labour

Contract labourers are indirect employees who are hired, supervised and paid by a contractor who, in turn, is reimbursed by the company. Contract labour has to be employed for tasks that are specific and for a definite duration. The *Contract Labour (Regulation & Abolition) Act, 1970* (the CL Act) is the governing legislation enacted with the purpose of preventing the exploitation of contract labour and introducing better working conditions for them.

According to Section 10(1) of the CL Act, the government has the authority to prohibit the employ of contract labour in any sector of an establishment. During the due diligence, company X must ascertain that no contract labour has been engaged in prohibited activities. However, it has become a common practice to employ contract labour on jobs that are permanent in nature.

The CL Act requires that both the contractor as well as the company employing the contract labour (principal employer) must fulfil their respective obligations. The contractor and the principal employer must obtain the necessary statutory approvals for employing such labour. Both the contractor and the principal employer must fulfil their legal obligations, including payment of wages and statutory benefits (like provident fund and employees' state insurance). Proper working conditions should be provided to the contract labourer because contravention of any provisions of the CL Act can be grounds for penal action.

Company X must scrutinize the contract executed between the principal employer and the contractor because it is important that the principal employer ensures compliance of all the benefits that a contract labourer is entitled to receive under various labour legislations. If the contractor fails to perform his duties then the burden falls on the principal employer.

A common cause for concern during acquisitions relates to potential liability and exposure for acquirers when the contract labour is engaged in production activities for which most of the shop floor employees of the target company are contract labourers. A necessary corollary is the likelihood of enlisting the contract labour onto the payroll of the company (which means increasing headcount) if the authorities prohibit employment of contract labour in some establishments. Initially, the view held by the courts was that if the work done by contract labour is prohibited because it is perennial or permanent in nature or falls under a plan that has been discontinued *vide* a notification of the appropriate authority, then the principal employer is bound to enlist that contract labour on its payroll. This view was upheld in *Air India Statutory Corporation Ltd. & Ors vs. United Labour Union & Others*. The Supreme Court held that although there is no express provision in the CL Act for enlisting contract employees as employees in establishments where the contract labour system is abolished by publication of a notification under section 10 (1) of the CL Act, the principal employer is under a statutory obligation to enlist the contract labour. The link between the contractor and an employee was broken and a direct relationship was restored between the principal employer and contract labour as its employees. However, the judgment in the Air India case was countered in *Steel Authority of India Ltd. vs. National Union of Waterfront Workers* wherein the appellants employed contract labour through contractors to handle the goods in stockyards. This activity was prohibited by the government. Aggrieved by this order, a writ of petition was filed in which the Calcutta High Court directed, basing its order on the Air India case, that contract labour be enlisted and regularized from the date of the prohibition notification. The matter was appealed at the Supreme Court, where the core issue was deemed to be "whether the automatic absorption of contract labour should automatically follow on issuance of a valid notification under section 10 (1) (a) of the CL Act, prohibiting employment of the contract labour in the concerned establishment".

The Supreme Court held that the contract workers would have no right to automatic absorption upon prohibition of an activity for which they were employed. They would only have a first preference over the workers, which the employer intends to hire to fill the vacancies created by the removal of the contract workers. The bench added that, on issuance of a notification by the appropriate government prohibiting the employment of contract labour, it is the duty of the contractor to provide work to this labour in other establishments where such contract labour is not prohibited. This view was upheld in *Oil and Natural Gas Commission vs. Petroleum*

Employees Union and Others.

(v) Trade unions

In India, trade unions consider themselves the sole representatives of the working class and endeavour to protect and promote its interests. The *Indian Trade Unions Act, 1926* (TU Act) defines a trade union as a combination, whether temporary or permanent, formed primarily for the purpose of regulating the relations between workmen and employers, or between workmen and workmen, or between employers for imposing restrictive conditions on the conduct of any trade or business, and includes any federation of two or more unions. Under the TU Act, registration of a union is not compulsory. It is, however, desirable, as it entails certain rights and privileges. An unregistered trade union is not necessarily unlawful, but only registered unions afford immunity to office bearers and members against certain civil and criminal proceedings and liabilities. Sections 17, 18 and 19 of the TU Act deal with such immunities with regard to civil and criminal proceedings including tortious liability for acts connected with union activities committed by members or leaders.

A recognized registered trade union maintains all necessary registers and documents prescribed under the TU Act. A factory or an establishment that has more than 100 employees can form a trade union. Section 4 of the TU Act requires that from these 100 workers at least seven workers must submit their names with the concerned authorities for the registration of the trade union. Company X must carefully scrutinize collective bargaining agreements that describe the terms and conditions of any settlement between the management of Y and its trade union.

Key points for consideration in a JV agreement

In view of the above, while negotiating and executing a JV agreement, Company X must safeguard itself against (a) any potential financial liabilities, (b) industrial disputes, and (c) potential operational disruptions by incorporating adequate indemnities vis-à-vis the employees of Y. Company Y must indemnify JVC and company X from the following:

(i) Continuity of service

If the JVC wishes to retain the trained and experienced employees of Y then it must ensure at least the same terms and conditions of employment are provided. Company Y should contractually agree with X and the JVC for the smooth transfer of funds, to provide certain statutory benefits to the employees, from the old to the new company. At the same time, necessary indemnifications from Y must be taken so that no previous labour liabilities fall either on X or the JVC.

(ii) Contract labour

From X's perspective, care should be taken to ensure that if the contractor has not fulfilled his obligations, thereby leading to liabilities for Y, such liabilities must be quantified and an appropriate indemnity should be taken from Y to protect JVC and X from past claims wherever possible. Further, based on views held by the Supreme Court, the JVC is under no obligation to employ contract labour directly on its payroll if Y has terminated the contractor's contract or the project for which they were engaged has been completed.

(iii) Trade unions

If a trade union exists in Y then X should verify if any settlement agreements have been executed between Y and the trade union. Both JVC and X should be aware of all the benefits Y has agreed to provide to its employees based on any collective bargaining agreements. Thereafter, the JVC can try its best to assimilate those agreed benefits into its scheme or, if unacceptable, renegotiate the terms with the trade union.

Although considerable deregulation has taken place in India, remnants of the socialist past remain. The ID Act makes it difficult to dismiss workers and to employ new ones. Companies with more than 100 employees require approval from the government to dismiss workers. Consequently, factories must tread cautiously before increasing headcounts. Finally, companies may not take on contract workers for tasks deemed to be permanent. Against this backdrop, due care must be taken to protect the interests of workers, but at the same time, appropriate contractual safeguards must be provided to protect an acquirer against potential labour disputes.

About the author

Priti Suri is the proprietor of PSA Legal. She has two decades of experience on three continents in diverse areas of international commercial law, mergers and acquisitions, joint ventures, technology transfers, and arbitration and litigation. After earning an LL.M. degree in the United States, she took part in the ABA's International Legal Exchange program and worked at law firms in the US. Based in Paris in the early 1990s, she returned to India in February 1997 to set up the practice in New Delhi. She continues to represent several clients in a broad spectrum of industry ranging from automobiles, defence, energy, information technology, infrastructure, pharmaceuticals and telecommunications. *The author is grateful to Namrata Wadhawan for her valuable assistance in preparing this article.*