Corporate Finance/M&A - India

Companies Bill 2011: key changes from an M&A perspective

Contributed by PSA, Legal Counsellors

March 07 2012

Authors

Priti Suri

Kartikay Sharma

Introduction

Mergers and acquisitions in India are governed by a large number of individual laws. However, unlike China, India has no distinct set of rules and regulations for each type of transaction codified in a single law. Instead, Indian companies are governed not only by the Companies Act 1956, but also, for example, if the target is a publicly listed company and certain threshold limits are crossed, by the mechanism prescribed under the Securities and Exchange Board of India Act 1992 and contained in the Securities Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations 1997.

It is more than 50 years since the act was enacted. Since then, and particularly in the last two decades, the continuous growth of the Indian economy has encouraged a large number of global companies to invest in the Indian market. However, changes in a business environment are meaningless without corresponding changes in the relevant legislation. The legal framework must therefore be clear and able adequately to respond to the ever-evolving economic activities and business models of Indian companies.

On December 14 2011 the Indian government tabled its proposed Companies Bill 2011 before the Lower House of Parliament, the *Lok Sabha*, seeking to replace the outdated 1956 act. Section 3 of the bill provides that provides that the central government may notify different dates in the *Official Gazette* for different provisions, which are not expected to come into force simultaneously.

This update examines the key changes proposed in the bill and their corresponding impact on M&A transactions involving Indian companies.

Cross-border mergers

In commercial parlance, 'merger' essentially means an arrangement whereby one or more existing companies merge their identities into another existing company or form a distinct new entity. Simply put, the transferor integrates with the transferee and the former loses its identity and dissolves without winding-up. Under the act, in the context of mergers, the term used is 'amalgamation'. Despite the absence of a definition of the term 'amalgamation', the act provides for an amalgamation of two or more companies, which may be either an 'arrangement' or a 'reconstruction'.

In a dramatic change to the law, the draft provisions of the bill provide for both inbound and outbound cross-border mergers between Indian and foreign companies. A 'cross-border merger' refers to a combination of two or more companies belonging to, or registered in, different countries. The dual limitations imposed on such mergers are that:

- the foreign company be located in a country that has been notified by the central government; and
- prior approval be obtained from India's federal bank, the Reserve Bank of India (RBI).

In recent years it has become clear that the regulatory authorities are determined to investigate corporate structures allegedly put together to take advantage of specific 'tax havens'. At this point, it is unclear which jurisdictions are likely to be notified by the central government, but the list of notified countries will undoubtedly play a critical role in determining whether such cross-border provisions will have a positive or negative impact.

In the absence of specific methodology, the requirement for seeking prior approval from the RBI has the potential to act as a deterrent. The inherent paperwork and lengthy timelines surrounding regulatory approval, particularly when the regulators will themselves take time to understand the process, could prove practically onerous for the entities involved. It is also unclear how such cross-border mergers will be affected by other laws, such as the antitrust laws, both of India and of the other jurisdiction in question. For example, should notification of the merger become mandatory, necessitating prior approval of the antitrust regulator, it could affect the completion of the transaction. In general, speed and short timelines are key to the successful closing of any cross-border activity.

Therefore, although the introduction of cross-border mergers can be perceived as an effective tool for Indian companies to globalise their business operations, the number of regulations requiring compliance is doubled, on account of the two jurisdictions. Strategic harmonisation will be a crucial component for ensuring a smooth, effective and successful cross-border merger. With time, it may become necessary to provide for a single window clearance to deal efficaciously with cross-border mergers.

Prohibition of treasury shares

The concept of treasury shares is relatively unknown in India and the law makes no mention of provisions for the creation of such shares. Simply put, these shares are acquired through a buy-back arrangement and held by a company. However, although the act allows for the buy-back of shares, there is no statutory provision that permits a company to hold such shares, as the bought-back shares must be cancelled or extinguished within seven days. Indian companies therefore cannot hold treasury stock.

Nonetheless, as a matter of practice, some creative companies have used innovative means for holding treasury stock in some schemes of amalgamation, pursuant to a court order - particularly wherever there is involvement of cross-holding between two companies. In these limited cases, treasury stock is usually held in a separate trust. For instance, consider an example by which Company A holds shares in Company B and both merge. Consequently, Company A issues shares to all shareholders of Company B. However, as Company A cannot issue shares to itself, it may either cancel the shares it holds in Company B or transfer the shares to a special purpose entity, usually a trust. If it transfers the shares to a trust, it can issue its own shares to that trust by treating it as a shareholder.

The bill now prohibits a transferee company from holding treasury shares either through a 'trust' or by any other manner, whether on its behalf or on behalf of its subsidiary or associate companies. When notified, the proposed provision should not affect the existing trusts that hold treasury shares, but could affect those companies that have consistently adopted this route and then sold such treasury shares in an open market or through private placements, instead of raising money through other means.

From a regulatory perspective, the abolition of treasury shares will ensure that those companies that were taking advantage by using treasury shares now desist from so doing. However, from the companies' perspective, an additional route for raising money will be lost and they will have no option but to extinguish the shares that they through such mergers.

Removal of court approval

At present, all mergers - including those between group companies or between a parent and a subsidiary - must follow the procedure prescribed under the act, which necessarily involves intervention of the high court. However, the bill provides that a scheme of merger or amalgamation may be entered into between two or more small companies,(1) between a holding company and its wholly owned subsidiary or such other class(es) of companies as may be prescribed by the central government, without the approval of the high court or National Company Law Tribunal (NCLT).(2) For such mergers or amalgamations, certain necessary conditions must be fulfilled.

As a first step, a scheme must be prepared by the companies, and the transferor and transferee must notify the registrar of companies and official liquidator of the proposed scheme. The registrar and liquidator are expected to give their objections or suggestions within 30 days of the date on which they receive notification of the scheme. The merging entities must then consider the concerns of the registrar and liquidator and approve the scheme in their respective general meetings. Next, both transferor and transferee companies must file a declaration of solvency with the registrar that has jurisdiction. The merging entities must also seek approval from their respective creditors.

The bill stipulates that any objection to the proposed scheme must be made only by persons that hold at least a 10% shareholding or with outstanding debt amounting to at least 5% of the total outstanding debt, as detailed in the last audited financial statement. On receipt of approval from the shareholders and creditors, the scheme must be filed with the NCLT and the registrar and liquidator that have jurisdiction. The bill also describes the process addressing situations where objections may again be raised by the relevant authorities. If no objections are raised, the NCLT will confirm, approve and register the scheme and thereafter notify the registrar. Registration of the scheme will have the effect of liquidating the transferor company or companies.

The process appears to be detailed, but several questions have arisen and more are expected during testing. For example, it is unclear whether the shareholders and creditors must approve the scheme in the same or in two separate general meetings. As the proposed provision requires no approval from the high court or NCLT, it is therefore aimed at providing substantial relief to small companies, as well as to their holdings and subsidiaries, when deciding on consolidation and mergers - particularly those that have so far desisted due to the cumbersome process involved.

New regulators

The bill provides that no civil court shall have jurisdiction over any suit or proceeding in respect of any matter that the NCLT is empowered to determine under the bill. The only exception is in out-of-court approvals, where the objections or suggestions of the registrar of companies and official liquidator prevail - if they object, the matter will proceed to the NCLT. The bill proposes the establishment of both the NCLT and the National Company Law Appellate Tribunal (NCLAT), which will replace several existing forums, including the Company Law Board, the Board for Industrial and Financial Restructuring and the Appellate Authority for Industrial and Financial Reconstruction. The NCLT will consist of a president and other judicial and technical members, as prescribed. The president will be appointed by the central government but, following consultation with the chief justice of India and the members, will be appointed by the central government on the recommendation of a selection committee.

The NCLT is expected to take over the role of the high court in approving schemes for amalgamations and liquidation and dealing with petitions for oppression and mismanagement and other roles performed by the Company Law Board and the Board for Industrial and Financial Restructuring. However, the creation of the NCLT has been controversial right from the start.(3) Although the act was amended as early as 2002 to pave the way for the establishment of the NCLT, the body is yet to be established and the relevant provisions of the Amendment Act 2002 are yet to be notified, as several aspects of its constitution and functioning have been the subject of litigation. In a recent development, a constitution bench of the Supreme Court has upheld the creation of the NCLT as constitutional.(4)

Once the proposed provision has been notified, it will also quash the Company Law Board. The purpose of the provision is to reduce the burden of the high courts by creating a high-power tribunal that will hear all company law matters. Keeping this in view, the expectation is that the formation of the NCLT should help to expedite the M&A process. Under the existing regime, a decision of the high court can be challenged before the Supreme Court. The bill provides that appeals from the NCLT will now go to the NCLAT, and thereafter directly to the Supreme Court. This should ensure that uniform decisions are received on a particular subject by the NCLAT instead of different decisions on the same or similar matters by different high courts, leading to confusion in relation to jurisprudence.

It is hoped that the establishment and constitution of the NCLT and the NCLAT as exclusive tribunals for the administration of all matters arising out of the bill will:

- reduce, if not negate, the substantial delay involved in M&A proceedings;
- avoid multiplicity of litigation; and
- streamline the appeal process.

Comment

Few laws can claim to be as comprehensive and far-reaching in their sweep as the proposed bill, demonstratrating as it does a closer step towards globalisation and an attempt to reflect the changing environment. If approved by Parliament, the bill will end Indian companies' long wait for a new law. Although it would be premature to assume that the new regime will be entirely positive, it appears to be progressive and future-proof to a certain extent. Despite its chequered history, it is hoped that the bill's provisions will offer respite from some of the ills that currently plague the corporate sector.

On balance, the proposed bill should positively impact on M&A activity, as it seems to be calibrated towards managing the needs of Indian companies, shareholders and the country's growing economy. Only time, and the bill's on-ground implementation, will reveal its multiple facets.

For further information on this topic please contact Priti Suri *or* Kartikay Sharma *at PSA, Legal Counsellors by telephone (+91 11 4350 0500), fax (+ 91 11 4350 0502) or email (* p.suri@psalegal.com *or* k.sharma@psalegal.com*).*

Endnotes

(1) A 'small company' is defined under Section 2(85) of the bill as a company, other than a public company:

- whose paid-up share capital does not exceed approximately $101,000 (or such higher amount as may be prescribed, which shall not exceed approximately $1,014,000); or
- whose turnover in the last profit and loss account does not exceed approximately $405,000 (or such higher amount as may be prescribed, which shall not exceed approximately $4 million).

This is subject to the provision that nothing in this clause shall apply to:

- a holding company or a subsidiary company;
- a company registered for charitable purposes; or
- company or body corporate governed by any special act.

(2) The NCLT is a proposed body that is expected to become a comprehensive forum for various matters under the bill.

(3) In *R Gandhi v Union of India*, ([2004] 120 Com Cases (Mad)), the constitutional validity of the NCLT and NCLAT was challenged.

(4) *Union of India v R Gandhi/Madras Bar Association*, [2010] 100 SLC 142.