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# STUDY MATERIAL

## PROFESSIONAL PROGRAMME

# CORPORATE RESTRUCTURING, VALUATIONS AND INSOLVENCY

## MODULE 1

## PAPER 3



**THE INSTITUTE OF  
Company Secretaries of India**

**IN PURSUIT OF PROFESSIONAL EXCELLENCE**  
Statutory body under an Act of Parliament

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PROFESSIONAL PROGRAMME

**CORPORATE RESTRUCTURING, VALUATION AND INSOLVENCY**

Corporate Restructuring is a non-recurring exercise for an organisation but it has a lasting impact on the business and other concerned agencies due to its numerous considerations and immense advantages viz., improved corporate performance, better corporate governance etc. The regulatory provisions and the multitude of judicial and unresolved issues enunciate that the professionals dealing with restructuring should possess unequivocal and explicit knowledge of the objective approach and perspective of the subject.

The purpose of this study material is to provide an in-depth understanding of all aspects and intricacies of law and practical issues affecting and arising out of Corporate Restructuring, Valuation as well as Insolvency, aims at through each phase of preparation, stressing upon and dealing, exhaustively with key concepts, legislative aspects and procedures, duly annotated with judicial references.

Company Secretaryship being a professional course, the examination standards are set very high, with emphasis on knowledge of concepts, applications, procedures and case laws, for which sole reliance on the contents of this study material may not be enough. Besides, as per the Company Secretaries Regulations, 1982, students are expected to be conversant with the amendments to the laws made upto six months preceding the date of examination. The material may, therefore, be regarded as the basic material and must be read along with the original Bare Acts, Rules, Regulations, Case Law, Student Company Secretary bulletin published and supplied to the students by the Institute as well as recommended readings.

The subject of Corporate Restructuring, Valuation and Insolvency is inherently technical and is subjected to constant refinement through new legislations, rules and regulations made there under, court decisions on specific legal issues and corporate business dynamics. It, therefore, becomes necessary for every student to constantly update himself with the various legislative changes made as well as judicial pronouncements rendered from time to time by referring to the Institute's journal 'Chartered Secretary' and bulletin 'Student Company Secretary' as well as other law/professional journals like Company Law Journal, Corporate Law Advisor, SEBI and Corporate Laws, Company Cases etc.

His Study Material is based on the Companies Act, 1956 except for the provisions relating to Buy Back of Shares which are notified upto June 30, 2014 under Companies Act, 2013. However, it may so happen that some developments might have taken place during the printing of the study material and its supply to the students.

The students are therefore, advised to refer to the Student Company Secretary and other publications for updation of the study material.

In the event of any doubt, students may write to the Directorate of Academic in the Institute for clarification at [academics@icsi.edu](mailto:academics@icsi.edu).

Although care has been taken in publishing this study material, yet the possibility of errors, omissions and/or discrepancies cannot be ruled out. This publication is released with an understanding that the Institute shall not be responsible for any errors, omissions and/or discrepancies or any action taken in that behalf.

Should there be any discrepancy, error or omission noted in the study material, the Institute shall be obliged if the same are brought to its notice for issue of corrigendum in the Student Company Secretary.

**PROFESSIONAL PROGRAMME**

**SYLLABUS**

**FOR**

**MODULE I - PAPER 3: CORPORATE RESTRUCTURING, VALUATION AND  
INSOLVENCY**

**Level of Knowledge:** *Advance Knowledge*

**Objective:** *To acquire knowledge of the legal, procedural and practical aspects of Corporate Restructuring, Valuation and Insolvency.*

**Detailed Contents:**

**PART A - Corporate Restructuring (50 Marks)**

**1. Introduction and Concepts**

- Meaning of Corporate Restructuring
- Need, Scope and Modes of Restructuring
- Historical Background
- Emerging Trends
- Planning, Formulation and Execution of Various Corporate Restructuring Strategies - Mergers, Acquisitions, Takeovers, Disinvestments and Strategic Alliances, Demerger and Hiving off
- Expanding Role of Professionals

**2. Merger and Amalgamation**

- Introduction
- Legal, Procedural, Economic, Accounting, Taxation and Financial Aspects of Mergers and Amalgamations including Stamp Duty and Allied Matters
- Interest of Small Investors
- Merger Aspects under Competition Law
- Jurisdiction of Courts; Filing of Various Forms
- Amalgamation of Banking Companies and Government Companies
- Cross Border Acquisition and Merger

**3. Corporate Demerger and Reverse Merger**

- Concept of Demerger; Modes of Demerger - by Agreement, under Scheme of Arrangement
- Demerger and Voluntary Winding Up
- Legal and Procedural Aspects; Tax Aspects and Reliefs
- Reverse Mergers – Procedural Aspects and Tax Implications

**4. Takeover**

- Meaning and Concept
- Types of Takeovers; Legal Aspects – SEBI Takeover Regulations

(v)

- Disclosure and Open Offer Requirements
- Bail Out Takeovers and Takeover of Sick Units
- Takeover Defences
- Cross Border Takeovers

#### **5. Funding of Merger and Takeover**

- Financial Alternatives; Merits and Demerits
- Funding through various Types of Financial Instruments including Equity and Preference Shares, Debentures, Securities with Differential Rights, Swaps, Stock Options; ECBs, Funding through Financial Institutions and Banks
- Rehabilitation Finance
- Management Buyouts/Leveraged Buyouts

#### **6. Financial Restructuring**

- Reduction of Capital
- Reorganization of Share Capital
- Buy-Back of Shares – Concept and Necessity
- Procedure for Buy-Back of Shares by Listed and Unlisted Companies

#### **7. Post Merger Reorganization**

- Factors involved in Post Merger Reorganization
- Integration of Businesses and Operations
- Assessing Accomplishment of Post Merger Objectives; Measuring Post Merger Efficiency

#### **8. Case Studies**

### **PART B – Valuation (30 Marks)**

#### **9. Introduction**

- Meaning, Objective & Scope of Valuation
- Principles of Valuation
- Preliminary Work relating to Valuation
- Valuation Standards and Valuation Analysis

#### **10. Valuation Techniques**

- Historical Earnings Valuation
- Asset Based Valuation
- Market Based Valuation

#### **11. Regulatory and Taxation Aspects**

- Legal & Regulatory aspects related to Valuation such as SEBI Regulations/ RBI Regulations
- Income Tax Implications

#### **12. Valuations for Different Strategies**

- Merger & Acquisition, Demerger, Slump Sale
- Liquidation and Corporate Insolvency

(vi)

- Internal & External Restructuring
- Valuation of Intangibles
- Valuation of Securities

### **PART C – Insolvency (20 Marks)**

#### **13. Introduction**

- Concept of Insolvency, Historical Developments
- History of Bankruptcy Laws in USA, UK and India

#### **14. Revival, Rehabilitation and Restructuring of Sick Companies**

- Sick Companies and their Revival with Special Reference to the Law and Procedure relating to Sick Companies

#### **15. Securitization and Debt Recovery**

- Overview of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002; Process; Participants
- Special Purpose Vehicle (SPV), Asset Reconstruction Companies (ARCs), Qualified Institutional Buyers (QIB)
- Overview of the Recovery of Debts Due to Banks and Financial Institutions Act, 1993
- Tribunal, Procedure; Compromises and Arrangements with Banks and Creditors

#### **16. Winding Up**

- Concept; Modes of Winding Up; Administrative Machinery for Winding Up
- Winding up Process and Procedure; Managing Stakeholders and Parties in Liquidation; Conducting Meetings of Shareholders/Creditors; Dealing with Contracts; Managing Estate
- Outsourcing Responsibilities to Professionals/Service providers such as Valuers, Security Agencies
- Best Practices in Performing Liquidation/Administrator Functions; Accountability and Liabilities; Role of Liquidators and Insolvency Practitioners
- Consequences of Winding Up; Winding Up of Unregistered Companies; Dissolution

#### **17. Cross Border Insolvency**

- UNCITRAL Model Law on Cross Border Insolvency
- UNCITRAL Legislative Guide to Insolvency Law
- World Bank Principles for Effective Insolvency and Creditor Rights
- Asian Development Bank Principles of Corporate Rescue and Rehabilitation
- Bankruptcy under chapter 11 of US Bankruptcy Code



## LIST OF RECOMMENDED BOOKS

### MODULE I

### PAPER 3 : CORPORATE RESTRUCTURING, VALUATION AND INSOLVENCY

#### Recommended Readings and References:

1. A. Ramaiya : Guide to Companies Act, LexisNexis Butterworths, Wadhwa, Nagpur
2. M.C. Bhandari : Guide to Company Law Procedures, LexisNexis Butterworths Wadhwa Nagpur
3. ICSI : Handbook on Mergers Amalgamations and takeovers.
4. K. R. Sampath : Mergers/Amalgamations, Takeovers, Joint Ventures, LLPs and Corporate Restructure, Snow White Publications
5. S. Ramanujam : Mergers et al, LexisNexis Butterworths Wadhwa Nagpur
6. Ray : Mergers and Acquisitions Strategy, Valuation and Integration, PHI

#### Important Websites

- (a) [www.sebi.gov.in](http://www.sebi.gov.in)
- (b) [www.rbi.org.in](http://www.rbi.org.in)
- (c) [www.finmin.nic.in](http://www.finmin.nic.in)
- (d) [www.dipp.nic.in](http://www.dipp.nic.in)
- (e) [www.mca.gov.in](http://www.mca.gov.in)

*Students are advised to read relevant Bare Acts and Rules and Regulations relating thereto. 'Student Company Secretary' e-bulletin and 'Chartered Secretary' should also be read regularly for updating the knowledge.*

## ARRANGEMENT OF STUDY LESSONS

### MODULE I - PAPER 3: CORPORATE RESTRUCTURING, VALUATION AND INSOLVENCY

*Lesson No.*

*Subject*

#### **PART A - Corporate Restructuring**

1. Corporate Restructuring – Introduction & Concepts
2. Mergers and Amalgamations – Legal and Procedural Aspects
3. Economic and Competition Law Aspects of Mergers and Amalgamations
4. Accounting Aspects of Amalgamations
5. Financial, Stamp Duty and Taxation Aspects of Amalgamation
6. Interest of the Small Investors in Mergers
7. Amalgamation of Banking and Government Companies
8. Corporate Demergers and Reverse Mergers
9. Takeovers
10. Funding of Mergers and Takeovers
11. Financial Restructuring
12. Post Merger Re-Organisation
13. Case Studies

#### **PART B – Valuation**

14. Valuation Introduction and Techniques
15. Regulatory Aspects of Valuation with reference to Corporate Strategies

#### **PART C – Insolvency**

16. Insolvency – Concepts and Evolution
17. Revival and Restructuring of Sick Companies
18. Securitization
19. Debt Recovery
20. Winding Up
21. Cross Border Insolvency

Test Papers



**PROFESSIONAL PROGRAMME**  
**CORPORATE RESTRUCTURING, VALUATIONS AND INSOLVENCY**

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# Lesson 1

## CORPORATE RESTRUCTURING – INTRODUCTION & CONCEPTS

### LESSON OUTLINE

The objective of this study lesson is to enable the students to understand

- Meaning of Corporate Restructuring
- Need & Scope of Corporate restructuring
- Various Modes of Restructuring
- Historical Background
- Emerging Trends
- Planning formulation execution of various restructuring strategies
- Role of professionals in restructuring process

### LEARNING OBJECTIVES

The speed of business dynamics demands the business organizations not only to revamp their internal business strategies like effective market expansion, increased customer base, product diversification and innovation etc., but also expects the corporates to devise inorganic business strategies like mergers, acquisitions, takeovers etc., that results in faster pace of growth, effective utilization of resources, fulfillment of increasing expectations of stakeholders. These restructuring strategies work positively for the business both during the time of business prosperity and recession.

This lesson would help you in understanding the concept of corporate restructuring, available tools, historical background & emerging trends in restructuring strategies etc., the role of professionals like company secretaries in the process of restructuring right from the strategy development and pre diligence stage till the post integration stage.

## INTRODUCTION

There are primarily two ways of growth of business organization, i.e. organic and inorganic growth.

Organic growth is through internal strategies, which may relate to business or financial restructuring within the organization that results in enhanced customer base, higher sales, increased revenue, without resulting in change of corporate entity..

Inorganic growth provides an organization with an avenue for attaining accelerated growth enabling it to skip few steps on the growth ladder. Restructuring through mergers, amalgamations etc constitute one of the most important methods for securing inorganic growth.

### **Growth can be organic or inorganic**

A company is said to be growing organically when the growth is through the internal sources without change in the corporate entity. Organic growth can be through capital restructuring or business restructuring.

Inorganic growth is the rate of growth of business by increasing output and business reach by acquiring new businesses by way of mergers, acquisitions and take-overs and other corporate restructuring Strategies that may create a change in the corporate entity.

The business environment is rapidly changing with respect to technology, competition, products, people, geographical area, markets, customers. It is not enough if companies keep pace with these changes but are expected to beat competition and innovate in order to continuously maximize shareholder value. Inorganic growth strategies like mergers, acquisitions, takeovers and spinoffs are regarded as important engines that help companies to enter new markets, expand customer base, cut competition, consolidate and grow in size quickly, employ new technology with respect to products, people and processes. Thus the inorganic growth strategies are regarded as fast track corporate restructuring strategies for growth.

## MEANING OF CORPORATE RESTRUCTURING

Restructuring as per Oxford dictionary means “to give a new structure to, rebuild or rearrange”.

As per Collins English dictionary, meaning of corporate restructuring is a change in the business strategy of an organization resulting in diversification, closing parts of the business, etc, to increase its long-term profitability.

Corporate restructuring is defined as the process involved in changing the organization of a business. Corporate restructuring can involve making dramatic changes to a business by cutting out or merging departments. It implies rearranging the business for increased efficiency and profitability. In other words, it is a comprehensive process, by which a company can consolidate its business operations and strengthen its position for achieving corporate objectives-synergies and continuing as competitive and successful entity.

### **Corporate Restructuring as a Business Strategy**

Corporate restructuring is the process of significantly changing a company's business model, management team or financial structure to address challenges and increase shareholder value. Restructuring may involve major layoffs or bankruptcy, though restructuring is usually designed to minimize the impact on employees, if possible. Restructuring may involve the company's sale or a merger with another company. Companies use restructuring as a business strategy to ensure their long-term viability. Shareholders or creditors might force a restructuring if they observe the company's current business strategies as insufficient to prevent a loss on their investments. The nature of these threats can vary, but common catalysts for restructuring involve a loss



of market share, the reduction of profit margins or declines in the power of their corporate brand. Other motivators of restructuring include the inability to retain talented professionals and major changes to the marketplace that directly impact the corporation's business model.

**Corporate restructuring is the process of significantly changing a company's business model, management team or financial structure to address challenges and increase shareholder value. Corporate restructuring is an inorganic growth strategy.**

### NEED AND SCOPE OF CORPORATE RESTRUCTURING

Corporate Restructuring is concerned with arranging the business activities of the corporate as a whole so as to achieve certain predetermined objectives at corporate level. Such objectives include the following:

- orderly redirection of the firm's activities;
- deploying surplus cash from one business to finance profitable growth in another;
- exploiting inter-dependence among present or prospective businesses within the corporate portfolio;
- risk reduction; and
- development of core competencies.

When we say corporate level it may mean a single company engaged in single activity or an enterprise engaged in multi activities. It could also mean a group having many companies engaged in related or unrelated activities. When such enterprises consider an exercise for restructuring their activities they have to take a wholesome view of the entire activities so as to introduce a scheme of restructuring at all levels. However such a scheme could be introduced and implemented in a phased manner. Corporate Restructuring also aims at improving the competitive position of an individual business and maximizing its contribution to corporate objectives. It also aims at exploiting the strategic assets accumulated by a business i.e. natural monopolies, goodwill, exclusivity through licensing etc. to enhance the competitive advantages. Thus restructuring would help bringing an edge over competitors.

Competition drives technological development. Competition from within a country is different from cross-country competition. Innovations and inventions do not take place merely because human beings would like to be creative or simply because human beings tend to get bored with existing facilities. Innovations and inventions do happen out of necessity to meet the challenges of competition. Cost cutting and value addition are two mantras that get highlighted in a highly competitive world. Monies flow into the stream of production in order to be able to face competition and deliver the best possible goods at the convenience and affordability of the consumers. Global Competition drives people to think big and it makes them fit to face global challenges. In other words, global competition drives enterprises and entrepreneurs to become fit globally. Thus, competitive forces play an important role. In order to become a competitive force, Corporate Restructuring exercise could be taken up. Also, in order to drive competitive forces, Corporate Restructuring exercise could be taken up.

The scope of Corporate Restructuring encompasses enhancing economy (cost reduction) and improving efficiency (profitability). When a company wants to grow or survive in a competitive environment, it needs to restructure itself and focus on its competitive advantage. The survival and growth of companies in this environment depends on their ability to pool all their resources and put them to optimum use. A larger company, resulting from merger of smaller ones, can achieve economies of scale. If the size is bigger, it enjoys a higher corporate status. The status allows it to leverage the same to its own advantage by being able to raise larger funds at lower costs. Reducing the cost of capital translates into profits. Availability of funds allows the enterprise to grow in all levels and thereby become more and more competitive.

### **Corporate Restructuring .....an Example**

ABC Limited has surplus funds but it is not able to consider any viable projects. Whereas XYZ Limited has identified viable projects but has no money to fund the cost of the project. The merger of ABC LTD and XYZ Limited is a mutually beneficial option and would result in positive synergies of both the Companies.

Corporate Restructuring aims at different things at different times for different companies and the single common objective in every restructuring exercise is to eliminate the disadvantages and combine the advantages. The various needs for undertaking a Corporate Restructuring exercise are as follows:

- (i) to focus on core strengths, operational synergy and efficient allocation of managerial capabilities and infrastructure.
- (ii) consolidation and economies of scale by expansion and diversion to exploit extended domestic and global markets.
- (iii) revival and rehabilitation of a sick unit by adjusting losses of the sick unit with profits of a healthy company.
- (iv) acquiring constant supply of raw materials and access to scientific research and technological developments.
- (v) capital restructuring by appropriate mix of loan and equity funds to reduce the cost of servicing and improve return on capital employed.
- (vi) Improve corporate performance to bring it at par with competitors by adopting the radical changes brought out by information technology.

### **Planning, formulation and execution of various restructuring strategies**

Corporate restructuring strategies depends on the nature of business, type of diversification required and results in profit maximization through pooling of resources in effective manner, utilization of idle resources, effective management of competition etc.,.

Planning the type of restructuring requires detailed business study, expected business demand, available resources, utilized/idle portion of resources, competitor analysis, environmental impact etc., The bottom line is that the right restructuring strategy provides optimum synergy for the organizations involved in the restructuring process.

It involves examination of various aspects before and after the restructuring process.

### **Important aspects to be considered while planning or implementing corporate restructuring strategies**

The restructuring process requires various aspects to be considered before, during and after the restructuring. They are

- Valuation & Funding
- Legal and procedural issues
- Taxation and Stamp duty aspects
- Accounting aspects
- Competition aspects etc.
- Human and Cultural synergies

Based on the analysis of various aspects, a right type of strategy is chosen.

## Types of Corporate Restructuring Strategies

**Various types of corporate restructuring strategies include:**

1. Merger
2. Demerger
3. Reverse Mergers
4. Disinvestment
5. Takeovers
6. Joint venture
7. Strategic alliance
8. Slump Sale
9. Franchising
10. Strategic alliance etc.

**1. Merger**

Merger is the combination of two or more companies which can be merged together either by way of amalgamation or absorption. The combining of two or more companies, is generally by offering the stockholders of one company securities in the acquiring company in exchange for the surrender of their stock.

Mergers may be

- (i) **Horizontal Merger:** It is a merger of two or more companies that compete in the same industry. It is a merger with a direct competitor and hence expands as the firm's operations in the same industry. Horizontal mergers are designed to achieve economies of scale and result in reduce the number of competitors in the industry.
- (ii) **Vertical Merger:** It is a merger which takes place upon the combination of two companies which are operating in the same industry but at different stages of production or distribution system. If a company takes over its supplier/producers of raw material, then it may result in backward integration of its activities. On the other hand, Forward integration may result if a company decides to take over the retailer or Customer Company. Vertical merger provides a way for total integration to those firms which are striving for owning of all phases of the production schedule together with the marketing network
- (iii) **Co generic Merger:** It is the type of merger, where two companies are in the same or related industries but do not offer the same products, but related products and may share similar distribution channels, providing synergies for the merger. The potential benefit from these mergers is high because these transactions offer opportunities to diversify around a common case of strategic resources.
- (iv) **Conglomerate Merger:** These mergers involve firms engaged in unrelated type of activities i.e. the business of two companies are not related to each other horizontally nor vertically. In a pure conglomerate, there are no important common factors between the companies in production, marketing, research and development and technology. Conglomerate mergers are merger of different kinds of businesses under one flagship company. The purpose of merger remains utilization of financial resources enlarged debt capacity and also synergy of managerial functions. It

does not have direct impact on acquisition of monopoly power and is thus favoured throughout the world as a means of diversification.

## 2. Demerger

It is a form of corporate restructuring in which the entity's business operations are segregated into one or more components. A demerger is often done to help each of the segments operate more smoothly, as they can focus on a more specific task after demerger.

## 3. Reverse Merger

Reverse merger is the opportunity for the unlisted companies to become public listed company, without opting for Initial Public offer (IPO). In this process the private company acquires the majority shares of public company, with its own name.

## 4. Disinvestment

Disinvestment means the action of an organization or government selling or liquidating an asset or subsidiary. It is also known as "divestiture".

## 5. Takeover/Acquisition

Takeover means an acquirer takes over the control of the target company. It is also known as acquisition. Normally this type of acquisition is undertaken to achieve market supremacy. It may be friendly or hostile takeover.

**Friendly takeover:** In this type, one company takes over the management of the target company with the permission of the board.

**Hostile takeover:** In this type, one company takes over the management of the target company without its knowledge and against the wish of their management.

## 6. Joint Venture (JV)

A joint venture is an entity formed by two or more companies to undertake financial activity together. The parties agree to contribute equity to form a new entity and share the revenues, expenses, and control of the company. It may be Project based joint venture or Functional based joint venture.

**Project based Joint venture:** The joint venture entered into by the companies in order to achieve a specific task is known as project based JV.

**Functional based Joint venture:** The joint venture entered into by the companies in order to achieve mutual benefit is known as functional based JV.

## 7. Strategic Alliance

Any agreement between two or more parties to collaborate with each other, in order to achieve certain objectives while continuing to remain independent organizations is called strategic alliance.

## 8. Franchising

Franchising may be defined as an arrangement where one party (franchiser) grants another party (franchisee) the right to use trade name as well as certain business systems and process, to produce and market goods or services according to certain specifications.

The franchisee usually pays a one-time franchisee fee plus a percentage of sales revenue as royalty and gains.

## 9. Slump sale

Slump sale means the transfer of one or more undertaking as a result of the sale of lump sum consideration without values being assigned to the individual assets and liabilities in such sales. If a company sells or disposes of the whole or substantially the whole of its undertaking for a predetermined lump sum consideration, then it results in a slump sale.

## CORPORATE RESTRUCTURING - HISTORICAL BACKGROUND

In earlier years, India was a highly regulated economy. Though Government participation was overwhelming, the economy was controlled in a centralized way by Government participation and intervention. In other words, economy was closed as economic forces such as demand and supply were not allowed to have a full-fledged liberty to rule the market. There was no scope of realignments and everything was controlled. In such a scenario, the scope and mode of Corporate Restructuring were very limited due to restrictive government policies and rigid regulatory framework.

These restrictions remained in vogue, practically, for over two decades. These, however, proved incompatible with the economic system in keeping pace with the global economic developments if the objective of faster economic growth were to be achieved. The Government had to review its entire policy framework and under the economic liberalization measures removed the above restrictions by omitting the relevant sections and provisions.

The real opening up of the economy started with the Industrial Policy, 1991 whereby 'continuity with change' was emphasized and main thrust was on relaxations in industrial licensing, foreign investments, transfer of foreign technology etc. With the economic liberalization, globalization and opening up of economies, the Indian corporate sector started restructuring to meet the opportunities and challenges of competition.

The economic and liberalization reforms, have transformed the business scenario all over the world. The most significant development has been the integration of national economy with 'market-oriented globalized economy'. The multilateral trade agenda and the World Trade Organization (WTO) have been facilitating easy and free flow of technology, capital and expertise across the globe. A restructuring wave is sweeping the corporate sector the world over, taking within its fold both big and small entities, comprising old economy businesses, conglomerates and new economy companies and even the infrastructure and service sector. From banking to oil exploration and telecommunication to power generation, petrochemicals to aviation, companies are coming together as never before. Not only this new industries like e-commerce and biotechnology have been exploding and old industries are being transformed.

With the increasing competition and the economy, heading towards globalisation, the corporate restructuring activities are expected to occur at a much larger scale than at any time in the past. Corporate Restructuring play a major role in enabling enterprises to achieve economies of scale, global competitiveness, right size, and a host of other benefits including reduction of cost of operations and administration.

## EMERGING TRENDS

### Doing Deals Successfully in India – A Survey by KPMG India and Merger Market in 2012

In order to present a composite view of effective practices that have emerged from inbound investors' experience conducting M&A in India. KPMG in India and mergermarket in the year 2012, shortlisted a

number of successful deals based on their size and prominence in the Indian marketplace.

They conducted interviews with key M&A Heads or equivalent from International companies involved in these transactions over the course of 2012. The report represents a summary of these conversations and the learnings that have emerged from these transactions.

Almost all participants acknowledged that India was an important part of their overall global expansion strategy, and by and large, participants have been pleased with the success of their respective deals despite the fact that some are still in the process of completing integration.

**The key insights that emerged are as follows:**

*Acquirers come to India for its domestic market and the innovation capabilities of its companies*

The primary attraction for acquirers when investing in India is the potential of its domestic market and the opportunity to use India as a springboard to access some of the regional South Asian, Middle East and even African markets. Participants also cited capabilities for innovation that Indian companies have built over the last two decades, especially to serve low cost value conscious consumers in the emerging markets as a key reason behind doing deals in India.

*Investable targets are hard (but not impossible) to find*

Given India's size, its federal regulatory structure and socio-political diversity, most businesses take a regional approach to market growth in the country, and as a result, few truly national players exist. Having said that, many of the regional markets these businesses serve have the potential of being as large as or even larger than national markets in other countries.

Coverage and availability of information on domestic companies in India is still patchy, making secondary market scans difficult. And while auction processes are prevalent, many deals are done based on local relationships and a deep understanding of the regional operations of potential targets. In fact, for many of the successful acquisitions and partnerships highlighted in this report, acquirers were in India building relationships well before their transactions materialized either by forming an Indian subsidiary or by maintaining trading relationships.

Even once a potential deal is on the table it can take time for a seller to furnish historical financials and realistic forecasts that link back to past performance. Most acquirers tended to take an independent view of a target's growth prospects while factoring in the right level of investment support post deal.

*It takes time and effort to get to know the family*

Managing the relationship with the promoter (seller) can be of paramount importance for a successful deal. Promoters are also typically involved in direct management of the business, and selling would mean losing regular income, personal status and an important family asset. Furthermore, promoter-led businesses often have more than one decision maker and depending on family history, internal politics often become part of the M&A process. For International Companies looking to acquire in India, it means spending considerable months to get to know and understand the promoters and the family well, before starting a transaction conversation.

*The process can seem long and complicated (because it often is)*

The deal process in India can initially seem long even when there is no competitive bidding process. Finding issues with compliance, tax or historical financial performance is common during diligence and these may seem like deal breakers at first.

To manage these challenges, acquirers preferred to implement transaction structures that allow buyers to leave liabilities behind with the sellers where possible, while ensuring sufficient engagement from promoters to ensure a smooth transition post deal. Participants also highlighted the need to build a business forecast bottom up, seeking independent verification of future contract commitments and an assessment of the dependence on promoter relationships for continuity of business.

Respondents to this study also highlighted the fact that sellers in India are often inexperienced in the M&A process and can start the process without adequate preparation. Where possible, buyers should request involvement of professional advisors on the sell side and ask for a well managed process including electronic data rooms, verified financial information, explanation of discrepancies with published results, etc., at the start of the process.

*The hard work begins once the deal is done*

Most participants had a small base in India prior to the acquisition and hence integration of local domestic operations with the target was not really a big challenge. Key focus during the integration revolved around navigating cultural differences, managing employee expectations from an international acquirer and alignment of management styles. Their approach was cautious, with over half the respondents spending between 1-3 years to complete the integration activities. In almost all the cases, integration was a distinct project led by teams based locally and with significant senior management involvement.

Reflecting on the overall success of the transaction, most respondents felt that they were by and large happy with the overall outcome of the deal and with the quality of management that they had acquired as a result of the transaction.

### **M & A trends in India 2-11-2013**

Mergers and Acquisition (M&A) activity in the Indian market continued at pace in 2013, despite ongoing uncertainty over the country's wider economic prospects.

Overall, 500 publically announced M&A deals were recorded in 2013, amounting to US \$28.19 billion in transactions. Although representing a 16% year-on-year drop in volume and 20% year-on-year decline in total value of deals, the analysis suggests that investor's interest in India remains relatively stable in light of ongoing economic pressure which have seen inflation rate rises and a depreciating rupee over the past 12 months.

Five M&A deals valued at over one billion US dollars were witnessed in 2013, compared with four such deals in 2012; although still a sharp drop from the 10 deals of this caliber recorded in 2011. Excluding 2012's blockbuster Vedanta Group restructuring deal (valued at US \$ 12billion), the value of M&A in 2013 represents a 15% year-on-year increase.

Private equity (PE) deals in 2013 saw steady improvement, with a 12% year-on-year increase in deal volumes (totaling 450) and a 40% year-on-year rise in total value (reaching US \$ 10.39 billion). Top sectors for PE investment included: IT & ITES (20%), Pharma, Healthcare & Biotech (14%), Real Estate (13%), Telecoms (12%), Banking (11%) and Automotives (8%). There were 23 private equity investments over the year with recorded values of over US \$100 million each.

Despite an overall mixed year in 2013, the Indian economy still retains pockets of competitiveness; particularly in sectors such as the pharmaceutical and aviation industries, which will likely see M&A activity increase in 2014 as the commercial and regulatory environments in India play strongly in their favour.

"Though not a blockbuster year, 2013 proved to be fairly resilient despite political and fiscal uncertainties in

India. The gradual stabilization of the rupee and key stock indices in the second half of the year offer promising signs, and we're hopeful this cautiously positive sentiment will lead to resurgence in M&A activity following the 2014 elections. India – corporate and otherwise – is bracing itself, while looking ahead.”

**Table 1: Deal summary for Indian M&A and PE activity for 2011-2013**

Deal Summary	Volume			Value (US\$bn)		
	2011	2012	2013	2011	2012	2013
Domestic	216	234	220	5.04	6.08	5.75
Cross Border	288	262	221	39.58	14.51	17.89
Mergers & Internal Restructuring	140	102	59	-	14.80	4.55
Total M&A	644	598	500	44.61	35.38	28.19
PE	373	401	450	8.75	7.38	10.39
Grand Total	1,017	999	950	53.36	42.76	38.58
Cross Border includes:						
Inbound	142	140	139	28.73	5.96	8.64
Outbound	146	122	82	10.84	8.55	9.25

Source: Grant Thornton.Co. UK

### Expanding role of professionals in corporate restructuring process

The restructuring process does not only involve strategic decision making based on the market study, competitor analysis, forecasting of synergies on various respects, mutual benefits, expected social impact etc, but also the technical and legal aspects such as valuation of organizations involved in restructuring process, swap ratio of shares if any, legal and procedural aspects with regulators such as Registrar of Companies, High Court etc., optimum tax benefits after merger, human and cultural integration, stamp duty cost involved etc.

It involves a team of professionals including business experts, Company Secretaries, Chartered Accountants, HR professionals, etc., who have a role to play in various stages of restructuring process. The Company Secretaries being the vital link between the management and stakeholders are involved in the restructuring process through out as co-coordinator, in addition to their responsibility for legal and regulatory compliances.

The restructuring deals are increasing day by day to be in line with business dynamics and international demands. It necessitates the expanded role of professionals in terms of maximum quality in optimum time.

### Companies Act, 2013

The Companies Act, 2013 has brought many enabling provisions with regard to mergers, compromise or arrangements, especially with respect to cross border mergers, time bound and single window clearances, enhanced disclosures, disclosures to various regulators, simplified procedure for smaller companies etc. It may be noted that Section 230-240 of the Companies Act, 2013 and the rules made thereunder are yet to be notified.

### Salient Features of Companies Act, 2013 relating to Corporate Restructuring (Section 230-240)

- National Company Law Tribunal to assume jurisdiction of High Court.



- **Section 230(2)** – Application for compromise or arrangement to be accompanied by an affidavit, disclosing
  1. All material facts relating to the company.
  2. Reduction of capital if any included in the compromise or arrangement;
  3. Any scheme of corporate debt restructuring consented to by not less than 75% of the secured creditors in value along with creditors responsibility statement, report of the auditor as to the funds requirement after CDR and the conformity to liquidity test etc.
- **Proviso to Section 230(3)** – Notice relating to compromise or arrangement and other documents to be placed on the website of the company.
- **Section 230(5)** – Notice of meeting for approval of the scheme of compromise or arrangement be sent to various regulators including:
  1. The Central Government;
  2. Income-tax Authorities;
  3. Reserve Bank of India ('RBI');
  4. Securities Exchange Board of India ('SEBI');
  5. The Registrar;
  6. Respective Stock Exchange;
  8. The Competition Commission of India; if necessary; and
  9. Other Sectoral regulators which could likely be affected by the scheme. Representation, if any, by the above authorities will have to be made within a period of 30 days from receipt of notice.
- **Proviso to Section 230(4)** – Persons holding not less than 10% of the shareholdings or persons having outstanding debt amounting to not less than 5% of the total outstanding debt as per the latest audited financial statement, entitled to object the scheme of compromise or arrangement.
- **Proviso to Section 230(7)** – No sanction for Compromise or arrangement if accounting treatment is no AS compliant.
- **Section 234** – Cross border Merger permitted. The 1956 act permits merger of foreign company with Indian company and not vice versa.
- **Section 233 (10)** – Abolishing the practice of companies holding their own shares through a trust (Treasury Stock) in case of merger of holding and subsidiary companies. Ultimately the shares are to be cancelled.
- **Section 233** – Fast track mergers introduced. – The new Act enables fast track merger without the approval of NCLT, between:
  1. Two or more small companies. Small company is defined under the Act.
  2. Holding and wholly owned subsidiary company
  3. Other class of companies as may be prescribed
- **Section 230(6)** – Approval of scheme by postal ballot thereby involving wider participation;
- **Section 230(11)** – Any compromise or arrangement may also include takeover offer made in prescribed manner. In case of listed companies, takeover offer shall be as per the regulations framed by SEBI.

## LESSON ROUND UP

- Growth of organization may be organic/inorganic growth. Growth in the factors of production is organic growth, whereas corporate restructuring initiatives leads to inorganic growth which is relatively faster.
- Restructuring may be financial restructuring, technological, market and organizational restructuring.
- The most commonly applied tools of corporate restructuring are amalgamation, merger, demerger, acquisition, joint venture, disinvestments etc.
- The important aspects to be considered during Corporate Restructuring process are financial, valuation, stamp duty, taxation and accounting aspects.
- The regulatory framework for corporate restructuring includes, The Companies Act, 1956, notified Sections of Companies Act, 2013, SEBI(SAST) Regulations; 2011, Listing agreement, Indian Stamp Act, 1899, Companies(Court) Rules; etc.
- The restructuring process over the years has expanded the role of professionals in the restructuring process at various stages.
- The companies Bill; 2012 has provided several provisions for revamping the corporate restructuring process in India.

## SELF TEST QUESTIONS

1. What are different types of growth strategies?
2. Briefly discuss the scope and mode of Corporate Restructuring.
3. Discuss about different restructuring strategies.
4. Write a brief note on the role of professionals in restructuring strategies.
5. Restructuring is just not a strategic plan. Discuss.

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# Lesson 2

## MERGERS AND AMALGAMATIONS – LEGAL AND PROCEDURAL ASPECTS

### LESSON OUTLINE

- Regulatory Framework
- Provisions of the Companies Act, 1956 relating to mergers/amalgamation
- Approvals in the scheme of amalgamation
- Process/steps involved in mergers/Amalgamation
- Filing of various forms in the process of mergers/amalgamation

### LEARNING OBJECTIVES

While implementing the strategic decision of merger/amalgamation, the transferor/transferee company has to comply with a number of regulations viz., the Companies Act, 1956, Companies (Court) Rules, 1959, Income Tax Act, 1961, Listing Agreement, The Indian Stamp Act 1899, The Competition Act, 2002 etc. It involves conducting of various meeting including board/general meetings, obtaining of various approvals from regulators like Stock Exchanges, High Court, Ministry of Corporate Affairs (ROC/RD), drafting of documents such as preparation of scheme, notices/explanatory statements, filing of various documents including e-forms with ROC, filing of scheme of amalgamation with High Court etc., After reading this lesson you will be able to understand the regulatory framework, interpretations of provisions in the Companies Act relating to merger/amalgamation, different approvals, steps involved, judicial pronouncements etc. The aspects as to stamp duty, valuation, competition law aspects are being dealt in separate chapters.

Section 230-240 of Companies Act, 2013 are not yet notified and accordingly the provisions of Companies Act, 1956 are dealt in this lesson.

## REGULATORY FRAMEWORK FOR MERGER/AMALGAMATION

The Regulatory Framework of Mergers and Amalgamations covers

1. The Companies Act, 1956
2. Companies (Court) Rules, 1959
3. Income Tax Act, 1961
4. Listing Agreement
5. The Indian Stamp Act, 1899
6. Competition Act, 2002

### 1. Companies Act, 1956

Chapter V of Companies Act, 1956 comprising Section 390 to 396A contains provisions on 'Arbitration, Compromises, Arrangements and Reconstructions'. There are however, no provision on Arbitration Since Section 389 which dealt with Arbitration was deleted. The scheme of Chapter V goes as follows.

1. Section 390 contains interpretation of certain expressions used in Section 391 and 393
2. Section 391 is relating to the power of the company to compromise or to make arrangement with its creditors and members.
3. Section 393 deals with regard to information as to compromises and arrangements with creditors and members.
4. Section 394 deals with facilitation of reconstruction and amalgamation of companies.
5. Section 394A deals with a notice to be given to the Central Government in respect of applications under Section 391 and 394.
6. Section 395 deals with provisions regarding the power and duty to acquire shares of shareholders dissenting from scheme or contract approved by majority shareholders.
7. Section 396 contains provisions as to the power of the central government to provide for amalgamation of companies in national interest.
8. Section 396 A deals with preservation of books and papers of amalgamated companies.

### 2. Companies Court Rules, 1959

Rules 67-87 contains provisions dealing with the procedure for carrying out a scheme of compromise or arrangement including amalgamation or reconstruction.

### 3. Under the Income Tax Act, 1961

The Income Tax Act, 1961 covers aspects such as tax reliefs to amalgamating/amalgamated companies, carry forward of losses, exemptions from capital gains tax etc. For example, when a scheme of merger or demerger involves the merger of a loss making company or a hiving off of a loss making division, it is necessary to check the relevant provisions of the Income Tax Act and the Rules for the purpose of ensuring, *inter alia*, the availability of the benefit of carrying forward the accumulated losses and setting of such losses against the profits of the Transferor Company.

### 4. Under the Listing Agreement

Under Clause 24(f) of the Listing Agreement, where the scheme of merger or demerger involves a listed

company, it is necessary to send a copy of the scheme to the stock exchanges where the shares of the said company are listed to obtain their No Objection Certificate (NOC). Generally stock exchanges raise several queries and on being satisfied that the scheme does not violate any laws concerning securities such as the takeover code or the SEBI (ICDR) Regulations, Stock Exchanges accord their approval. Where the shares are listed on BSE or NSE, other Stock Exchanges wait for the approval by BSE or NSE before granting their approval.

### 5. Under the Indian Stamp Act

It is necessary to refer to the Stamp Act to check the stamp duty payable on transfer of undertaking through a merger or demerger.

### 6. Competition Act, 2002

The provisions of Competition Act and the Competition Commission of India (Procedure in regard to the Transaction of Business relating to Combinations) Regulations, 2011 are to be complied with.

## PROVISIONS OF THE COMPANIES ACT 1956

### Section 391 – Power to compromise or make arrangements with creditors and members.

Section 391 lays down in detail the power to make compromise or arrangements with its creditors and members. Under this Section, a company can enter into a compromise or arrangement with its creditors or its members, or any class thereof.

#### *Scope of Section 391*

Section 391 deals with the rights of a company to enter into a compromise or arrangement (i) between itself and its creditors or any class of them; and (ii) between itself and its members or any class of them. The arrangement contemplated by the section includes a reorganisation of the share capital of a company by consolidation of its shares of different classes or by sub-division of its shares into shares of different classes or by both these methods.

Once a compromise or arrangement comes within the ambit of the section, it may be sanctioned by the court, even if it involves certain acts for which a particular procedure is specified in other sections of the Act e.g., reduction of share capital of a company may form part of a compromise or arrangement and when the court sanctions the compromise or arrangement as a whole, reduction of share capital is also sanctioned and the company is not required to follow the procedure laid down in Section 100 of the Act. The court can refuse to sanction a scheme of merger or amalgamation or reconstruction if it is satisfied that the scheme involves any fraud or illegality. Once the reduction of share capital of a company is a part of a compromise or arrangement, the requirements of the Companies Act as regards reduction of share capital are not applicable because the court is empowered to sanction reduction of share capital as a part of the compromise or arrangement.

The section also applies to compromise or a management entered into by companies under winding up. Therefore, an arrangement under this section can take a company out of winding up.

Once a compromise or arrangement under this section is approved by statutory majority, it binds the dissenting minority, the company and also the liquidator, if the company is in the process of winding up.

Reduction of capital forming part of compromise/arrangement sanctioned by the court does not require the procedure to be followed under Section 100.

*Sub-section (1) – Application to the court for convening meetings of members/creditors.*

Where a company proposes a compromise or arrangement between it and its creditors or between it and its members or with any class of the creditors or any class of members, the company or the creditor or member may make an application to the court. On such application the court may order a meeting of the creditors or members or any class of them as the case may be and such meeting shall be called, held and conducted in such manner as the court may direct. In the case of a company which is being wound up, any such application should be made by the liquidator.

The key words and expressions under sub-section are 'creditors', 'court', 'class of creditors or members', 'a company which is being wound up', 'liquidator'. When a company is ordered to be wound up, the liquidator is appointed and once winding up commences liquidator takes charge of the company in all respects and therefore it is he who could file any application of any compromise or arrangement in the case of a company which is being wound up. A company which is being wound up would mean a company in respect of which the court has passed the winding up order.

Who can make application under Section 391 to the court for the purpose of calling meeting of creditors/members as the case may be?

1. The Company
2. Creditor/Member
3. Liquidator in case of the company being wound up.

*Sub-section (2) – Approval of the Scheme and order of the court sanctioning the scheme of amalgamation.*

Sub-section (2) provides that when the court directs the convening, holding and conducting of a meeting of creditors or members or a class of them, a particular majority of the creditors or members or a class of them should agree to the scheme of compromise or arrangement. As per the sub-section, the majority required is the majority in number representing three-fourths in value of the creditors or members or a class of them, as the case may be, present and voting in the meeting so convened either in person, or by proxy. After the said meeting agrees with such majority, if the scheme is sanctioned, by the court, it shall be binding upon the creditors or members or a class of them, as the case may be.

As per the proviso under Sub-section (2), no order sanctioning any compromise or arrangement shall be made by the court unless it is satisfied that the applicant has made sufficient disclosure about the following particulars:

- All material facts relating to the company;
- Latest financial position of the company;
- Latest auditors report on the accounts of the company;
- Information about pendency of any investigation proceeding in relation to the company under Sections 235 to 251 and the like.

What is the majority required for compromise under Section 391?

Majority in number representing three fourths in value.

*Sub-section (3) – Filing of court order with ROC.*

The order made by the court under Sub-section (2) should be filed with the Registrar of Companies. If the

order is not filed with the Registrar, it will not have any effect. The requirement under this section is limited to filing of the order of the court and it does not specify the need for the Registrar to register it.

The order of the court under Section 391 sanctioning compromise or arrangement will not have effect unless filed with Registrar of Companies.

*Sub-section (4) – Memorandum to be annexed to the copy of court order while filing.*

It is necessary to annex a copy of every such order to every copy of the Memorandum of company issued after the filing of the certified copy of the order. In the case of a company not having a memorandum the order aforesaid shall be annexed to every copy of the instrument constituting or defining the constitution of the company.

*Sub-section (5) – Penalty.*

Any default in complying with Sub-section (4) invites the penalty prescribed in this sub-section. As per the penal clause contained in this sub-section, the company and every officer of the company who is in default shall be punishable with fine which may extend to `100/- for each copy in respect of which the default is made.

*Sub-section (6)*

The court has powers to stay the commencement of or continuation of any suit or proceeding against the company on such terms as it thinks fit until the application is finally disposed of.

### **Section 392 – Power to enforce compromise and arrangement.**

*Sub-section (1)*

The court has the power to supervise the carrying out of the scheme. The court may give such directions or make such modifications to the scheme for the purpose of proper working of the scheme.

*Sub-section (2)*

The court has the power to order winding up of the company if it thinks that the scheme sanctioned cannot work satisfactorily.

### **Section 393 – Information as to compromise or arrangements with creditors and members.**

*Sub-section (1)*

Every notice of any meeting called as per orders of court under Section 391, should include an explanatory statement. The statement should set out the terms of compromise or arrangement and all material interests of the directors, managing director or manager of the company and effect of such interest on the scheme. It can also be given by way of an advertisement containing the above mentioned particulars.

*Sub-section (2)*

Such disclosure shall also be made, in the case of a scheme affecting debenture holders, about the interest of the debenture trustees.

*Sub-section (3)*

If the notice states that creditors or members can have copies of the scheme from the company, the company shall provide copies of the scheme of compromise or arrangement, to the creditor or member who applies for the same.

*Sub-section (4)*

This sub-section is a penal clause. In case of default in complying with the requirements of Section 393, the default is a punishable offence.

*Sub-section (5)*

Every director, managing director, manager or as the case may be, the debenture trustees, shall give all necessary information to the company failing which they shall be liable for the penal consequences stipulated in this sub-section.

**Section 394 – Provisions for facilitating reconstruction and amalgamation of companies.**

It is only in Section 394 of the Act there is reference to reconstruction of any company or companies or amalgamation of any two or more companies.

*Sub-section (1)*

Where the scheme involves reconstruction of any company or companies or amalgamation of any two or more companies and vesting of the whole or substantially the whole of the properties or liabilities of any company concerned in the scheme (Transferor Company) to another company (Transferee company), the court may make provision for the following matters also:

- Transfer to the Transferee Company of the whole or any part of the undertaking, property or liabilities of any transferor company;
- The allotment or appropriation by the Transferee company of any shares, debentures to any person under the scheme.
- Continuation of proceedings by or against the Transferee Company of any legal matters pending by or against any Transferor Company.
- The dissolution, without winding up, of any Transferor Company.
- Provision to be made for any person who does not agree to the scheme.
- Such incidental, consequential and supplemental orders passed by the court as it may think fit so that the reconstruction or amalgamation could be fully and effectively carried out.

As per the proviso under this sub-section, it is necessary to have the report from the Registrar of Companies in case the scheme involves a company that is being wound up and the report of the liquidator, in case the scheme involves the dissolution of a company. These reports are mandatory in order to ensure that the affairs of the company in question have not been conducted in a manner prejudicial to the interests of its members or to public interest.

*Sub-section (2)*

The sub-section provides for the order of the Court and the vesting of the properties and liabilities of the transferor company to the transferee company.

*Sub-section (3)*

Under this sub-section, the time limit for filing the order of the Court for registration by the Registrar is 30 days after the making of the order.

*Sub-section (4)*

As per clause (a), the expression 'property' has been defined to include property, rights and powers of every description and the expression 'liabilities' includes duties of every description. As per clause (b), 'Transferee



Company' does not include any company other than a company within the meaning of this Act but 'Transferor company' includes any body corporate, whether a company within the meaning of this Act or not. Thus, the transferee company in a scheme of merger or amalgamation has to be necessarily a company within the meaning of the Act.

### Section 394A

The court is supposed to give notice of every scheme under Section 391 or 394 to the Central Government and consider representation, if any by the said Government.

Therefore, merger or amalgamation under a scheme of arrangement as provided under Sections 391-394 of the Act is the most convenient and most common method of a complete merger or amalgamation between the companies. There is active involvement of the Court and an amalgamation is complete only after the Court sanctions it under Section 394(2) and takes effect when such order of court is filed with the Registrar of Companies. In fact, Sections 391 to 394 of the Act read with Companies (Court) Rules, 1959 serve as a complete code in themselves in respect of provisions and procedures relating to sponsoring of the scheme, the approval thereof by the creditors and members, and the sanction thereof by the Court.

**Accordingly, amalgamation can be effected in any one of the following ways:**

(i) *Transfer of undertaking by order of the High Court (Section 394 of the Companies Act, 1956)*

Under Section 394 of the Companies Act, the High Court may sanction a scheme of amalgamation proposed by two or more companies after it has been approved by a meeting of the members of the company convened under the orders of the court with majority in number of shareholders holding more than 75 percent of the shares who vote at the meeting, approve the scheme of amalgamation, and the companies make a petition to the High Court for approving the Scheme. The High Court serves a copy of petition on the Regional Director, Company Law Board and if they do not object to the amalgamation, the Court sanctions it. Once the Court sanctions the scheme, it is binding on all the members of the respective companies.

(ii) *Purchase of shares of one company by another company (Section 395 of the Companies Act, 1956)*

Under Section 395 of the Companies Act, 1956, the undertaking of one company can be takenover by another company by the purchase of shares. This section obviates the need to obtain the High Court's sanction. While purchasing shares, the company which acquires shares should comply with the requirements of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 and Section 372A of the Companies Act, 1956. This Section also provides the procedure for acquiring the shares of dissenting members.

(iii) *Amalgamation of Companies in National Interest (Section 396)*

Where the Central Government is satisfied that an amalgamation of two or more companies is essential in the public interest, then the Government may, by an order notified in the Official Gazette, provide for the amalgamation of those companies into a single company. The amalgamated company shall have such constitution, property, powers, rights, interest and privileges as well as such liabilities, duties and obligations as may be specified in the Government's order.

(iv) *Amalgamation for Revival and Rehabilitation*

The Board for Financial and Industrial Reconstruction (BIFR) can in exceptional cases order

amalgamation for the revival and rehabilitation of a sick industrial company under the provisions of Sick Industrial Companies (Special Provisions) Act, 1985.

## APPROVALS IN SCHEME OF AMALGAMATION

The companies are required to obtain following approvals in respect of the scheme of amalgamation:

### (i) Approval of Board of Directors

- The first step in carrying out amalgamation is approval of scheme of amalgamation by the Board of both the companies.
- Board resolution should, besides approving the scheme, authorise a Director/Company Secretary/other officer to make application to court, to sign the application and other documents and to do everything necessary or expedient in connection therewith, including changes in the scheme.

### (ii) Approval of Shareholders/Creditors

Members' and creditors' approval to the scheme of amalgamation is sine qua non for Court's sanction. Without that the Court cannot proceed. This approval is to be obtained at specially convened meetings held as per court's directions [Section 391(1)]. However, the court may dispense with meetings of members/creditors. Normally, creditors' meetings are dispensed with subject to certain conditions. For instance, members' meeting may be dispensed with if all the members' individual consent is obtained.

However, it is a discretionary power of the court for which a separate application must be made for court's order.

The scheme of compromise or arrangement has to be approved as directed by the High Court, by—

- the members of the company; or
- the members of each class, if the company has different classes of shares; and
- the creditors; or
- each class of creditors, if the company has different classes of creditors.

The approval of the members and creditors (or each class of them) has to be obtained at specially convened meetings as per High Court directions. [Section 391(1)]. An application seeking directions to call, hold and conduct meetings is made to the High Court, which has jurisdiction having regard to the location of the registered office of the company.

A learned Judge of Bombay High Court in *Kaveri Entertainment Ltd. in re.*, (2003) 117 Comp Cas 245 (Bom) expounded the procedure required to be followed by a company which seeks the court's sanction to a scheme of compromise or arrangement as:

“A company which desires to enter into any arrangement with its members and/or creditors first makes an application to the court under Sub-section (1) of Section 391 of the Act for directions for convening of the meeting or meetings of the members and/or creditors, as the case may be, for considering the proposed scheme of arrangement.

The court, on receiving such an application, issues directions for convening of separate meetings of the members and/or creditors or different classes of members and/or creditors, as the case may be. In those meetings, the scheme of arrangement is required to be approved by majority in number representing 3/4th in value of the creditors or class of creditors or members or class of members as the case may be. After the

scheme is approved by all concerned, a petition is presented to the court for sanctioning of the scheme of arrangement.

If the court is satisfied that the scheme is just and fair and not prejudicial to the interest of the members/class of members or creditors/class of creditors, as the case may be, then the court may sanction it."

A subsidiary company being a creditor cannot be included along with other unsecured creditors; their interest in supporting a scheme proposed by the holding company would not be the same as the interest of the other unsecured creditors [*Hindustan Development Corporation Ltd. v. Shaw Wallace & Co. Ltd.* (supra)]. Secured creditors should not be clubbed together with the unsecured creditors. Their interest would not be the same.

#### *Scheme to be approved by special majority*

The Scheme must be approved by a resolution passed with the special majority stipulated in Section 391(2), namely a majority in number representing three-fourths in value of the creditors, or class of creditors, or members, or class of members, as the case may be, present and voting either in person or, by proxy.

Thus, 51% majority in number, and 75% in value present and voting at the meeting must approve the scheme. [Section 391(2)]. For example, if at the meeting 100 persons (members in person and proxies) are present, at least 51 of them must vote in favour the resolution and they must be holding at least 75% of the paid-up share capital carrying voting rights. In the case of creditors, those voting in favour must have the claim not less than 75% of the total amount of claim of all the creditors present and voting.

The majority is dual, in number and in value. A simple majority of those voting is sufficient, whereas the 'three - fourths' requirement relates to value. The three-fourths value is to be computed with reference to paid-up capital held by members (or to total amount owed by company to creditors) present and voting at the meeting. [*Re Maknam Investments Ltd. (1995) 6 SCL 93 Cal*; *Re Mafatlal Industries Ltd. (1995) 84 Comp Cas 230 (Guj)*].

A full bench of the Punjab and Haryana High Court in *Hind Lever Chemicals Limited and Another* [2005] 58S CL 211(Punj. & Har.) held that In our view, the language of Section 391(2) of the Act is totally unambiguous and a plain reading of this provision clearly shows that the majority in number by which a compromise or arrangement is approved should represent three-fourth in value of the creditors/ shareholders who are 'present and voting' and not of the total value of the shareholders or creditors of the company.

This is neither an ordinary resolution nor a special resolution within the purview of Section 189 of the Act. This is an extraordinary resolution. A copy of this resolution need not be filed with the Registrar of Companies under Section 192.

Where a Scheme is not approved at a meeting, by the requisite majority, but is subsequently approved by individual affidavits, the court may sanction the Scheme as Section 391(2) is not mandatory but is merely directory and there should be substantial compliance thereof. [*SM Holdings Finance Pvt Ltd. v. Mysore Machinery Mfrs Ltd.* (1993) 78 Comp Cas 432 (Kar)].

In *Kaveri Entertainment Ltd., in re.* (2003) 17 Comp Cas 245 (Bom.): (2003) 45 SCL 294 (Bom): (2003) 57 CLA 127 (Bom), a learned Judge of the Bombay High Court expounded the requirement of Sub-section (2) as:

"Sub-section (2) of Section 391 of the Act requires that the resolution approving the scheme of arrangement should be passed by majority in number representing 3/4th in value of the creditors or class of creditors and/or members or class of members as the case may be. If the resolution granting approval to the scheme of arrangement is passed by more than 3/4th in value of the creditors but, is not carried by the majority in

number of the creditors, the scheme would not be approved by the court. The majority in number of the creditors is provided in the section for safeguarding the interests of the large number of small creditors whose voice is often lost amongst small number of big creditors. The conditions of approval by majority in number and 3/4th in value of credit are cumulative.”

In determining whether a resolution has been passed by the requisite majority or not, the members remaining neutral or not participating in voting are to be ignored. This is because the section clearly provides that the votes of only the members present and voting either in person or, by proxy, are to be taken into account. Where in a meeting for the sanction of a scheme, holders of shares of the value of ₹6,42,700 were present but holders of shares of the value of ₹4,42,700 alone voted in favour of the resolution and the others remained neutral, voting neither in favour of, nor against, the resolution, it was held that there was a unanimous passing of the resolution and the requisite majority contemplated by Section 391(2) agreed to the scheme. [*Hindustan General Electric Corporation Ltd., in re. (1959) 29 Comp Cas 46 (Cal)*].

In *Re: Kirloskar Electric Company Ltd., [2003] 116 Com Cas 413 (Kar)*: The Karnataka High Court held that the three-fourth majority required under Sub-section (2) of Section 391 of the Act was of the value represented by the members who were not only present but who had also voted. In fact, it went a step further to hold that the creditors who were present and had even voted but whose votes had been found to be invalid, could not be said to have voted because casting an invalid vote is no voting in the eyes of law. Thus, it was held that "the proper construction to be placed in calculating whether any resolution is approved or passed by a three-fourth majority present and voting necessarily mean the value of the valid votes and out of the same whether the resolution has been passed with three-fourth the majority"

### **(iii) Approval of the Stock Exchanges**

As per Clause 24(f) of the Listing Agreement all the listed companies are required to file the scheme of merger or amalgamation with all the stock exchanges where it is listed at least one month prior to filing it with High Court and obtain its No Objection to scheme.

### **(iv) Approval of Financial Institutions**

The approval of the Financial Institutions, trustees to the debenture holders and banks, investment corporations would be required if the Company has borrowed funds either as term loans, working capital requirements and/or have issued debentures to the public and have appointed any one of them as trustees to the debenture holders.

### **(v) Approval from the Land Holders**

If the land on which the factory is situated is the lease-hold land and the terms of the lease deed so specifies, the approval from the lessor will be needed.

### **(vi) Approval of the High Court**

- Both companies (amalgamating as well as amalgamated) involved in a scheme of compromise or arrangement or reconstruction or amalgamation are required to seek approval of the respective High Courts for sanctioning the scheme.
- Every amalgamation, except those, which involve sick industrial companies, requires sanction of High Court which has jurisdiction over the State/area where the registered office of a company is situated.
- If transferor and transferee companies are under the jurisdiction of different High Courts, separate approvals are necessary.

- If both are under jurisdiction of one High Court, joint application may be made. [*Mohan Exports Ltd. v. Tarun Overseas P. Ltd.* (1994) 14 CLA 279 (Del) dissenting from *Re Electro Carbonium P. Ltd.* (1979) 49 Comp Cas 825 (Kar) wherein it was held that a joint application cannot be made]. Alternatively, where both the companies are situated in the same State and only one company moves the court under Section 391, the other company may be made a party to the petition (DCA Circular No.14 of 1973 dated 5th June, 1973).
- The notice of every application filed with the Court has to be given to the Central Government (Regional Director, having jurisdiction of the State concerned).
- After the hearing is over, the Court will pass an order sanctioning the Scheme of amalgamation, with such directions in regard to any matter and with such modifications in the Scheme as the Judge may think fit to make for the proper working of the Scheme. [Section 391(2); Rule 81, Companies (Court) Rules].

The court under Section 391-394 of the Act is also empowered to order the transfer of undertaking, property or liabilities either wholly or in part, allotment of shares or debentures and on other supplemental and incidental matters.

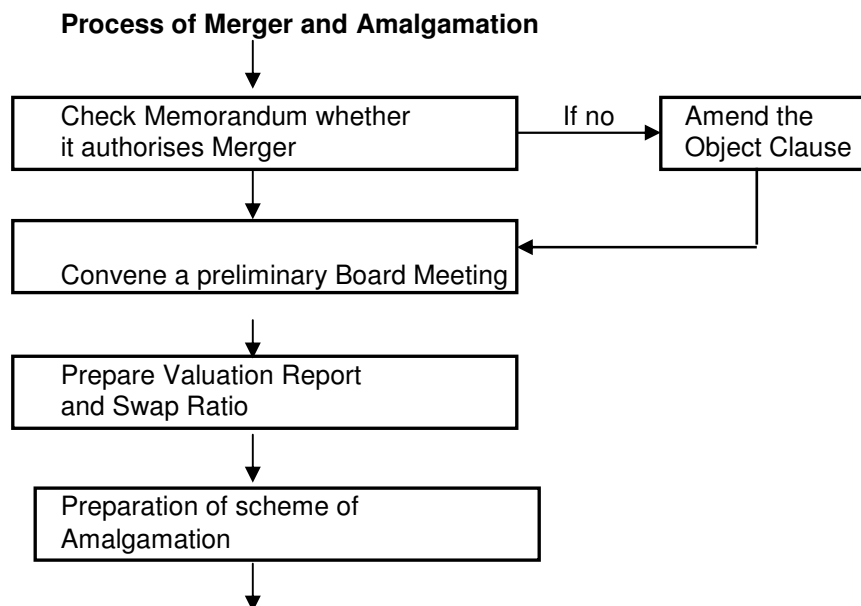
#### (vii) Approval of Reserve Bank of India

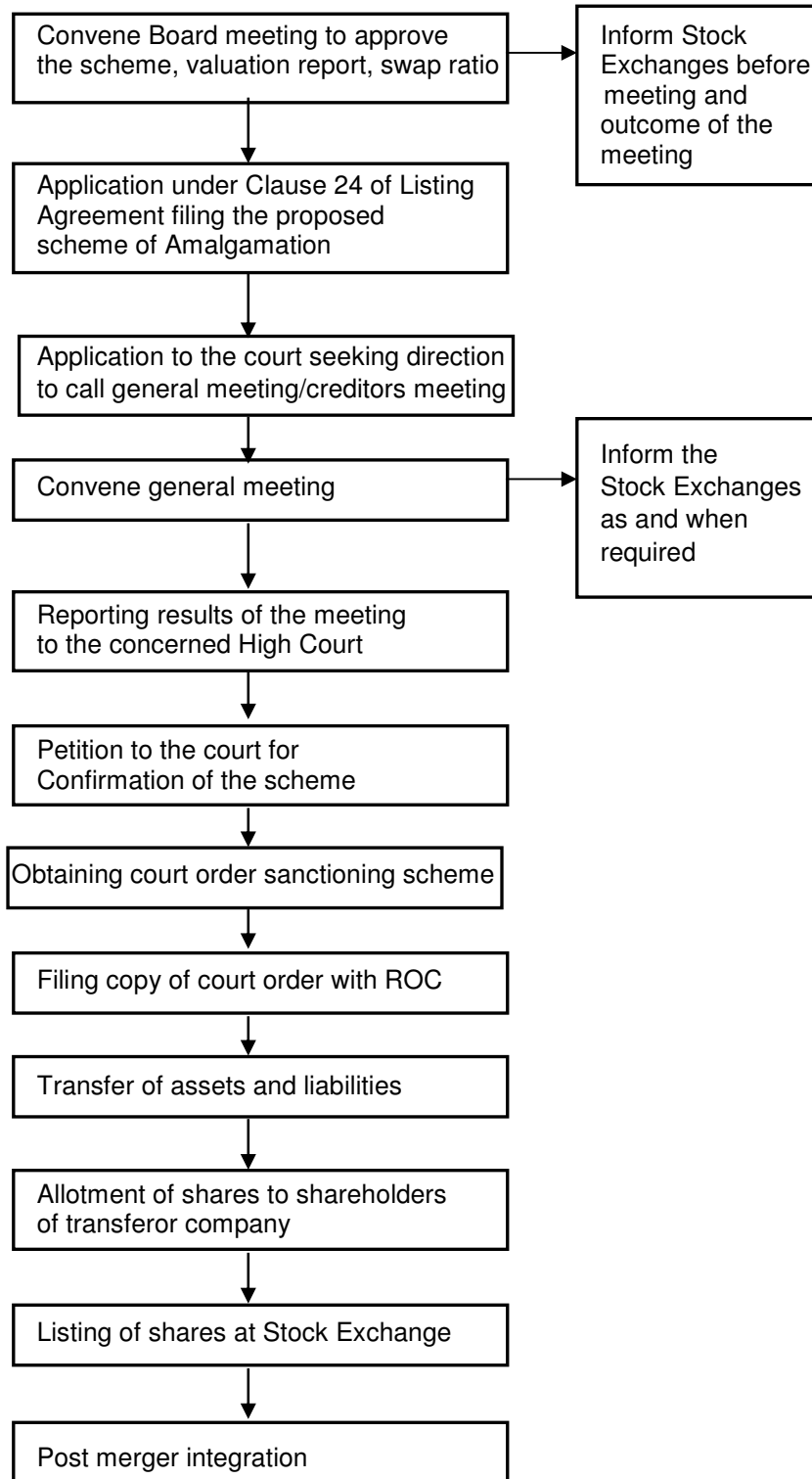
Where the scheme of amalgamation envisages issue of shares/cash option to Non-Resident Indians, the amalgamated company is required to obtain the permission of Reserve Bank of India subject to conditions prescribed under the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000.

#### (viii) Approvals from Competition Commission of India (CCI)

The provisions relating to regulation of combination as provided under Sections 5 and 6 of the Competition Act, 2002 would also be required to be complied with by companies, if applicable. These provisions would be effective from June 01, 2011.

#### STEPS INVOLVED IN MERGER - A FLOW CHART





The procedure commencing with an application for seeking directions of the Court for convening, holding and conducting meetings of creditors or class of creditors, members or class of members, as the case may be, to the stage of the court's order sanctioning the scheme of compromise or arrangement is contained in Sections 391 to 395 of the Companies Act, 1956 and rules 67 to 87 of the Companies (Court) Rules, 1959. The Rules also prescribe Forms for various purposes relating to compromise or arrangement:

The following are the process involved:

**(i) Memorandum to authorise amalgamation**

The memorandum of association of most of the companies contain provisions in their objects clause, authorising amalgamation, merger, absorption, take-over and other similar strategies of corporate restructuring. If the memorandum of a company does not have such a provision in its objects clause, the company should alter the objects clause, for which the company is required to hold a general meeting of its shareholders, pass a special resolution under Section 17 of the Companies Act, 1956 and file e-Form No. 23 along with a certified copy of the special resolution along with copy of explanatory statement under Section 173 and Memorandum of Association & Articles of Association and a copy of agreement with the concerned Registrar of Companies and the prescribed filing fee. The e-form should be digitally signed by Managing Director or Director or Manager or Secretary of the company duly authorized by the Board of Directors. The e-form should also be certified by chartered accountant or cost accountant or company secretary (in whole time practice) by digitally signing the e-form.

Alteration should be registered by the Registrar of companies and only on such registration the alteration will become effective.

No confirmation by the Company Law Board or by any outside agency is now required. The compromise or arrangement should be within the powers of the company and not ultra vires. If it is beyond the company's objects or power, the court will have no jurisdiction to sanction it. [*Oceanic Steam Navigation Co., Re, (1939) Com Cases 229: (1938) 3 All ER 740 (Ch.D)*]

There are two different opinions expressed by various courts on a simple query that whether the court can sanction an amalgamation when the Memorandum of Association of the company does not contain powers to amalgamate. It has been held by certain courts that there is no necessity to have special power in the objects clause of the memorandum of association of a company for its amalgamation with another company as to amalgamate with another company, is a power of the company and not an object of the company. The *Karnataka High Court in Hindhivac (P) Ltd. In re (CP No.15 and 16 of 2005), (206) 62 CC 58*, the High Court had sanctioned the scheme of amalgamation taking note of the fact that the shareholders of both the companies had unanimously approved the scheme. The Court held that Section 17 is an aid to company seeking amalgamation, reconstruction etc. Therefore, there would be no impediment on the scheme of amalgamation even if there is no provision in the objects clause of Memorandum of Association as to amalgamate with another company. In *Marybong & Kyel Tea Estates Ltd., Re (1977) 47 Com Cases 802*, a previous decision in *Hari Krishan Lohia v. Hoolungoree Tea Company, (1970) 40 Com Cases 458: AIR 1969 Cal 312 (DB)* was followed and it was asserted that where there is a statutory provision dealing with the amalgamation of companies, no special power in the objects clause of memorandum of association of a company is necessary for its amalgamating with another company. It is submitted that to amalgamate with another company is a power of the company and not an object of the company. Amalgamation may be effected by order of the court under Sections 391 and 394.

**Observing Memorandum of Association of Transferee Company**

It has to be ensured that the objects of the Memorandum of Association of the transferee company cover the objects of the transferor company or companies. If not then it will be necessary to follow the procedure for amendment of objects by passing a special resolution at an Extraordinary General Meeting convened for this purpose. It has been held by various decisions of the courts that there is no necessity to have special power in the object clause of the Memorandum of Association of a company for its amalgamation with another company. It has been laid down that to amalgamate with another company is power of the company and not an object of the company.

Since the amalgamation will involve issue of shares by the transferee company to the shareholders of the transferor companies, a general meeting convened for the purpose of the amendment of the Object Clause of Memorandum of Association of the transferee company to incorporate the object of the transferor company, should also cover resolutions relating to the increase of authorised capital, consequential changes in the Articles of Association and resolution under Section 81(1A) of the Companies Act, 1956 authorising the Directors to issue shares of the shareholders of the transferor companies without offering them to the existing shareholders of the company. It is also a normal practice that alongwith the special resolution for amendment of the Object Clause, special resolution is also passed under Section 149(2A) of the Companies Act, 1956 authorising the transferee company to commence the business of the transferor company or companies as soon as the amalgamation becomes effective.

### **Convening a Board Meeting**

A Board Meeting is to be convened and held to consider and approve in principle, amalgamation and appoint an expert for valuation of shares to determine the share exchange ratio.

Consequent upon finalisation of scheme of amalgamation, another Board Meeting is to be held to approve the scheme.

### **Preparation of Valuation Report**

Simultaneously, Chartered Accountants are requested to prepare a Valuation Report and the swap ratio for consideration by the Boards of both the transferor and transferee companies and if necessary it may be prudent to obtain confirmation from merchant bankers on the valuation to be made by the Chartered Accountants.

### **Preparation of scheme of amalgamation or merger**

All the companies, which are desirous of effecting amalgamation or merger must interact through their companies auditors, legal advisors and practicing company secretary who should report the result of their interaction to their respective Board of directors. The Boards of the involved companies should discuss and determine details of the proposed scheme of amalgamation or merger and prepare a draft of the scheme of amalgamation or merger. If need be, they can obtain opinion of experts in the matter. The drafts of the scheme finally prepared by the Boards of both the companies should be exchanged and discussed in their respective Board meetings. After such meetings a final draft scheme will emerge. The scheme must define the “effective date” from which it shall take effect subject to the approval of the High Courts.

#### *Contents of Amalgamation Scheme*

Any model scheme of amalgamation should include the following:

- *Appointed Date or Transfer Date:* This is usually the first day of the financial year preceding the financial year for which audited accounts are available with the companies. In other words, this is a cut-off date from which all the movable and immovable properties including all rights, powers, privileges of every kind, nature and description of the transferor-company shall be transferred or deemed to be transferred without any further act, deed or thing to the transferee company.
- *Effective Date:* This is the date on which the transfer and vesting of the undertaking of the transferor-company shall take effect i.e., all the requisite approvals would have been obtained, i.e., date of filing of High Court order with ROC.
- Arrangement with secured and unsecured creditors including debenture-holders.
- *Arrangement with shareholders (equity and preference):* This refers to the exchange ratio, which will



have to be worked out based on the valuation of shares of the respective companies as per the audited accounts and accepted methods and valuation guidelines.

- *Cancellation of share capital/reduction of share capital:* This will be necessitated when the shares of the transferor-company(ies) are held by the transferee-company and/or its subsidiary(ies) or vice versa.
- Pending receipt of the requisite approvals to the amalgamation, the transferor-company(ies) possesses the property to be transferred and to carry on the business for and on behalf and in trust for the transferee-company.

The Scheme should suitably provide for:

1. Brief details of transferor and transferee companies.
2. Appointed date.
3. Main terms of transfer of assets and liabilities from transferor to transferee, with power to execute on behalf or for transferee, the deed/documents being given to transferee.
4. Effective date of the scheme.
5. Details of happenings and consequences of the scheme coming into effect on effective date.
6. The terms of carrying on the business activities by transferor between 'appointed date' and 'effective date'.
7. Details of share capital of transferor and transferee company.
8. Proposed share exchange ratio, conditions attached thereto, fractional certificates to be issued to transferee company, approvals and consent required etc.
9. Conditions about payment of dividend, ranking of equity shares, prorata dividend declaration and distribution.
10. Status of employees of transferor companies and various schemes or funds created for their benefit, from the effective date.
11. Agreement between transferor and transferee companies towards making applications/petitions under Sections 391 and 394 and other provisions to the respective High Courts.
12. Impact of various provisions covering income tax dues, contingencies and other accounting entries deserving attention.
13. Statement to bear costs, expenses etc. in connection with the scheme by transferee company.
14. Qualifications attached to the Scheme, requiring various approvals and sanctions etc.
15. Enhancement of borrowing limits of the transferee company upon the scheme coming into effect.
16. Surrender of shares by shareholder of transferor company for exchange into new share certificates.

### **Approval of Scheme**

- It would be necessary to convene a Board Meeting of both the transferor and transferee companies for approving the Scheme of Amalgamation, Explanatory Statement under Section 393 and the Valuation Report including the swap ratio.
- Notice has to be given to the regional Stock Exchanges and other Stock Exchanges where shares of the Company are listed under the listing requirements at least two days before the Board Meeting is proposed to be held for purpose of approving the Amalgamation.

- Within 15 minutes after the Board Meeting, the Regional Stock Exchange and all other Stock Exchanges are required to be given intimation of the decision of the Board as well the swap ratio before such information is given to the shareholders and the media.
- Pursuant to clause 24 of the listing agreement, all listed companies shall have to file scheme/petition proposed to be filed before any Court/Tribunal under Sections 391, 394 and 101 of Companies Act, 1956, with the stock exchange, for approval, at least a month before it is presented to the Court or Tribunal.

### **Application to High Court seeking direction to hold meetings**

Rule 67 of the Companies (Court) Rules, 1959 lays down that an application under Section 391(1) of the Companies Act, 1956 for an order seeking direction for convening meeting(s) of creditors and/or members or any class of them shall be by way of Judge's summons supported by an affidavit. A copy of the proposed scheme should be annexed to the affidavit as an exhibit thereto. The summons should be moved ex parte in Form No. 33 of the Companies (Court) Rules, 1959. The affidavit in support of the application should be in Form No. 34.

### **Jurisdiction of High Court**

As explained earlier if the registered offices of both the companies are situated in the same State, a joint application or separate applications should be moved to the High Court having jurisdiction over the State in which registered offices of the companies are situated. However, if the registered offices of the companies involved are situated in different States, they should make separate applications to their respective High Courts.

Accordingly, an application should be made to the concerned High Court under Section 391(1) of the Companies Act, 1956 in accordance with the provisions of rule 67 of the Companies (Court) Rules, 1959, for an order directing convening of meeting(s) of creditors and/or members or any class of them, by a Judge's summons supported by an affidavit.

Normally, an application under Section 391 of the Act is made by the company, but a creditor or a member may also make the application. Although a creditor or a member or a class of creditors or a class of members may move an application under Section 391(1) of the Act, yet, such an application may not be accepted by the court because the scheme of compromise or arrangement submitted to the court along with the application may not have the approval of the Board of directors of the company or of the company in general meeting. However, the court has the discretion to give such directions as it may deem proper.

#### *Where the company is not the applicant*

Rule 68 lays down that where the company is not the applicant, a copy of the summons and of the affidavit shall be served on the company, or, where the company is being wound up on the liquidator not less than 14 days before the date fixed for the hearing of the summons.

Where an arrangement is proposed for the merger or for the amalgamation of two or more companies, the petition must pray for appropriate orders and directions under Section 394 of the Act for facilitating the reconstruction or amalgamation of the company or companies.

### **Obtaining order of the court for holding class meeting(s)**

On receiving a petition, the court may order meeting(s) of the members/creditors to be called, held and conducted in such manner as the court directs. Once the ordered meetings are duly convened, held and

conducted and the scheme is approved by the prescribed majority in value of the members/creditors, the court is bound to sanction the scheme.

The court looks into the fairness of the scheme before ordering a meeting because it would be no use putting before the meeting, a scheme containing illegal proposals which are not capable of being implemented. At that stage, the court may refuse to pass order for the convening of the meeting.

According to Rule 69 of the said Rules, upon hearing of the summons, or any adjourned hearing thereof, the judge shall, unless he thinks fit for any reasons to dismiss the summons, give directions as he may think necessary in respect of the following matters:

- (i) determining the members/creditors whose meeting or meetings have to be held for considering the proposed scheme of merger or amalgamation;
- (ii) fixing time and place for such meetings;
- (iii) appointing a chairman or chairmen for the meetings;
- (iv) fixing quorum and procedure to be followed at the meetings including voting by proxy;
- (v) determining the values of the members/creditors, whose meetings have to be held;
- (vi) notice to be given of the meetings and the advertisement of such notice; and
- (vii) the time within which the chairman of the meeting or chairmen of the meetings are to report to the Court the result of the meeting or meetings as the case may be.

The order made on the summons shall be in Form No. 35 of the said rules, with such variations as may be necessary. Draft Notice, Explanatory statement under Section 393 of the Companies Act, 1956 and form of proxy are required to be filed and settled by the concerned High Court before they can be printed and dispatched to the shareholders.

After obtaining the court's order containing directions to hold meeting(s) of members/creditors, the company should make arrangement for the issue of notice(s) of the meeting(s). The notice should be in Form No. 36 of the said Rules and must be sent by the person authorised by the court in this behalf. The person authorised may be the person appointed by the court as chairman of the meeting, or if the court so directs by the company or its liquidator if the company is in liquidation, or by any other person as the court may direct. The court usually appoints an advocate to be the chairman of such a meeting.

Notice of the meeting should be sent under certificate of posting to the creditors/members of the company, at their last known addresses at least twenty-one clear days before the date fixed for the meeting. The notice must be accompanied by a copy of the scheme for the proposed compromise or arrangement and of the statement required to be furnished under Section 393 setting forth the terms of the proposed compromise or arrangement explaining its effects and an explanatory statement in terms of the provision of clause (a) of Sub-section (1) of Section 393 of the Companies Act.

A form of proxy in Form No. 37, as prescribed in the said rules, is also required to be sent to the shareholders/creditors to enable them to attend the meeting by proxy, if they so desire.

### **Notice by advertisement**

Generally, the Court directs that the notice of meeting of the creditors and members or any class of them be given through newspapers advertisements also. Where the court has directed that the notice of the meetings should also be given by newspaper advertisements, such notices are required to be given in the prescribed

Form and published once in an English newspaper and once in the regional language of the state in which the registered office of the company is situated.

The notice must particularly disclose any material interest of the directors, managing director or manager whether as shareholders or creditors or otherwise and the effect on their interests on the compromise or arrangement, if, and in so far as, it is different from the effect on the like interests of other persons. Such information must also be included in the form of a statement in the notice convening the meeting, where such notice is given by a newspaper advertisement, or, if this is not practicable, such advertised notice must give notification of the place at and the manner in which creditors or members entitled to attend the meeting may obtain copies of such a statement. If debenture holders are affected, the statement must give like information as far as it affects the trustees for the debenture holders. Statements which have to be supplied to creditors and members as a result of press notification must be supplied by the company to those entitled, free of charge. The Chairman appointed by the High Court has to file an affidavit atleast 7 days before the meeting confirming that the direction relating to issue of notices and the advertisement has been duly complied with, as required under Rule 76 of the said Rules.

### **Information as to merger or amalgamation**

Section 393(1) of the Companies Act, 1956 lays down that where a meeting of creditors or members or any class of them is called under Section 391:

- (a) with every notice calling the meeting which is sent to a creditor or a member, there shall be sent also a statement setting forth the terms of the compromise or arrangement and explaining its effects; and in particular, stating any material interests of the directors, managing director or manager of the company, whether in their capacity as such or as members or creditors of the company or otherwise and the effect on those interests, of the compromise or arrangement, if, and in so far as, it is different from the effect on the like interests of other persons; and
- (b) in every notice calling the meeting which is given by advertisement, there shall be included either such a statement as aforesaid or a notification of the place at which and the manner in which creditors or members entitled to attend the meeting may obtain copies of such a statement as aforesaid.

Sub-section (2) lays down that where the arrangement affects the rights of debenture holders of the company, the said statement should give the like information and explanation as respects the trustees of any deed for securing the issue of the debentures as it is required to give as respects the companies directors.

According to Sub-section (3) of Section 393, where a notice given by advertisement includes a notification that copies of the statement setting forth the terms of the compromise or arrangement proposed and explaining its effect can be obtained by creditors or members entitled to attend the meeting, every creditor or member so entitled shall, on making an application in the manner indicated by the notice, be furnished by the company, free of charge, with a copy of the statement.

Every director, managing director or manager of the Company and every trustee for debentureholders of the company, must give notice to the company of such matter relating to himself as may be necessary for the purposes of this section. A failure to do so is an offence punishable under Section 393(5).

### **Holding meeting(s) as per Court's direction**

The meetings are to be held as per directions of the Court under the chairmanship of the person appointed by the Court for the purpose. Normally, the Court appoints a Chairman and alternate Chairman of each meeting.

### Convening of General Meeting

- At the General Meeting convened by the High Court, resolution will be passed approving the scheme of amalgamation with such modification as may be proposed and agreed to at the meeting. The Extraordinary General Meeting of the Company for the purpose of amendment of Object Clause (Section 17), commencement of new business [Section 149(2A)], consequent change in Articles (Section 31) and issue of shares [Section 81(1A)] can be convened on the same day either before or after conclusion of the meeting convened by the High Court for the purpose of approving the amalgamation.
- Following points of difference relating to the holding and conducting of the meeting convened by the High Court may be noted:
  - (a) Proxies are counted for the purpose of quorum;
  - (b) Proxies are allowed to speak;
  - (c) The vote must be put on poll [Rule 77 of the Companies (Court) Rules].

In terms of Section 391, the resolution relating to the approval of amalgamation has to be approved by a majority of members representing three-fourths in value of the creditors or class of creditors or members or class of members as the case may be present and voting either in person or by proxy. The resolution will be passed only if both the criteria namely, majority in number and three fourth in value vote for the resolution.

- The minutes of the meeting should be finalised in consultation with the Chairman of the meeting and should be signed by him once it is finalised and approved. Copies of such minutes are required to be furnished to the Stock Exchange in terms of the listing requirements.

### Reporting of the Results

The chairman of the meeting will submit a report of the meeting indicating the results to the concerned High Court in Form 39 of the Court Rules within 7 days of the conclusion of the meeting or such other time as fixed by the Court. The Report must state accurately—

- (a) the number of creditors or class of creditors or the number of members or class of members, as the case may be, who were present at the meeting;
- (b) the number of creditors or class of creditors or the number of members or class of members, as the case may be, who voted at the meeting either in person or by proxy;
- (c) their individual values; and
- (d) the way they voted.

### Petition to court for confirmation of scheme

When the proposed scheme of compromise or arrangement is agreed to, with or without modifications, as provided in Section 391(2) of the Act, a petition must be made to the court for confirmation of the scheme of compromise or arrangement. The petition must be made by the company and if the company is in liquidation, by the liquidator, within seven days of the filing of the report by the chairman. The petition is required to be made in Form No. 40 of the said rules. On hearing the petition the Court shall fix the date of hearing and shall direct that a notice of the hearing shall be published in the same newspapers in which the notice of the

meeting was advertised or in such other papers as the court may direct, not less than 10 days before the date fixed for hearing. (Rule 80) The court also directs that notices of petition be sent to the concerned Regional Director, Registrar of Companies and the official liquidator.

### **Obtaining order of the court sanctioning the scheme**

An order of the court on summons for directions should be obtained which will be in Form No. 41 (Refer Rule 69).

### **Filing of copy of Court's order with ROC**

According to the provisions of Section 391(3) and Section 394(3) of the Companies Act, a certified copy of the order passed by the Court under both the sub-sections is required to be filed with the concerned Registrar of Companies. This is required to be filed with e-Form No. 21 as prescribed in the Companies (Central Government's) General Rules and Forms, 1956.

### **Conditions precedent and subsequent to court's order sanctioning scheme of arrangement**

The court shall not sanction a scheme of arrangement for amalgamation, merger etc. of a company which is being wound up with any other company or companies unless it has received a report from the Company Law Board (Central Govt. acting through Regional Director) or the Registrar of Companies to the effect that the affairs of the company have not been conducted in a manner prejudicial to public interest. When an order has been passed by the court for dissolution of the transferor company, the transferor company is required to deliver to the Registrar a certified copy of the order for registration within thirty days and the order takes effect from the date on which it is so delivered.

Copies of the order of High Court are required to be affixed to all copies of Memorandum and Articles of Association of the transferee company issued after certified copy has been filed as aforesaid. The transferor company or companies will continue in existence till such time the court passes an order for dissolution without winding up, prior to which it must receive a report from the official liquidator to the effect that the affairs of the company have not been conducted in a manner prejudicial to the interest of the members or to public interest. The practice in India is that in certain High Courts the Order on amalgamation is passed only after the Report of the Official Liquidator is received, whereas in certain cases the order of dissolution is passed after which amalgamation is approved by the concerned High Court.

The above sets out briefly the procedure relating to merger and amalgamation in India. It will be obvious from the foregoing that considerable amount of paper work and documents are required to be prepared during the course of the process of merger. Since the law requires approval of the shareholders both in majority in number and three-fourth in value, it has to be ensured that adequate number of shareholders, whether in person or by proxy attend the meeting so that the resolution can be passed by the requisite majority as mentioned above. Normally the time frame for such merger will depend on the opposition, if any, to the proposed merger from shareholders or creditors but in normal case it may take anything between six months to one year to complete the merger from the time the Board approves the scheme of amalgamation till the merger becomes effective on filing of the certified copies of the Court's Order.

## **JUDICIAL PRONOUNCEMENTS**

### **Broad Principles evolved by Courts in Sanctioning the Scheme**

- (a) The resolutions should be passed by the statutory majority in accordance with Section 391(2) of Companies Act, at a meeting(s) duly convened and held. The court should not usurp the right of the members or creditors;

- (b) Those who took part in the meetings are fair representative of the class and the meetings should not coerce the minority in order to promote the adverse interest of those of the class whom they purport to represent;
- (c) the scheme as a whole, having regard to the general conditions and background and object of the scheme, is a reasonable one ; it is not for court to interfere with the collective wisdom of the shareholders of the company. If the scheme as a whole is fair and reasonable, it is the duty of the court not to launch an investigation upon the commercial merits or demerits of the scheme which is the function of those who are interested in the arrangement;
- (d) There is no lack of good faith on the part of the majority;
- (e) The scheme is not contrary to public interest;
- (f) The scheme should not be a device to evade law.

In *Miheer H Mafatlal v. Mafatlal Industries Ltd.* (1996) 4 Comp. LJP. 124, The Supreme Court explained the contours of the court jurisdictions, as follows:

- (i) The sanctioning court has to see to it that all the requisite statutory procedures for supporting such a scheme have been complied with and that the requisite meetings as contemplated by Section 391(1)(a) of the Companies Act, 1956 have been held.
- (ii) That the scheme put up for sanction of the court is backed up by the requisite majority vote as required by Section 391(2) of the Act.
- (iii) That the concerned meetings of the creditors or members or any class of them had the relevant material to enable the voters to arrive at an informed decision for approving the scheme in question. That the majority decision of the concerned class of voters is just and fair to the class as a whole so as to legitimately bind even the dissenting members of that class.
- (iv) That all the necessary material indicated by the Section 393(1)(a) of the Act is placed before the voters at the concerned meetings as contemplated by Section 391(1) of the Act.
- (v) That all the requisite material contemplated by the proviso of Sub-section (2) of Section 391 of the Act is placed before the court by the concerned applicant seeking sanction for such a scheme and the court gets satisfied about the same.
- (vi) That the proposed scheme of compromise and arrangement is not found to be violative of any provision of law and is not contrary to public policy. For ascertaining the real purpose underlying the scheme with a view to be satisfied on this aspect, the court, if necessary, can pierce the veil of apparent corporate purpose underlying the scheme and can judiciously x-ray the same.
- (vii) That the Company Court has also to satisfy itself that members or class of members or creditors or class of creditors, as the case may be, were acting bona fide and in good faith and were not coercing the minority in order to promote any interest adverse to that of the latter comprising of the same class whom they purported to represent.
- (viii) That the scheme as a whole is also found to be just, fair and reasonable from the point of view of prudent men of business taking a commercial decision beneficial to the class represented by them for whom the scheme is meant.
- (ix) Once the aforesaid broad parameters about the requirements of a scheme for getting sanction of court are found to have been met, the court will have no further jurisdiction to sit in appeal over the commercial wisdom of the majority of the class of persons who with their open eyes have given their

approval to the scheme even if in the view of the court, there could be a better scheme for the company and its members or creditors for whom the scheme is framed. The court cannot refuse to sanction such a scheme on that ground as it would otherwise amount to the court exercising appellate jurisdiction over the scheme rather than its supervisory jurisdiction.

#### *Judicial Interpretations of Mergers and Amalgamations*

- Court will sanction the scheme if alteration of the memorandum is by reshuffling of the Objects Clause by shifting Other Objects to Main Objects, if transferee company has complied with provisions of Section 149(2A) [*Re: Rangkala Investments Ltd. (1996) 1 Comp LJ 298 (Guj)*].
- There need not be unison or identity between objects of transferor company and transferee company. Companies carrying entirely dis-similar businesses can amalgamate. [*Re: PMP Auto Inds Ltd. (1994) 80 Comp Cas 291 (Bom)*; *Re: EITA India Ltd. (ibid)*; *Re: Mcleod Russel (India) Ltd. (1997) 13 SCL 126(Cal)*].
- Scheme of amalgamation should provide that on amalgamation the main objects of the transferor company shall be deemed to be (additional) main objects of the transferee company. No need for compliance under Section 17 of the Companies Act [*Vasant Investment Corporation Ltd. v. Official Liquidator (1981) 51 Comp Cas 20 (Bom)*].
- Sanction to scheme of amalgamation cannot be refused on the ground that the transferee company does not have sufficient authorised capital on the appointed date. If the scheme is sanctioned, the transferee company can thereafter increase its authorised capital to give effect to the scheme [*Re: Mahavir Weaves Pvt. Ltd. (1985) 83 Comp. Cas 180*].
- The Supreme Court of India in *Meghal Homes Private Limited v. Shreeniwas Girmikk Samiti and others* (2007) 78 SCL 482 (SC) held that the company court could sanction a scheme even in the case of a company where an order of winding-up has been made and a liquidator has been appointed. The essential factors to be seen by the Court are whether the scheme is bonafide and whether there is a genuine attempt to revive the company and such attempt is in public interest.
- Where amalgamation involves reorganisation of capital by reduction thereof, the provisions of Sections 100 to 102 of Companies Act need to be complied with vide rule 85 of Companies (Court) Rules. However, it has been held that, if reduction of capital is a part of scheme of amalgamation, those provisions are substantially complied with when the scheme is approved by shareholders and court. Therefore, no separate compliance is necessary. [*Re: Maneckchowk and Ahmedabad Mfg. Co. Ltd. (1970) 40 Comp Cas 819 (Guj)*; *Re: Asian Investments Ltd. (1992) 73 Comp Cas 517 (Mad)*; *Re: Novopan India Ltd. (1997) 88 Comp Cas 596 (AP)*].
- Post amalgamation events such as increase of capital or total number of members exceeding fifty (in case of a private company) cannot affect sanction of a scheme. [*Re: Winfield Agro Services Pvt. Ltd. (1996) 3-Comp LJ 347 (AP)*].
- In view of its wide powers, court may approve a change in the name of the transferee company as part of scheme of amalgamation. However, Mumbai High Court has held that change of name cannot be effected merely on amalgamation becoming effective; transferee company should independently comply with Section 21. [*Re: Govind Rubber Ltd. (1995) 83 Comp Cas 556 (Bom)*].
- Change of name of transferee company, independent of amalgamation after approval of the scheme is not invalid; hence no change in appointed date needed. [*Re: Hipolin Products Ltd. (1996) 2 Comp LJ 61 (Guj)*].



The Bombay High Court has held in *Sadanand S. Varde v. State of Maharashtra* [(2001) 30 SCL 268 (Bom.)] that Sections 391 to 394 of the Companies Act constitutes a complete code on the subject of amalgamation. The court has no special jurisdiction under Article 226 of the Constitution to sit in appeal over an order made under Section 391 of the Companies Act, 1956 which has become final, binding and conclusive. Ministry of Industry need not be impleaded or heard, on the ground that its approval for the transfer of letter of intent to the transferee company is required. [*Re: Ucal Fuel Systems Ltd. (supra)*].

Also in *PMP Auto Industries Ltd., S.S. Mirando Ltd. and Morarjee Goculdas Spg & Wvg Co. Ltd.*, (1994) 80 Comp Cases 289 (Bom) it has been held that not only is Section 391 a complete code (as is the view of various High Courts), it is intended to be in the nature of 'single window clearance' system to ensure that the parties are not put to avoidable, unnecessary and cumbersome procedure of making repeated applications to the court for various other alterations or changes which might be needed effectively to implement the sanctioned scheme whose overall fairness and feasibility has been judged by the court under Section 394.

There is a statutory power of amalgamation under the Act even if the objects of the company are construed as not specifically empowering companies to amalgamate [*Aimco Pesticides Ltd. (2001) 103 Comp Cas 4163 (Bom)*].

- No special notice need be given to Income Tax Dept. to find out whether there is a motive of tax evasion in the proposed amalgamation; general public notice in newspapers is sufficient. [*Re: Vinay Metal Printers Pvt. Ltd. (1996) 87 Comp Cas 266 (AP)*].
- The compromise or arrangement should be within the powers of the company and not ultra vires. If it is beyond the company's objects or power, the court will have no jurisdiction to sanction it. [*Oceanic Steam Navigation Co., Re, (1939) Com Cases 229: (1938) 3 All ER 740 (Ch.D)*]
- It is not necessary that the parties to the amalgamation need be financially unsound or under winding-up as per Section 390(a). For purposes of Section 391 'company' means "any company liable to be wound up". But it does not debar amalgamation of financially sound companies. [*Re: Rossell Inds Ltd. (1995) 6 SCL 79 Cal*].
- Section 390(a) is applicable to a company incorporated outside India. If court has jurisdiction to wind up such a company on any of the grounds specified in the Act, court has jurisdiction to sanction scheme of amalgamation if a company incorporated outside India is a transferor company. [*Bombay Gas Co. Pvt. Ltd. v. Regional Director (1996) 21 CLA 269 (Bom)*].
- There is no bar to a company amalgamating with a fifteen-day old company having no assets and business. [*Re: Apco Industries Ltd. (1996) 86 Comp Cas 457 (Guj)*].
- Amalgamation of a company licensed under Section 25 of the Companies Act with a commercial, trading or manufacturing company could be sanctioned under Section 391/394. [*Re: Sir Mathurdas Vissanji Foundation (1992) 8 CLA 170 (Bom)*; *Re: Walvis Flour Mills Company P. Ltd. (1996) 23 CLA 104*]. There is nothing in law to prevent a company carrying on business in shares from amalgamating with one engaged in transport. [*Re: EITA India Ltd. (1997) 24 CLA 37 (Cal)*].

In *Vishnu Chemicals (P) Limited, In Re* [2002] 35 SCL 459 (AP), the Andhra Pradesh High Court held that when a class of creditors does not agree to the proposed scheme of arrangement it is the duty of the court to examine whether the consent is unreasonably withheld or in the alternative if the sanction would prejudicially affect that set of creditors who have withheld their consent.

A scheme is a document of an arrangement of settlement or agreement which can be interpreted on the personal perception of each group or members of group of creditors, so it will not be legal to say at the

preliminary stage, before the scheme comes up for the court's consideration after examination by the creditors and members, to go into the details of allegations made against the company or any of the transactions into which it had entered with the scheme till the preliminary formalities are completed and the scheme comes up for detailed consideration in the court. – *Commerz Bank AG v. Arvind Mills Ltd.* (2002) 49 CLA 392: (2002) CLC 1136: (2002) 39 SCL 9 (Guj).

Where the written consent to the proposed scheme is granted by all the members and secured and unsecured creditors, separate meeting of members and secured and unsecured creditors can be dispensed with. – *Re Feedback Reach Consultancy Services (P) Ltd.* (2003) 52 CLA 260: (2003) CLC 498: (2003) 42 SCL 82: (2003) 115 Comp Cas 897 (Del).

In *Milind Holdings (P) Ltd. & Darshan Holdings (P) Ltd. v. Mihir Engineers Ltd.* (1996) 7 SCL 172 (Bom), it was held that the sanction of the court is necessary even where the petitioner company had no secured creditor and all unsecured creditors had accorded their approval to the proposed scheme along with the shareholders of both the companies and their official liquidator also did not raise any objections to the scheme

As per section 391(2), any compromise or arrangement approved by a majority of creditors will be binding on all the creditors only if the said compromise or arrangement is sanctioned by the Court. Till the time sanction is not granted by the Court to the scheme of arrangement, it cannot be said that the scheme is binding on all creditors or that the creditors are not entitled to file the individual application. *Smt. Promila v. DCM Financial Services Ltd.* (2001) 45 CLA 292 (Del.)

When the majority of the shareholders with their open eyes have given their approval to the scheme, even if in the view of the Court there would be a better scheme, for the company and its members, the Court cannot refuse to sanction such a scheme on that ground as it would otherwise amount to the Court exercising appellate jurisdiction over the scheme rather than its supervisory jurisdiction. – *Alembic Ltd. v. Dipak Kumar J. Shah* (2003) 41 SCL 145: (2003) 52 CLA 272: (2002) 6 Comp LJ 513 (Guj).

In *National Organic Chemical Industries Limited v. Miheer H. Mafatlal* [JT 2004 (5) SC 612] / [2004] XXXIV CS LW 83, the question before Supreme Court was whether the company court can decide the issue of shareholding of a member when the issue was pending before a civil court. The Supreme Court held that there was no statutory need for the company court to decide this issue and the findings of the company court of the title of the appellant over the shares or beyond the jurisdiction of the company and on that ground the Supreme Court set aside the said findings.

The full bench of Punjab and Haryana High Court in *Hind Lever Chemicals Limited In Re* [2004] 61 CLA 32 (P&H)/[2004] XXXIV CS LW 85, held that the words and phrases employed in Sub-section (2) of Section 391 clearly shows that the requirement of three-fourth majority relates to the value of shares/credit represented by the shareholders or creditors who are present and voting and not of the total value of shares or credit of the company.

In *TCI Industries Limited In Re* [2004] 118 Comp Cas 373 (AP), the scheme was approved by the majority of the shareholders. The ROC representing the Central Government raised an objection that the purpose of the scheme is to buy shares and as such the company ought to have followed the provisions of Section 77A. The court held that Section 77A is merely an enabling provision and the court's powers under Section 391 is not in any way affected. Similarly, the conditions for a buy back under Section 77A cannot be applied to a scheme under Sections 100 to 104 and Section 391. The two provisions operate in independent fields.

In *Larsen & Toubro Limited In re* [2004] 60 CLA 335 (Bom) [2004] XXXIV CS LW 72 the Mumbai High Court

held that a composite scheme could be made involving de-merger, of one of the undertakings of the transferor company, for the transfer of the demerged undertaking of a subsidiary company and for the reduction in the capital of the transferor-company.

In *Jaypee Cement Limited v. Jayprakash Industries Limited* [2004] 2 Comp LJ 105 (All) / [2004] XXXIV CS LW 50 the Allahabad High Court held that the combining of the authorised share capital of the transferor company with that of the transferee company resulting in increase in the authorised share capital of the transferee company does not require the payment of registration fee or the stamp duty because there is no reason why the same fee should be paid again by the transferee company on the same authorised capital.

In *SEBI/Union of India v. Sterlite Industries (India) Limited* [2002] 113 Comp Cas 273 (Bom), the division bench of the Bombay High Court held that the word arrangement is of a wider import and is not restricted to a compulsory purchase or acquisition of shares. There is no reason as to why a cancellation of shares and the consequent reduction of capital cannot be covered by Section 391 read with Section 100 merely because a shareholder is given an option to cancel or to retain his shares. In view of the foregoing discussion, the objection of the appellants based on Section 77A must be rejected.

## FILING OF VARIOUS FORMS IN THE PROCESS OF MERGER/ AMALGAMATION

The following forms, reports, returns etc. are required to be filed with the Registrar of Companies, SEBI and Stock Exchanges at various stages of the process of merger/amalgamation:

1. (a) when the objects clause of the memorandum of association of the transferee company is altered to provide for amalgamation/merger, for which special resolution under Section 17 of the Companies Act, 1956, is passed;
  - (b) the company's authorised share capital is increased to enable the company to issue shares to the shareholders of the transferor company in exchange for the shares held by them in that company for which a special resolution under Section 31 of the Act for alteration of its articles is passed;
  - (c) a special resolution under Section 81(1A) of the Act is passed to authorise the company's Board of directors to issue shares to the shareholders of the transferor company in exchange for the shares held by them in that company; and
  - (d) a special resolution is passed under Section 149(2A) of the Act authorising the transferee company to commence the business of the transferor company or companies as soon as the amalgamation/merger becomes effective; the company should file with ROC within thirty days of passing of the aforementioned special resolutions, e-Form No. 23. The following documents should be annexed to the said e-form: (i) certified true copies of all the special resolutions; (ii) certified true copy of the explanatory statement annexed to the notice for the general meeting at which the resolutions are passed, for registration of the resolution under Section 192 of the Act. This e-form should be digitally signed by Managing Director/Director/Manager or Secretary of the Company duly authorized by Board of Directors. This e-form should also be certified by Company Secretary or Chartered Accountant or Cost Accountant (in whole time practice) by digitally signing the e-form.
2. When a special resolution is passed under Section 149(2A) of the Act, authorising the transferee company to commence the business of the transferor company or companies as soon as the amalgamation/merger becomes effective, the transferee company should also file with the Registrar

of Companies, a duly verified declaration of compliance with the provisions of Section 149(2A) by one of the directors or the secretary or, where the company has not appointed a secretary, a secretary in whole-time practice in e-Form No. 20A. The original duly filled in and signed e-form 20A on stamp paper, of the value applicable in the State where declaration is executed, is also required to be sent to the concerned ROC office simultaneously, failing which the filing will not be considered and legal action will be taken.

3. In compliance with the listing agreement, the transferee company is required to give notice to the stock exchanges where the securities of the company are listed, and to the Securities and exchange Board of India (SEBI), of the Board meeting called for the purpose of discussing and approving amalgamation.
4. In compliance with the listing agreement, the transferee company is required to give intimation to the stock exchanges where the securities of the company are listed, of the decision of the Board approving amalgamation and also the swap ratio, before such information is given to the shareholders and the media.
5. The transferee company is required to file with the Registrar of Companies, e-Form No. 21 along with a certified copy of the High Court's order on summons directing the convening and holding of meetings of equity shareholders/creditors including debentures holders etc. as required under Section 391(3) of the Companies Act. This e-form should be digitally signed by the Managing Director or Director or Manager or Secretary of the Company duly authorized by the Board of Directors. However, in case of foreign company, the e-form should be digitally signed by an authorized representative of the company duly authorized by the Board of Directors.

The original certified copy of the Courts order is also required to be submitted at the concerned ROC office simultaneously of filing e-form 21, failing which the filing will not be considered and legal action will be taken.

6. In compliance with the listing agreement, the transferee company is required to simultaneously furnish to the stock exchanges where the securities of the company are listed, copy of every notice, statement, pamphlet etc. sent to members of the company in respect of a general meeting in which the scheme of arrangement of merger/amalgamation is to be approved.
7. In compliance with the listing agreement, the transferee company is required to furnish to the stock exchanges where the securities of the company are listed, minutes of proceedings of the general meeting in which the scheme of arrangement of merger/amalgamation is approved.
8. To file with ROC within thirty days of passing of the special resolution, e-Form No. 23. The following documents should be annexed to the said e-form: (i) certified true copy of the special resolution approving the scheme of arrangement of merger/amalgamation; (ii) certified true copy of the explanatory statement annexed to the notice for the general meeting at which the resolution is passed, for registration of the resolution under Section 192 of the Act. This e-form should be digitally signed by Managing Director/ Director/Manager or Secretary of the Company duly authorized by Board of Directors. The e-form should also be certified by Company Secretary or Chartered Accountant or Cost Accountant (in whole time practice) by digitally signing the e-form.
9. The transferee company is required to file with the Central Government notice of every application made to the court under Section 391 to 394 of the Companies Act, 1956. No notice need be given to the Central Government once again when the Court proceeds to pass final order to dissolve the transferor company.

10. To file with the Registrar of Companies within thirty days of allotment of shares to the shareholders of the transferor company in lieu of the shares held by them in that company in accordance with the shares exchange ratio incorporated in the scheme of arrangement for merger/amalgamation, e-Form No. 2 the return of allotment along with the prescribed filing fee as per requirements of Sections 75 of the Act. This e-form should be digitally signed by Managing Director or Director or Manager or Secretary of the Company duly authorised by the Board of Directors. The e-form should also be certified by Company Secretary or Chartered Accountant or Company Secretary (in whole time practice) by digitally signing the e-form.

### LESSON ROUND UP

- Amalgamation is a legal process by which two or more companies are joined together to form a new entity.
- Merger and amalgamation have various advantages e.g. synergy, economies of scale, reduction in production and other expenses, tax advantages, competitive advantage etc.
- While implementing the strategic decision of merger/amalgamation, the transferor/transferee company has to comply with a number of regulations viz., the Companies Act, 1956, Companies(Court) Rules, 1959, Income Tax Act, 1961, Listing Agreement, The Indian Stamp Act, 1899, The Competition Act, 2002 etc.,
- Section 391 is relating to the power of the company to compromise or to make arrangement with its creditors and members.
- Section 393 deals with regard to information as to compromises and arrangements with creditors and members.
- Section 394 deals with facilitation of reconstruction and amalgamation of companies.
- Section 394A deals with a notice to be given to the Central Government in respect of applications under Section 391 and 394.
- Section 395 deals with provisions regarding the power and duty to acquire shares of shareholders dissenting from scheme or contract approved by majority shareholders.
- Section 396 contains provisions as to the power of the central government to provide for amalgamation of companies in national interest.
- Rules 67-87 contains provisions dealing with the procedure for carrying out a scheme of compromise or arrangement including amalgamation or reconstruction.
- Mergers involves approvals from Board of Directors, Shareholders, Court, Stock Exchanges etc.,
- Mergers involves filing of various forms with different regulators.

### SELF TEST QUESTIONS

*(These are meant for recapitulation only. Answers to these questions are not required to be submitted for evaluation).*

1. Briefly describe the legal framework for mergers?
2. What are the approvals required in merger?
3. What are the procedural steps involved in a merger?
4. Discuss the role of courts in approving a scheme of reconstruction or restructuring under Sections 391–394 of the Companies Act, 1956 based on decided cases from the standpoint of shareholders and employees.

5. ABC & Co (P) Ltd. and XYZ Ltd. have finalized a scheme of arrangement. The registered offices of both the companies are located in Delhi. A joint-petition is proposed to be filed before the High Court for sanction of the scheme.

Give your brief opinion in the light of the provisions of the Companies Act, 1956 and the Companies (Court) Rules, 1959 whether such a joint-petition can be filed.

6. Discuss the law as laid down by the Supreme Court in *Miheer H. Mafatlal v. Mafatlal Industries Ltd.* with regard to the role of the court in sanctioning scheme of arrangement under Section 391 of the Companies Act, 1956.

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# Lesson 3

## ECONOMIC AND COMPETITION LAW

### ASPECTS OF MERGERS AND AMALGAMATIONS

#### LESSON OUTLINE

- Reason for mergers and amalgamations
- Underlying economic objectives in mergers
- Competition aspects of combinations
- Combination thresholds
- Regulation of combinations
- Compulsory wait period
- Exemptions
- Inquiry into combination by the Commission

#### LEARNING OBJECTIVES

As the countries are getting integrated into one global platform, the businesses across the jurisdictions are also competing on the flat platform, providing multiple choices to consumers and calling for highest quality of output supported by innovation and technology. The paradigm requires the corporates to possess multiple expertise, through business restructuring. Mergers, acquisitions and takeovers are widely accepted business strategies in the global platform. The economic reasons behind such strategies may be increased market share, cost reduction, managing competition, financial/tax benefits, increased economies of scale etc.,

Further the competition law being an economic legislation regulates merger(called combinations) deals with threshold limits (domestic/cross border), notice to Competition Commission of India etc.

After reading this lesson, you will be able to understand, the economic aspects of merger and the important regulatory aspects of combinations as specified in the Competition Act, 2002.

## ECONOMIC ASPECTS

### Reasons for Merger and Amalgamation

Mergers must form part of the business and corporate strategies aimed at creating sustainable competitive advantage for the company. Mergers and amalgamations are important strategic decisions leading to the maximisation of a company's growth.

Mergers and amalgamations are usually intended to achieve any or all of the following purposes:

- (1) Synergistic operational advantages – Coming together to produce a new or enhanced effect compared to separate effects.
- (2) Economies of scale (scale effect) – Reduction in the average cost of production and hence in the unit costs when output is increased, to enable to offer products at more competitive prices and thus to capture a larger market share.
- (3) Reduction in production, administrative, selling, legal and professional expenses.
- (4) Benefits of integration – Combining two or more companies under the same control for their mutual benefit by reducing competition, saving costs by reducing overheads, capturing a larger market share, pooling technical or financial resources, cooperating on research and development, etc. Integration may be horizontal (or lateral) or vertical and the later may be backward integration or forward integration.
- (5) Optimum use of capacities and factors of production.
- (6) Tax advantages – Carry forward and set off of losses of a loss-making amalgamating company against profits of a profit-making amalgamated company, e.g. Section 72A of the Income-Tax Act, 1961.
- (7) Financial constraints for expansion – A company which has the capacity to expand but cannot do so due to financial constraints may opt for merging into another company which can provide funds for expansion.
- (8) Strengthening financial position.
- (9) Diversification.
- (10) Advantage of brand-equity.
- (11) Loss of objectives with which several companies were set up as independent entities.
- (12) Survival.
- (13) Competitive advantage: The factors that give a company an advantage over its rivals.
- (14) Eliminating or weakening competition.
- (15) Revival of a weak or sick company.
- (16) Sustaining growth.
- (17) Accelerating company's market power and reducing the severity of competition.



## Underlying Objectives In Mergers

Major objectives and their benefits are given below:

### ***Market Leadership***

The amalgamation can enhance value for shareholders of both companies through the amalgamated entity's access to greater number of market resources. With the addition to market share, a company can afford to control the price in a better manner with a consequent increase in profitability. The bargaining power of the firm vis-a-vis labour, suppliers and buyers is also enhanced. In the case of the amalgamation of Reliance Petroleum Limited with Reliance Industries Limited, the main consideration had been that the amalgamation will contribute towards strengthening Reliance's existing market leadership in all its major products. It was foreseen that the amalgamated entity will be a major player in the energy and petrochemical sector, bringing together Reliance's leading positions in different product categories.

### ***Improving Economies of Scale***

One of the most frequent reasons for merger is to improve the economies of scale. Economies of scale may be obtained when increase in volume of production leads to a reduction in cost of production per unit. They are generally associated with the manufacturing operations, so that the ratio of output to input improves with the volume of operations. Mergers and amalgamations help to expand the volume of production without a corresponding increase in fixed costs. Thus, the fixed costs are distributed over a large volume causing the unit cost of production to decline. Economies of scale may also be obtained from the optimum utilisation of resources and planning, budgeting, reporting and control. A combined business with a large size can make the optimum use of the management resources and systems resulting in economies of scale. This gives the company a competitive advantage by gaining an ability to reduce the prices to increase market share, or earn higher profits while maintaining a price.

### ***Operating Economics***

Apart from economies of scale, a combination of two or more companies may result in reduction of costs due to operating economies. A combined company may avoid overlapping of functions and facilities. Various functions may be consolidated and duplicate channels may be eliminated by implementing an integrated planning and control system.

### ***Financial Benefits***

A merger or amalgamation is capable of offering various financial synergies and benefits such as eliminating financial constraints, deployment of surplus cash, enhancing debt capacity and lowering the costs of financing. Mergers and amalgamations enable external growth by exchange of shares, releasing thereby the financial constraint. Also, sometimes cash rich companies may not have enough internal opportunities to invest surplus cash. Their wealth may increase through an increase in the market value of their shares if surplus cash is used to acquire another company. A merger can bring stability of cash flows of the combined company, enhance the capacity of the new entity to service a larger amount of debt, allowing a higher interest tax shield thereby adding to the shareholders wealth. Also, in a merger since the probability of insolvency is reduced due to financial stability, the merged company may borrow at a lower rate of interest. Apart from this, a merged company is able to realize economies of scale in floatation and transaction costs related to an issue of capital i.e. issue costs are saved when the merged company makes a larger security issue.

### ***Acquiring a New Product or Brand Name***

Acquiring a new product is different from acquiring a brand name. A company may be able to build a brand name for a particular line of business. In a related field, the company might think of introducing another

product so that reputation and goodwill associated with a brand name of the company could be advantageously exploited. In this situation, the company would be either installing a manufacturing facility for the new product or looking for a good party in the market with a reasonable market share. If the company acquires its manufacturing facility, the company can save a lot of time and energy in creating a new industry. The combination of the ability of the company to takeover the manufacturing facility and build the said product with the company's brand name develops a great market for the company.

On the one hand, the company has bought a competitor because the party from whom the company had bought the unit would have given up the said line of business. Another advantage is that the company with its definite name and reputation and with plenty of money would be able to establish a strong presence for its new product and create a higher market share. At the same time, there could be a case, where the company has a production facility but its market share for the said product is abysmally low. In spite of its best efforts the product may not receive encouraging response from customers or consumers. In such a situation the company, for strategic reasons, may wish to acquire a brand name by buying out the entire market share of another party who may be having strong presence for the said product.

This acquisition can happen in certain circumstances only. An aggressive player in the market will be always on the look out for such possibilities and cash in when opportunity strikes. Thus through amalgamation, it is possible to acquire either the entire production facility including human resources or a new brand for an existing product or range of products. However, in acquisition of a facility, the difficulties of getting the required know-how from reliable sources, installing and commissioning a plant and then launching the new product which may take a lot of time and result in heavy cost, could be avoided. Amalgamation in such cases would make available ready-made facilities, which would provide a quicker entry for encashing the comparative advantage of the new product before new entrants make the market much more competitive and much less profitable.

### ***Diversifying the Portfolio***

Another reason for merger is to diversify the company's dependence on a number of segments of the economy. Diversification implies growth through the combination in unrelated businesses. All businesses go through cycles and if the fortunes of a company were linked to only one or a few products then in the decline stage of their product life cycles, the company would find it difficult to sustain itself. The company therefore looks for either related or unrelated diversifications, and may decide to do so not internally by setting up new projects, but externally by merging with companies of the desired product profile. Such diversification helps to widen the growth opportunities for the company and smoothen the ups and downs of their life cycles.

### ***Strategic integration***

Considering the complementary nature of the businesses of the concerned companies, in terms of their commercial strengths, geographic profiles and site integration, the amalgamated entity may be able to conduct operations in the most cost effective and efficient manner. The amalgamation can also enable optimal utilization of various infrastructural and manufacturing assets, including utilities and other site facilities.

### ***Synergies***

Synergy refers to a situation where the combined entity is more valuable than the sum of individual combining firms ( $2+2=5$ ). The combination of operations can create a unique level of integration for the amalgamated entity spanning the entire value chain in the line of business. This enables the amalgamated entity to achieve substantial savings on costs and significantly enhancing its earnings potential.

Synergies can be expected to flow from more focused operational efforts, rationalization, standardization and simplification of business processes, productivity improvements, improved procurement, and the elimination of duplication. The main criteria for synergy lies in the ability of an organization to leverage on resources to deliver more than its optimum levels. By combining the strengths of two complementary organizations, not only one could achieve synergy but also eliminate the disadvantages each had. One of the most important reasons for mergers and amalgamations is to realize synergy; either through cost effective production bases or by cost savings and pooling of resources in R&D marketing and distribution.

### ***Taxation or Investment Incentives***

A company, which has incurred losses in the past, can carry forward such losses and offset them against future taxable profits and reduce tax liabilities. Such a company when merged with a company with large taxable profits would help to absorb the tax liability of the later.

A similar advantage exists when a company is modernizing or investing heavily in plant and machinery, which entitles it to substantial investment incentives, but has not much taxable profits to offset them with. Acquiring or merging such a company with a highly profitable company would help make full use of the investment incentives for the later.

### ***Survey findings***

In the early seventies, the Organization for Economic Cooperation and Development (OECD) published a Report of their Committee of Experts on Restrictive Business Practices, on 'Mergers and Competition Policy'. The report listed twelve motives most often cited for mergers, which may be grouped together under the following categories:

<i>Category</i>	<i>Motives</i>
A. Economies of Scale	1 Obtain Real Economies of Scale
	2 Acquire Capacity at Reduced Prices
B. Market share	3 Increase market power
	4 Expand production without price reduction
	5 Build an empire
	6 Rationalize production
C. Financial Synergy	7 Obtain Tax advantages
	8 Obtain monetary economies of scale
	9 Use complementary resources
	10 Gain promotional profits
D. Diversification of Risk	11 Spread risks by diversification
	12 Avoid firm's failure

### ***Limiting Competition***

It would be wrong to conclude that mergers limit or restrict competition from the consumers' point of view. In mergers business enterprises achieve what could be termed as a buy out of the competition's market shares or stake. The purpose of such acquisition could be to consolidate or to eliminate the competition posed by the acquired enterprise. It does not mean new competitive forces cannot emerge or survive. It is only natural for business enterprises and the people who drive such enterprises to look at opportunities for acquiring more and more market stake. Mergers therefore are tools in the hands of the entrepreneurial community to keep a watch on the competition and take appropriate action.

### **Acquisition and Mergers were identified as one of the key factor to overcome economic recession**

2008 was a traumatic year for the global economy. A decade of global economic growth had come to a sudden, grinding halt. However, there has been improvement in the global economy since the last review in July 2009.

New Zealand Trade & Enterprise has conducted a research on corporates during world economic recession as to how they adopt strategies to survive during the recession and to succeed subsequently. This research focused primarily on 13 companies that were established members of the Global Fortune 500 index. They were the examples of organisations that have adapted, survived, and prospered during recessionary periods. All of the companies studied achieved dramatic increases in growth and profitability during the period of economic downturn or in the following recovery period. These companies were chosen because they exhibit characteristics and strategies that enabled them to achieve success from difficult economic periods. The study has identified seven key factors to have greatest impact on firms' ability to emerge strongly from recessionary periods. Among other key factors, they have identified acquisitions and strategic alliances as a key factor to overcome economic recession to strengthen, re-focus, and position the company for increased growth and profitability. The study identified that companies also made acquisitions to access new markets, products, technologies, customers and talent at an accelerated pace.

### **COMPETITION ASPECTS OF COMBINATIONS**

Antitrust law seeks to make enterprises compete fairly. It has had a serious effect on business practices and the organization of U.S. industry. Premised on the belief that free trade benefits the economy, businesses, and consumers alike, the law forbids several types of restraints of trade and monopolization. These cover areas such as agreements between or among competitors, contractual arrangements between sellers and buyers, the pursuit or maintenance of monopoly power, and mergers.

The Sherman Anti-Trust Act of 1906 is the origin of Anti-trust/Competition Law in many countries. This legislation was the result of intense public opposition to the concentration of economic power in large corporations and in combinations of business concerns that had been taking place in the U.S. in the decades following the Civil War.

The Sherman Antitrust Act was the first measure enacted by the U.S. Congress. The Sherman Antitrust Act, was based on the constitutional power of Congress to regulate interstate commerce. In 1914, US Congress passed two measures that provided additional support for the Sherman Antitrust Act. One was the Clayton Antitrust Act, which elaborated on the general provisions of the Sherman Act and specified a number of illegal practices that either contributed to or resulted from monopolization. It explicitly outlawed commercial practices such as price discrimination (i.e., charging different prices to different customers), the buying out of competitors and interlocking boards of directors. The other was the establishment of the Federal Trade Commission, an agency with the power to investigate possible violations of antitrust laws and to issue orders forbidding unfair competitive practices. Gradually, competition law came to be recognized as one of the key pillars of a market economy. This recognition led to enactment of competition law in many countries including developing countries.

### **COMPETITION ACT, 2002**

Based on the recommendations of the Raghavan Committee, the Competition Bill, 2000 was introduced in Parliament which was later enacted as the Competition Act, 2002.

## Preamble

An Act to provide for, keeping in view of the economic development of the country, the establishment of a Commission to prevent practices having adverse effect on competition, to promote and sustain competition in markets, to protect the interest of consumers and to ensure freedom of trade carried on by other participants in market, in India, and for matters connected therewith or incidental thereto.

## Combination under Competition Act, 2002

Combination means acquisition of control, shares, voting rights or assets, acquisition of control by a person over an enterprise where such person has control over another enterprise engaged in competing business, and mergers and amalgamations between or amongst enterprises when the combining parties exceed the thresholds set in the Act. The thresholds are unambiguously specified in the Act in terms of assets or turnover in India and abroad. Entering into a combination which causes or is likely to cause an appreciable adverse effect on competition within the relevant market in India is prohibited and such combination would be void.

### Sections 5 and 6 came into force on 1 June 2011

The Ministry of Corporate Affairs has notified the date of 4 March, for effecting sections 5, 6, 20, 29, 30 and 31 of Competition Act. The CCI (Procedure in regard to the transaction of business relating to combination) Regulations, 2011.

### Combinations – Thresholds

The current thresholds for the combined assets/turnover of the combining parties are as follows:

- Individual: Either the combined assets of the enterprises are more than Rs. 1,500 crore in India or the combined turnover of the enterprise is more than Rs. 4,500 crore in India. In case either or both of the enterprises have assets/turnover outside India also, then the combined assets of the enterprises are more than US\$750 crore in India, or turnover is more than US\$ 2,250 million, including at least Rs. 2,250 crore in India.
- Group: The group to which the enterprise whose control, shares assets or voting rights are being acquired would belong after the acquisition or the group to which the enterprise remaining the merger or amalgamation would belong has either Rs. 6,000 crore in India or turnover more than Rs. 18,000 crore in India. Where the group has presence in India as well as outside India then the group has assets more than US\$3 billion including at least Rs. 750 crore in India or turnover more than US \$9 billion including at least Rs. 2,250 crore in India.
- The term Group has been explained in the Act. Two enterprises belong to a “Group” if one is in position to exercise at least 26 percent voting rights or appoint at least 50 per cent of the directors or controls the management or affairs in the other. Vide notification S.O. 481(E) dated 4 March, 2011, the government has exempted “Group” exercising less than fifty per cent of voting rights in other enterprise from the provisions of section 5 of the Act for a period of five years.
- In exercise of the powers conferred by clause (a) of section 54 of the Competition Act, 2002 (12 of 2003), the Central Government, in public interest, hereby exempts an enterprise, whose control, shares, voting rights or assets are being acquired has either assets of the value of not more than Rs. 250 crore in India or turnover of not more than Rs.750 crore in India from the provisions of section 5 of the said Act for a period of five years.

The above thresholds are presented in the form of a table below:

In India	Applicable to	Assets		Turnover	
	Individual	₹ 1,500 Cr.		₹ 4,500 Cr.	
	Group	₹ 6,000 Cr.		₹18,000 Cr.	
In India and Outside	Applicable to	Assets		Turnover	
		Total	Minimum Indian Component	Total	Minimum Indian Component out of Total
	Individual parties	\$750 m	₹ 750 Cr.	\$ 2,250 m	₹ 2,250 Cr.
	Group	\$ 3 bn.	₹ 750 Cr.	\$ 9 bn.	₹ 2,250 Cr.

The turnover shall be determined by taking into account the value of sales of goods or services. The value of assets shall be determined by taking the book value of the assets as shown in the audited books of account of the enterprise, in the financial year immediately preceding the financial year in which the date of proposed combination falls, as reduced by any depreciation. The value of the assets shall include the brand value, value of goodwill, or intellectual Property Rights etc. referred to in explanation (c) to section 5 of the Act.

### Regulation of combinations

Section 6 of the Combination Act prohibits any person or enterprise from entering into a combination which causes or is likely to cause an appreciable adverse effect on competition within the relevant market in India and if such a combination is formed, it shall be void.

#### ***Notice to the Commission disclosing details of the proposed combination***

Section 6(2) envisages that any person or enterprise, who or which proposes to enter into any combination, shall give a notice to the Commission disclosing details of the proposed combination, in the form prescribed and submit the form together with the fee prescribed by regulations. Such intimation should be submitted within 30 days of:

- approval of the proposal relating to merger or amalgamation, referred to in section 5(c), by the board of directors of the enterprise concerned with such merger or amalgamation, as the case may be;
- execution of any agreement or other document for acquisition referred to in section 5(a) or acquiring of control referred to in section 5(b).

#### ***Compulsory wait period***

The Competition Commission of India (CCI) has been empowered to deal with such notice in accordance with provisions of sections 29, 30 and 31 of the Act. Section 29 prescribes procedure for investigation of combinations. Section 30 empowers the Commission to determine whether the disclosure made to it under section 6(2) is correct and whether the combination has, or is likely to have, an appreciable adverse effect on the competition. Section 31 provides that the Commission may allow the combination if it will not have any appreciable adverse effect on competition or pass an order that the combination shall not take effect, if in its opinion, such a combination has or is likely to have an appreciable adverse effect on competition.

### Exemptions

The provisions of section 6 do not apply to share subscription or financing facility or any acquisition, by a public financial institution, foreign institutional investor, bank or venture capital fund, pursuant to any covenant of a loan agreement or investment agreement. This exemption appears to have been provided in the Act to facilitate raising of funds by an enterprise in the course of its normal business. Under section 6(5), the public financial institution, foreign institutional investor, bank or venture capital fund, are required to file in prescribed form, details of the control, the circumstances for exercise of such control and the consequences of default arising out of loan agreement or investment agreement, within seven days from the date of such acquisition or entering into such agreement, as the case may be.

As per the explanation to section 6(5):

- (a) “foreign institutional investor” has the same meaning as assigned to it in clause (a) of the Explanation to section 115AD of the Income-tax Act, 1961;
- (b) “venture capital fund” has the same meaning as assigned to it in clause (b) of the Explanation to clause (23FB) of section 10 of the Income-tax Act, 1961.

It may be noted that under the law, the combinations are only regulated whereas anti-competitive agreements and abuse of dominance are prohibited.

### Inquiry into combination by the Commission

The Commission under section 20 of the Competition Act may inquire into the appreciable adverse effect caused or likely to be caused on competition in India as a result of combination either upon its own knowledge or information (suo moto) or upon receipt of notice under section 6(2) relating to acquisition referred to in section 5(a) or acquiring of control referred to in section 5(b) or merger or amalgamation referred to in section 5(c) of the Act. It has also been provided that an enquiry shall be initiated by the Commission within one year from the date on which such combination has taken effect. Thus, the law has provided a time limit within which suo moto inquiry into combinations can be initiated. This provision dispels the fear of enquiry into combination between merging entities after the expiry of stipulated period.

On receipt of the notice under section 6(2) from the person or an enterprise which proposes to enter into a combination, it is mandatory for the Commission to inquire whether the combination referred to in that notice, has caused or is likely to cause an appreciable adverse effect on competition in India.

The Commission shall have due regard to all or any of the factors for the purposes of determining whether the combination would have the effect of or is likely to have an appreciable adverse effect on competition in the relevant market, namely:

- (a) actual and potential level of competition through imports in the market;
- (b) extent of barriers to entry into the market;
- (c) level of combination in the market;
- (d) degree of countervailing power in the market;
- (e) likelihood that the combination would result in the parties to the combination being able to significantly and sustainably increase prices or profit margins;
- (f) extent of effective competition likely to sustain in a market;
- (g) extent to which substitutes are available or likely to be available in the market;

- (h) market share, in the relevant market, of the persons or enterprise in a combination, individually and as a combination;
- (i) likelihood that the combination would result in the removal of a vigorous and effective competitor or competitors in the market;
- (j) nature and extent of vertical integration in the market;
- (k) possibility of a failing business;
- (l) nature and extent of innovation;
- (m) relative advantage, by way of the contribution to the economic development, by any combination having or likely to have appreciable adverse effect on competition;
- (n) whether the benefits of the combination outweigh the adverse impact of the combination, if any.

The above yardsticks are to be taken into account irrespective of the fact whether an inquiry is instituted, on receipt of notice under section 6(2) or upon its own knowledge. The scope of assessment of adverse effect on competition will be confined to the “relevant market”. Most of the facts enumerated in section 20(4) are external to an enterprise. It is noteworthy that sub clause (n) of Section 20(4) requires to invoke principles of a “balancing”. It requires the Commission to evaluate whether the benefits of the combination outweigh the adverse impact of the combination, if any. In other words if the benefits of the combination outweigh the adverse effect of the combination, the Commission will approve the combination. Conversely, the Commission may declare such a combination as void.

### **Procedure for investigation of combination**

The procedure for investigation by the Commission has been stipulated under section 29 of the Act. It involves the following stages:

- (i) The Commission first has to form a prima facie opinion that a combination is likely to cause, or has caused an appreciable adverse effect on competition within the relevant market in India. Further, when the Commission has come to such a conclusion then it shall proceed to issue a notice to the parties to the combination, calling upon them to show cause why an investigation in respect of such combination should not be conducted.
- (ii) After receipt of the response of the parties to the combination, the Commission may call for the report of the Director General.
- (iii) When pursuant to response of parties or on receipt of report from the Director General whichever is later, the Commission is, prima facie, of the opinion that the Combination is likely to cause an appreciable adverse effect on competition in relevant market, it shall, within seven days, direct the parties to the combination to publish within ten working days, the details of the combination, in such manner as it thinks appropriate so as to bring to the information of public and persons likely to be affected by such combination.
- (iv) The Commission may invite any person affected or likely to be affected by the said combination, to file his written objections within fifteen working days of the publishing of the public notice, with the Commission for its consideration.
- (v) The Commission may, within fifteen working days of the filing of written objections, call for such additional or other information as it deem fit from the parties to the said combination and the information shall be furnished by the parties above referred within fifteen days from the expiry of the period notified by the Commission.



- (vi) After receipt of all the information and within 45 days from expiry of period for filing further information, the Commission shall proceed to deal with the case, in accordance with provisions contained in section 31 of the Act.

Thus, the provisions of section 29 provides for a specified timetable within which the parties to the combination or parties likely to be affected by the combination are required to submit the information or further information to the Commission to ensure prompt and timely conduct of the investigation. It further imposes on Commission a time limit of 45 working days from the receipt of additional or other information called for by it under sub-section (4) of section 29 for dealing with the case of investigation into a combination, which may have an adverse effect of the competition.

### **Inquiry into disclosures under section 6(2)**

Section 6(2) casts an obligation on any person or enterprise, who or which proposes to enter into combination, to give notice to the Commission, in the form as may be specified, and the fee which may be determined, by regulations, disclosing the details of the proposed combination within thirty days of:

- (i) Approval of the proposal relating to merger or amalgamation by the board of directors of the enterprises concerned with such merger or amalgamation;
- (ii) Execution of any agreement or other document for acquisition referred to in section 5(a) or acquiring of control referred to in section 5(b).

### **Non-filing of notice attracts penalty in terms of section 43A of the Act**

The section 6(2A) envisages that no combination shall come into effect until 210 days have passed from the day on which notice has been given to Commission or the Commission has passed orders, whichever is earlier.

Upon receipt of such notice, the Commission shall examine such notice and form its prima facie opinion as to whether the combination has, or is likely to have, an appreciable adverse effect on the competition in the relevant market in India.

### **Orders of Commission on certain combinations**

The Commission, after consideration of the relevant facts and circumstances of the case under investigation by it under section 28 or 30 and assessing the effect of any combination on the relevant market in India, may pass any of the written orders indicated herein below. Where the Commission comes to a conclusion that any combination does not, or is not likely to, have an appreciable adverse effect on the Competition in relevant market in India, it may, approve that Combination.

- (i) Where the Commission is of the opinion that the combination has, or is likely to have an adverse effect on competition, it shall direct that the combination shall not take effect.
- (ii) Where the Commission is of the opinion that adverse effect which has been caused or is likely to be caused on competition can be eliminated by modifying such combination then it shall direct the parties to such combination to carry out necessary modifications to the combination.
- (iii) The parties accepting the proposed modification shall carry out such modification within the period specified by the Commission.
- (iv) Where the parties have accepted the modification, but fail to carry out such modification within the period specified by the Commission, such combination shall be deemed to have an appreciable adverse effect on competition and shall be dealt with by the Commission in accordance with the

provisions of the Act.

- (v) Where the parties to the Combination do not accept the proposed modification such parties may within 30 days of modification proposed by the Commission, submit amendment to the modification proposed by the Commission.
- (vi) Where the Commission agrees with the amendment submitted by the parties, it shall, by an order approve the combination.
- (vii) Where the Commission does not accept the amendment, parties shall be allowed a further period of 30 days for accepting the amendment proposed by the Commission.
- (viii) Where the parties to the combination fail to accept the modification within thirty days, then it shall be deemed that the combination has an appreciable adverse effect on competition and will be dealt with in accordance with the provisions of the Act.
- (ix) Where Commission directs under section 31(2) that the combination shall not take effect or it has, or is likely to have an appreciable adverse effect, it may order that,
  - (a) the acquisition referred to in section 5(a); or
  - (b) the acquiring of control referred to in section 5(b); or
  - (c) the merger or the amalgamation referred to in section 5(c) shall not be given effect to by the parties.

As per proviso the Commission may, if it considers appropriate, frame a scheme to implement its order in regard to the above matters under section 31(10).

- (x) A deeming provision has been introduced by section 31(11). It provides that, if the Commission does not, on expiry of a period of 210 days from the date of filing of notice under section 6(2) pass an order or issue any direction in accordance with the provisions of section 29(1) or section 29(2) or section 29(7), the combination shall be deemed to have been approved by the Commission. In reckoning the period of 210 days, the period of thirty days specified in section 29(6) and further period of thirty working days specified in section 29(8) granted by Commission shall be excluded.
- (xi) Further more where extension of time is granted on the request of parties the period of two hundred ten days shall be reckoned after deducting the extended time granted at the request of the parties.
- (xii) Where the Commission has ordered that a combination is void, as it has an appreciable adverse effect on competition, the acquisition or acquiring of control or merger or amalgamation referred to in section 5, shall be dealt with by other concerned authorities under any other law for the time being in force as if such acquisition or acquiring of control or merger or amalgamation had not taken place and the parties to the combination shall be dealt with accordingly.
- (xiii) Section 29(14) makes it clear that nothing contained in Chapter IV of the Act shall affect any proceeding initiated or may be initiated under any other law for the time being in force. It implies that provisions of this Act are in addition to and not in derogation of provisions of other Acts.

Thus, approval under one law does not make out a case for approval under another law.

### **Extra Territorial Jurisdiction of Commission**

Section 32 extends the jurisdiction of Competition Commission of India to inquire and pass orders in accordance with the provisions of the Act into an agreement or dominant position or combination, which is likely to have, an appreciable adverse effect on competition in relevant market in India, notwithstanding that,

- (a) an agreement referred to in section 3 has been entered into outside India; or

- (b) any party to such agreement is outside India; or
- (c) any enterprise abusing the dominant position is outside India; or
- (d) a combination has taken place outside India; or
- (e) any party to combination is outside India; or
- (f) any other matter or practice or action arising out of such agreement or dominant position or combination is outside India.

The above clearly demonstrate that acts taking place outside India but having an effect on competition in India will be subject to the jurisdiction of Commission. The Competition Commission of India will have jurisdiction even if both the parties to an agreement are outside India but only if the agreement, dominant position or combination entered into by them has an appreciable adverse effect on competition in the relevant market of India.

### **Power to impose penalty for non-furnishing of information on combination**

Section 43A provides that if any person or enterprise who fails to give notice to the Commission under sub-section (2) of section 6, the Commission shall impose on such person or enterprise a penalty which may extend to one per cent of the total turnover or the assets, whichever is higher, of such a combination.

Thus, failure to file notice of combination falling under section 5 attracts deterrent penalty.

### **LESSON ROUND UP**

- The economic aspects of merger include market leadership, acquiring new product/brand name, imposing economies of scale, rationalization in production etc.
- The preamble of the Competition Act, 2002 states that this is an Act to establish a Commission to prevent anti-competitive practices, promote and sustain competition, protect the interests of the consumers and ensure freedom of trade in markets in India.
- Combination means acquisition of control, shares, voting rights or assets, acquisition of control by a person over an enterprise where such person has direct or indirect control over another enterprise engaged in competing businesses, mergers and amalgamations between or amongst enterprises.
- Any person or enterprise, who or which proposes to enter into any combination, shall give a notice to the Commission disclosing details of the proposed combination, in the form, prescribed and submit the form together with the fee prescribed by regulations. Such intimation should be submitted within 30 days of approval of the proposal relating to merger or amalgamation by the board of directors of the enterprise concerned with such merger or amalgamation, as the case may be, or execution of any agreement or other.
- Section 32 of the Competition Act, 2002 extends the extra territorial jurisdiction of the Competition Commission of India to enquiry and pass orders in accordance with the provisions of the Act in to an agreement, dominant position and regulates combinations i.e. mergers and acquisitions with a view to ensure that there is no adverse effect on competition in India.

### **SELF TEST QUESTIONS**

1. What are the reasons for mergers?
2. Enumerate the preamble of the Competition Act, 2002.
3. Discuss about the thresholds limits of Combination.
4. Explain about Competition Commission of India extra territorial jurisdiction.

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# Lesson 4

## MERGERS AND AMALGAMATIONS- ACCOUNTING ASPECTS OF AMALGAMATIONS

### LESSON OUTLINE

- Applicability
- Types of amalgamation under AS 14
  - i. Amalgamation in the nature of merger
  - ii. Amalgamation in the nature of purchase
- Methods of accounting for amalgamations
  - i. Pooling of interest method and
  - ii. Purchase method.
- Consideration for amalgamation
- Treatment of Reserves on Amalgamation
- Goodwill on amalgamation
- Balance of profit & Loss account
- Disclosure Requirements
- Amalgamation after the Balance Sheet date
- Requirement under Listing agreement..

### LEARNING OBJECTIVES

Accounting Standard 14(AS 14) deals with Accounting for amalgamations. According to AS 14 amalgamation may be either in the nature of merger or in the nature of purchase. It prescribes certain conditions to be fulfilled for consideration of amalgamation in the nature of merger. It includes aspects relating to transfer of assets and liabilities, shareholders of transferor companies becoming shareholders of transferee company, consideration for amalgamation continuity of business of transferor Company(ies) etc.,

AS 14 further prescribes that amalgamation in the nature of merger should be accounted for under pooling of interest method and amalgamation in the nature of purchase should be accounted for under the purchase method. It also covers aspects such as treatment of reserves/goodwill in a scheme of amalgamation, amalgamation after the balance-sheet etc., After reading this lesson you will be able to understand the applicability of AS 14 to various strategic decisions, accounting methods, disclosure requirements etc.

## APPLICABILITY

Accounting Standard-14 'Accounting for Amalgamations' lays down the accounting and disclosure requirements in respect of amalgamations of companies and the treatment of any resultant goodwill or reserves.

### Exception

This standard does not deal with cases of acquisitions which arise when there is a purchase by one company (acquiring company) of the whole or part of the shares, or the whole or part of the assets, of another company (acquired company) in consideration by payment in cash or by issue of shares or other. Securities in the acquiring company or partly in one form and partly in the other. The distinguishing feature of an acquisition is that the acquired company is not dissolved and its separate entity continues to exist.

### Is AS-14 Applicable to Demerger?

#### **Case 1 – Scheme of arrangement between Sony India Private Limited (Sony India) and Sony Software Centre Private Limited (Sony Software) with reference to transfer of software undertaking of Sony India to Sony Software**

The Delhi High Court (the High Court), while approving scheme of arrangement between Sony India and Sony Software in 2012 has clarified that. AS-14 (i.e., accounting standards issued by the Institute of Chartered Accountants) is applicable only to amalgamations and not to demerger. As per the scheme of arrangement, 'Software Undertaking' of Sony India is proposed to be transferred to Sony Software under Sections 391 to 394 of the Companies Act, 1956. One of the conditions of the scheme was that any excess in the value of net assets of software undertaking transferred to the resulting company shall be applicable for distribution to the shareholders of the resulting company

Regional Director of Northern Region, Ministry of Corporate has raised objection in his affidavit filed with the High Court stating that excess if any, in the value of the net assets of the software undertaking should be adjusted to the capital reserve as prescribed in AS-14 and not to the general reserve as proposed in the scheme of arrangements.

The petitioners contended that **AS-14** is applicable only to amalgamations and not to demerger. It was clarified that **AS-14 is applicable only to amalgamations and not to demerger**. On a plain reading of the accounting standard under reference, it is clear that the same is applicable only in case of an amalgamation and not in case of demergers. This has also been held by the Gujarat High Court in the case of *2010 1 CLJ 351 tiled Gallops Realty (P) Ltd*. Copy of the order has been placed on record.

#### **Case 2 - Gujarat, Gallops Realty (P.) Ltd**

In Case of High Court of Gujarat, *Gallops Realty (P.) Ltd., In re v. K.A. PUJ, J.(2010)*, under Section 391, read with sections 394 and 100, of the Companies Act, 1956 Petitioner-companies, i.e., demerged company and resulting company, sought for sanction of composite scheme of arrangement in nature of purchase of shares and demerger of hotel business of demerged company to resulting company and consequent reconstruction of share capital of demerged company under section 391, read with sections 394, 78 and 100 consisting of reduction of paid-up share capital as well as utilization of share premium account. Regional Director stated that as per scheme, capital profit on demerger would be transferred to general reserve in books of resulting company which was not in consonance with generally accepted

accounting principles as also Accounting Standard - 14 which provide that any profit arising out of a capital transaction ought to be treated as capital profit and, hence, would be transferred to capital reserve and not to general reserve. It was held that the observation of Regional Director was not in consonance with accounting principles in general and Accounting Standard-14 in particular, as ***Accounting Standard-14 is applicable only in case of amalgamation and not in case of demerger, as envisaged in instant scheme.***

## TYPES OF AMALGAMATION

Accounting Standard (AS)-14 recognizes two types of amalgamation:

- (a) Amalgamation in the nature of merger.
- (b) Amalgamation in the nature of purchase.

An amalgamation should be considered to be an amalgamation in the nature of merger when all the following conditions are satisfied:

- (i) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.
- (ii) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.
- (iii) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.
- (iv) The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.
- (v) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

An amalgamation should be considered to be an amalgamation in the nature of purchase, when any one or more of the conditions specified above is not satisfied. These amalgamations are in effect a mode by which one company acquires another company and hence, the equity shareholders of the combining entities do not continue to have a proportionate share in the equity of the combined entity or the business of the acquired company is not intended to be continued after amalgamation.

## METHODS OF ACCOUNTING FOR AMALGAMATION

There are two main methods of accounting for amalgamations:

- (a) the pooling of interests method; and
- (b) the purchase method.

The pooling of interests method is used in case of amalgamation in the nature of merger. The purchase method is used in accounting for amalgamations in the nature of purchase.

### **The Pooling of Interest Method**

Since merger is a combination of two or more separate business, there is no reason to restate carrying amounts of assets and liabilities. Accordingly, only minimal changes are made in aggregating the individual financial statements of the amalgamating companies.

In preparing the transferee company's financial statements, the assets, liabilities and reserves (whether capital or revenue or arising on revaluation) of the transferor company should be recorded at their existing carrying amounts and in the same form as at the date of the amalgamation. The balance of the Profit and Loss Account of the transferor company should be aggregated with the corresponding balance of the transferee company or transferred to the General Reserve, if any.

If, at the time of the amalgamation, the transferor and the transferee company having conflicting accounting policies, a uniform set of accounting policies should be adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies should be reported in accordance with Accounting Standard (AS-5), Net Profit or Loss for the Period 'Prior Period Items and Changes in Accounting Policies'.

The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company should be adjusted in reserves. It has been clarified that the difference between the issued share capital of the transferee company and share capital of the transferor company should be treated as capital reserve. The reason given is that this difference is akin to share premium. Furthermore, reserve created on amalgamation is not available for the purpose of distribution to shareholders as dividend and/or bonus shares. It means that if consideration exceeds the share capital of the transferor company (or companies), the unadjusted amount is a capital loss and adjustment must be made, first of all in the capital reserves and in case capital reserves are insufficient, in the revenue reserves. However, if capital reserves and revenue reserves, are insufficient the unadjusted difference may be adjusted against revenue reserves by making addition thereto by appropriation from profit and loss account. There should not be direct debit to the profit and loss account. If there is insufficient balance in the profit and loss account also, the difference should be reflected on the assets side of the balance sheet in a separate heading.

### **The Purchase Method**

In preparing the transferee company's financial statements, the assets and liabilities of the transferor company should be incorporated at their existing carrying amounts or, alternatively, the consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation. The reserves (whether capital or revenue or arising on revaluation) of the transferor company, other than the statutory reserves, should not be included in the financial statements of the transferee company except as in case of statutory reserve.

Any excess of the amount of the consideration over the value of the net assets of the transferor company acquired by the transferee company should be recognised in the transferee company's financial statements as goodwill arising on amalgamation. If the amount of the consideration is lower than the value of the net assets acquired, the difference should be treated as Capital Reserve.

The goodwill arising on amalgamation should be amortised to income on a systematic basis over its useful life. The amortisation period should not exceed five years unless a somewhat longer period can be justified.

The reserves of the transferor company, other than statutory reserve should not be included in the financial statements of the transferee company. The statutory reserves refer to those reserves which are required to



be maintained for legal compliance. The statute under which a statutory reserve is created may require the identity of such reserve to be maintained for a specific period.

Where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with such statutory reserves of the transferor company should be recorded in the financial statements of the transferee company by crediting the relevant statutory reserve account. The corresponding debit should be given to a suitable account head (e.g., 'Amalgamation Adjustment Account') which should be disclosed as a part of "miscellaneous expenditure" or other similar category in the balance sheet. When the identify the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account should be reserved.

#### **Let us recapitulate**

There are two types of amalgamation and two methods of accounting for amalgamations under AS 14. The types of amalgamation are amalgamation, in the nature of merger and amalgamation in the nature of purchase. There are two main methods of accounting for amalgamations viz. the pooling of interests method; and the purchase method. The pooling of interests method is used in case of amalgamation in the nature of merger. The purchase method is used in accounting for amalgamations in the nature of purchase.

### **CONSIDERATION FOR AMALGAMATION**

The consideration for amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company. In determining the value of the consideration, assessment is made of the fair value of its various elements.

The consideration for the amalgamation should include any non-cash element at fair value. The fair value may be determined by a number of methods. For example, in case of issue of securities, the value fixed by the statutory authorities may be taken to be the fair value. In case of other assets, the fair value may be determined by reference to the market value of the assets given up, and where the market value of the assets given up cannot be reliably assessed, such assets may be valued at their respective book values.

While the scheme of amalgamation provides for an adjustment to the consideration contingent on one or more future events, the amount of the additional payment should be included in the consideration if payment is probable and a reasonable estimate of the amount can be made. In all other cases, the adjustment should be recognised as soon as the amount is determinable.

### **Treatment of Reserves on Amalgamation**

*If the amalgamation is an 'amalgamation in the nature of merger'*

If the amalgamation is an 'amalgamation in the nature of merger', the identity of the reserves is preserved and they appear in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company. Thus, for example, the General Reserve of the transferor company becomes the General Reserve of the transferee company, the Capital Reserve of the transferor company becomes the Capital Reserve of the transferee company and the Revaluation Reserve of the transferor company becomes the Revaluation Reserve of the transferee company. As a result of preserving the identity, reserves which are available for distribution as dividend before the amalgamation would also be available for distribution as dividend after the amalgamation. The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company is adjusted in reserves in the financial statements of the transferee company.

*If the amalgamation is an 'amalgamation in the nature of purchase'*

If the amalgamation is an 'amalgamation in the nature of purchase', the identity of the reserves, other than the statutory reserves is not preserved, dealt within the certain circumstances mentioned below.

Certain reserves may have been created by the transferor company pursuant to the requirements of, or to avail of the benefits under, the Income-tax Act, 1961; for example, Development Allowance Reserve, or Investment Allowance Reserve. The Act requires that the identity of the reserves should be preserved for a specified period. Likewise, certain other reserves may have been created in the financial statements of the transferor company in terms of the requirements of other statutes. Though, normally, in an amalgamation in the nature of purchase, the identity of reserves is not preserved, an exception is made in respect of reserves of the aforesaid nature (referred to hereinafter as 'statutory reserves') and such reserves retain their identity in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company, so long as their identity is required to be maintained to comply with the relevant statute. This exception is made only in those amalgamations where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with. In such cases the statutory reserves are recorded in the financial statements of the transferee company by a corresponding debit to a suitable account head (e.g., 'Amalgamation Adjustment Account') which is disclosed as a part of 'miscellaneous expenditure' or other similar category in the balance sheet. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account are reversed.

The amount of the consideration is deducted from the value of the net assets of the transferor company acquired by the transferee company. If the result of the computation is negative, the difference is debited to goodwill arising on amalgamation and dealt with in the manner stated below 'under' treatment of goodwill on amalgamation, . If the result of the computation is positive, the difference is credited to Capital Reserve.

### **Goodwill on Amalgamation**

Goodwill arising on amalgamation represents a payment made in anticipation of future income and it is appropriate to treat it as an asset to be amortised to income on a systematic basis over its useful life. Due to nature of goodwill, it is difficult to estimate its useful life, but estimation is done on a prudent basis. Accordingly, it should be appropriate to amortise goodwill over a period not exceeding five years unless a somewhat longer period can be justified.

The following factors are to be taken into account in estimating the useful life of goodwill:

- (i) the forceable life of the business or industry;
- (ii) the effects of product obsolescence, changes in demand and other economic factors;
- (iii) the service life expectancies of key individuals or groups of employees;
- (iv) expected actions by competitors or potential competitors; and
- (v) legal, regulatory or contractual provisions affecting the useful life.

### **Balance of Profit and Loss Account**

In the case of an 'amalgamation in the nature of merger', the balance of the Profit and Loss Account appearing in the financial statements of the transferor company is aggregated with the corresponding balance appearing in the financial statements of the transferee company. Alternatively, it is transferred to the General Reserve, if any.

In the case of an ‘amalgamation in the nature of purchase’, the balance of the Profit and Loss Account appearing in the financial statements of the transferor company, whether debit or credit, loses its identity.

### Disclosure Requirements

- (a) For **amalgamations of every type of the following disclosures** should be made in the first financial statements following the amalgamations:
  - (i) names and general nature of business of the amalgamating companies;
  - (ii) effective date of amalgamation for accounting purposes;
  - (iii) the method accounting used to reflect the amalgamation; and
  - (iv) particulars of the scheme sanctioned under a statute.
- (b) In case of **amalgamations accounted for under the pooling of interests method, the following additional disclosures** are required to be made in the first financial statements following the amalgamation :
  - (i) description and number of shares issued, together with the percentage of each company's equity shares exchanged to effect the amalgamation;
  - (ii) the amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof.
- (c) In case of **amalgamations accounted for under the purchase method the following additional disclosures** are required to be made in the first financial statements following the amalgamations:
  - (i) consideration for the amalgamation and a description of the consideration paid or contingently payable, and
  - (ii) the amount of any difference between the consideration and the value of net identifiable assets required, and the treatment thereof including the period of amortization of any goodwill arising on amalgamation.

### Amalgamation after the Balance Sheet Date

While an amalgamation is effected after the balance sheet date but before the issuance of the financial statements of either party to the amalgamation, disclosure should be made as per the provisions of AS-4, ‘Contingencies and Events Occurring after the Balance Sheet Date’, but the amalgamation should not be incorporated in that financial statements. In certain circumstances, the amalgamation may also provide additional information affecting the financial statements themselves, for instance, by allowing the going concern assumption to be maintained.

### Requirement under listing agreement with respect to accounting treatment for amalgamations

While filing for approval any draft Scheme of amalgamation/merger/ reconstruction, etc. with the stock exchange under the listing agreement, the company is also required to file an auditors' certificate to the effect that the accounting treatment contained in the scheme is in compliance with all the Accounting Standards specified by the Central Government in Section 211(3C) of the Companies Act, 1956.

However, in case of companies where the respective sectoral regulatory authorities have prescribed norms for accounting treatment of items in the financial statements contained in the scheme, the requirements of the regulatory authorities shall prevail.

For this purpose, mere disclosure of deviations in accounting treatments shall not be deemed as compliance.

## LESSON ROUND UP

- Accounting Standard-14 'Accounting for Amalgamations' lays down the accounting and disclosure requirements in respect of amalgamations of companies and the treatment of any resultant goodwill or reserves.
- AS 14 is not applicable to demergers.
- AS 14 provides for two types of amalgamations viz amalgamation, in the nature of merger and amalgamation in the nature of purchase.
- There are two main methods of accounting for amalgamations viz the pooling of interests method; and the purchase method.
- The pooling of interests method is used in case of amalgamation in the nature of merger. The purchase method is used in accounting for amalgamations in the nature of purchase.
- The consideration for amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company.
- If the amalgamation is an 'amalgamation in the nature of merger', the identity of the reserves is preserved and they appear in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company.
- If the amalgamation is an 'amalgamation in the nature of purchase', the identity of the reserves, other than the statutory reserves is not preserved, dealt within the certain circumstances specified.
- Goodwill arising on amalgamation represents a payment made in anticipation of future income and it is appropriate to treat it as an asset to be amortised to income on a systematic basis over its useful life.
- AS 14 also prescribes certain disclosure requirements.
- While an amalgamation is effected after the balance sheet date but before the issuance of the financial statements of either party to the amalgamation, disclosure should be made as per the provisions of AS-4, 'Contingencies and Events Occurring after the Balance Sheet Date', but the amalgamation should not be incorporated in that financial statements.
- While filing for approval any draft Scheme of amalgamation/merger/ reconstruction, etc. with the stock exchange under the listing agreement, the company is also required to file an auditors' certificate to the effect that the accounting treatment contained in the scheme is in compliance with all the Accounting Standards.

## SELF TEST QUESTIONS

*(These are meant for recapitulation only. Answers to these questions are not to be submitted for evaluation)*

1. Does AS 14 apply to Demerger? Explain.
2. What are the types of amalgamation provided under AS 14?
3. What are the methods of accounting provided under AS 14?
4. How the balance in profit and loss account of transferor is treated in case of amalgamation in the nature of merger?

# Lesson 5

## Financial, Stamp Duty and Taxation Aspects of Amalgamation

### LESSON OUTLINE

- Financial aspects of mergers and amalgamations
- Constitutional background on levy of stamp duty
- Stamp duty payable on high court order sanctioning amalgamation
- Amalgamation of holding and subsidiary companies – exemption from payment of stamp duty
- Taxation aspects of mergers and amalgamation
- Taxation aspects of slump sale

### LEARNING OBJECTIVES

As the financial aspects of merger denotes financial benefits. Stamp duty and taxation aspects are closely linked to the financial aspects. Similarly, the incidence of stamp duty is an important consideration in the planning of any merger. In fact, in some cases, the whole form in which the merger is sought to take place is selected taking into account the savings in stamp duty. Taxation aspects of merger includes aspects such as carry forward of losses after merger.

After reading this lesson you will be able to understand the regulatory aspects and court decisions as to the stamp duty aspects of mergers, tax advantage on mergers etc.,

## FINANCIAL ASPECTS OF MERGERS AND AMALGAMATIONS

### INTRODUCTION

In any merger or amalgamation, financial aspects of the transaction are of prime importance. It denotes the benefits in terms of financial benefits, i.e., increase in productivity, improved profitability and enhanced dividend paying capacity of the merged or the amalgamated company, which the management of each company involved in this exercise would be able to derive.

Each amalgamation or merger is aimed at the following financial aspects:

- (a) To pool the resources of all the companies involved in the exercise of amalgamation or merger so as to achieve economies of production, administrative, financial and marketing management.
- (b) To secure the required credit on terms from financial institutions, banks, suppliers, job workers etc.
- (c) To cut down cost of production, management, marketing etc. by effecting savings in all spheres with the combined strength of qualified and competent technical and other personnel.
- (d) To reinforce the united research and development activities for product development to ensure a permanent, dominant and profit making position in the industry.
- (e) To improve productivity and profitability in order to maintain a regular and steady dividend to the shareholders.
- (f) To concentrate on the core competence of the merged or the amalgamated company.
- (g) To consolidate the resource base and improve generation, mobilisation and utilisation of physical, financial, human, knowledge, information and other important tangible and intangible resources.

An important aspect in the scheme of mergers and amalgamations relates to the valuation of shares to decide the exchange ratio. Objections have been raised about the method of valuation even in cases where the schemes had been approved by a large majority of shareholders and the lending Financial Institutions. The courts have declared their unwillingness to engage themselves on a study of the fitness of the mode of valuation.

According to a High Court statement : “The valuation of shares is a technical matter which requires considerable skill and expertise. There are bound to be differences of opinion as to the correct value of the shares of the company. Simply because it is possible to value the shares in a manner different from the one adopted in a given case, it cannot be said that the valuation agreed upon has been unfair”.

In the Hindustan Lever Ltd. case, the Supreme Court held that it would not interfere with the valuation of shares, when more than 99 per cent of the shareholders have approved the scheme, and with the valuation having been perused by the Financial Institutions.

Valuation and Acquisition Motives is an important aspect in the merger/amalgamation /takeover activity. The valuation of business, however, depends to a great extent on the acquisition motives. The acquisition activity is usually guided by strategic behavioural motives. The strategic reasons could be either purely financial (taxation, asset-stripping, financial restructuring involving an attempt to augment the resources base and portfolio-investment) or business related (expansion or diversification). The behavioural reasons have more to do with the personal ambitions or objectives (desire to grow big) of the top management. The expansion and diversification objectives are achievable either by building capacities on one's own or by buying the

existing capacities. This would effectively mean a “make (build) or buy decision” of capital nature. The decision criteria in such a situation would be the present value of the differential cash flows. These differential cashflows would, therefore, be the limit on the premium which the acquirer would be willing to pay. On the other hand, if the acquisition is motivated by financial considerations (specifically taxation and asset-stripping), the expected financial gains would form the limit on the premium, over and above the price of physical assets in the company. The cashflow from operations may not be the main consideration in such situations. Similarly, a merger with financial restructuring as its objective will have to be valued mainly in terms of financial gains. It would, however, not be easy to determine the level of financial gains because the financial gains would be a function of the use to which these resources are put. Finally, the pricing of behaviourally motivated acquisitions is not really guided by the financial considerations. Since the acquisitions are not really the market driven transactions, a set of non-financial considerations will also affect the price. The price could be affected by the number and the motives of other bidders. The value of a target is effected not only by the motive of the acquiring company, but also by the target company’s own objectives. The motives of the target company could also be viewed as to be strategic, financial or behavioural. In addition, if the target company is an unwilling dis-investor, the price of an acquisition may not have much to do with the potential financial benefits.

## STAMP DUTY ASPECTS OF MERGERS AND AMALGAMATIONS

The incidence of stamp duty is an important consideration in the planning of any merger. In fact, in some cases, the whole form in which the merger is sought to take place is selected taking into account the savings in stamp duty. The incidence of stamp duty, more particularly on transfer of immovable property is fairly high to merit serious consideration. The fact that, in India, stamp duty is substantially levied by the States has given considerable scope for savings in stamp duty.

### Constitutional background on levy of stamp duty on Amalgamation and Mergers

#### *Article 265*

Article 265 of the Constitution prohibits levy or collection of tax except by authority of law.

Article 246, read with the Seventh Schedule of the Constitution provides legislative powers to be exercised by the Parliament and the State Legislatures.

The Seventh Schedule consists of three viz., List I - Union List, List II - State List and List III - Concurrent List. List I is the exclusive domain of the Parliament to make laws in relation to that matter and it becomes a prohibited field for the State Legislature. List II is within the exclusive competence of the State Legislature and then the Parliament is prohibited to make any law with regard to the same except in certain circumstances. In List III, both Parliament and State Legislature can make laws subject to certain conditions. Matters not mentioned in any of the three lists fall within the exclusive domain of the Parliament.

#### *Article 372*

All the laws in force immediately before the commencement of the Constitution continue to be in force until altered or repealed or amended by a competent Legislature or other competent authority.

Accordingly, the Indian Stamp Act is continuing to this extent.

The relevant entries in the Seventh Schedule regarding stamp duty are as follows:

#### *List I entry 91*

“91. Rates of stamp duty in respect of bills of exchange, cheques, promissory notes, bills of lading, letters of credit, policies of insurance, transfer of shares, debentures, proxies and receipts.”

*List II entry 63*

“63. Rates of stamp duty in respect of documents other than those specified in the provisions of List I with regard to stamp duty.”

*List III entry 44*

“44. Stamp duties other than duties or fees collected by means of judicial stamps, but not including rates of stamp duties.”

In exercise of power conferred by Entry 63, List II the State Legislature can make amendment in the Indian Stamp Act under article 372, in regard to the rates of stamp duty in respect of documents other than those specified in provisions of List I.

Stamp duty is levied in India on almost all, except a few documents, by the States and hence the rate and incidence of stamp in different states varies. The State Legislature has jurisdiction to levy stamp duty under entry 44, List III of the Seventh Schedule of the Constitution of India and prescribe rates of stamp duty under entry 63, List 11.

By sanctioning of amalgamation scheme, the property including the liabilities are transferred as provided in sub-section (2) of section 394 of the Companies Act and on that transfer instrument, stamp duty is levied.

Therefore, it cannot be said that the State legislature has no jurisdiction to levy such duty on an order of the High Court sanctioning a scheme of compromise or arrangement under section 394 of the Companies Act, 1956. [*Li taka Pharmaceuticals Ltd. and another v. State of Maharashtra and others* *ibid*].

***Stamp Duty Payable on a High Court Order Sanctioning Amalgamation***

1. In amalgamation the undertaking comprising property, assets and liabilities, of one (or more) company (amalgamating or transferor company) are absorbed by and transferred company merges into or integrates with transferee company. The former loses its entity and is dissolved (without winding up).
2. The transfer and vesting of transferor company's property, assets, etc. into transferee company takes place “by virtue of” the High Court's order. [Section 394(2)]. Thus, the vesting of the property occurs on the strength of the order of the High Court sanctioning the scheme of amalgamation, without any further document or deed. Property includes every kind of property, rights and powers of every description. [Section 394(4)(d)].
3. For the purpose of conveying to the transferee company the title to the immovable property of the transferor company, necessary registration in the lands records in the concerned office of the State in which the property is situated, will be done on the basis of the High Court order sanctioning the amalgamation. If any stamp duty is payable under the Stamp Act of the State in which the property is situated, it will be paid on the copy of the High Court order.
4. An order of the High Court under section 394 is founded and based on the compromise or arrangement between the two companies for transferring assets and liabilities of the transferor company to the transferee company and that order is an instrument as defined in Section 2(1) of the Bombay Stamp Act which included every document by which any right or liability is transferred [*Li taka Pharmaceuticals Ltd. v. State of Maharashtra* (1996) 22 CLA 154: AIR 1997 Bom 7].
5. Thus, an order of the High Court sanctioning a scheme of amalgamation under Section 394 of the Companies Act is liable to stamp duty only in those states where the states stamp law provides.



In *Hindustan Lever Ltd. v. State of Maharashtra* (2003)117 Comp Cas SC 758 the Supreme Court considered this issue. Tata Oil Mills Company Ltd (TOMCO) was merged with the Hindustan Lever Ltd (HLL). The State imposed stamp duty on the order sanctioning the scheme of merger. The demand was challenged by the company on two grounds that State Legislature is not competent to impose stamp duty on the order of amalgamation passed by a court and such order of the court is neither instrument nor document (transferring properties from transferor company to transferee company) liable to stamp duty.

The Supreme Court dismissed the appeal of the company on following reasons:

Transfer of property has been defined to mean an act by which a living person conveys property, in present or in future, to one or more living persons. Companies or associations or bodies of individuals, whether incorporated or not, have been included amongst living persons. It clearly brings out that a company can effect transfer of property. The word *inter vivos* in the context of section 394 of the Companies Act would include, within its meaning, also a transfer between two juristic persons or a transfer to which a juristic person is one of the parties. The company would be a juristic person created artificially in the eyes of law capable of owning and transferring the property. The method of transfer is provided in law. One of the methods prescribed is dissolution of the transferee company along with all its assets and liabilities. Where any property passes by conveyance, the transaction is said to be *inter vivos* as distinguished from a case of succession or devise. The Supreme Court dismissed the appeal on following reasons.

The State Legislature would have the jurisdiction to levy the stamp duty under entry 44 List III of the Seventh Schedule of the constitution and prescribes rate of stamp duty under entry 63, List II. It does not in any way impinge upon any entry in List I. Entry 44 of List III empowers the State Legislature to prescribe rates of stamp duty in respect of documents other than those specified in List I. By sanctioning a scheme of amalgamation, the property including the liabilities are transferred as provided in Section 394 of the Companies Act and on that transfer instrument stamp duty is levied. It, is therefore, cannot be said that the State Legislature has no jurisdiction to levy such duty. Under the scheme of amalgamation, the whole or any part of the undertaking, properties or liability of any company concerned in the scheme are to be transferred to the other company. The intended transfer is a voluntary act of the contracting parties. The transfer is a voluntary act of the contracting parties. The transfer has all trappings of a sale. While exercising its power in sanctioning a scheme of arrangement, the court has to examine as to whether the provisions of the statute have been complied with. Once the court finds that the parameters set out in section 394 of the Companies Act have been met then the court would have no further jurisdiction to sit in appeal over the commercial wisdom of the lass of persons who with their eyes open give their approval, even if, in the view of the court a better scheme could have been framed. Two broad principles underlying a scheme of amalgamation are that the order passed by the court amalgamating the company is based on a compromise or arrangement arrived at between the parties; and that the jurisdiction of the company court while sanctioning the scheme is supervisory only. Both these principles indicate that there is no adjudication by the court on merits as such.

The order of the court under sub-section (2) of section 391 has to be presented before the Registrar of Companies within 30 days for registration and shall not have effect till a certified copy of the order has been filed with the Registrar and the Registrar of Companies certifies that the transferor company stands amalgamated with the transferee company along with all its assets and liabilities. Thus, the amalgamation scheme sanctioned by the court would be an instrument within the meaning of section 2(i) of the Bombay Stamp Act, 1958. By the said instrument the properties are

transferred from the transferor company to the transferee company, the basis of which is the compromise or arrangement arrived at between the two companies. A document creating or transferring a right is an instrument. An order effectuating the transfer is also a document.

6. The company will provide to the Collector of Stamps —
  - application for adjudication of the High Court order for determination of stamp duty payable;
  - proof of the market value of equity shares of the transferor company (Stock Exchange quotation or a certificate from Stock Exchange) as of the appointed day;
  - certificate from an approved valuer or valuation of the immovable property being transferred to the transferee company.
7. The Collector thereafter will adjudicate the order and determine stamp duty.
8. The stamp duty will be paid in the manner prescribed under the Stamp Rules. The duty-paid Order will be registered with the Sub-Registrar of Assurances where the lands and buildings are located.

### **Incidence of Levy of Stamp Duty**

Stamp duty is levied on “Instruments”. Section 3 of the Bombay Stamp Act, 1958 specifies the following essentials for the levy of stamp duty :

- (1) There must be an instrument
- (2) Such instrument is one of the instruments specified in Schedule I
- (3) Such instrument must be executed.
- (4) Such instrument must have either —
  - (a) not having been previously executed by any person is executed in the ‘state’ or
  - (b) having been executed outside the state, relates to any property situated in the State or any matter or thing done or to be done in the state and is received in the state.

### **Instrument**

The term ‘instrument’ is defined in Section 2(i) of the Bombay Stamp Act, 1958 as follows:

“Instrument” includes every document by which any right or liability is or purports to be created, transferred limited extended, extinguished or recorded but does not include a bill of exchange, cheque, promissory note, bill of lading, letter of credit, policy of insurance, transfer of shares, debentures, proxy and receipt.”

An award is an instrument within the meaning of the Stamp Act and the same is required to be stamped as was decided in the case *Hindustan Steel Ltd. v. Dilip Construction Co.*, AIR 1969 SC 1238 (at page 1240)

The scheme of amalgamation sanctioned by the court would be an instrument within the meaning of Section 2(1) where by the properties are transferred from the transferor company to the transferee company based on compromise arrived at between the two companies. The state legislature would have the jurisdiction to levy stamp duty under Entry 44, List II of the Seventh Schedule of the Constitution on the order of the court sanctioning scheme of amalgamation vide the case *Hindustan Lever v. State of Maharashtra*, AIR 2004 at pp. 335, 339.

This definition is an inclusive definition and any document which purports to transfer assets or liabilities considered as an instrument.

**Order of Court under Section 394 of Companies Act, 1956 - A Transfer**

It was earlier held that when transfer takes place by virtue of a court order to a scheme of amalgamation, stamp duty is leviable. By virtue of Section 2(g), the order of the Court ordering the transfer of assets and liabilities of the transferor Company to the transferee Company is deemed to be a conveyance. This definition of conveyance is given below:

As per Section 2(g) “Conveyance” includes, —

- (i) a conveyance on sale,
- (ii) every instrument,
- (iii) every decree or final order of any Civil Court,
- (iv) every order made by the High Court under Section 394 of the Companies Act, 1956 (I of 1956) in respect of amalgamation of companies;

by which property, whether moveable or immovable, or any estate or interest in any property is transferred to, or vested in, any other person, inter vivos, and which is not otherwise specifically provided for by Schedule I;....”

The amended definition of term ‘conveyance’ under section 2(g) of the Bombay Stamp Act, 1958 (amended in 1985) inter-alia includes every order made by the High Court under section 394 of the Companies Act, 1956 in respect of amalgamation of Companies by which property, whether moveable or immovable, or any estate or interest in any property of transferor is transferred to, or vested in the transferee company.

*Transfer of the property of a partnership firm to a limited company on its conversion was held to be treated as a conveyance and, hence, chargeable to stamp duty, irrespective of the fact that the partners of the firm were the shareholders of the Company [In re The Kandoli Tea Company 13 Cal 43; Foster v. Commissioners, (1894) 1 QB 516].*

The landmark decision of Bombay High Court in *Li Taka Pharmaceuticals v. State of Maharashtra* (1996) 8 SC 102 (Bom.) has serious implications for mergers covered not just by the Bombay Stamp Act, 1958 but also mergers covered by Acts of other States. The following are the major conclusions of the Honourable Court:

- (1) An amalgamation under an order of Court under Section 394 of the Companies Act, 1956 is an instrument under the Bombay Stamp Act.
- (2) States are well within their jurisdiction when they levy stamp duty on instrument of amalgamation.
- (3) Stamp duty would be levied not on the gross assets transferred but on the “undertaking”, when the transfer is on a going concern basis, i.e. on the assets less liabilities. The value for this purpose would thus be the value of shares allotted. This decision has been accepted in the Act and now stamp duty is leviable on the value of shares allotted plus other consideration paid.

The Calcutta High Court in the case of *Emami Biotech Ltd* (2012) held that a Court order sanctioning a scheme of amalgamation or demerger under section 391 to 394 of the Companies Act, 1956 is an instrument and conveyance within the meaning of the Stamp Act applicable to the State of West Bengal and is accordingly, subject to stamp duty.

This case related to an scheme sanctioned by the Calcutta High Court in West Bengal.

### Stamp Duty on Other Documents

Usually, in a merger, several other documents, agreements, indemnity bonds, etc. are executed, depending on the facts of each case and requirements of the parties. Stamp duty would also be leviable as per the nature of the instrument and its contents.

No stamp duty is payable on an order issued by the Board for Industrial and Financial Reconstruction (BIFR), sanctioning an amalgamation, apparently on the ground that such an order aims at rehabilitating business and undertaking of a sick industrial company.

### Amalgamation Between Holding And Subsidiary Companies — Exemption From Payment Of Stamp Duty

The Central Government has exempted the payment of stamp duty on instrument evidencing transfer of property between companies limited by shares as defined in the Indian Companies Act, 1913, in a case:

- (i) where at least 90 per cent of the issued share capital of the transferee company is in the beneficial ownership of the transferor company, or
- (ii) where the transfer takes place between a parent company and a subsidiary company one of which is the beneficial owner of not less than 90 per cent of the issued share capital of the other, or
- (iii) where the transfer takes place between two subsidiary companies each of which not less than 90 per cent of the share capital is in the beneficial ownership of a common parent company :

Provided that in each case a certificate is obtained by the parties from the officer appointed in this behalf by the local Government concerned that the conditions above prescribed are fulfilled.

Therefore, if property is transferred by way of order of the High Court in respect of the Scheme of Arrangement/Amalgamation between companies which fulfill any of the above mentioned three conditions, then no stamp duty would be levied provided a certificate certifying the relation between companies is obtained from the officer appointed in this behalf by the local Government (generally this officer is the Registrar of Companies).

However, stamp being a state subject, the above would only be applicable in those states where the State Government follows the above stated notification of the Central Government otherwise stamp duty would be applicable irrespective of the relations mentioned in the said notification.

## TAXATION ASPECTS OF MERGERS AND AMALGAMATIONS

**The word ‘amalgamation’ or ‘merger’ is not defined anywhere in the Companies Act, 1956. However, Section 2(1B) of the Income Tax Act, 1961 defines the term ‘amalgamation’ as follows:**

“Amalgamation” in relation to companies, means the merger of one or more companies with another company or the merger of two or more companies to form one company (the company or companies which so merge being referred to as the amalgamating company or companies and the company with which they merge or which is formed as a result of the merger, as the amalgamated company), in such a manner that—

- (i) all the property of the amalgamating company or companies immediately before the amalgamation becomes the property of the amalgamated company by virtue of the amalgamation;
- (ii) all the liabilities of the amalgamating company or companies immediately before the amalgamation become the liabilities of the amalgamated company by virtue of the amalgamation;
- (iii) shareholders holding not less than three-fourths in value of the shares in the amalgamating

company or companies (other than shares already held therein immediately before the amalgamation by, or by a nominee for, the amalgamated company or its subsidiary) become shareholders of the amalgamated company by virtue of the amalgamation, otherwise than as a result of the acquisition of the property of one company by another company pursuant to the purchase of such property by the other company or as a result of the distribution of such property to the other company after the winding up of the first mentioned company.

Thus, for a merger to be qualified as an 'amalgamation' for the purpose of the Income Tax Act, the above three conditions have to be satisfied.

### **Carry forward and set off of accumulated loss and unabsorbed depreciation allowance**

Under Section 72A, a special provision is made which relaxes the provision relating to carrying forward and set off of accumulated business loss and unabsorbed depreciation allowance in certain cases of amalgamation. Where there has been an amalgamation of a company owning an industrial undertaking or a ship or a hotel with another company, or an amalgamation of a banking company referred to in clause (c) of Section 5 of the Banking Regulations Act, 1949 with a specified bank, or one or more public sector company or companies engaged in the business of operation of aircraft with one or more public sector company or companies engaged in similar business, then, notwithstanding anything contained in any other provision of this Act, the accumulated loss and the unabsorbed depreciation of the amalgamating company shall be deemed to be the loss or; as the case may be, allowance for depreciation of the amalgamated company for the previous year in which the amalgamation was effected, and other provisions of this Act relating to set-off and carry forward of loss and allowance for depreciation shall apply accordingly.

*It is to be noted that as Unabsorbed losses of the amalgamating company are deemed to be the losses for the previous year in which the amalgamation was effected, the amalgamated company will have the right to carry forward the loss for a period of eight assessment years immediately succeeding the assessment year relevant to the previous year in which the amalgamation was effected.*

However, the above relaxations shall not be allowed in the assessment of the amalgamated company unless

- (a) the amalgamated company –
  - (i) has been engaged in the business in which the accumulated loss occurred or depreciation remains unabsorbed, for three or more years;
  - (ii) has held continuously as on date of the amalgamation at least three fourth of the book value of fixed assets held by it two years prior to the date of amalgamation;
- (b) the amalgamated company —
  - (i) holds continuously for a minimum of five years from the date of amalgamation at least three fourths of the book value of fixed assets of the amalgamating company acquired in a scheme of amalgamation;
  - (ii) continues the business of the amalgamating company for a minimum period of five years from the date of amalgamation;
  - (iii) fulfills such other conditions as may be prescribed to ensure the revival of the business of the amalgamating company or to ensure that the amalgamation is for genuine business purpose.

It further provides that in case where any of the above conditions are not complied with, the set off of loss or allowance of depreciation made in any previous year in the hands of the amalgamated company shall be

deemed to be the income of amalgamated company chargeable to tax for the year in which such conditions are not complied with.

For the purpose of this section, “accumulated loss” means so much of the loss of the predecessor firm or the proprietary concern or the amalgamating company or demerged company, as the case may be, under the head “Profit and gains of business or profession” (not being a loss sustained in a speculation business) which such predecessor firm or the proprietary concern or the amalgamated company or demerged company, would have been entitled to carry forward and set off under the provisions of Section 72 if the reorganization of business or amalgamation or demerger had not taken place. Similarly “unabsorbed depreciation” means so much of the allowance for depreciation of the predecessor firm or the proprietary concern or the amalgamating company or demerged company, as the case may be, which remains to be allowed and which would have been allowed to the predecessor firm or the proprietary concern or amalgamating company or demerged company, as the case may be, under the provisions of this Act, if the reorganization of business or amalgamation or demerger had not taken place.

#### **Amendments in Finance Act 2010 which will be effective from 1-4-2011**

It may be noted that under Finance Act 2010, the definition of accumulated loss and unabsorbed depreciation is as follows.

“accumulated loss” means so much of the loss of the predecessor firm or the proprietary concern or the private company or unlisted public company before conversion into limited liability partnership or the amalgamating company or the demerged company, as the case may be, under the head “Profits and gains of business or profession” (not being a loss sustained in a speculation business) which such predecessor firm or the proprietary concern or the company or amalgamating company or demerged company, would have been entitled to carry forward and set off under the provisions of section 72 if the reorganisation of business or conversion or amalgamation or demerger had not taken place;

“unabsorbed depreciation” means so much of the allowance for depreciation of the predecessor firm or the proprietary concern or the private company or unlisted public company before conversion into limited liability partnership or the amalgamating company or the demerged company, as the case may be, which remains to be allowed and which would have been allowed to the predecessor firm or the proprietary concern or the company or amalgamating company or demerged company, as the case may be, under the provisions of this Act, if the reorganisation of business or conversion or amalgamation or demerger had not taken place;

The following sub-section (6A) shall be inserted after sub-section (6) of section 72A by the Finance Act, 2010, w.e.f. 1-4-2011:

(6A) Where there has been reorganisation of business whereby a private company or unlisted public company is succeeded by a limited liability partnership fulfilling the conditions laid down in the proviso to clause (xiiib) of section 47, then, notwithstanding anything contained in any other provision of this Act, the accumulated loss and the unabsorbed depreciation of the predecessor company, shall be deemed to be the loss or allowance for depreciation of the successor limited liability partnership for the purpose of the previous year in which business reorganisation was effected and other provisions of this Act relating to set off and carry forward of loss and allowance for depreciation shall apply accordingly:

Provided that if any of the conditions laid down in the proviso to clause (xiiib) of section 47 are not complied with, the set off of loss or allowance of depreciation made in any previous year in the hands of the successor limited liability partnership, shall be deemed to be the income of the limited liability partnership chargeable to tax in the year in which such conditions are not complied with.

## Capital Gains Tax

Capital gains tax is leviable if there arises capital gain due to transfer of capital assets. The word 'transfer' under section 2(47) of the Act includes the sale, exchange or relinquishment of the asset or the extinguishment of any rights therein or the compulsory acquisition thereof under any law or in a case where the asset is converted by the owner thereof into, or is treated by him as, stock-in-trade of a business carried on by him, such conversion or treatment or any transaction involving the allowing of the possession of any immovable property to be taken or retained in part performance of a contract of the nature referred to in Section 53A of the Transfer of Property Act, 1882 (4 of 1882) or any transaction (whether by way of becoming a member of, or acquiring shares in, a co-operative society, company or other association of persons or by way of any agreement or any arrangement or in any other manner whatsoever) which has the effect of transferring or enabling the enjoyment of any immovable property.

Under section 47(vi) and (vii), transfer does not include any transfer in a scheme of amalgamation of a capital asset by the amalgamating company to the amalgamated company if the latter is an Indian company. From the assessment year 1993-94 any transfer of shares in an Indian company held by a foreign company to another foreign company in pursuance of a scheme of amalgamation between the two foreign companies will not be regarded as 'transfer' for the purpose of levying tax on capital gains. This provision will apply only if at least twenty five percent of the shareholders of the amalgamating foreign company continue to remain shareholders of the amalgamated foreign company and such transfer does not attract tax on capital gains in the country in which the amalgamating company is incorporated.

Further, the term transfer also does not include any transfer by a shareholder in a scheme of amalgamation of a capital asset being a share or the shares held by him in the amalgamating company if the transfer is made in consideration of the allotment to him of any share or the shares in the amalgamated company and the amalgamated company is an Indian company. Even in the absence of Section 47(vii) of the Act, a shareholder is not liable to pay any capital gains tax since an amalgamation does not include exchange or relinquishment of the assets. Amalgamation does not involve an exchange or relinquishment of shares by amalgamating company as held in *CIT v. Rasik Lal Manek Lal* (1975) 95 ITR 656). However, no benefit will be available under Section 47(vii) if the shareholders of amalgamating company are allotted something more than share in the amalgamated company viz. bonds or debentures [*CIT v. Gautam Sarabhai Trust* (1988) 173 ITR 216 (Guj.)].

## Amortisation of Preliminary Expenses

The benefit of amortisation of preliminary expenses under section 35D are ordinarily available only to the assessee who incurred the expenditure. However, the benefit will not be lost in case the undertaking of an Indian company which is entitled to the amortisation is transferred to another Indian company in a scheme of amalgamation within the 10 years/5 years period of amortisation. In that event the deduction in respect of previous year in which the amalgamation takes place and the following previous year within the 10 years/5 years period will be allowed to the amalgamated company and not to the amalgamating company.

## Capital Expenditure on Scientific Research

In the case of an amalgamation if the amalgamating company transfers to the amalgamated company, which is an Indian company, any asset representing capital expenditure on scientific research, provision of section 35 would apply to the amalgamated company as they would have applied to amalgamating company if the latter had not transferred the asset.

## Expenditure on Acquisition of Patent Right or Copyright

Where the assessee has purchased patent right or copyrights he is entitled to a deduction under Section 35A

for a period of 14 years in equal instalments. The amalgamated company gets the right to claim the unexpired instalments as a deduction from its total income.

The deduction under this section is however available for expenditure incurred before 1st April, 1998 only.

### **Expenditure on Amalgamation**

Section 35DD provides that where an assessee being an Indian company incurs any expenditure, on or after the 1st day of April, 1999, wholly and exclusively for the purposes of amalgamation or demerger of an undertaking, the assessee shall be allowed a deduction of an amount equal to one-fifth of such expenditure for each of the five successive previous years beginning with the previous year in which the amalgamation or demerger takes place.

### **Expenditure on know-how**

Section 35AB(3) of the Income-tax Act provides that where there is a transfer of an undertaking under a scheme of amalgamation or demerger and the amalgamating or the demerged company is entitled to a deduction under this section, then the amalgamated or the resulting company, as the case may be, shall be entitled to claim deduction under this section in respect of such undertaking to the same extent and in respect of the residual period as it would have been allowable to the amalgamating company or the demerged company, as the case may be, had such amalgamation or demerger not taken place.

The deduction under this section is however available for any lump sum consideration paid in any previous year relevant to the assessment year commencing on or before 1.4.1998.

### **Expenditure for obtaining Licence to Operate Telecommunication Services (Section 35ABB)**

The provisions of the section 35ABB of the Income Tax Act relating to deduction of expenditure, incurred for obtaining licence to operate communication services shall, as far as may be, apply to the amalgamated company as they would have applied to the amalgamating company if the latter had not transferred the licence.

## **TAX ASPECTS ON SLUMP SALE**

Section 293 of the Companies Act empowers the Board of Directors of a company, after obtaining the consent of the company in general meeting to sell lease or otherwise dispose off the whole or substantially the whole of the undertaking(s) of a company.

The transaction in this case, is normally of either of the following type:

- (a) Sale of a running concern.
- (b) Sale of a concern which is being wound up.

### *(a) Sale of a Running Concern*

This type of sale as a going concern provides for the continuation of the running of the undertaking without any interruption. But there is always a problem of fixing a value in the case of a running concern for all tangible and intangible assets including fixing a value for the infrastructure and other environmental facilities available. In view of all this, the seller normally fixes a lump sum price called 'slump price'.

The noun 'slump' means 'a gross amount, a lump'. Similarly, 'slump sum' means a 'lump sum' [Chambers Twentieth Century Dictionary, 1983 Edn., p 1220]. A slump sale or a slump transaction would, therefore, mean a sale or a transaction which has a lump sum price for consideration.



*(b) Sale of a concern which is being wound up*

On the other hand a sale in the course of winding up, is nothing but a realisation sale aimed at collecting the maximum price for distributing to the creditors and the balance to the contributories (the shareholders). By the very nature of the transaction, this is a piecemeal sale and not a slump sale. In this case, there will be liability to tax as per the various provisions of the Income Tax Act and the criteria which is applicable to a slump sale is not applicable here.

Normally, any sale of a capital asset will give rise to a capital receipt and any profit derived may give rise to capital gains in certain cases. This is true in the case of sale of an undertaking also.

In *Doughty v. Commissioner of Taxes*, the Privy Council laid down the following principles: The sale of a whole concern engaged in production process, e.g. dairy farming or sheep rearing, does not give rise to a revenue profit. The same might be said of a manufacturing business which is sold with the lease holds and plant, even if there are added to the sale piece goods in stock and even if these piece goods form a very substantial part of the aggregate sold. Where, however, business consists entirely in buying and selling, it is difficult to distinguish for income tax purposes between an ordinary and realisation sale, the object in either case being to dispose of the goods at a profit. The fact that the stock is sold out in one sale does not render the profit obtained any different in kind from the profit obtained by a series of gradual and smaller sales. In the case of such a realisation sale, if there is an item which can be traced as representing the stock-in-trade sold, the profit obtained by the sale of the stock-in-trade, though it is in conjunction with the sale of the whole concern, may be treated as taxable income. But where there is a sale of the whole concern and a transfer of all the assets for a single unapportioned consideration, there cannot be said to be any revenue profit realised on the sale of the stock-in-trade which is sold with all the other assets, although the business of the concern may consist entirely in buying and selling.

The Supreme Court, based on the above decision held in the following two cases that the price received on the sale of industrial undertaking is a capital receipt.

*CIT v. West Coast Chemicals and Industries Ltd.* – 46 ITR 135 — Where a slump price is paid and no portion is attributable to the stock-in-trade, it may not be possible to say that there is a profit other than what results from the appreciation of capital. The essence of the matter, however, is not that an extra amount has been gained by the selling out or the exchange but whether it can fairly be said that there was a trading, from which alone profit can arise in business.

*CIT v. Mugneeram Bangur and Co.* – 57 ITR 299 — In the case of a concern carrying on the business of buying land, developing it and then selling it, it is easy to distinguish a realisation sale from an ordinary sale, and it is very difficult to attribute part of the slump price to the cost of land sold in the realisation sale. The mere fact that in the schedule, the price of land was stated does not lead to the conclusion that part of the slump price is necessarily attributable to the land sold.

The same view was also reiterated by the Gujarat High Court in the following cases:

1. *Sarabhai M. Chemicals Pvt. Ltd. v. P.M. Mittal*, Competent Authority– 126 ITR 1.
2. *Artex Manufacturing Co. v. CIT* – 131 ITR 559.

At the same time, the Gujarat High Court also recognised that when an undertaking as a whole is sold as a going concern there will be liability under the head Capital Gains. In 126 ITR 1 the Gujarat High Court stated as follows:

It is well settled that business is property and the undertaking of a business is a capital asset of the owner of

the undertaking. When an undertaking as a whole is transferred as a going concern together with its goodwill and all other assets, what is sold is not the individual itemised property but what is sold is the capital asset consisting of the business of the undertaking and any tax that can be attracted to such a transaction for a slump price at book value would be merely capital gains tax and nothing else but capital gains tax. Plant or machinery of any fixture or furniture is not being sold as such. What is sold is the business of undertaking for a slump price. If the capital asset, namely, the business of the undertaking, has a greater value than its original cost of acquisition, then, capital gains may be attracted in the ordinary case of a sale of an undertaking.

The Bombay High Court also recognised that there will be a capital gains tax when a sale of business as a whole occurs (Refer *Killic Nixon and Co. v. CIT* 49 ITR 244).

### LESSON ROUND UP

- Financial aspects of mergers denotes financial benefits, i.e., increase in productivity, improved profitability and enhanced paying capacity.
- The incidence of stamp duty is an important consideration in the planning of any merger. In fact, in some cases, the whole form in which the merger is sought to take place is selected taking into account the savings in stamp duty. The incidence of stamp duty, more particularly on transfer of immovable property is fairly high to merit serious consideration. The fact that, in India, stamp duty is substantially levied by the States has given considerable scope for savings in stamp duty.
- Usually, in a merger, several other documents, agreements, indemnity bonds, etc. are executed, depending on the facts of each case and requirements of the parties. Stamp duty would also be leviable as per the nature of the instrument and its contents.
- Under Section 72A, a special provision is made which relaxes the provision relating to carrying forward and set off of accumulated business loss and unabsorbed depreciation allowance in certain cases of amalgamation.
- Capital gains tax is leviable if there arises capital gain due to transfer of capital assets.

### SELF TEST QUESTIONS

1. Describe the financial benefits that would arise out of merger.
2. Explain the constitutional background of Indian stamp act with respect to merger?
3. Is the order of high court an instrument? Is the stamp duty compulsory on the court order?
4. What are the tax advantages of mergers?

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# Lesson 6

## Interest of the Small Investors in Mergers

### LESSON OUTLINE

- Minority interest and substantive law
- Right of minority shareholders during mergers/amalgamation
- Fair valuation as a means of safeguarding minority interests
- Existing provisions of the Companies Act 1956
- Judicial pronouncements
- SEBI circular to protect the interest of minority in mergers.

### LEARNING OBJECTIVES

Shareholders have important rights which they can exercise democratically at the general meeting. They have the power to control and supervise management of the company. The term shareholder democracy relates to the different ways in which shareholders can influence or even determine a company's course of life. As regards mergers, the minority shareholders' interest may be protected through rational valuation, proper disclosure etc., After reading this lesson you will be able to understand the regulatory aspects, case laws, recent SEBI initiatives for the protection of minority shareholders in mergers.

Section 230-240 of Companies Act, 2013 are not yet notified and accordingly the provisions of Companies Act, 1956 are dealt in this lesson.

## INTRODUCTION\*

The fundamental principle defining operation of shareholders democracy is that the rule of majority shall prevail. However, it is also necessary to ensure that this power of the majority is placed within reasonable bounds and does not result in oppression of the minority and mis-management of the company. The minority interests, therefore, have to be given a voice to make their opinions known at the decision making levels. The law should provide for such a mechanism. If necessary, in cases where minority has been unfairly treated in violation of the law, the avenue to approach an appropriate body for protecting their interests and those of the company should be provided for. The law must balance the need for effective decision making on corporate matters on the basis of consensus without permitting persons in control of the company, i.e., the majority, to stifle action for redressal arising out of their own wrong doing.

### Minority and 'Minority Interest' under Companies Act

1. At present, in case of a company having share capital, not less than 100 members or not less than 1/10th of total number of members, whichever is less or any member or members holding not less than 1/10th of issued share capital have the right to apply to CLB/NCLT in case of oppression and mismanagement. In case of companies not having share capital, not less than 1/5th of total number of members have the right to apply.

2 To reflect the interest of the "Minority", a 10% criteria in case of companies having share capital and a 20% criteria in the case of other companies is provided for in the existing Act. In Section 395 of the Act, the dissenting shareholders have been put at the limit of 10% of shares. Thus Minority could be defined as holding not more than 10% shares for the limited purpose of agitating their rights before the appropriate forum.

3 Oppression is defined in section 397(2). It is defined as conducting the company's affairs in a manner prejudicial to public interest or in a manner oppressive to any member or members. Mis-management has been defined in section 398(1) of the Act, as conducting the affairs of the company in a manner prejudicial to public interest or in a manner prejudicial to the interests of the company.

### Rights of minority shareholders during mergers/amalgamations/ takeovers

1 As per existing provisions of the Act, approval of High Court/Tribunal is required in case of corporate restructuring (which, *inter-alia*, includes, mergers/amalgamations etc.) by a company. The Scheme is also required to be approved by shareholders, before it is filed with the High Court. The scheme is circulated to all shareholders along with statutory notice of the court convened meeting and the explanatory statement u/s 393 of the Act for approving the scheme by shareholders.

2 Though there may not be any protection to any dissenting minority shareholders on this issue, the Courts, while approving the scheme, follow judicious approach by mandating publicity about the proposed scheme in newspaper to seek objections, if any, against the scheme from the shareholders. Any interested person (including a minority shareholder) may appear before the Court. There have been, however, occasions when shareholders holding miniscule shareholdings, have made frivolous objections against the scheme, just with the objective of stalling or deferring the implementation of the scheme. The courts have, on a number of occasions, overruled their objections.

3 It is therefore, felt that there should be specific provision in the Act to put a limit (either according to a

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\* Source : <http://www.mca.gov.in/Ministry/chapter6.html>

minimum number of persons or according to a minimum percentage of shareholding) for entitling any body to object such a scheme. It would also be appropriate to provide for acquisition of remaining 10% shares in a company, of which 90% has been acquired by an acquirer. Such acquisition of 10% shares should be as per Rules to be framed by Central Government. The Committee has also made recommendations separately in para 19 of Chapter X, concerning a threshold limit for maintainability of objections by barring minority shareholders with insignificant stake from obstructing schemes of arrangement.

4 In case of Takeovers, as per SEBI (Substantial Acquisition of Shares and Takeover) Regulations, SEBI has powers to appoint investigating officer to undertake investigation, in case complaints are received from the investors, intermediaries or any other person on any matter having a bearing on the allegations of substantial acquisition of shares and takeovers. SEBI may also carry out such investigation suo moto upon its own knowledge or information about any breach of these regulations. Under section 395 of the Act, a transferee company, which has acquired 90% shares of a transferor company through a scheme or contract, is entitled to acquire shares of remaining 10% shareholders. Dissenting shareholders have been provided with an opportunity to approach Court/Tribunal. This scheme of things appears to be fair and should be continued. In order to object a scheme of amalgamation by investors, a limit shall be determined either according to the minimum number of members or according to the minimum percentage of shareholding;

**Existing legal provisions of Companies Act, with respect to 'Minority interest in Mergers/ Amalgamation etc'.**

Sections 391 to 396 of The Companies Act, 1956 guide the legal procedure for corporate strategies, including mergers, amalgamations and reconstructions.

Sections 391 to 394 *inter-alia* give the Court the power to sanction enforce and supervise a compromise or arrangement between a company and its creditors/members subject to certain conditions. These include providing for the availability of information required by creditors and members of the concerned company when acceding to such an arrangement and facilitating the reconstruction and amalgamation of companies, by making an appropriate application to the Court.

Section 395 gives the right to acquire the shares of dissenting shareholders from the scheme or contract, which has been approved by the majority. Section 396 deals with the powers of the Central Government to provide for an amalgamation of companies in the national interest.

In any scheme of amalgamation, both the amalgamating company and the amalgamated company are required to comply with the requirements specified in Sections 391 to 394 and submit the details of all the formalities for consideration of the Court.

**Protection of minority Interest**

Section 394(1) authorises the court to make provision for those who dissent from a scheme. Thus, the courts have to play a very vital role. It is not only a supervisory role but also a pragmatic role which requires the forming of an independent and informed judgement as regards the feasibility or proper working of the scheme and making suitable modifications in the scheme and issuing appropriate directions with that end in view [*Mafatlal Industries Ltd. In re.* (1995) 84 Comp. Cas. 230 (Guj.)].

**The court considers Minority interest while approving the scheme of merger**

As per existing provisions of the Act, approval of High Court/Tribunal is required in case of corporate restructuring (which, inter-alia, includes, mergers/amalgamations etc.) by a company. The Scheme is also

required to be approved by shareholders, before it is filed with the High Court. The scheme is circulated to all shareholders along with statutory notice of the court convened meeting and the explanatory statement u/s 393 of the Act for approving the scheme by shareholders

Though there may not be any protection to any dissenting minority shareholders on this issue, the Courts, while approving the scheme, follow judicious approach by mandating publicity about the proposed scheme in newspaper to seek objections, if any, against the scheme from the shareholders. Any interested person (including a minority shareholder) may appear before the Court. There have been, however, occasions when shareholders holding miniscule shareholdings, have made frivolous objections against the scheme, just with the objective of stalling or deferring the implementation of the scheme. The courts have, on a number of occasions, overruled their objections.

### **Some Judicial Pronouncements**

There have been occasions when the minority shareholders have raised objections and have succeeded in preventing the implementation of a scheme of arrangement. A lone minority shareholder of *Tainwala Polycontainers Ltd (TPL)*, *Dinesh V Lakhani*, had apparently forced the company to call off its merger plans with Tainwala Chemicals and Plastics (India) Ltd (TCPL). Lakhani had opposed the proposed merger on several grounds including allegations of willful suppression of material facts and malafide intention of promoters in floating separate companies (TPL and TCPL).

A division bench of the Bombay High Court had stayed the proposed TPL-TCPL merger. After almost two years of courtroom battle, the company decided to withdraw the amalgamation petition without citing any reasons.

#### *Frivolous objections by Minority shareholders are not entertained by Court*

There have however been some instances when shareholders holding a small number of shares, have made frivolous objections against the scheme, just with the objective of deferring the implementation of the scheme. The courts have, on a number of occasions, overruled their objections. But Companies had to bear the consequences in the form of time and cost over-runs.

#### *In case of Parke-Davis India Limited*

In 2003, Parke-Davis India Limited and Pfizer Limited were considering implementation of a Scheme of Merger. The Minority shareholders of Parke-Davis India Ltd objected to the Scheme on the grounds that the approval from the requisite majority as prescribed under the Companies Act, 1956 had not been obtained. They filed an urgent petition before the division bench of the Bombay High Court. The division bench of the Bombay High Court by its order executed a stay order in March 2003 restraining the company from taking further steps in the implementation of the scheme of amalgamation, which was further extended till September 2003. The dissenting shareholders filed a Special Leave Petition with the Supreme Court. The turmoil came to an end when the Supreme Court dismissed the petition filed by the shareholders. Parke-Davis then proceeded to complete the implementation of the scheme of amalgamation with Pfizer.

#### *In case of Tomco with HLL Merger*

Similarly, in the case of the merger of Tomco with HLL, the minority shareholders put forward an argument that, as a result of the amalgamation, a large share of the market would be captured by HLL. However, the court turned down the argument and observed that there was nothing unlawful or illegal about it.

**Majority approval cannot deprive minority from raising objections.**

Approval of majority of shareholders is not an automatic rejection of objections of minority shareholders. The court has to apply its mind to dissent or objections raised by minority shareholders. The majority view will prevail if there is nothing cogent or valid in the objections (In case of Consolidated Coffee Limited (1999))

**Fair and reasonable Scheme made in good faith**

Any scheme which is fair and reasonable and made in good faith will be sanctioned if it could reasonably be supported by sensible people to be for the benefit to each class of the members or creditors concerned. In *Sussex Brick Co. Ltd., Re*, (1960) 1 All ER 772 : (1960) 30 Com Cases 536 (Ch D) it was held, *inter alia*, that although it might be possible to find faults in a scheme that would not be sufficient ground to reject it. It was further held that in order to merit rejection, a scheme must be obviously unfair, patently unfair, unfair to the meanest intelligence. It cannot be said that no scheme can be effective to bind a dissenting shareholder unless it complies with the basic requirements to the extent of 100 per cent. It is the consistent view of the Courts that no scheme can be said to be fool-proof and it is possible to find faults in a particular scheme but that by itself is not enough to warrant a dismissal of the petition for sanction of the scheme. If the court is satisfied that the scheme is fair and reasonable and in the interests of the general body of shareholders, the court will not make any provision in favour of the dissentients. For such a provision is not a *sine qua non* to sanctioning a fair and reasonable scheme, unless any special case is made out which warrants the exercise of court's discretion in favour of the dissentients. *Re, Kami Cement & Industrial Co. Ltd.*, (1937) 7 Com Cases 348, 364-65 (Bom).

The Courts have gone further to say that a scheme must be held to be unfair to the meanest intelligence before it can be rejected. It must be affirmatively proved to the satisfaction of the Court that the scheme is unfair before the scheme can be rejected by the Court. *English, Scottish & Australian Chartered Bank, Re*, (1893) 3 Chancery 385.

A conjoint reading of sections 391 and 393 makes it clear at once that the Company Court which is called upon to sanction a scheme has not merely to go by the *ipse dixit*\* of the majority of the shareholders or creditors or their respective classes who might have voted in favour of the scheme by requisite majority but the court has to consider the pros and cons of the scheme with a view to finding out whether the scheme is fair, just and reasonable and is not contrary to any provisions of law and it does not violate any public policy. This is implicit in the very concept of compromise or arrangement which is required to receive the imprimatur of a court of law. No court of law would ever countenance any scheme of compromise or arrangement arrived at between the parties and which might be supported by the requisite majority if the court finds that it is an unconscionable or an illegal scheme or is otherwise unfair or unjust to the class of shareholders or creditors for whom it is meant. It is trite to say that once the scheme gets sanctioned by the court it would bind even the dissenting minority shareholders or creditors. Therefore, the fairness of the scheme qua them also has to be kept in view by the Company Court while putting its seal of approval on the concerned scheme. [*Miheer H. Mafatlal v. Mafatlal Industries Ltd.*, (1996) 87 Com Cases 792 at 812 (SC)]

**Measures by SEBI to protect the interest of Minority Shareholders**

SEBI has issued a Circular No. CIR/CFD/DIL/5/2013 dated 4th February, 2013, to revamp the whole process of approval of Scheme of Mergers/demergers involving listed Companies. At present all schemes of merger/demerger/reduction of capital involving listed companies require a No Objection of Stock Exchanges before the schemes/petitions are filed before the High Court having jurisdiction over the companies.

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\* *ipse dixit* means an unsupported statement.

Similarly, schemes which allow listing of unlisted companies require approval of the SEBI after the scheme is approved by the High Court. As per the circular, SEBI has observed that, in the recent past, the applications received for seeking exemption, contained inadequate disclosures, convoluted schemes of arrangement, exaggerated valuations, etc and is of the view that granting listing permission or exemption based on such applications may not be in the interest of minority shareholders.

The amended provisions now require Stock Exchanges to give their reasoned observations on the scheme and refer the same to SEBI. SEBI would also analyse the scheme, the valuation report etc. and give their observations on very Scheme of Merger/Demerger and Reduction of Capital. Besides this all relevant information and documents would be made public by the Company as well as Stock Exchanges and Comments/Objections received during 21 days would be addressed by the Company and considered by the Stock Exchanges/SEBI while granting No Objection. The other important change is mandatory Postal Ballot approval and e-Voting on the scheme. SEBI also mandated approval of the scheme by at least 2/3rd of Minority shareholders. These changes would create much better transparency and protection of minority investors. The process has become very much similar to Takeover Offers/Rights Issues.

The Circular is applicable with immediate effect and would be applicable to:

Listed companies which are entering into the Scheme of Arrangements but have not submitted the Scheme with the Hon'ble High Court; and

The companies that have submitted the Draft Scheme with the stock exchanges under Clause 24(f) of Listing Agreement and such schemes have not yet been submitted with the Hon'ble High Court for approval.

All scheme which have already got their No Objection from Stock Exchanges but have not yet filed with High Court would require resubmission with the Stock Exchange

The salient features of the revised rules include the following:

#### *OBLIGATIONS OF LISTED COMPANIES*

1. It shall file the Draft Scheme of Arrangement, with the Stock Exchange in accordance with Clause 24 (f) of the Listing Agreement;
2. It shall place before its Audit Committee the Valuation Report obtained from an Independent Chartered Accountant. The Audit Committee shall furnish a report recommending the Draft Scheme, taking into consideration, inter alia, the aforementioned valuation report;
3. Immediately upon filing of the Draft Scheme with the stock exchanges, it shall disclose the Draft Scheme and all the documents on its website.
4. It is required to:-
  - Include the observation letter of the Stock Exchange in the notice sent to the shareholders;
  - Bring the same to the notice of the Hon'ble High Court at the time of seeking approval of the Scheme;
  - Disclose the Observation Letter of the stock exchanges on its website within 24 hours of receiving the same.
5. It shall ensure that the Scheme provides for obtaining shareholders' approval through special resolution passed through postal ballot and e-voting. The Scheme shall also provide that the special resolution shall be acted upon only if the votes cast by public shareholders in favor of the proposal amount to at least two times the number of votes cast by public shareholders against it.



6. It shall submit to stock exchanges a 'Complaints Report' which shall contain the details of complaints/comments received by it on the Draft Scheme from various sources prior to obtaining Observation Letter from stock exchanges
7. 'Complaints Report' shall also be included in the notice sent to the shareholders while seeking approval of the Scheme.
8. 'Complaints Report', shall be submitted to the stock exchanges within 7 days of expiry of 21 days from the date of filing of Draft Scheme with stock exchanges
9. Upon sanction of Scheme by the Hon'ble High Court, the listed company shall submit the documents, to the stock exchanges.
10. The designated stock exchange shall forward its recommendations to SEBI
11. SEBI shall endeavour to offer its comments/approval, to the designated stock exchange in 30 days.

### LESSON ROUNDUP

- At present, in case of a company having share capital, not less than 100 members or not less than 1/10th of total number of members, whichever is less or any member or members holding not less than 1/10th of issued share capital have the right to apply to CLB/NCLT in case of oppression and mismanagement.
- Section 394(1) authorises the court to make provision for those who dissent from a scheme.
- There have been occasions when the minority shareholders have raised objections and have succeeded in preventing the implementation of a scheme of arrangement.
- SEBI has observed that, in the recent past, the applications received for seeking exemption, contained inadequate disclosures, convoluted schemes of arrangement, exaggerated valuations, etc and is of the view that granting listing permission or exemption based on such applications may not be in the interest of minority shareholders and has issued circulars in the interest of minority for corporate restructuring decisions.

### SELF TEST QUESTIONS

1. Write a brief regulatory background about protection of minority interest?
2. Describe the success of minority shareholders in merger decision with case laws.
3. What measures have been taken by SEBI to protect the interest of minority shareholders?

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# Lesson 7

## Amalgamation of Banking and Government Companies

### LESSON OUTLINE

- Amalgamation of Banking Companies- Background
- Guidelines issued by RBI for amalgamation of private sector banks
- Amalgamation of NBFC with banking company
- Procedure for amalgamation of government companies

### LEARNING OBJECTIVES

Mergers and acquisitions (M&As) are most widely used strategy by firms to strengthen and maintain their position in the market place. M&As are considered as a relatively fast and efficient way to expand into new markets and incorporate new technologies. Banking companies are not exceptions to this practicality. Procedures for merger, acquisition, and amalgamation of banking companies are clearly defined in section 44(A) of the Banking Regulation Act 1949.

Section 396 of Companies Act, 1956 confers on the Central Government special power to order amalgamation of two or more companies into a single company, if the Government is satisfied that it is essential in the public interest that two or more companies should amalgamate. Ministry of Corporate Affairs prescribed certain simplified procedure for amalgamation of government companies.

After reading this lesson you will be able to understand the procedural aspects as to the merger of private sector banks, amalgamation of NBFC with a banking company, procedural aspects relating to amalgamation of government companies under Section 396 of the companies.

## AMALGAMATION OF BANKING COMPANIES

### Background

Amalgamation of one banking company with another banking company is governed by the provisions of Banking Regulation Act, 1949. The provisions of the Companies Act, 1956 are not applicable in this case.

According to section 2(5) of the Companies Act, 1956 “Banking company” has the same meaning as in the Banking Companies Act, 1949. (now the Banking Regulation Act, 1949). Section 5(1)(c) of the Banking Regulation Act, 1949 defines a “banking company” as any company which transacts the business of banking in India.

Section 44A of the Banking Regulation Act, 1949 provides for the procedure for amalgamation of banking companies.

The RBI's power under section 44A shall not affect the power of the Central government to provide for the amalgamation of two or more banking companies under section 396 of the Companies Act, 1956. But, in such a case, the Central Government must consult the RBI before passing any order under Section 396. [Section 44A(7)].

### Major Mergers of Last Decade

<i>Year</i>	<i>Transferor Bank</i>	<i>Transferee Bank</i>
2001	Bank of Madura	ICICI Bank Ltd.
2002	Benaras State Bank Ltd.	Bank of Baroda
2003	Bank Muscat	Centurion Bank of Punjab
2004	Global Trust Bank Ltd.	Oriental Bank of Commerce
2005	Bank of Punjab Ltd.	Centurion Bank of Punjab.
2006	Lord Krishna Bank	Centurion Bank of Punjab
2007	Sangli Bank	ICICI Bank Ltd.
2008	State Bank of Saurashtra	State Bank of India
2009	Centurion Bank of Punjab	HDFC Bank Ltd.
2010	Bank of Rajasthan	ICICI Bank Ltd.

## GUIDELINES ISSUED BY RBI FOR MERGER /AMALGAMATION OF PRIVATE SECTOR BANKS

### Amalgamation between two banking companies

- Section 44A of the Banking Regulation Act, 1949 requires that the draft scheme of amalgamation has to be approved by the shareholders of each banking company by a resolution passed by a majority in number representing two-thirds in value of the shareholders, present in person or by proxy at a meeting called for the purpose.
- Before convening the meeting for the purposes of obtaining the shareholders' approval, the draft scheme of amalgamation needs to be approved individually by the Boards of Directors of the two

banking companies. When according this approval, the Boards need to give particular consideration to the following matters:-

- (a) The values at which the assets, liabilities and the reserves of the amalgamated company are proposed to be incorporated into the books of the amalgamating banking company and whether such incorporation will result in a revaluation of assets upwards or credit being taken for unrealized gains.
  - (b) Whether due diligence exercise has been undertaken in respect of the amalgamated company.
  - (c) The nature of the consideration, which, the amalgamating banking company will pay to the shareholders of the amalgamated company.
  - (d) Whether the swap ratio has been determined by independent valuers having required competence and experience and whether in the opinion of the Board such swap ratio is fair and proper.
  - (e) The shareholding pattern in the two banking companies and whether as a result of the amalgamation and the swap ratio the shareholding of any individual, entity or group in the amalgamating banking company will be violative of the Reserve Bank guidelines or require its specific approval.
  - (f) The impact of the amalgamation on the profitability and the capital adequacy ratio of the amalgamating banking company.
  - (g) The changes which are proposed to be made in the composition of the board of directors of the amalgamating banking company, consequent upon the amalgamation and whether the resultant composition of the Board will be in conformity with the Reserve Bank guidelines in that behalf.
- Section 44A of the Banking Regulation Act, 1949 also requires that after the scheme of amalgamation is approved by the requisite majority of shareholders in accordance with the provisions of the Section, it shall be submitted to the Reserve Bank for sanction.
- To enable the Reserve Bank to consider the application for sanction, the amalgamating banking company should submit to the Reserve Bank the information and documents specified below:
1. Draft scheme of amalgamation as placed before the shareholders of the respective banking companies for approval.
  2. Copies of the notices of every meeting of the shareholders called for such approval together with newspaper cuttings evidencing that notices of the meetings were published in newspapers at least once a week for three consecutive weeks in two newspapers circulating in the locality or localities in which the registered offices of the banking companies are situated and that one of the newspapers was in a language commonly understood in the locality or localities.
  3. Certificates signed by each of the officers presiding at the meeting of shareholders certifying the following:
    - (a) a copy of the resolution passed at the meeting;
    - (b) the number of shareholders present at the meeting in person or by proxy;
    - (c) the number of shareholders who voted in favour of the resolution and the aggregate number of shares held by them;
    - (d) the number of shareholders who voted against the resolution and the aggregate number of

shares held by them;

- (e) the number of shareholders whose votes were declared as invalid and the aggregate number of shares held by them;
  - (f) the names and ledger folios of the shareholders who voted against the resolution and the number of shares held by each such shareholder;
  - (g) the names and designations of the scrutineers appointed for counting the votes at the meeting together with certificates from such scrutineers confirming the information given in items (c) to (f) above;
  - (h) the name of shareholders who have given notice in writing to the Presiding Officer that they dissented from the scheme of amalgamation together with the number of shares held by each of them.
4. Certificates from the concerned officers of the banking companies giving names of shareholders who have given notice in writing at or prior to the meeting to the banking company that they dissented from the scheme of amalgamation together with the number of shares held by each of them.
  5. The names, addresses and occupations of the Directors of the amalgamating banking company as proposed to be reconstituted after the amalgamation and indicating how the composition will be in compliance with Reserve Bank regulations.
  6. The details of the proposed Chief Executive Officer of the amalgamating banking company after the amalgamation.
  7. Copies of the reports of the valuers appointed for the determination of the swap ratios.
  8. Information which is considered relevant for the consideration of the scheme of amalgamation and the swap ratio.
  9. Information certified by the valuers as is considered relevant to understand the proposed swap ratio including in particular:
    - (a) the methods of valuation used by the valuers;
    - (b) the information and documents on which the valuers have relied and the extent of the verification, if any, made by the valuers to test the accuracy of such information;
    - (c) if the valuers have relied upon projected information, the names and designations of the persons who have provided such information and the extent of verification, if any, made by the valuers in relation to such information;
    - (d) details of the projected information on which the valuers have relied;
    - (e) detailed computations of the swap ratios containing explanations for adjustments made to the published financial information for the purposes of the valuation;
    - (f) if these adjustments are made based on valuations made by third parties, details regarding the persons who have made such valuations;
    - (g) capitalisation factor and weighted average cost of capital (WACC) used for the purposes of the valuation and justification for the same;
    - (h) if market values of shares have been considered in the computation of the swap ratio, the

market values considered and the source from which such values have been derived;

- (i) if there are more than one valuer, whether each of the valuers have recommended a different swap ratio and if so, the above details should be given separately in respect of each valuer and it may be indicated how the final swap ratio is arrived at.

10. Such other information and explanations as the Reserve Bank may require.

- To enable the Reserve Bank to determine such value, the amalgamated banking company should submit the following:-
  - (a) a report on the valuation of the share of the amalgamated company made for this purpose by the valuers appointed for the determination of the swap ratio
  - (b) detailed computation of such valuation
  - (c) where the shares of the amalgamated company are quoted on the stock exchange:-
    - (i) details of the monthly high and low of the quotation on the exchange where the shares are most widely traded together with number of shares traded during the six months immediately preceding the date on which the scheme of amalgamation is approved by the Boards.
    - (ii) the quoted price of the share at close on each of the fourteen days immediately preceding the date on which the scheme of amalgamation is approved by the Boards.
  - (d) Such other information and explanations as the Reserve Bank may require.

### **Amalgamation of an NBFC with a banking company**

Where the NBFC is proposed to be amalgamated into a banking company, the banking company should obtain the approval of the Reserve Bank of India after the scheme of amalgamation is approved by its Board but before it is submitted to the High Court for approval.

The following are ensured while granting the approval

- (a) The NBFC has violated / is likely to violate any of the RBI/SEBI norms and if so, ensure that these norms are complied with before the scheme of amalgamation is approved.
- (b) The NBFC has complied with the 'Know Your Customer' norms for all the accounts, which will become accounts of the banking company after amalgamation.
- (c) The NBFC has availed of credit facilities from banks/FIs and if so, whether the loan agreements mandate the NBFC to seek consent of the bank/FI concerned for the proposed merger/amalgamation.

### **Prior approval of RBI in cases of acquisition or transfer of control of deposit taking NBFCs**

As per, Non-Banking Financial Companies (Deposit Accepting) (Approval of Acquisition or Transfer of Control) Directions, 2009, any takeover or acquisition of control of a deposit taking NBFC, whether by acquisition of shares or otherwise, or any merger/amalgamation of a deposit taking NBFC with another entity, or any merger/amalgamation of an entity with a deposit taking NBFC, shall require prior written approval of Reserve Bank of India. The Reserve Bank of India may, if it considers necessary for avoiding any hardship or for any other just and sufficient reason, exempt any NBFC or class of NBFCs, from all or any of the provisions of these Directions either generally or for any specified period, subject to such conditions as the Reserve Bank of India may impose.

### **Approval of Scheme of Amalgamation**

- To amalgamate one banking company with another banking company, a scheme of amalgamation must be placed in draft before the shareholders of each of the banking companies concerned separately, and approved by a resolution passed by a majority in number representing two-thirds in value of the shareholders of each of the said companies, present either in person or by proxy. [Section 44A(1)].
- The approval of the shareholders must be secured at an extraordinary general meeting of each of the concerned companies, specially convened for the purpose of approving the scheme.
- In the first instance, the scheme shall be placed before the Board of Directors of each of the concerned companies.
- The Board will pass resolutions to –
  - (a) approve the scheme of amalgamation;
  - (b) fix the time, date and place of the extraordinary general meeting;
  - (c) authorise the Managing Director/Company Secretary/any director or officer of the company to issue notice of the meeting;
  - (d) do such other acts, things and deeds as may be necessary or expedient to do for the purpose of securing approval of the shareholders or others to the scheme.

### **Convening General Meeting**

- Notice of every extraordinary general meeting as is referred to above must be given to every shareholder of each of the banking companies concerned in accordance with the relevant articles of association [section 44A(2)].
- The notice of the meeting must indicate the time, place and object of the meeting [section 44A(2)].
- The notice of the meeting must also be published at least once a week for three consecutive weeks in not less than two newspapers which circulate in the locality or localities where the registered offices of the banking companies concerned are situated, one of such newspapers being in a language commonly understood in the locality or localities [section 44A(2)].
- It is advisable to explain in a note the salient features of the scheme and also to enclose to the notice full scheme of amalgamation.

### **Resolution for approval of the scheme**

- The scheme of amalgamation must be approved by means of a resolution passed at the general meeting, by a majority in number representing two-third in value of the shareholders of each of the said companies, present either in person or by proxy at a meeting called for the purpose [section 44A(1)].

### **Dissenting shareholders' right to claim return of capital**

- Any shareholder, who has voted against the scheme of a amalgamation at the meeting or has given notice in writing at or prior to the meeting to the company concerned or to the presiding officer of the meeting that he dissents from the scheme of amalgamation, shall be entitled in the event of the scheme being sanctioned by the RBI, to claim from the banking company concerned, in respect of



the shares held by him in that company, their value as determined by the RBI when sanctioning the scheme [section 44A(3)].

- The determination by the RBI regarding the value of the shares to be paid to the dissenting shareholders shall be final for all purposes [section 44A(3)].

### **Approval by Reserve Bank of India**

- If the scheme of amalgamation is approved by the requisite majority of shareholders in accordance with the provisions of this section, it shall be submitted to the RBI (Reserve Bank of India) for its sanction [section 44A(4)].
- The RBI may sanction a scheme by an order in writing [section 44A(4)].
- A scheme sanctioned by the RBI shall be binding on the banking companies concerned and also on all the shareholders thereof [section 44A(4)].
- An order sanctioning a Scheme of Amalgamation, passed by the RBI under section 44A(4) shall be conclusive evidence that all the requirements of this section relating to amalgamation have been complied with [section 44A(6C)].
- A copy of the said order certified in writing by an officer of the RBI to be a true copy of such order and a copy of the scheme certified in the like manner to be a true copy thereof shall, in all legal proceedings (whether in appeal or otherwise) be admitted as evidence to the same extent as the original order and the original scheme [section 44A(6C)].

### **Transfer of property**

- On the sanctioning of a scheme of amalgamation by the RBI, the property of the amalgamated banking company, i.e. the transferor company, shall, by virtue of the order of sanction, be transferred to and vest in the transferee company. No other or further document will be necessary for effecting the transfer and vesting of the property from the transferor company to the transferee company [section 44A(6)].
- Similarly, the liabilities of the transferor company shall, by virtue of the said order, be transferred to, and become the liabilities of the transferee company [section 44A(6)].

### **Dissolution of transferor company**

- Where a scheme of amalgamation is sanctioned by the RBI, the RBI may, by a further order in writing, direct that on the date specified in the order, the amalgamated banking company i.e., the transferor company, shall stand dissolved [section 44A(6A)].
- A copy of the order directing dissolution of the amalgamated banking company shall be forwarded by the RBI to the office of the Registrar of companies at which it has been registered. On receipt of such order, the Registrar shall strike off the name of the company. [section 44A(6B)].

### **Salient Features of Banking Laws (Amendment) Bill 2012**

The Banking Laws (Amendment) Bill 2012 was introduced in order to amend the Banking Regulation Act, 1949, the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980. This Bill would strengthen the regulatory powers of Reserve Bank of India (RBI) and to further develop the banking sector in India. It will also enable the nationalized banks to raise capital by issue of preference shares or rights issue or issue of bonus shares.

The salient features of the Bill from the point of view of restructuring are as follows:

- To enable banking companies to issue preference shares subject to regulatory guidelines by the RBI;
- To increase the cap on restrictions on voting rights;
- To provide prior approval of RBI for acquisition of 5% or more of shares or voting rights in a banking company by any person and empowering RBI to impose such conditions as it deems fit in this respect.
- To empower RBI to collect information and inspect associate enterprises of banking companies;
- To enable the nationalized banks to raise capital through “bonus” and “rights” issue and also enable them to increase or decrease the authorized capital with approval from the Government and RBI without being limited by the ceiling of a maximum of Rs. 3000 crore under the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/80.

#### **PROCEDURE FOR MERGER AND AMALGAMATION RELATED TO GOVERNMENT COMPANIES (vide MCA circular dated 20.04.2011)**

The Ministry of Corporate Affairs (MCA) have been dealing with the amalgamation of Government Companies in the Public Interest under section 396 of the Companies Act, 1956 by following the procedures prescribed under Companies (Court) Rules, 1959 which are applicable to amalgamation under Sections 391-394 of the Companies Act, 1956. Without prejudice to the generality of Section 396, it has now been decided that, in appropriate cases, simpler procedures shall be adopted for the amalgamation of Government Companies under section 396 of the Companies Act, 1956 as given below:-

- (1) (a) Every Central Government Company which is applying to the Central Government for amalgamation with any other Government Company or Companies under the simplified prescribed procedure, shall obtain approval of the Cabinet i.e. Union Council of Ministers to the effect that the proposed amalgamation is essential in the ‘public interest’.
- (b) In the case of State government companies, the approval of the State Council of Ministers would be required.
- (c) Where both central and state government companies are involved, approval of both State Cabinet(s) and Central Cabinet shall be necessary.
- (2) (i) A Government Company may, by a resolution passed at its general meeting decide to amalgamate with any other Government Company, which agrees to such transfer by a resolution passed at its general meeting;
- (ii) Any two or more Government Companies may, by a resolution passed at any general meetings of its Members, decide to amalgamate and with a new Government Company.
- (3) Every resolution of a Government Company under this section shall be passed at its general meeting by members holding 100% of the voting power and such resolution shall contain all particulars of the assets and liabilities of amalgamating government companies.
- (4) Before passing a resolution under this section, the Government Company shall give notice thereof of not less than 30 days in writing together with a copy of the proposed resolution to all the Members and creditors.
- (5) A resolution passed by a Government Company under this section shall not take effect until (i) the assent of all creditors has been obtained, or (ii) the assent of 90% of the creditors by value has been received and the company certifies that there is no objection from any other creditor.

- (6) The resolutions passed by the transferor and transferee companies along with written confirmation of the Cabinet decision shall then be submitted to the Central Government which shall, if it is satisfied that all the requirements of Section 396 and the circular issued by MCA on this behalf have been fulfilled, order by notification in the Gazette that the said amalgamation shall take effect.
- (7) The order of the Central Government shall provide:-
  - (a) for the transfer to the transferee company of the whole or any part of the undertaking, property or liabilities of any transferor company
  - (b) that the amalgamation of companies under the foregoing sub-sections shall not in any manner whatsoever affect the pre-existing rights or obligations and any legal proceedings that might have been continued or commenced by or against any erstwhile company before the amalgamation, may be continued or commenced by, or against, the concerned resulting company, or transferee company, as the case may be.
  - (c) for such incidental, consequential and supplemental matters as are necessary to secure that the amalgamation shall be fully and effectively carried out
- (8) The Cabinet decision referred to in para (1) above may precede or follow the passing of the resolution referred to in para (2).
- (9) When an order has been passed by the Central Government under this section, it shall be a sufficient conveyance to vest the assets and liabilities in the transferee.
- (10) Where one government company is amalgamated with another government company, under these provisions, the registration of the first-mentioned Company i.e. transferor company, shall stand cancelled and that Company shall be deemed to have been dissolved and shall cease to exist forthwith as a corporate body.
- (11) Where two or more Government Companies are amalgamated into a new Government Company in accordance with these provisions and the Government Company so formed is duly registered by the Registrar, the registration of each of the amalgamating companies shall stand cancelled forthwith on such registration and each of the Companies shall thereupon cease to exist as a corporate body.
- (12) The amalgamation of companies under the foregoing sub-sections shall not in any manner whatsoever affect the pre-existing rights or obligations, and any legal proceedings that might have been continued or commenced by or against any erstwhile company before the amalgamation, may be continued or commenced by, or against, the concerned resulting company, or transferee company, as the case may be.
- (13) The Registrar shall strike off the names of every Government Company deemed to have been dissolved under sub-sections (10) to (11).
- (14) Government companies are not prevented from applying for amalgamation before the Central Government under Sections 391-394 of the Companies Act.

## LESSON ROUND UP

- Amalgamation of one banking company with another banking company is governed by the provisions of Banking Regulation Act, 1949. The provisions of the Companies Act, 1956 are not applicable in this case.
- Section 44A of the Banking Regulation Act, 1949 requires that the draft scheme of amalgamation has to be approved by the shareholders of each banking company by a resolution passed by a majority in number representing two-thirds in value of the shareholders, present in person or by proxy at a meeting called for the purpose.
- Where the NBFC is proposed to be amalgamated into a banking company, the banking company should

obtain the approval of the Reserve Bank of India after the scheme of amalgamation is approved by its Board but before it is submitted to the High Court for approval.

- As per, Non-Banking Financial Companies (Deposit Accepting) (Approval of Acquisition or Transfer of Control) Directions, 2009, any takeover or acquisition of control of a deposit taking NBFC, whether by acquisition of shares or otherwise, or any merger/amalgamation of a deposit taking NBFC with another entity, or any merger/amalgamation of an entity with a deposit taking NBFC, shall require prior written approval of Reserve Bank of India.
- Without prejudice to the generality of Section 396, it has now been notified by the Ministry of Corporate Affairs that, in appropriate cases, simpler procedures shall be adopted for the amalgamation of Government Companies under section 396 of the Companies Act, 1956.

## SELF TEST QUESTIONS

1. Describe the procedure for amalgamation of private sector banks.
2. Explain the procedural aspects with respect to amalgamation of NBFC with a banking company.
3. Amalgamation of government companies has simplified procedure to comply with. Explain this statement.

This image shows a single sheet of white paper with horizontal black ruling lines. The lines are evenly spaced and run across the width of the page. There is a solid black header bar at the top of the page. The paper appears to be part of a binder or notebook, as evidenced by the hole punches along the left edge.

# Lesson 8

## Corporate Demergers and Reverse Mergers

### LESSON OUTLINE

- Meaning of demerger, demerged and resulting company
- Difference between demerger and reconstruction
- Legal aspects of demerger
- Spin off and split off
- Modes of demerger
- Importance of appointed date
- Procedural aspects
- Taxation aspects
- Reverse merger

### LEARNING OBJECTIVES

Companies have to downsize their operations in certain circumstances such as when a division of the company is performing poorly or simply because it no longer fits into the company's plans. This may also be necessary to undo a previous merger or acquisition which proved unsuccessful. Such downsizing of corporate restructuring is carried out through strategies such as demerger or spin off, split off, etc.

In a reverse merger, a healthy company merges with a financially weak company. The main reason for this type of reverse merger is to avail tax benefits under the Income-Tax Act, 1961.

After reading this lesson you will be able to understand the concepts of demerger, its methods, procedural compliances as to demerger, taxation aspects relating to demerger or reverse merger etc.

Section 230-240 of Companies Act, 2013 are not yet notified and accordingly the provisions of Companies Act, 1956 are dealt in this lesson.

## INTRODUCTION

In the era of globalization, corporates all over the world are moving towards consolidation and redefining core competencies to survive and achieve their objectives. The corporate sector in India is also resorting to various mechanism of corporate restructuring to improve efficiency. Over the last few years, different modes of corporate restructuring such as stock splits, capital restructuring, mergers and acquisitions etc. have been adopted by companies in India.

Companies have to downsize or 'contract' their operations in certain circumstances such as when a division of the company is performing poorly or simply because it no longer fits into the company's plans or to give effect to rationalisation or specialisation in the manufacturing process. This may also be necessary to undo a previous merger or acquisition which proved unsuccessful. This type of restructuring can take various forms such as demerger or spin off, split off, etc.

Large entities sometimes hinder entrepreneurial initiative, sideline core activities, reduce accountability and promote investment in non-core activities. There is an increasing realisation among companies that demerger may allow them to strengthen their core competence and realise the true value of their business.

## DEMERGER UNDER THE COMPANIES ACT, 1956

The expression demerger is not expressly defined in the Companies Act, 1956. However, it is covered under the expression 'arrangement' as defined in clause (b) of Section 390 of the Companies Act, 1956. According to this definition, 'arrangement' includes a re-organisation of the Share Capital of the Company by the consolidation of shares of different classes, or by the division of shares into shares of different classes or, by both these methods. Such divisions may take place for various reasons internal or external. Internal factors are generally split in family rather than lack of competence on the part of management.

The Companies Act does not contain the concept of 'de-merger' as such, but indirectly, it does recognize it in the following sections—

- (a) Section 391/394 – as a scheme of compromise, arrangement or reconstruction; and
- (b) Section 293(1)(a) – sale, lease or otherwise dispose of –
  - the whole of the undertaking of the company; or
  - substantially the whole of the undertaking of the company; or
  - if the company owns more than one undertaking, of the whole, or substantially the whole, of any such undertaking.

## DEMERGER UNDER INCOME TAX ACT 1961

The word demerger has been defined in Section 2(19AA) of the Income-tax Act, 1961 as follows :

“demerger”, in relation to companies, means the transfer, pursuant to a scheme of arrangement under sections 391 to 394 of the Companies Act, 1956 by a demerged company of its one or more undertakings to any resulting company in such a manner that -

- (i) all the property of the undertaking, being transferred by the demerged company, immediately before the demerger, becomes the property of the resulting company by virtue of the demerger;
- (ii) all the liabilities relatable to the undertaking, being transferred by the demerged company,

immediately before the demerger, become the liabilities of the resulting company by virtue of the demerger;

- (iii) the property and the liabilities of the undertaking or undertakings being transferred by the demerger company are transferred at values appearing in its books of account immediately before the demerger;
- (iv) the resulting company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis;
- (v) the shareholders holding not less than three-fourths in value of the shares in the demerged company (other than shares already held therein immediately before the demerger, or by a nominee for, the resulting company or, its subsidiary) become shareholders of the resulting company or companies by virtue of the demerger, otherwise than as a result of the acquisition of the property or assets of the demerged company or any undertaking thereof by the resulting company;
- (vi) the transfer of the undertaking is on a going concern basis;
- (vii) the demerger is in accordance with the conditions, if any, notified under sub-section (5) of section 72A by the Central Government in this behalf.

*Explanation 1.* – For the purposes of this clause, “undertaking” shall include any part of an undertaking, or a unit or division of an undertaking or a business activity taken as a whole, but does not include individual assets or liabilities or any combination thereof not constituting a business activity.

*Explanation 2.* – For the purposes of this clause, the liabilities referred to in sub-clause (ii), shall include-

- (a) the liabilities which arise out of the activities or operations of the undertaking;
- (b) the specific loans or borrowings (including debentures) raised, incurred and utilised solely for the activities or operations of the undertaking; and
- (c) in cases, other than those referred to in clause (a) or clause (b), so much of the amounts of general or multipurpose borrowings, if any, of the demerged company as stand in the same proportion which the value of the assets transferred in a demerger bears to the total value of the assets of such demerged company immediately before the demerger.

*Explanation 3.* – For the determining the value of the property referred to in sub-clause (iii), any change in the value of assets consequent to their revaluation shall be ignored.

*Explanation 4.* – For the purposes of this clause, the splitting up or the reconstruction of any authority of a body constituted or established under a Central, State or Provincial Act, or a local authority or a public sector company, into separate authorities or bodies or local authorities or companies, as the case may be, shall be deemed to be a demerger if such split up or reconstruction fulfills such conditions as may be notified in the Official Gazette by the Central Government.

### **Meaning of Demerged Company**

According to section 2(19AAA) of Income Tax Act ‘demerged company’ means the company whose undertaking is transferred, pursuant to a demerger, to a resulting company.

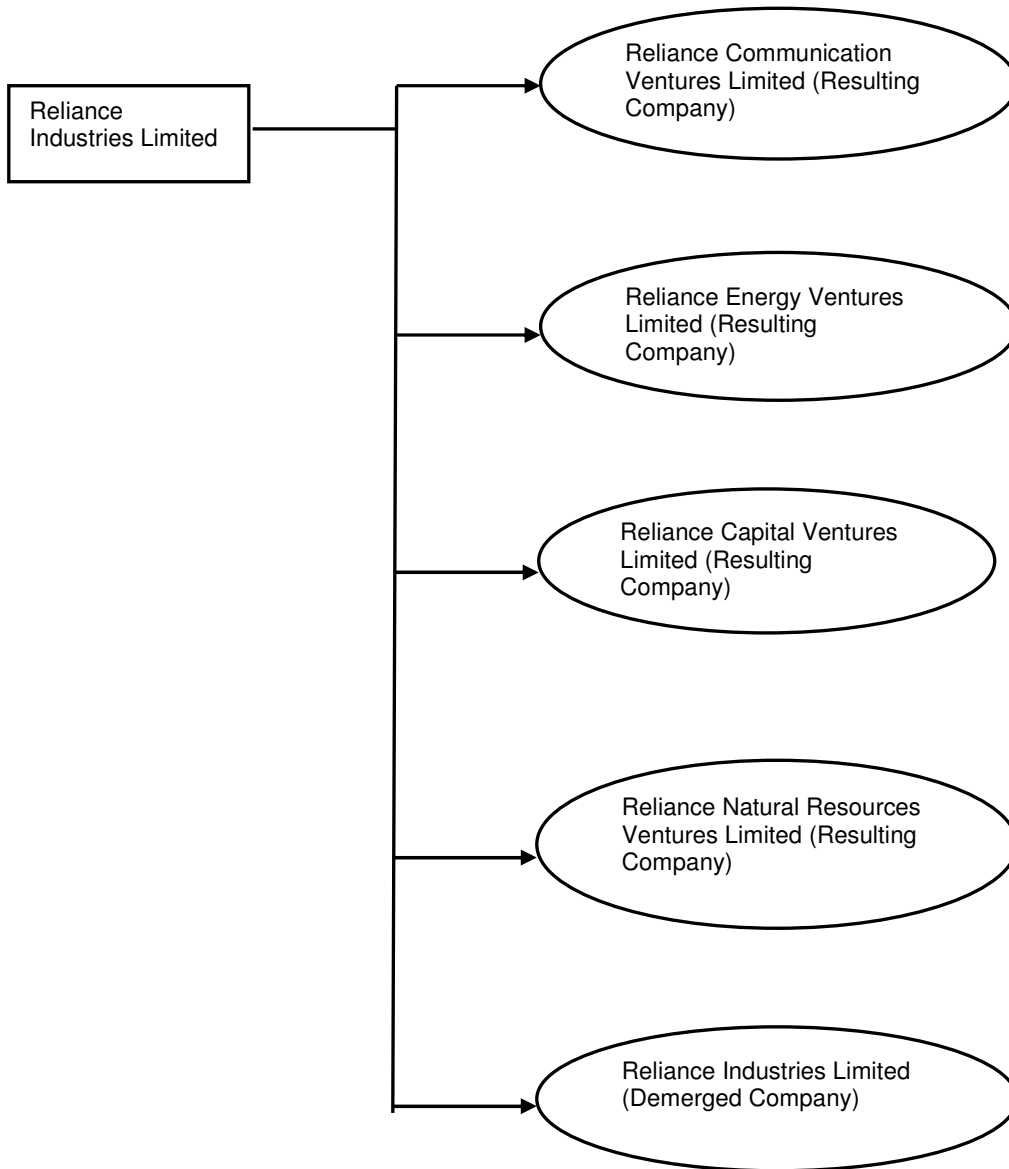
### **Meaning of Resulting Company**

According to section 2(41A) of Income Tax Act ‘resulting company’ means one or more companies (including a wholly owned subsidiary thereof) to which the undertaking of the demerged company is transferred in a

demerger and, the resulting company in consideration of such transfer of undertaking, issues shares to the shareholders of the demerged company and includes any authority or body or local authority or public sector company or a company established, constituted or formed as a result of demerger.

### Some Examples –Demerger

#### Reliance Industries Limited – Demerger of Four Units

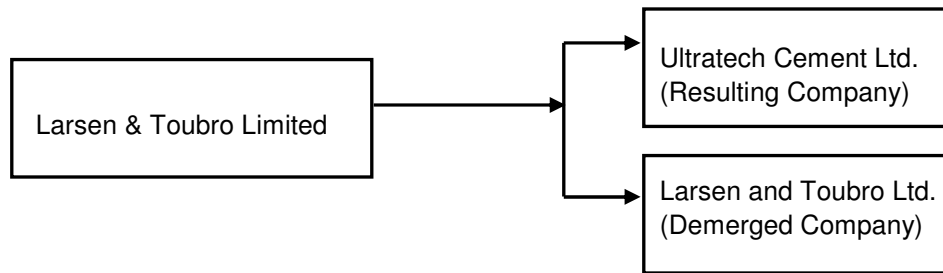


#### Demerger of the cement division of Larsen and Toubro Ltd

The demerger of the cement division of Larsen and Toubro Ltd. (L&T), named Ultratech Cement Ltd., seems to be one of the L&Ts grand strategies to concentrate more on infrastructure, engineering, energy and



turnkey businesses.



### Let us understand the recent Wipro Demerger which was approved by Karnataka High Court in March 2013

#### The scheme

The demerger of the

- Wipro Consumer Care & Lighting (including Furniture business),
- Wipro Infrastructure Engineering (Hydraulics & Water businesses), and
- Medical Diagnostic Product & Services business (through its strategic joint venture),

into a separate company to be named Wipro Enterprises Limited (Resulting Company). Wipro Limited (Demerged Company) will remain a publicly listed company that will focus exclusively on information technology. Wipro Enterprises Limited will be an unlisted company.

#### Background

In fiscal year 2011-12, the IT Business contributed to 86% of revenue and 94% of operating profit of Wipro Limited. The demerger is anticipated to provide fresh impetus for both Wipro Limited and Wipro Enterprises Limited to pursue their individual growth strategies. The demerger is also expected to improve the competitiveness in their respective markets.

According to the restructuring scheme as currently proposed, resident Indian shareholders of Wipro Limited on the record date can choose from multiple options as per their investment objectives. They may opt to:

- receive one equity share with face value of Rs.10 in Wipro Enterprises Limited for every five equity shares with face value of Rs.2 each in Wipro Limited that they hold; or
- receive one 7% Redeemable Preference Share in Wipro Enterprises Limited, with face value of Rs.50, for every five equity shares of Wipro Limited that they hold; or
- exchange the equity shares of Wipro Enterprises Limited and receive as consideration equity shares of Wipro Limited held by the Promoter. The exchange ratio will be 1 equity share in Wipro Limited for every 1.65 equity shares in Wipro Enterprises Limited.

Non-resident shareholders (excluding ADR holders) and the ADR holders on the record date would be entitled to receive equity shares of Wipro Enterprises Limited in the aforesaid ratio. The Non-resident shareholders (excluding ADR holders) shall further have the option to exchange the Wipro Enterprises Limited equity shares that they are entitled to and receive equity shares of Wipro Limited held by the Promoter in the aforesaid ratio.

### **The meeting pursuant to court order approving Demerger.**

Pursuant to the Order dated the 26th day of November, 2012, passed by the High Court of Karnataka, Bangalore, the meeting of the equity shareholders of Wipro Limited held on the 28th day of December, 2012.

### **The Court Order Approving Demerger**

Wipro Limited has informed the Exchange on March 21, 2013 that Hon'ble High Court of Karnataka has approved the Scheme of Arrangement for demerger of 'Diversified Business' of the Company as provided in the Scheme.

## **DIFFERENCE BETWEEN DEMERGER AND RECONSTRUCTION**

As discussed above “demerger” means transfer, pursuant to a scheme of arrangement under sections 391 to 394 of the Companies Act, 1956, by the demerged company of its one or more undertakings to a new company formed for the purpose, known as the resulting company, in such a manner that all the property of the undertaking, being transferred by the demerged company becomes the property of the resulting company by virtue of the demerger; all the liabilities relating to the undertaking, being transferred by the demerged company become the liabilities of resulting company by virtue of the demerger; the property and the liabilities of the undertaking or undertakings being transferred by the demerged company are transferred at values appearing in its books of account immediately before demerger; the resulting company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis; the shareholders holding not less than three fourths in value of the shares in the demerged company become shareholders of the resulting company or companies by virtue of the demerger; the transfer of the undertaking is on a going concern basis; the demerger is in accordance with the conditions, if any, notified under sub-section (5) of section 72 A by the Central Government in this behalf.

In the case of reconstruction, a new company (hereinafter referred to the transferee company) is formed, the existing company (hereinafter referred to the transferor company) is dissolved by passing a special resolution for members' voluntary winding up and authorising the liquidator to transfer the undertaking, business, assets and liabilities of the transferor company to the transferee company. The transferee company, instead of paying cash in lieu of their shares in the transferor company, issues and allots its shares to the shareholders of the transferor company in accordance with the pre-determined shares exchange ratio. In this process, the old company is demolished and is reconstructed in the form of new company with substantially the same shareholders and the same undertaking and business.

## **TYPES OF DEMERGER**

### **Partial Demerger**

In a partial demerger, one of the undertakings or a part of the undertaking or a department or a division of an existing company is separated and transferred to one or more new company/companies, formed with substantially the same shareholders, who are allotted shares in the new company in the same proportion as the separated division, department etc. bears to the total undertaking of the company.

### **Complete Demerger**

In the first case, i.e. in the case of partial demerger, the existing company also continues to maintain its separate legal identity and the new company, a separate legal identity, carries on the separated or spun off business and undertaking of the existing company.

In a complete demerger, an existing company transfers its various divisions, undertakings etc. to one or

more new companies formed for this purpose. The existing company is dissolved by passing a special resolution for members' voluntary winding up and also authorising the liquidator to transfer its undertakings, divisions etc. to one or more companies as per the scheme of demerger approved by the shareholders of the company by a special resolution. The shareholders of the dissolved company are issued and allotted shares in the new company or companies, as the case may be, on the basis of the pre-determined shares exchange ratio, as per the scheme of demerger.

In the case of complete demerger, the existing company disappears from the corporate scene. It is voluntarily wound up and its entire business, undertakings etc. are transferred to one or more new companies.

## WAYS OF DEMERGER

Demerger could be affected by either of the following three ways:

- (i) Demerger by agreement between promoters; or
- (ii) Demerger under the scheme of arrangement with approval by the court under section 391;
- (iii) Demerger under voluntary winding up and the power of liquidator.

### (i) Demerger by agreement

English Law is quite exhaustive on 'demerger'. While 'demerger is affected by agreement' and original company is wound up after division, it was held in *Cardiff Preserved Coal and Coke Co. v Norton* (1867) 2 Ch. App 405 that the liquidator has no power to dispute the validity of the transaction. He cannot require its shareholders to transfer to him the shares which the shareholders have been allotted in the new company or companies so that he may sell them and use the proceeds for paying the original company's debts.

The only remedy available to the liquidator and to unpaid creditors of the original company is to require the new company to apply the assets in satisfying the debts and liabilities of the original company. This right appears to be derived from the equitable rules relating to tracing assets, and it seems that the right is available to the original company's creditors, even though they cannot prove that the original company's directors or shareholders had any intent to defraud them.

This right might be lost to creditors against the new company in case of novation agreement, if any, between the purchasing company and the creditors of the original company. By such an agreement, the purchasing company may agree to indemnify the original company against claims by its creditors and make an offer to the creditors to meet their claims. If a creditor then accepts the liability of the new company, there will be a novation, and the creditor's rights against the original company will cease.

Further, the English law support that in such events where the creditor accepts an undertaking from the purchasing company for honouring the original company's obligations, or if he accepts a benefit from the purchasing company to which he is not entitled under his contract with the original company, there will be a novation and the original company's liability will be discharged.

Section 395 of the Companies Act, 1956 protects the interest of the shareholders dissenting from scheme or contract approved by majority even in the cases of demergers or divisions.

### (ii) Demerger under a Scheme of Arrangement

The law with respect to a scheme of demerger or division is the same as it is with respect to a scheme for a reconstruction, amalgamation or merger. In case of amalgamation, a scheme of amalgamation is required to be got approved by the respective High Courts of the amalgamating and amalgamated company. Similarly, a

company can be demerged or split into, through a scheme of demerger or division with the sanction of respective High Courts under the provisions of the Companies Act, 1956. The Memorandum of Association of the Company must contain provisions of demerger or split in order to accomplish the same.

### **(iii) Demerger and Voluntary Winding up**

A company, which has split into several companies after division can be wound up voluntarily pursuant to Section 484 to 498 of the Companies Act, 1956.

Section 494 of the Companies Act provides that where a company (referred to as the transferor company) is proposed to be or is in the course of being wound up voluntarily; and the whole or any part of its business or property is proposed to be transferred or sold to another company (referred to as the transferee company); the liquidator of the transferor company may, with the sanction of a special resolution of that company conferring on the liquidator either a general authority or an authority in respect of any particular arrangement, receive, by way of compensation or part compensation for the transfer or sale, shares, policies, or other like interests in the transferee company, for distribution among the members of the transferor company; or enter into any other arrangement whereby the members of the transferor company, may, in lieu of receiving cash, shares, policies or other like interests or in addition thereto, participate in the profits of or receive any other benefit from the transferee company.

The sale or arrangement in pursuance of this section is binding on the members of the transferor company.

## **PROCEDURAL ASPECTS OF DEMERGER**

### **Scheme must be within company's powers**

The court cannot sanction a scheme of compromise or arrangement which is beyond the powers of the company as defined in its Memorandum of Association. In such an event, the company should first take steps for alteration of the relevant clauses in its Memorandum and thereafter propose a scheme of compromise or arrangement and make an application for the court's sanction.

### **Res judicata**

Where a proposed scheme of compromise or arrangement has already been rejected by the court and the same persons propose another scheme which is substantially the same as the earlier one, the general principle of res judicata applies to bar the second scheme.

### **Rules and Forms in respect of Scheme of Demerger**

The procedure for convening, holding and conducting class meetings for affecting demerger, is laid down in rules 67 to 87 of the Companies (Court) Rules, 1959. The Rules also set out the following forms for various purposes:

- |                    |  |
|--------------------|--|
| <i>Form No. 33</i> | Summons for directions to convene a class meeting under Section 391 — Rule 67.       |
| <i>Form No. 34</i> | Affidavit in support of summons — Rule 67.   |
| <i>Form No. 35</i> | Order on summons for directions — Rule 69.   |
| <i>Form No. 36</i> | Notice convening meeting — Rule 73.  |
| <i>Form No. 37</i> | Form of proxy — Rule 73.   |
| <i>Form No. 38</i> | Advertisement of Notice convening meeting of creditors/ shareholders etc. — Rule 74. |

*Form No. 39* Report by Chairman of the meeting — Rule 78.

*Form No. 40* Petition to sanction the scheme of compromise or arrangement — Rule 79.

*Form No. 41* Order on petition Rule 81.

### **Steps to be taken for Demerger**

#### **1. Preparation of scheme of demerger**

- (i) Prepare a scheme of demerger in consultation with all interested parties and have the same approved in principle by the Board of Directors of the company at a meeting.
- (ii) Appoint an expert for valuing the shares to determine the share exchange ratio.
- (iii) Engage an advocate for the preparation of scheme and for appearing subsequently before the High Court.
- (iv) In case of listed companies, the stock exchanges where the shares are listed should be intimated.

#### **2. Application to court for direction to hold meetings of members/creditors**

Both the companies should make an application under Section 391(1) of the Companies Act, 1956 to respective High Courts for an order to convene and hold meeting(s) of members/creditors or any class of them, by a Judge's summons supported by an affidavit. A copy of the proposed scheme of demerger should be annexed to the affidavit as an exhibit thereto. The summons should be moved ex parte. The summons should be in Form No. 33 and the affidavit in support thereof in Form No. 34. [Rule 67 of the Companies (Court) Rules, 1959].

Save as provided in Rule 68, the summons shall be moved ex-parte. When the company is not the applicant, a copy of summons and of affidavit shall be served on the company or where it is being wound up, on its liquidator, not less than 14 days before the date fixed for hearing the summons. Application is to be filed to the High Court, where the Registered Office is situated, for directions to convene a meeting along with the following documents:

- 1. Judge's Summons [Form No. 33] under order XIV.
- 2. An affidavit in support of summons in Form No. 34 of Companies (Court) Rules, 1959.
- 3. Memorandum and Articles of Association of the company.
- 4. Latest Audited Balance Sheet.
- 5. List of Shareholders and Creditors (Optional) Scheme.
- 6. Extract of Board Resolution approving the scheme.
- 7. Draft notice of meeting, explanatory statement, proxy under Section 393 of Act.

(Above documents are to be prepared separately for both transferor and transferee companies and any Director may be authorized to sign the applications).

Normally, an application under Section 391 of the Act is made by the company, but a creditor or member may also make the application. Although a creditor or a member may move an application under Section 391(1) of the Act, yet, such an application may not be accepted by court because the scheme of arrangement submitted to the court along with the application will not have the approval of the Board of directors of the company or of the company in general meeting. However, the court

has the discretion to give whatever directions that it may deem proper.

Before an application under Section 391 of the Act is made by a company, as a matter of common procedure, the Chairman of the Board of directors of the company which is proposed to be reconstructed by demerger should send a circular letter to the members of the company explaining details of the scheme of reconstruction and the reasons which have prompted the Board to propose reconstruction. The circular letter should specify how the scheme would affect the shareholdings of the members. Copies of the circular should also be sent to the stock exchanges, where the shares of the company or companies are listed.

The petition must pray for appropriate orders and directions under Section 394 of the Act for facilitating the reconstruction (by demerger) of the company.

### 3. Obtaining court's order for holding meetings of members/creditors

On receiving a petition the court may order meeting(s) of the members/ creditors of the company, to be called, held and conducted in a prescribed manner. Once the ordered meeting(s) is/are duly convened, held and conducted and the scheme is approved by the prescribed majority in value of the creditors or number of members, as the case may be, the court is bound to sanction the scheme.

The court shall look into the fairness of the scheme before ordering meeting(s) because it would be no use putting before the meeting(s), a scheme containing proposals which are not capable of being implemented. At that stage, the court may refuse to pass an order for the convening of the meeting(s).

The court must also ensure that the circular about the details of the scheme which is sent to the members and creditors should give a fair picture of the proposed scheme.

Upon the hearing of the summons, or any adjourned hearing thereof, the judge shall, unless he thinks fit for any reason to dismiss the summons, give directions as he may think necessary in respect of the following matters:

- (i) determining the class or classes of creditors and/or members whose meeting or meetings have to be held for considering the proposed scheme of demerger;
- (ii) fixing the time and place for such meeting or meetings;
- (iii) appointing a Chairman or Chairmen for the meeting or meetings to be held, as the case may be;
- (iv) fixing the quorum and procedure to be followed at the meeting or meetings, including voting by proxy;
- (v) determining the values of the creditors and/or the members, or the creditors or members of any class, as the case may be whose meetings have to be held;
- (vi) notice to be given of the meeting or meetings and the advertisement of such notice; and
- (vii) the time within which the Chairman of the meeting or Chairmen of the meetings should report to the Court the result of the meeting or meetings, as the case may be;

and such other matters as the Court may deem necessary.

The order made on the summons should be in Form No. 35 of the Court Rules, with such variations as may be necessary. Within 3 days of orders being received by the Companies from the Court, the companies are required to get the draft explanatory statement, notice of meeting, draft resolutions,

proxy forms, publication also translated in regional language in Form No. 38 vouched by Registry of High Court.

An application under Sub-section (6) of Section 391 for stay of commencement or continuation of any suit or proceeding against the company may be moved by a Judge's summons ex-parte, provided where a petition for winding up or that under Section 397 or 398 is pending, notice of application shall be given to petitioner where a stay order has been made. Any person aggrieved by such order may apply to the court by a Judges summons to vacate or vary such order.

#### 4. Notice of the meetings of members/creditors

After obtaining the court's order containing directions to hold the meeting(s) of the creditors/members of company, the company should make arrangement for the issue of notice of the meeting(s) to them. The notice of such meeting(s) should be sent individually in Form No. 36 of the said rules and must be sent by the person authorised by the court in this behalf, who may be the Chairman appointed by the court for the meeting, or if the court so directs, by the company or by any other person as the court may direct. The notice should be sent by post under certificate of posting to their last known address at least twenty-one clear days before the date fixed for the meeting. The notice must be accompanied by a copy of the scheme for the proposed demerger and of the statement required to be furnished under Section 393 setting forth the terms of the proposed compromise or arrangement explaining its effects, and a form of proxy in Form No. 37 of the said rules. According to Rule 70 voting by proxies shall be permitted provided a proxy in the prescribed form duly signed by the person entitled to attend and vote at the meeting is filed with the company at its registered office not later than 48 hours before the meeting. Also Rules 227 to 229 relating to proxies apply to proxies lodged under this rule.

The notice must particularly disclose any material interest of the directors, managing director or manager whether as shareholders or creditors or otherwise and the effect on their interests of the compromise or arrangement, if, and in so far as, it is different from the effect on the like interests of other persons. Such information must also be included in the form of a statement in the notice convening the meeting, where such notice is given by advertisement, or, if this is not practicable, such advertised notice must give notification, of the place at and the manner in which creditors or members entitled to attend the meeting may obtain copies of such a statement. If debenture holders are affected, the statement referred to must give like information as far as it affects the trustees for the debenture holders. Statements which have to be supplied to creditors and members as a result of press notification must be supplied by the company to those entitled, free of charge. (Section 393)

The notice of the meeting shall be advertised in such newspapers and in such manner as the Judge may direct, not less than 21 clear days from the date fixed for the meeting. Advertisement shall be in Form No. 38.

Every creditor or member entitled to attend the meeting shall be furnished by the company, free of charge and within 24 hours of a requisition being made for the same, with a copy of the proposed compromise or arrangement together with a copy of the statement required to be furnished, unless the same had already been furnished to such member/creditor.

According to Rule 76, the Chairman appointed for the meeting or other person directed to issue the advertisement and the notices of the meeting shall file an affidavit not less than seven days before the date fixed for the holding of the meeting or first of the meetings, showing that the directions regarding the issue of notices and the advertisement have been duly complied with. Along with the

affidavit, the paper publications, one in English and another in vernacular daily and proof of certificate of posting are to be filed one week before the date of meeting.

5. Holding meeting(s) of members/creditors

Pursuant to the directions, the meeting(s) should be held. The chairman of the meeting, or where there are separate meetings, the chairman of each meeting, shall report the result thereof to the court. The report shall state accurately the number of creditors or class of creditors or the number of members or class of members, as the case may be, who were present and who voted at the meeting either in person or by proxy, their individual values and the way they voted.

6. Reporting the result of the meeting by the Chairman to the court

The result of the meeting must be decided only by taking poll and by separately counting the votes in favour and against the resolution. The chairman of the meeting should within the time fixed by the court or where no time has been fixed, within seven days after the conclusion of the meeting, report the result of the meeting in the prescribed Form 39 to the Court. (Rule 78)

7. Petition to the court for sanctioning the scheme of demerger

When the scheme of demerger has been approved by the required majority of shareholders/creditors, i.e. majority in number representing three-fourths in value of the creditors, or class of creditors, or members or class of members, as the case may be, present and voting either in person, or, where proxies are allowed, by proxy, at the meeting, a petition must be made to the court for sanctioning the scheme of demerger. The petition must be made by the company. The petition is required to be made in Form No. 40 of the said rules. The following documents are necessary for enabling the High Court to sanction the scheme: (Rule 79)

- (a) Company Petition (Form No. 40 with Court Fee).
- (b) An affidavit verifying petition in Form No. 3.
- (c) Scheme.
- (d) Memorandum and Articles of Association.
- (e) Audited Accounts.
- (f) Independent professional valuers' report.
- (g) Copy of the Chairman's Report in Form No. 35.
- (h) Six copies of Form No. 5 being the advertisement of petition and Form No. 6 being the notice of petition to be issued to Regional Director, Department of Company Affairs and Registrar of Companies.

The Court shall fix a date for the hearing of the petition, and notice of hearing shall be advertised in the same papers in which notice of the meeting was advertised, or in such other papers, as the court may direct not less than 10 days before the date fixed for hearing.

8. Obtaining order of the court sanctioning the scheme

Obtain an order of the court sanctioning the scheme of demerger. Where the Court sanctions the compromise or arrangement, the order shall include such directions in regard to any matter and such modifications as the Judge may think fit. The order shall direct that a certified copy of the same shall be filed with the Registrar of Companies within 14 days from the date of the order or such other time as may be fixed by the Court. (Rule 81)



### 9. Court's order on petition sanctioning the scheme of demerger

Section 394 of the Act provides that where the application is made to the court under Section 391 for the sanctioning of a scheme proposed between a company and its shareholders and it is shown to the court:

- (a) that the demerger has been proposed for the purposes of, or in connection with, a scheme for the reconstruction of the company; and
- (b) that under the scheme the whole or any part of the undertaking, property or liabilities of any company (the transferor company) concerned in the scheme is to be transferred to another company (the transferee company),

the court may either by the order sanctioning the scheme of demerger or by a subsequent order, make provision for all or any of the following matters:

- (i) The transfer to the transferee company of the whole or any part of the undertaking and of the property or liabilities of the transferor company.
- (ii) The allotment or appropriation by the transferee company of any shares, debentures, policies, or other like interests in that company to be allotted or appropriated by the company to or for any person.
- (iii) The continuation by or against the transferee company of any legal proceedings pending by or against any transferor company.
- (iv) Such incidental, consequential and supplemental matters as are necessary to secure that the demerger shall be fully and effectively carried out.

However, no order sanctioning any compromise or arrangement shall be made by the court unless the court is satisfied that the company or any other person by whom an application has been made has disclosed to the court, by affidavit or otherwise, all material facts relating to the company, such as the latest financial position of the company, the latest auditor's report on the accounts of the company, the pendency of any investigation proceedings in relation to the company under Sections 235 to 251 and the like.

#### Filing the order of the court with Registrar of Companies

The order made by the court will have effect only after a certified copy has been filed with the Registrar of Companies in e-form 21 and will be binding on all the creditors/members, or all the creditors/members of the class, as the case may be and also on the company or, in the case of a company which is being wound up, on the liquidator and contributories of the company.

## TAX ASPECTS OF DEMERGER

### Tax concession/incentives in case of demerger

If any demerger takes place within the meaning of section 2(19AA) of the Income-tax Act, the following tax concessions shall be available to:

1. Demerged company.
2. Shareholders of demerged company.
3. Resulting company

These concessions are on similar lines as are available in case of amalgamation. However some concessions available in case of amalgamation are not available in case of demerger.

## 1. Tax concession to demerged company

(i) Capital gains tax not attracted [Section 47(vib)]

According to section 47(vib), where there is a transfer of any capital asset in case of a demerger by the demerged company to the resulting company, such transfer will not be regarded as a transfer for the purpose of capital gain provided the resulting company is an Indian company.

(ii) Tax concession to a foreign demerged company [Section 47(vic)]

Where a foreign company holds any shares in an Indian company and transfers the same, in case of a demerger, to another resulting foreign company, such transaction will not be regarded as transfer for the purpose of capital gain under section 45 if the following conditions are satisfied:

- (a) at least seventy-five per cent of the shareholders of the demerged foreign company continue to remain shareholders of the resulting foreign company; and
- (b) such transfer does not attract tax on capital gains in the country, in which the demerged foreign company is incorporated.

(iii) Reserves for shipping business: Where a ship acquired out of the reserve is transferred in a scheme of demerger, even within the period of eight years of acquisition there will be no deemed profits to the demerged company.

## 2. Tax concessions to the shareholders of the demerged company [Section 47(vid)]

Any transfer or issue of shares by the resulting company, in a scheme of demerger to the shareholders of the demerged company shall not be regarded as a transfer if the transfer or issue is made in consideration of demerger of the undertaking.

In the case of demerger the existing shareholder of the demerged company will hold after demerger:

- (a) shares in resulting company; and
- (b) shares in demerged company.

and in case the shareholder transfers any of the above shares subsequent to the demerger, the cost of such shares shall be calculated as under:—

*Cost of acquisition of shares in the resulting company [Section 49(2C)]:*

It shall be the amount which bears to the cost of acquisition of shares held by the assessee in the demerged company the same proportion as the net book value of the assets transferred in a demerger bears to the net worth of the demerged company immediately before such demerger.

*Cost of acquisition of shares in the demerged company [Section 49(2 D)]:*

The cost of acquisition of the original shares held by the shareholder in the demerged company shall be deemed to have been reduced by the amount as so arrived at under section 49(2C) above.

For the above purpose net worth shall mean the aggregate of the paid up share capital and general reserves as appearing in the books of account of the demerged company immediately before the demerger.

*Period of holding of shares of the resulting company [Section 2(42A)(g)]:*

In the case of a capital asset, being a share or shares in an Indian company, which becomes the property of the assessee in consideration of a demerger, there shall be included the period for which the share or shares held in the demerged company were held by the assessee.

### 3. Tax concession to the resulting company

The resulting company shall be eligible for tax concessions only if the following two conditions are satisfied:

- (i) The demerger satisfies all the conditions laid down in section 2(19AA); and
- (ii) The resulting company is an Indian company.

The following concessions are available to the resulting company pursuant to a scheme of demerger:

- (a) Expenditure on acquisition of patent rights or copy rights [Section 35A(7)]

Where the patent or copyrights acquired by the demerged company is transferred to any resulting Indian company, the provisions of section 35A which were applicable to the demerged company shall become applicable in the same manner to the resulting company consequently:

- (i) The expenditure on patents copyrights not yet written off shall be allowed to the resulting company in the same number of balance instalments.
- (ii) Where such rights are later on sold by the resulting company, the treatment of the deficiency/surplus will be same as would have been in the case of demerger company.

However, if such expenditure is incurred by the demerged company after 31-3-1998, deduction under section 35A is not allowed, as such expenditure will be eligible for depreciation as intangible asset. In this case, provisions of depreciation shall apply.

- (b) Expenditure on know-how [Section 35AB(3)]

W.e.f. assessment year 2000-2001, where there is a transfer of an undertaking under a scheme of demerger, the resulting company shall be entitled to claim deduction under section 35AB in respect of such undertaking to the same extent and in respect of the residual period as it would have been allowable to the demerger company, had such demerger not taken place.

However, if such expenditure is incurred by the demerger company after 31-3-1998, deduction under section 35AB is not allowed, as such expenditure will be eligible for depreciation as intangible asset. In this case provisions of depreciation shall apply.

- (c) Expenditure for obtaining licence to operate telecommunication services [Section 35ABB(7)]

Where in a scheme of demerger, the demerged company sells or otherwise transfer its licence to the resulting company (being an Indian company), the provisions of section 35ABB which were applicable to the demerged company shall become applicable in the same manner to the resulting company, consequently:

- (i) The expenditure on acquisition of licence, not yet written off, shall be allowed to the resulting company in the same number of balance instalments.
- (ii) Where such licence is sold by the resulting company, the treatment of the deficiency/surplus will be same as would have been in the case of demerged company.

- (d) Treatment of preliminary expenses [Section 35D(5A)]

Where the undertaking of an Indian company which is entitled to deduction of preliminary expenses in transferred before the expiry of ten years/5 years, as the case may be, to another company in a scheme of demerger, the preliminary expenses of such undertaking which are not yet written off shall be allowed as deduction to the resulting company in the same manner as would have been allowed to the demerged company. The demerged company will not be entitled to the deduction thereafter.

## (e) Treatment of expenditure on prospecting, etc. of certain minerals [Section 35E(7A)]

Where the undertaking of an Indian company which is entitled to deduction on account of prospecting of minerals, is transferred before the expiry of period of 10 years to another company in a scheme of demerger, such expenditure of prospecting, etc. which is not yet written off shall be allowed as deduction to the resulting company in the same manner as would have been allowed to the demerged company.

The demerged company will not be entitled to the deduction thereafter.

## (f) Treatment of bad debts [Section 36(1)(vii)]

Where due to demerger the debts of the demerged company have been taken over by the resulting company and subsequently by such debt or part of debt becomes bad such bad debt will be allowed as a deduction to the resulting company. This is based upon the decision of the Supreme Court in the case of *CIT v. Veerabhadra Rao (T.), K. Koteswara Rao & Co.* (1985) 155 ITR 152 (SC) which was decided in the case of amalgamation of companies.

## (g) Amortisation of expenditure in case of demerger [Section 35DD]

Where an assessee, being an Indian company, incurs any expenditure, on or after the 1st day of April, 1999, wholly and exclusively for the purposes of demerger of an undertaking, the assessee shall be allowed a deduction of an amount equal to one-fifth of such expenditure for each of the five successive previous years beginning with the previous year in which the demerger takes place.

No deduction shall be allowed in respect of the expenditure mentioned in sub-section (1) under any other provision of this Act.

## (h) Carry forward and set off of business losses and unabsorbed depreciation of the demerged company [Section 72A(4) &amp; (5)]

The accumulated loss and unabsorbed depreciation, in a demerger, should be allowed to be carried forward by the resulting company if these are directly relatable to the undertaking proposed to be transferred. Where it is not possible to relate these to the undertaking, such loss and depreciation shall be apportioned between the demerged company and the resulting company in proportion of the assets coming to the share of each as a result of demerger.

In Central Government may, for the purposes of this Act, by notification in the Official Gazette, specifying such conditions on it considers necessary to ensure that the demerger is for genuine business purpose.

## (i) Deduction available under section 80-1A(12) or 80-1B(12)

Where an undertaking which is entitled to deduction under section 80-1A (12)/80-1B (12) is transferred before the expiry of the period to another Indian company in a scheme of amalgamation or dermerger –

- (i) no deduction under section 80-1A(12)/80-1B(12) shall be available to the demerged company for the previous year in which amalgamation takes place; and
- (ii) the provisions of section 80-1A (12)/80-1B(12) shall apply to the resulting company in such manner in which they would have applied to the demerged company.

## JUDICIAL PRONOUNCEMENTS ON DEMERGER

### Disclosure of Ratio of Exchange of Shares

In *Mercury Containers (P.) Ltd.*, [2010] 98 SCL 43 (ALL.), High Court Of Allahabad, Petitioner-

company/demerged-company filed a petition under section 391 for sanction of proposed scheme of its demerger - Pursuant to an order of Court, meeting of creditors of demerged company was convened and they unanimously approved proposed scheme of demerger - Advertisement of petition was published in newspapers and notices were issued to Official Liquidator and Regional Director - Official Liquidator had no objection to proposed scheme - However, Regional Director had objected to proposed scheme by stating that ratio of exchange of shares had not been disclosed - It was found that objection in respect of ratio of exchange of shares had been explained before authorities – It was held that scheme of arrangement or demerger was in interest of shareholders/creditors of companies, proposed scheme was to be approved.

### Application of AS-14 to Demergers

In Gallops Realty (P.) Ltd., In re [2010] 97 SCL 93 (GUJ.), High Court Of Gujarat

Petitioner-companies, i.e., demerged company and resulting company, sought for sanction of composite scheme of arrangement in nature of purchase of shares and demerger of hotel business of demerged company to resulting company and consequent reconstruction of share capital of demerged company under section 391, read with sections 394, 78 and 100 consisting of reduction of paid-up share capital as well as utilization of share premium account.

Meetings of equity shareholders of both companies and unsecured creditors of demerged company had been dispensed with in view of their written consent. Regional Director stated that as per the scheme, capital profit on demerger would be transferred to general reserve in books of resulting company which was not in consonance with generally accepted accounting principles as also Accounting Standard- 14 which provide that any profit arising out of a capital transaction, like merger or demerger, ought to be treated as capital profit and, hence, would be transferred to capital reserve and not to general reserve. The observation of Regional Director about the scheme not in consonance with Accounting Standard-14 and not tenable, as Accounting Standard-14 is applicable only in case of amalgamation and not in case of demerger. It was held that since proposed scheme of arrangement was in interest of companies and their members, same was to be sanctioned.

### REVERSE MERGER

It must be understood at the outset that amalgamation and merger are corporate restructuring methods. Both the terms are synonymous. The procedure to be adopted for both is the same and the consequences of both are also the same. For achieving amalgamation as well as merger, an existing company (which is referred to as the “amalgamating or merging or transferor company”), under a scheme of amalgamation or merger, loses its own legal identity and is dissolved without being wound up and its assets, properties and liabilities are transferred to another existing company (which is referred to as the “amalgamated or merged or transferee company”).

Generally, a loss making or less profit earning company merges with a company with track record, to obtain the benefits of economies of scale of production, marketing network, etc. This situation arises when the sick company's survival becomes more important for strategic reasons and to conserve the interest of community.

In a reverse merger, a healthy company merges with a financially weak company. The main reason for this type of reverse merger is the tax savings under the Income-Tax Act, 1961. Section 72A ensures the tax relief, which becomes attractive for such reverse mergers, since the healthy and profitable company can take advantage of the carry forward losses/of the other company. The healthy units loses its name and surviving sick company retains its name. In the context of the Companies Act, 1956 there is no difference between a merger and a reverse merger. It is like any amalgamation. A reverse merger is carried out through the High Court route. However, where one of the merging companies is a sick industrial company in terms of the Sick

Industrial Companies (Special Provisions) Act, 1985, such merger has necessarily to be through the Board for Industrial and Financial Reconstruction (BIFR). On the reverse merger becoming effective, the name and objects of the sick company (merged company) may be changed to that of the healthy company.

To save the Government from social costs in terms of loss of production and employment and to relieve the Government of the uneconomical burden of taking over and running sick industrial units, Section 72A was introduced in Income Tax Act, 1961.

Provisions relating to carry forward and set off of accumulated loss and unabsorbed depreciation allowance in amalgamation or demerger, etc.

Section 72A of Income Tax Act, 1961 is meant to facilitate rejuvenation of sick industrial undertaking by merging with healthier industrial companies possessing incentives of tax savings, to benefit the general public through continued productivity, increased avenues for employment and revenue generation.

The provisions of Section 72A relating to reverse merger are given hereunder.

(1) Where there has been an amalgamation of a company owning an industrial undertaking or a ship or a hotel with another company or an amalgamation of a banking company referred to in clause (c) of Section 5 of the Banking Regulation Act, 1949 (10 of 1949) with a specified bank, then, notwithstanding anything contained in any other provision of this Act, the accumulated loss and the unabsorbed depreciation of the amalgamating company shall be deemed to be the loss or, as the case may be, allowance for depreciation of the amalgamated company for the previous year in which the amalgamation was reflected, and other provisions of this Act relating to set off and carry forward of loss and allowance for depreciation shall apply accordingly.

W.e.f. 1.4.2008 (A.Y. 2009-10):

(1) Where there has been an amalgamation of—

- (a) a company owning an industrial undertaking or a ship or a hotel with another company; or
- (b) a banking company referred to in clause (c) of Section 5 of the Banking Regulation Act, 1949 (10 of 1949) with a specified bank; or
- (c) one or more public sector company or companies engaged in the business of operation of aircraft with one or more public sector company or companies engaged in similar business,

then, notwithstanding anything contained in any other provision of this Act, the accumulated loss and the unabsorbed depreciation of the amalgamating company shall be deemed to be the loss or, as the case may be, allowance for unabsorbed depreciation of the amalgamated company for the previous year in which the amalgamation was effected, and other provisions of this Act relating to set off and carry forward of loss and allowance for depreciation shall apply accordingly.

(2) Notwithstanding anything contained in Sub-section (1), the accumulated loss shall not be set off or carried forward and the unabsorbed depreciation shall not be allowed in the assessment of the amalgamated company unless—

- (a) the amalgamating company—
  - (i) has been engaged in the business, in which the accumulated loss occurred or depreciation remains unabsorbed, for three or more years;
  - (ii) has held continuously as on the date of the amalgamation at least three-fourths of the book value of fixed assets held by it two years prior to the date of amalgamation;

(b) the amalgamated company—

- (i) holds continuously for a minimum period of five years from the date of amalgamation at least three-fourths of the book value of fixed assets of the amalgamating company acquired in a scheme of amalgamation;
- (ii) continues the business of the amalgamating company for a minimum period of five years from the date of amalgamation;
- (iii) fulfils such other conditions as may be prescribed to ensure the revival of the business of the amalgamating company or to ensure that the amalgamation is for genuine business purpose.

(3) In a case where any of the conditions laid down in Sub-section (2) are not complied with, the set off of loss or allowance of depreciation made in any previous year in the hands of the amalgamated company shall be deemed to be the income of the amalgamated company chargeable to tax for the year in which such conditions are not complied with.

(4) Notwithstanding anything contained in any other provisions of this Act, in the case of a demerger, the accumulated loss and the allowance for unabsorbed depreciation of the demerged company shall—

- (a) where such loss or unabsorbed depreciation is directly relatable to the undertakings transferred to the resulting company, be allowed to be carried forward and set off in the hands of the resulting company;
- (b) where such loss or unabsorbed depreciation is not directly relatable to the undertakings transferred to the resulting company, be apportioned between the demerged company and the resulting company in the same proportion in which the assets of the undertakings have been retained by the demerged company and transferred to the resulting company, and be allowed to be carried forward and set off in the hands of the demerged company or the resulting company, as the case may be.

(5) The Central Government may, for the purposes of this Act, by notification in the Official Gazette, specify such conditions as it considers necessary to ensure that the demerger is for genuine business purposes.

(6) Where there has been reorganization of business, whereby, a firm is succeeded by a company fulfilling the conditions laid down in clause (xiii) of Section 47 or a proprietary concern is succeeded by a company fulfilling the conditions laid down in clause (xiv) of Section 47, then, notwithstanding anything contained in any other provision of this Act, the accumulated loss and the unabsorbed depreciation of the predecessor firm or the proprietary concern, as the case may be, shall be deemed to be the loss or allowance for depreciation of the successor company for the purpose of previous year in which business reorganization was effected and other provisions of this Act relating to set off and carry forward of loss and allowance for depreciation shall apply accordingly:

Provided that if any of the conditions laid down in the proviso to clause (xiii) or the proviso to clause (xiv) to Section 47 are not complied with, the set off of loss or allowance of depreciation made in any previous year in the hands of the successor company, shall be deemed to be the income of the company chargeable to tax in the year in which such conditions are not complied with.

(7) For the purposes of this section,—

- (a) “accumulated loss” means so much of the loss of the predecessor firm or the proprietary concern or the amalgamating company or the demerged company, as the case may be, under the head “Profits and gains of business or profession” (not being a loss sustained in a speculation business) which such predecessor firm or the proprietary concern or amalgamating company or demerged company,

would have been entitled to carry forward and set off under the provisions of Section 72 if the reorganization of business or amalgamation or demerger had not taken place;

- (aa) “industrial undertaking” means any undertaking which is engaged in—
- (i) the manufacture or processing of goods; or
  - (ii) the manufacture of computer software; or
  - (iii) the business of generation or distribution of electricity or any other form of power; or
  - (iiia) the business of providing telecommunication services, whether basic or cellular, including radio paging, domestic satellite service, network of trunking, broadband network and internet services; or
  - (iv) mining; or
  - (v) the construction of ships, aircrafts or rail systems;
- (b) “unabsorbed depreciation” means so much of the allowance for depreciation of the predecessor firm or the proprietary concern or the amalgamating company or the demerged company, as the case may be, which remains to be allowed and which would have been allowed to the predecessor firm or the proprietary concern or amalgamating company or demerged company, as the case may be, under the provisions of this Act, if the reorganization of business or amalgamation or demerger had not taken place;
- (c) “specified bank” means the State Bank of India constituted under the State Bank of India Act, 1955 (23 of 1955) or a subsidiary bank as defined in the State Bank of India (Subsidiary Banks) Act, 1959 (38 of 1959) or a corresponding new bank constituted under Section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 (5 of 1970) or under Section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 (40 of 1980).

In the discussion that follows, “reverse merger” means “reverse amalgamation” and vice versa. SICA used the term “amalgamation”, which means “merger” also.

### **Salient features of reverse mergers under Section 72A**

1. Amalgamation should be between the companies and none of them should be a firm of partners or sole-proprietor. In other words, partnership firm or sole-proprietary concerns cannot get the benefit of tax relief under Section 72A merger.
2. The companies entering into amalgamation should be engaged in either industrial activity or shipping business or hotel with another company or banking business under Section 5(c) of the Banking Regulation Act, 1949 or Public Sector Companies engaged in the business of operation of aircraft. In other words, the tax relief under Section 72A would not be made available to companies engaged in trading activities or services.
3. After amalgamation, the “sick” or “financially unviable company” shall survive and the other income generating company shall extinct. In other words, essential condition to be fulfilled is that the acquiring company will be able to revive or rehabilitate having consumed the healthy company.
4. One of the merger partner should be financially unviable and have accumulated losses to qualify for the merger and the other merger partner should be profit earning so that tax relief to the maximum extent could be had. In other words, the company which is financially unviable should be technically sound and feasible, commercially and economically viable but financially weak because of financial stringency or lack of financial



resources or its liabilities have exceeded its assets and is on the brink of insolvency. The second requisite qualification associated with financial unviability is the accumulation of losses for past few years.

5. Amalgamation should be in the public interest i.e. it should not be against public policy, should not defeat the basic tenets of law, and must safeguard the interest of employees, consumers, customers, creditors and shareholders apart from the promoters of the company through the revival of the company.

6. The merger should result into the following benefits to the amalgamated (acquired/target) company i.e. (a) carry forward of accumulated business losses of the amalgamating company; (b) carry forward of unabsorbed depreciation of the amalgamating company and (c) accumulated loss would be allowed to be carried forward and set off for eight subsequent years under Section 72A of the Income-tax Act, from the A.Y. 2009-10, the accumulated loss or the case may be, allowance for unabsorbed depreciation of amalgamating company shall be deemed to be the loss or as the case may be, allowance for unabsorbed depreciation of the amalgamated company for the previous year in which the amalgamation was effected and other provisions of the Income Tax Act relating to set off and carry forward of loss and allowance for depreciation.

7. Accumulated loss should arise from “Profits and Gains from business or profession” and not be loss under the head “Capital Gains” or “Speculation”.

8. For qualifying carry forward loss, the provisions of Section 72 should not have been contravened.

9. Similarly for carry forward of unabsorbed depreciation the conditions of Section 32 should not have been violated.

10. Specified Authority has to be satisfied of the eligibility of the company for the relief under Section 72 of the Income-tax Act. It is only on the recommendation of the specified authority that Central Government may allow the relief.

11. The company should make an application to the “specified authority” for requisite recommendation of the case to the Central Government for granting or allowing the relief.

12. Procedure for merger or amalgamation to be followed in such cases is the same as discussed above. Specified Authority makes recommendation after taking into consideration the court’s direction on scheme of amalgamation.

### Concept of reverse merger under SICA

Section 18 of the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) provides for the preparation and sanction of schemes of rehabilitation of sick industrial companies, which are registered with the Board for Industrial and Financial Reconstruction (BIFR).

Sub-section (1) of Section 18 lays down that where an order is made under Section 17(3) in relation to any sick industrial company, the operating agency specified in the order shall prepare, as expeditiously as possible and ordinarily within ninety days from the date of such order, a scheme with respect to such company providing for specified measures.

One of the measures, which is mentioned in clause (c) to Sub-section (1) of Section 18 reads as:

“The amalgamation of—

- (i) the sick industrial company with any other company, or
- (ii) any other company with the sick industrial company (hereinafter in this section, in the case of sub-clause (i), the other company, and in the case of sub-clause (ii), the sick industrial company, referred to as “transferee company”).

The concept is that while ordinarily a sick and economically weak company seeks the support and strength of a healthy and fit company by amalgamating itself with such a company. In a reverse merger, a healthy, strong and economically viable company amalgamates itself with a sick and economically weak company, thereby giving up its own identity to the sick company.

Relevant extracts of certain other provisions, of the Act, which provide for amalgamation or merger or reverse merger are produced hereunder —

Section 18(2): The scheme may provide, inter alia, for the following:

- (i) Alteration of the memorandum or articles of association of the sick industrial company or the transferee company for the purpose of altering the capital structure thereof, or for such other purposes as may be necessary to give effect to the reconstruction or amalgamation.
- (ii) Any other terms and conditions for the reconstruction or amalgamation of the sick industrial company.
- (iii) Such incidental, consequential and supplemental matters as may be necessary to secure that the reconstruction or amalgamation or other measures mentioned in the scheme are fully and effectively carried out.

Section 18(3)(a):

The scheme prepared by the operating agency shall be examined by the BIFR and copies of the scheme with modifications, if any, made by BIFR, shall be sent to the sick industrial company, the operating agency and in case of amalgamation, also to any other company concerned and the BIFR shall also publish or caused to be published the draft scheme in brief in such daily newspapers as the BIFR may consider necessary for suggestions and objections if any, within the specified period.

With the above amendments, for a reverse merger of a sick industrial company, the compliance under Section 72A of the Income tax Act, 1961 is not required. Similarly, once the reverse merger is approved by the BIFR, the procedures outlined in Sections 391 or 394 of the Companies Act, 1956 are not required to be followed. The BIFR can thus make distinctive provisions in a scheme of rehabilitation of a sick company through reverse merger.

### LESSON ROUND UP

- Companies have to downsize or ‘contract’ their operation in certain circumstances such as when a division of the company is performing poorly or simply because it no longer fits into the company’s plans or to give effect to rationalization.
- Demerger is defined as division or separation of different undertakings of a business functioning hitherto under a common umbrella.
- Demerger may take the shape of spin off, split off or split up.
- Demerger may be partial or complete.
- Demerger may be by agreement between promoters or under scheme of arrangement with approval by the court under section 391 or under voluntary winding up.
- Chapter covers in detail the procedure for demerger of a company.
- There are various tax incentives to demerged company, to shareholders of demerged company and to resulting company.
- In a reverse merger, a healthy company merges with a financially weak company. The chapter provides for salient features of reverse merger and the provisions of Section 72A of Income-tax Act, 1961.

## SELF TEST QUESTIONS

(These are meant for recapitulation only. Answers to these questions are not required to be submitted for evaluation).

1. Define the term 'Demerger' and Reverse merger and briefly explain their relevance as a tool of restructuring.
2. What do you mean by 'demerged company' and 'resulting company'?
3. Is demerger different from reconstruction in concept? If so, how?
4. X Ltd. and Y Ltd. propose to effectuate a scheme of demerger. Assuming any of them as a loss making company, enumerate the steps to be taken in this respect.
5. Explain in brief the tax reliefs emerging in demerger to:
  - (a) Shareholders;
  - (b) Demerged company;
  - (c) Resulting company.

[illegible]



# Lesson 9

## Takeovers

### LESSON OUTLINE

- Concept of takeover
- Kinds of takeover
- Takeover bids
- Legal aspects of takeover
- Bail out takeover and takeover of sick units
- Takeover Defenses
- Cross Border Takeovers

### LEARNING OBJECTIVES

Corporate Sector is an attractive medium for carrying on business as it offers a lot of benefits. Raising money from public has its own positive features and it helps setting up big projects. When promoters of a company desire to expand, they take a quick view of the industrial and business map. If they find there are opportunities, they will always yearn for capitalizing such opportunities. Compared to the efforts required, cost and time needed in setting up a new business, it would make sense to them to look at the possibilities of acquiring an existing entity. SEBI (Substantial Acquisition of Shares and Takeovers) 2011 prescribes disclosure requirements, open offer thresholds and other procedural aspects to takeover. After reading this lesson you will be able to understand the meaning, concept, objectives of takeover, procedural requirements as to takeover of listed/unlisted companies, takeover defenses etc.

Section 230-240 of Companies Act, 2013 are not yet notified and accordingly the provisions of Companies Act, 1956 are dealt in this lesson.

## MEANING AND CONCEPT OF TAKEOVERS

A high level of competitive pressure and an increasing appetite for growth have led firms across geographies and industries to choose the inorganic growth path. Mergers & Acquisitions and Takeovers provide a robust growth vehicle often best suited for such firms seeking an entry into a market, geography, product category or broadening its product and / or client base.

Takeover, an inorganic corporate growth device whereby one company acquires control over another company, usually by purchasing all or a majority of its shares.

Takeover implies acquisition of control of a company, which is already registered, through the purchase or exchange of shares. Takeovers usually take place when shares are acquired or purchased from the shareholders of a company at a specified price to the extent of at least controlling interest in order to gain control of that company.

Takeover of management and control of a business enterprise could take place in different modes. The management of a company may be acquired by acquiring the majority stake in the share capital of a company. A company may acquire shares of an unlisted company through what is called the acquisition under Section 395 of the Companies Act, 1956. Where the shares of the company are closely held by a small number of persons, a takeover may be effected by agreement with the holders of those shares. However, where the shares of a company are widely held by the general public, it involves the process as set out in the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011.

Ordinarily, a larger company takes over a smaller company. In a reverse takeover, a smaller company acquires control over a larger company.

The takeover strategy has been conceived to improve corporate value, achieve better productivity and profitability by making optimum use of the available resources in the form of men, materials and machines.

Company Secretaries have important role to play in the take over process especially with regard to compliances under the Companies Act, SEBI (SAST) Regulations 2011, Competition Law aspects, FEMA regulations etc. The role would be with respect to preparation of checklist, drafting of documents, obtaining of necessary approvals etc. The advisory role of company secretaries in the effective execution of takeover deals is vital throughout the takeover process.

## Emergence of concept of takeover

Corporate Sector is an attractive medium for carrying on business as it offers a lot of benefits. Raising money from public has its own positive features and it helps setting up big projects. When promoters of a company desire to expand, they take a quick view of the industrial and business map. If they find there are opportunities, they will always yearn for capitalizing such opportunities. Compared to the efforts required, cost and time needed in setting up a new business, it would make sense to them to look at the possibilities of acquiring an existing entity.

While the possibility of takeover of a company through share acquisition is desirable for achieving certain strategic objectives, there has to be well defined regulations so that the interests of all concerned are not jeopardized by sudden takeover threats. In this perspective, if one were to analyse, it would be clear that there has to be a systematic approach enabling and leading the takeovers, while simultaneously providing adequate opportunity to the original promoters to protect/counter such moves. Thus, while the acquirer should adopt a disciplined method with proper disclosure of intentions so that not only the original promoters

who are in command are protected but also the investors. It would be in the interests of all concerned that the takeover is carried out in a transparent manner.

When adequate checks and balances are introduced and ensured, takeovers become a good tool. That is the reason why regulations have been put in place and these regulations require sufficient disclosures at every stage of acquisition. These regulations take so much care that they cover not only direct acquisition of the acquirer but also includes acquisitions through relatives and associates and group concerns.

In India, the process of economic liberalisation and globalisation ushered in the early 1990's created a highly competitive business environment, which motivated many companies to restructure their corporate strategies. The restructuring process led to an unprecedented rise in strategies like amalgamations, mergers including reverse mergers, demergers, takeovers, reverse takeovers and other strategic alliances.

### Objects of takeover

The objects of a takeover may inter alia be

- (i) To effect savings in overheads and other working expenses on the strength of combined resources;
- (ii) To achieve product development through acquiring firms with compatible products and technological/manufacturing competence, which can be sold to the acquirer's existing marketing areas, dealers and end users;
- (iii) To diversify through acquiring companies with new product lines as well as new market areas, as one of the entry strategies to reduce some of the risks inherent in stepping out of the acquirer's historical core competence;
- (iv) To improve productivity and profitability by joint efforts of technical and other personnel of both companies as a consequence of unified control;
- (v) To create shareholder value and wealth by optimum utilisation of the resources of both companies;
- (vi) To achieve economy of numbers by mass production at economical costs;
- (vii) To secure advantage of vertical combination by having under one command and under one roof, all the stages or processes in the manufacture of the end product, which had earlier been available in two companies at different locations, thereby saving loading, unloading, transportation costs and other expenses and also by affecting saving of time and energy unnecessarily spent on excise formalities at different places and stages;
- (viii) To secure substantial facilities as available to a large company compared to smaller companies for raising additional capital, increasing market potential, expanding consumer base, buying raw materials at economical rates and for having own combined and improved research and development activities for continuous improvement of the products, so as to ensure a permanent market share in the industry;
- (ix) To increase market share;
- (x) To achieve market development by acquiring one or more companies in new geographical territories or segments, in which the activities of acquirer are absent or do not have a strong presence.

### KINDS OF TAKEOVER

Takeovers may be broadly classified into three kinds:

- (i) *Friendly Takeover*: Friendly takeover is with the consent of taken over company. In friendly takeover, there is an agreement between the management of two companies through negotiations

and the takeover bid may be with the consent of majority or all shareholders of the target company. This kind of takeover is done through negotiations between two groups. Therefore, it is also called negotiated takeover.

- (ii) *Hostile Takeover*: When an acquirer company does not offer the target company the proposal to acquire its undertaking but silently and unilaterally pursues efforts to gain control against the wishes of existing management.
- (iii) *Bail Out Takeover*: Takeover of a financially sick company by a profit earning company to bail out the former is known as bail out takeover. There are several advantages for a profit making company to takeover a sick company. The price would be very attractive as creditors, mostly banks and financial institutions having a charge on the industrial assets, would like to recover to the extent possible. Banks and other lending financial institutions would evaluate various options and if there is no other go except to sell the property, they will invite bids. Such a sale could take place in the form by transfer of shares. While identifying a party (acquirer), lenders do evaluate the bids received, the purchase price, the track record of the acquirer and the overall financial position of the acquirer. Thus a bail out takeover takes place with the approval of the Financial Institutions and banks.

## TAKEOVER BIDS

“Takeover bid” is an offer to the shareholders of a company, whose shares are not closely held, to buy their shares in the company at the offered price within the stipulated period of time. It is addressed to the shareholders with a view to acquiring sufficient number of shares to give the offeror company, voting control of the target company.

A takeover bid is a technique, which is adopted by a company for taking over control of the management and affairs of another company by acquiring its controlling shares.

### Type of takeover bids

A takeover bid may be a “friendly takeover bid” or a “hostile takeover bid”. Bids may be mandatory/competitive bids.

#### *Mandatory Bid*

The SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 2011, require acquirers to make bids for acquisition of certain level of holdings subject to certain conditions. A takeover bid is required to be introduced through a public announcement through newspapers. Such requirements arise in the following cases:

- (a) for acquisition of 25% or more of the shares or voting rights;
- (b) for acquiring additional shares or voting rights to the extent of 5% of the voting rights in any financial year ending on 31st March if such person already holds not less than 25% but not more than 75% or 90% of the shares or voting rights in a company as the case may be;
- (c) for acquiring control over a company.

### Factors Determining Vulnerability of Companies to Takeover Bids

The enquiry into such strategies is best initiated by an analysis of factors, which determine the “vulnerability” of companies to takeover bids. It is possible to identify such characteristics that make a company a desirable candidate for a takeover from the acquirer’s point of view. Thus, the factors which make a company vulnerable are:

- Low stock price with relation to the replacement cost of assets or their potential earning power;
- A highly liquid balance sheet with large amounts of excess cash, a valuable securities portfolio, and



significantly unused debt capacity;

- Good cash flow in relation to current stock prices;
- Subsidiaries and properties which could be sold off without significantly impairing cash flow; and
- Relatively small stockholdings under the control of an incumbent management.

A combination of these factors can simultaneously make a company an attractive proposition or investment opportunity and facilitate its financing. The company's assets may act as collateral for an acquirer's borrowings, and the target's cash flows from operations and divestitures can be used to repay the loans.

## LEGAL ASPECTS OF TAKEOVER

The legislations/regulations that mainly govern takeover is as under

1. SEBI (SAST) Regulations 2011
2. Companies Act, 1956
3. Listing Agreement

SEBI (SAST) Regulations 2011 lays down the procedure to be followed by an acquirer for acquiring majority shares or controlling interest in another company.

As far as Companies Act is concerned, the provisions of Section 372A apply to the acquisition of shares through a Company. Section 395 of the Companies Act lays down legal requirements for purpose of takeover of an unlisted company through transfer of undertaking to another company.

The takeover of a listed company is regulated by clause 40A and 40B of the Listing Agreement. These clauses in the Listing Agreement seek to regulate takeover activities independently and impose certain requirements of disclosure and transparency.

## Takeover of Unlisted and Closely Held Companies

Section 395 of the Companies Act contains a compulsory acquisition mode for the transferee company to acquire the shares of minority shareholders of Transferor Company.

Where the scheme has been approved by the holders of not less than nine tenth (90%) in value of the shares of the transferor company whose transfer is involved, the transferee company, may, give notice to any dissenting shareholders that transferee company desires to acquire their shares. The scheme shall be binding on all the shareholders of the transferor company (including dissenting shareholders), unless the Court Orders otherwise (i.e. that the scheme shall not be binding on all shareholders).

### When the scheme is binding on minority shareholders including dissenting shareholders?

When the scheme is approved by the holders of not less than nine tenth (90%) in value of the shares of the transferor company whose transfer is involved, it shall be binding on all the shareholders of the transferor company (including dissenting shareholders), unless the Court Orders otherwise.

**Case Law 1:** Power of Acquisition of Shares of dissentient minority shareholders is not *ultra vires* the constitution of India. *S Viswanathan v. East India Distilleries & Sugar Factories Limited*(1957) 27 Com Cases 175:AIR 1957 Mad 341.

**Case Law 2:** Where the scheme or contract has been approved by 90% of the shareholders, the offer of the transferee company will be treated as prima-facie a fair one and the onus will be on the dissentients to show the contrary. *Benarasi Das Saraf v. dalmia Dadri Cement Ltd*(1958)28 Com cases 435(Punj)

Accordingly, the transferor company shall be entitled and bound to acquire these shares on the terms on which it acquires under the scheme (the binding provision).

The advantage of going through the route contained in Section 395 of the Act is the facility for acquisition of minority stake. The transferee company shall give notice to the minority dissenting shareholders and express its desire to acquire their shares within 2 months of the expiry of the period of 4 months envisaged under Section 395 of the Act.

When a Company intends to take over another Company through acquisition of 90% or more in value of the shares of that Company, the procedure laid down under Section 395 of the Act could be beneficially utilized. When one Company has been able to acquire more than 90% control in another Company, the shareholders holding the remaining control in the other Company are reduced to a miserable minority. They do not even command a 10% stake so as to make any meaningful utilization of the power. Such minority can not even call an extra-ordinary general meeting under Section 168 of the Act nor can they constitute a valid strength on the grounds of their proportion of issued capital for making an application to Company Law Board under Section 397 and 398 of the Act alleging acts of oppression and/or mismanagement. Hence the statute itself provides them a meaningful exit route.

The advantage of going through the route is the facility for acquisition of minority stake. But even without going through this process, if an acquirer is confident of acquiring the entire control, there is no need to go through Section 395 of the Act. It is purely an option recognized by the statute.

The merit of this scheme is that without resort to tedious court procedures the takeover is affected. Only in cases where any dissentient shareholder or shareholders exist, the procedures prescribed by this section will have to be followed. It provides machinery for adequately safeguarding the rights of the dissentient shareholders also.

Section 395 lays down two safeguard in respect of expropriation of private property (by compulsory acquisition of majority shares). First the scheme requires approval of a large majority of shareholders. Second the Court's discretion to prevent compulsory acquisition.

Section 395 requires mandatory compliance of certain formalities including registration of a scheme or contract for acquisition of shares of Transferor Company. The scheme or contract between the Transferee Company and Transferor Company is solemnized with blessings of the Board of Directors of both the companies.

*The following are the important ingredients of the Section 395 route:*

- The Company, which intends to acquire control over another Company by acquiring share, held by shareholders of that another Company is known under Section 395 of the Act as the "Transferee Company".
- The Company whose shares are proposed to be acquired is called the "Transferor Company".
- The "Transferee Company" and "Transferor Company" join together at the Board level and come out with a scheme or contract.
- Every offer or every circular containing the terms of the scheme shall be duly approved by the Board of Directors of the companies and every recommendation to the members of the transferor Company by its directors to accept such offer. It shall be accompanied by such information as provided under the said Act.

- Every offer shall contain a statement by or on behalf of the Transferee Company, disclosing the steps it has taken to ensure that necessary cash will be available. This condition shall apply if the terms of acquisition as per the scheme or the contract provide for payment of cash in lieu of the shares of the Transferor Company which are proposed to be acquired.
- Every circular containing or recommending acceptance of the offer made by the transferee Company shall be duly accompanied by e-Form No. 35A of the Companies (Central Govt.'s) General Rules and Forms, 1956. They shall be filed with the Registrar for registration. Only after such registration can the Transferee Company arrange for circulation of the scheme or contract or the recommendatory letter, if any, of the directors of the transferor company to the shareholders of the Transferor Company.
- The Registrar may refuse to register any such circular, which does not contain the prescribed information, if such information is given in a manner likely to give a false impression.
- An appeal shall lie to the Court against an order of the Registrar refusing to register any such circular.
- Any person issuing a circular containing any false statement or giving any false impression or containing any omission shall be punishable with fine, which may extend to five hundred rupees.
- After the scheme or contract and the recommendation of the Board of Directors of the transferor Company, if any, shall be circulated and approval of not less than 9/10th in value of "Transferor Company" should be obtained within 4 months from the date of circulation. It is necessary that the Memorandum of Association of the transferee company should contain as one of the objects of the company, a provision to takeover the controlling shares in another company. If the memorandum does not have such a provision, the company must alter the objects clause in its memorandum, by convening an extra ordinary general meeting. The approval is not required to be necessarily obtained in a general meeting of the shareholders of the Transferor Company.
- Once approval is available, the 'Transferee Company' becomes eligible for the right of compulsory acquisition of minority interest.
- The Transferee Company has to send notice to the shareholders who have not accepted the offer (i.e. dissenting shareholders) intimating them the need to surrender their shares.
- Once the acquisition of shares in value, not less than 90% has been registered in the books of the transferor Company, the transferor Company shall within one month of the date of such registration, inform the dissenting shareholders of the fact of such registration and of the receipt of the amount or other consideration representing the price payable to them by the transferee Company.
- The transferee Company having acquired shares in value not less than 90% is under an obligation to acquire the minority stake as stated aforesaid and hence it is required to transfer the amount or other consideration equal to the amount or other consideration required for acquiring the minority stake to the transferee Company. The amount or consideration required to be so transferred by the transferee Company to the transferor company, shall not in any way, less than the terms of acquisition offered under the scheme or contract.
- Any amount or other consideration received by the Transferor Company in the manner aforesaid shall be paid into a separate bank account. Any such sums and any other consideration so received shall be held by the transferor Company in trust for the several persons entitled to the shares in respect of which the said sums or other consideration were respectively received.

The takeover achieved in the above process through this Section 395 of the Act will not fall within the

meaning of amalgamation under the Income Tax Act and as such benefits of amalgamation provided under the said Act will not be available to the acquisition under consideration. The takeover in the above process will not enable carrying forward of unabsorbed depreciation and accumulated losses of the transferor Company in the transferee Company for the reason that the takeover does not result in the transferor Company losing its identity.

### **Check list**

#### *Transferor Company*

The transferor company has to take care of the following points:

1. The offer of a company (Transferee Company) to acquire shares of a Transferor Company should be received from the transferee company.
2. It should have been approved by the Board of Directors at a duly convened and held meeting. If proviso to Sub-section (1) of Section 395 is attracted, the terms of offer should be same for all the holders of that class of shares, whose transfer is involved.
3. Offer received from the transferee company along with other documents, particulars etc. should have been circulated to the members of the company in e-Form No. 35A prescribed in the Companies (Central Government's) General Rules and Forms, 1956. [For e-form 35A, see Part B of the Company Secretarial Practice Study]
4. E-form No. 35A must be filed with the Registrar of companies before issuing to the members of the company.
5. The scheme or contract for transfer of shares of the company to the transferee company has been approved by the shareholders of not less than nine-tenths in value of the shares within the stipulated period of four months. If proviso to Sub-section (1) of Section 395 is attracted, the number of such approving shareholders should comprise not less than three-fourths in number of the holders of the shares proposed to be transferred.
6. Comply with any order of the court if any dissenting shareholder had approached the Court against the proposed transfer and if the Court had passed any order contrary to the proposed transfer.
7. If the transferee company wanted to acquire the shares held by dissenting shareholders, the transferor company has received from the transferee company a copy of the notice sent by the transferor company to the dissenting shareholders together with duly filled in and signed transfer instruments along with value of the shares sought to be transferred.
8. The transferee company should have been registered as holder of the transferred shares and the consideration received for the shares has been deposited in a separate bank account to be held in trust for the dissenting shareholders.

#### *Documents etc. involved in this process:*

1. Offer of a scheme or contract from the transferee company.
2. Minutes of Board meeting containing consideration of the offer and its acceptance or rejection.
3. Notice calling general meeting.
4. e-form No. 35A circulated to the members.
5. Minutes of general meeting of the company containing approval of the offer by statutory majority in value and in numbers also, if required.

6. Court order if any.
7. Copy of e-form No. 21 which has been filed with the Registrar along with a copy of the Court Order.
8. Register of Members.
9. Notice sent by the transferee company to dissenting shareholders for acquiring their shares.
10. Duly filled in and executed instrument(s) of transfer of shares held by the dissenting shareholders.
11. Bank Pass Book or Statement of Account in respect of the amount deposited in the special bank account to be kept in trust for the dissenting shareholders.
12. Annual Report.

#### *Transferee Company*

The transferee company has to take care of the following points:

1. Offer made to the transferor company.
2. Copy of notice for the general meeting along with a copy of e-form No. 35A circulated by the transferor company to its members.
3. Intimation received from the transferor company in respect of approval of the offer by the requisite majority of the shareholders of that company.
4. Notice as prescribed in Section 395 of the Companies Act, 1956 given by the company to dissenting shareholders of the transferor company for the purpose of acquiring their shares.
5. If there is any Court order in favour of the dissenting shareholders of the transferor company, terms of the same has been complied with.
6. If Sub-section (2) is attracted, the company must ensure that the prescribed notice has been sent to those shareholders of the transferor company who have not assented to the transfer of the shares and that such shareholders have agreed to transfer their shares to the company.
7. To ensure that a copy of the notice has been sent to the dissenting shareholders of the transferor company and duly executed instrument(s) of transfer together with the value of the shares have been sent to the transferor company.

#### *Documents etc. involved in this process*

1. Minutes of Board meeting containing consideration and approval of the offer sent to the transferor company.
2. Offer of a scheme or contract sent to the transferor company.
3. Notice to dissenting shareholders if any, of the transferor company.
4. Notice to the remaining shareholders of the transferor company, who have not assented to the proposed acquisition, if any.
5. e-form No. 35A received from the transferor company, which has been circulated to its members by that company.
6. Minutes of general meeting of the company containing approval of the shareholders to the offer of scheme or contract sent to the transferor company.
7. Court order, if any.
8. Copy of e-form No. 21 which has been filed with the Registrar along with a copy of the Court Order.

9. Register of Investments.
10. Duly filled in and executed instrument(s) of transfer for shares held by the dissenting shareholders.
11. Balance Sheets showing investments in the shares of the transferor company.

## TAKEOVER OF LISTED COMPANIES

Takeover of companies whose securities are listed on one or more recognized stock exchanges in India is regulated by the provisions of the Listing Agreements with various stock exchanges and the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (the Regulations).

Therefore, before planning a takeover of a listed company, any acquirer should understand the compliance requirements under the Regulations and also the requirements under the Listing Agreement and the Companies Act. There could also be some compliance requirements under the Foreign Exchange Management Act if acquirer were a person resident outside India.

## Listing Agreement

### Conditions for continued listing

Clauses 40A and 40B of the listing agreement were amended to bring them in consonance with the Regulations. These clauses are placed under the heading "Conditions for Continued Listing".

#### 40A. – Minimum level of public shareholding

- (i) The issuer company agrees to comply with the requirements specified in Rule 19(2) and Rule 19A of the Securities Contracts (Regulation) Rules, 1957.
- (ii) Where the issuer company is required to achieve the minimum level of public shareholding specified in Rule 19(2)(b) and/or Rule 19A of the Securities Contracts (Regulation) Rules, 1957, it shall adopt any of the following methods to raise the public shareholding to the required level:-
  - (a) issuance of shares to public through prospectus; or
  - (b) offer for sale of shares held by promoters to public through prospectus; or
  - (c) sale of shares held by promoters through the secondary market in terms of SEBI circular CIR/MRD/DP/05/2012 dated February 1, 2012; or
  - (d) Institutional Placement Programme (IPP) in terms of Chapter VIIIA of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009, as amended; or
  - (e) Rights Issues to public shareholders, with promoter/promoter group shareholders forgoing their entitlement to equity shares, whether present or future, that may arise from such issue; or
  - (f) Bonus Issues to public shareholders, with promoter/promoter group shareholders forgoing their entitlement to equity shares, whether present or future, that may arise from such issue; or
  - (g) any other method as may be approved by SEBI, on a case to case basis.

#### 40 B – Take Over Offer

A company agrees that it is a condition for continued listing that whenever the take-over offer is made or there is any change in the control of the management of the company, the person who secures the control of the management of the company and the company whose shares have been acquired shall comply with the relevant provisions of the SEBI (Substantial Acquisition of Shares and Take-overs) Regulations.

## REQUIREMENTS UNDER SEBI REGULATIONS

### Introduction

The earliest attempts at regulating takeovers in India can be traced back to the 1990s with the incorporation of Clause 40 in the Listing Agreement.

- While, the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1994 which were notified in November 1994 made way for regulation of hostile takeovers and competitive offers for the first time; the subsequent regulatory experience from such offers brought out certain inadequacies existing in those Regulations. As a result, the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 were introduced and notified on February 20, 1997, pursuant to repeal of the 1994 Regulations.
- Owing to several factors such as the growth of Mergers & Acquisitions activity in India as the preferred mode of restructuring, the increasing sophistication of takeover market, the decade long regulatory experience and various judicial pronouncements, it was felt necessary to review the Takeover Regulations 1997. Accordingly, SEBI formed a Takeover Regulations Advisory Committee (TRAC) in September 2009 under the Chairmanship of (Late) Shri. C. Achuthan, Former Presiding Officer, Securities Appellate Tribunal (SAT) for this purpose. After extensive public consultation on the report submitted by TRAC, SEBI came out with the SAST Regulations 2011 which were notified on September 23, 2011. The Takeover Regulations, 1997 stand repealed from October 22, 2011, i.e. the date on which SAST Regulations, 2011 come into force.

### Meaning of certain terms

#### Acquirer

Acquirer means any person who, whether by himself, or through, or with persons acting in concert with him, directly or indirectly, acquires or agrees to acquire shares or voting rights in, or control over a target company. An acquirer can be a natural person, a corporate entity or any other legal entity.

#### Person Acting in Concert (PACs)

PACs are individual(s)/company (ies) or any other legal entity (ies) who, with a common objective or purpose of acquisition of shares or voting rights in, or exercise of control over the target company, pursuant to an agreement or understanding, formal or informal, directly or indirectly cooperate for acquisition of shares or voting rights in, or exercise of control over the target company. SAST Regulations, 2011 define various categories of persons who are deemed to be acting in concert with other persons in the same category, unless the contrary is established.

#### Target Company

The company / body corporate or corporation whose equity shares are listed in a stock Exchange and in which a change of shareholding or control is proposed by an acquirer, is referred to as the 'Target Company'.

#### Control

"control" includes the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner:

Provided that a director or officer of a target company shall not be considered to be in control over such target company, merely by virtue of holding such position;

### Disclosures related provisions

It may be noted that the word “shares” for disclosure purposes include convertible securities also.

#### Event based Disclosures

(a) Any person, who along with PACs crosses the threshold limit of 5% of shares or voting rights, has to disclose his aggregate shareholding and voting rights to the Target Company at its registered office and to every Stock Exchange where the shares of the Target Company are listed within 2 working days of acquisition as per the format specified by SEBI.

(b). Any person who holds 5% or more of shares or Voting rights of the target company and who acquires or sells shares representing 2% or more of the voting rights, shall disclose details of such acquisitions/sales to the Target company at its registered office and to every Stock Exchanges where the shares of the Target Company are listed within 2 working days of such transaction, as per the format specified by SEBI.

Shares taken by way of encumbrance shall be treated as an acquisition and on release of such encumbrances it is a disposal.

#### Continual Disclosures

Continual disclosures of aggregate shareholding shall be made within 7 days of financial year ending on March 31 to the target company at its registered office and every stock exchange where the shares of the Target Company are listed by:

- (a) Shareholders (along with PACs, if any) holding shares or voting rights entitling them to exercise 25% or more of the voting rights in the target company.
- (b) Promoter (along with PACs, if any) of the target company irrespective of their percentage of holding.

#### Disclosures of encumbered shares

The promoter (along with PACs) of the target company shall disclose details of shares encumbered by them or any invocation or release of encumbrance of shares held by them to the target company at its registered office and every stock exchange where shares of the target company are listed, within 7 working days of such event.

As per Regulation 28(3), the term “encumbrance” shall include a pledge, lien or any such transaction, by whatever name called.” The promoters have to understand the nature of encumbrance and those encumbrances which entail a risk of the shares held by promoters being appropriated or sold by a third party, directly or indirectly, are required to be disclosed to the stock exchanges in terms of the Takeover Regulations, 2011.

### Computation of trigger limits for disclosures.

The word “shares” for disclosure purposes include convertible securities also. Hence for computation of trigger limits for disclosures given above, percentage w.r.t shares shall be computed taking in to account total number of equity shares and convertibles and the percentage w.r.t voting rights shall be computed after considering voting rights on equity shares and other securities (like GDRs, if such GDRs carry voting rights)

#### Illustration

An illustration is provided below for the calculation of trigger limits for disclosures.



Total Shares/voting capital of the company

- Company A has 100 equity shares, 50 partly convertible Debentures (PCDs) and 10 GDRs. 1 GDR carries 1 voting right.
- Total shares of company A=  $100+50+10 = 160$
- Total voting capital of Company A=  $100+10=110$

Persons B's holding of shares and voting rights

- Person B has 8 equity shares, 7 PCDs and 1 GDR.
- Person B has  $8+7+1 = 16$  shares (shares for disclosure purpose includes convertible securities)
- Person B's holding in terms of shares=  $16/160=10\%$  of shares
- Person B's voting rights=  $8+1= 9$  voting rights
- Person B's holding in terms of voting rights =  $9/110=8\%$  of voting rights

Since person B is holding more than 5% of shares or voting rights, he is required to make disclosures for any acquisition/ sale of 2% or more of shares or voting rights.

### Acquisition by Person B

#### Scenario I

- Person B acquires 2 equity shares and 2 PCDs.
- In terms of shares, person B has acquired  $4/160=2.5\%$  of shares
- In terms of voting rights, person B has acquired  $2/110= 1.8\%$  of voting rights
- Since acquisition done by person B represents 2 % or more of shares, the disclosure obligation is triggered.

#### Scenario II

- Person B acquires 20 PCDs
- In terms of shares, person B has acquired 20 shares, i.e.  $20/160$  i.e. 12.5% shares.
- In terms of voting rights, he has not acquired a single voting right i.e. 0 voting right
- However, since acquisition done by person B represents 2% or more of shares (though no voting rights), the disclosure obligations is triggered.

### Open offer thresholds (Regulation 3)

The following are the threshold limits for acquisition of shares/voting rights, beyond which an obligation to make an open offer is triggered

**Acquisition of 25% or more shares or voting rights:** An acquirer, who (along with PACs, if any) holds less than 25% shares or voting rights in a target company and agrees to acquire shares or acquires shares which along with his/PAC's existing shareholding would entitle him to exercise 25% or more shares or voting rights in a target company, will need to make an open offer before acquiring such additional shares.

**Acquisition of more than 5% shares or voting rights in a financial year:** An acquirer who (along with PACs, if any) holds 25% or more but less than the maximum permissible non-public shareholding in a target company, can acquire additional shares in the target company as would entitle him to exercise more than 5% of the voting rights in any financial year ending March 31, only after making an open offer.

*Maximum Permissible non-Public Shareholding means Such percentage shareholding in the target Company excluding the minimum Public Shareholding required under Securities Contracts Regulation (Rules) 1957. The SCRR requires minimum Public Shareholding in case of every listed company other than Public Sector Company to be at least 25%. In case of listed public sector company minimum Public Shareholding to be maintained at least 10%. Thus maximum permissible non public Share holder may be 75% and in case of Public Sector company 90%.*

### **Voluntary Offer (Regulation 6)**

A voluntary open offer under Regulation 6, is an offer made by a person who himself or through Persons acting in concert, if any, holds 25% or more shares or voting rights in the target company but less than the maximum permissible non-public shareholding limit.

### **Restrictions on voluntary open offer**

A voluntary offer cannot be made if the acquirer or PACs with him has acquired any shares of the target company in the 52 weeks prior to the voluntary offer. The acquirer is prohibited from acquiring any shares during the offer period other than those acquired in the open offer. The acquirer is also not entitled to acquire any shares for a period of 6 months, after completion of open offer except pursuant to another voluntary open offer.

### **Exemptions from open offer (Regulation 10)**

Exemption may be

Automatic Exemption (under Regulation 10)

Exemption by SEBI (Regulation 11)

### **Exemption under Regulation 10 (Automatic exemption)**

The following acquisitions shall be exempt from the obligation to make an open offer under regulation 3 and regulation 4 subject to fulfillment of the conditions stipulated therefor,—

- (a) acquisition pursuant to inter se transfer of shares amongst qualifying persons, being,—
  - (i) immediate relatives;
  - (ii) persons named as promoters in the shareholding pattern filed by the target company in terms of the listing agreement or these regulations for not less than three years prior to the proposed acquisition;
  - (iii) a company, its subsidiaries, its holding company, other subsidiaries of such holding company, persons holding not less than fifty per cent of the equity shares of such company, other companies in which such persons hold not less than fifty per cent of the equity shares, and their subsidiaries subject to control over such qualifying persons being exclusively held by the same persons;
  - (iv) persons acting in concert for not less than three years prior to the proposed acquisition, and disclosed as such pursuant to filings under the listing agreement;
  - (v) shareholders of a target company who have been persons acting in concert for a period of not less than three years prior to the proposed acquisition and are disclosed as such pursuant to filings under the listing agreement, and any company in which the entire equity share capital is owned by such shareholders in the same proportion as their holdings in the target company without any differential entitlement to exercise voting rights in such company:

**Provided** that for purposes of availing of the exemption under this clause,—

- (i) If the shares of the target company are frequently traded, the acquisition price per share shall not be higher by more than twenty-five per cent of the volume-weighted average market price for a period of sixty trading days preceding the date of issuance of notice for the proposed *inter se* transfer under sub-regulation (5), as traded on the stock exchange where the maximum volume of trading in the shares of the target company are recorded during such period, and if the shares of the target company are infrequently traded, the acquisition price shall not be higher by more than twenty-five percent of the price determined in terms of clause (e) of sub-regulation (2) of regulation 8; and
- (ii) the transferor and the transferee shall have complied with applicable disclosure requirements set out in Chapter V.

(b) acquisition in the ordinary course of business by,—

- (i) an underwriter registered with the Board by way of allotment pursuant to an underwriting agreement in terms of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009;
- (ii) a stock broker registered with the Board on behalf of his client in exercise of lien over the shares purchased on behalf of the client under the bye-laws of the stock exchange where such stock broker is a member;
- (iii) a merchant banker registered with the Board or a nominated investor in the process of market making or subscription to the unsubscribed portion of issue in terms of Chapter XB of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009;
- (iv) any person acquiring shares pursuant to a scheme of safety net in terms of regulation 44 of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009;
- (v) a merchant banker registered with the Board acting as a stabilizing agent or by the promoter or pre-issue shareholder in terms of regulation 45 of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009;
- (vi) by a registered market-maker of a stock exchange in respect of shares for which he is the market maker during the course of market making;
- (vii) a Scheduled Commercial Bank, acting as an escrow agent; and
- (viii) invocation of pledge by Scheduled Commercial Banks or Public Financial Institutions as a pledgee.

(c) acquisitions at subsequent stages, by an acquirer who has made a public announcement of an open offer for acquiring shares pursuant to an agreement of disinvestment, as contemplated in such agreement:

**Provided** that,—

- (i) both the acquirer and the seller are the same at all the stages of acquisition; and
- (ii) full disclosures of all the subsequent stages of acquisition, if any, have been made in the public announcement of the open offer and in the letter of offer.

(d) acquisition pursuant to a scheme,—

- (i) made under section 18 of the Sick Industrial Companies (Special Provisions) Act, 1985 (1 of 1986) or any statutory modification or re-enactment thereto;
  - (ii) of arrangement involving the target company as a transferor company or as a transferee company, or reconstruction of the target company, including amalgamation, merger or demerger, pursuant to an order of a court or a competent authority under any law or regulation, Indian or foreign; or
  - (iii) of arrangement not directly involving the target company as a transferor company or as a transferee company, or reconstruction not involving the target company's undertaking, including amalgamation, merger or demerger, pursuant to an order of a court or a competent authority under any law or regulation, Indian or foreign, subject to,—
    - (A) the component of cash and cash equivalents in the consideration paid being less than twenty-five per cent of the consideration paid under the scheme; and
    - (B) where after implementation of the scheme of arrangement, persons directly or indirectly holding at least thirty-three per cent of the voting rights in the combined entity are the same as the persons who held the entire voting rights before the implementation of the scheme.
  - (e) acquisition pursuant to the provisions of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (54 of 2002);
  - (f) acquisition pursuant to the provisions of the Securities and Exchange Board of India (Delisting of Equity Shares) Regulations, 2009;
  - (g) acquisition by way of transmission, succession or inheritance;
  - (h) acquisition of voting rights or preference shares carrying voting rights arising out of the operation of sub-section (2) of section 87 of the Companies Act, 1956 (1 of 1956).
- (2) The acquisition of shares of a target company, not involving a change of control over such target company, pursuant to a scheme of corporate debt restructuring in terms of the Corporate Debt Restructuring Scheme notified by the Reserve Bank of India vide circular no. B.P.BC 15/21.04, 114/2001 dated August 23, 2001, or any modification or re-notification thereto provided such scheme has been authorised by shareholders by way of a special resolution passed by postal ballot, shall be exempted from the obligation to make an open offer under regulation 3.
- (3) An increase in voting rights in a target company of any shareholder beyond the limit attracting an obligation to make an open offer under sub-regulation (1) of regulation 3, pursuant to buy-back of shares shall be exempt from the obligation to make an open offer provided such shareholder reduces his shareholding such that his voting rights fall to below the threshold referred to in sub-regulation (1) of regulation 3 within ninety days from the date on which the voting rights so increase.
- (4) The following acquisitions shall be exempt from the obligation to make an open offer under sub-regulation (2) of regulation 3,—
- (a) acquisition of shares by any shareholder of a target company, upto his entitlement, pursuant to a rights issue;
  - (b) acquisition of shares by any shareholder of a target company, beyond his entitlement, pursuant to a rights issue, subject to fulfillment of the following conditions,—
    - (i) the acquirer has not renounced any of his entitlements in such rights issue; and
    - (ii) the price at which the rights issue is made is not higher than the ex-rights price of the shares of

the target company, being the sum of,—

- (A) the volume weighted average market price of the shares of the target company during a period of sixty trading days ending on the day prior to the date of determination of the rights issue price, multiplied by the number of shares outstanding prior to the rights issue, divided by the total number of shares outstanding after allotment under the rights issue:

Provided that such volume weighted average market price shall be determined on the basis of trading on the stock exchange where the maximum volume of trading in the shares of such target company is recorded during such period; and

- (B) the price at which the shares are offered in the rights issue, multiplied by the number of shares so offered in the rights issue divided by the total number of shares outstanding after allotment under the rights issue:

- (c) increase in voting rights in a target company of any shareholder pursuant to buy-back of shares:

**Provided** that,—

- (i) such shareholder has not voted in favour of the resolution authorising the buy-back of securities under section 77A of the Companies Act, 1956 (1 of 1956);
- (ii) in the case of a shareholder resolution, voting is by way of postal ballot;
- (iii) where a resolution of shareholders is not required for the buyback, such shareholder, in his capacity as a director, or any other interested director has not voted in favour of the resolution of the board of directors of the target company authorising the buy-back of securities under section 77A of the Companies Act, 1956 (1 of 1956); and
- (iv) the increase in voting rights does not result in an acquisition of control by such shareholder over the target company:

Provided further that where the aforesaid conditions are not met, in the event such shareholder reduces his shareholding such that his voting rights fall below the level at which the obligation to make an open offer would be attracted under sub-regulation (2) of regulation 3, within ninety days from the date on which the voting rights so increase, the shareholder shall be exempt from the obligation to make an open offer;

- (d) acquisition of shares in a target company by any person in exchange for shares of another target company tendered pursuant to an open offer for acquiring shares under these regulations;
- (e) acquisition of shares in a target company from state-level financial institutions or their subsidiaries or companies promoted by them, by promoters of the target company pursuant to an agreement between such transferors and such promoter;
- (f) acquisition of shares in a target company from a venture capital fund or a foreign venture capital investor registered with the Board, by promoters of the target company pursuant to an agreement between such venture capital fund or foreign venture capital investor and such promoters.

(5) In respect of acquisitions under clause (a) of sub-regulation (1), and clauses (e) and (f) of sub-regulation (4), the acquirer shall intimate the stock exchanges where the shares of the target company are listed, the details of the proposed acquisition in such form as may be specified, at least four working days prior to the proposed acquisition, and the stock exchange shall forthwith disseminate such information to the public.

(6) In respect of any acquisition made pursuant to exemption provided for in this regulation, the acquirer shall file a report with the stock exchanges where the shares of the target company are listed, in such form as may be specified not later than four working days from the acquisition, and the stock exchange shall forthwith disseminate such information to the public.

(7) In respect of any acquisition of or increase in voting rights pursuant to exemption provided for in clause (a) of sub-regulation (1), sub-clause (iii) of clause (d) of sub regulation (1), clause (h) of sub-regulation (1), sub-regulation (2), sub-regulation (3) and clause (c) of sub-regulation (4), clauses (a), (b) and (f) of sub-regulation (4), the acquirer shall, within twenty-one working days of the date of acquisition, submit a report in such form as may be specified along with supporting documents to the Board giving all details in respect of acquisitions, along with a non-refundable fee of rupees twenty five thousand by way of a banker's cheque or demand draft payable in Mumbai in favour of the Board.

*Explanation.*— For the purposes of sub-regulation (5), sub-regulation (6) and sub regulation (7) in the case of convertible securities, the date of the acquisition shall be the date of conversion of such securities.

### **Exemptions by the SEBI (Regulation 11)**

(1) SEBI(The Board) may for reasons recorded in writing, grant exemption from the obligation to make an open offer for acquiring shares under these regulations subject to such conditions as the Board deems fit to impose in the interests of investors in securities and the securities market.

(2) The Board may for reasons recorded in writing, grant a relaxation from strict compliance with any procedural requirement under Chapter III and Chapter IV subject to such conditions as the Board deems fit to impose in the interests of investors in securities and the securities market on being satisfied that,—

- (a) the target company is a company in respect of which the Central Government or State Government or any other regulatory authority has superseded the board of directors of the target company and has appointed new directors under any law for the time being in force, if,—
  - (i) such board of directors has formulated a plan which provides for transparent, open, and competitive process for acquisition of shares or voting rights in, or control over the target company to secure the smooth and continued operation of the target company in the interests of all stakeholders of the target company and such plan does not further the interests of any particular acquirer;
  - (ii) the conditions and requirements of the competitive process are reasonable and fair;
  - (iii) the process adopted by the board of directors of the target company provides for details including the time when the open offer for acquiring shares would be made, completed and the manner in which the change in control would be effected; and
- (b) the provisions of Chapter III and Chapter IV are likely to act as impediment to implementation of the plan of the target company and exemption from strict compliance with one or more of such provisions is in public interest, the interests of investors in securities and the securities market.

(3) For seeking exemption under sub-regulation (1), the acquirer shall, and for seeking relaxation under sub-regulation (2) the target company shall file an application with the Board, supported by a duly sworn affidavit, giving details of the proposed acquisition and the grounds on which the exemption has been sought.

(4) The acquirer or the target company, as the case may be, shall along with the application referred to under sub-regulation (3) pay a non-refundable fee of rupees fifty thousand, by way of a banker's cheque or demand draft payable in Mumbai in favour of the Board.

(5) The Board may after affording reasonable opportunity of being heard to the applicant and after considering all the relevant facts and circumstances, pass a reasoned order either granting or rejecting the exemption or relaxation sought as expeditiously as possible:

Provided that the Board may constitute a panel of experts to which an application for an exemption under sub-regulation (1) may, if considered necessary, be referred to make recommendations on the application to the Board.

(6) The order passed under sub-regulation (5) shall be hosted by the Board on its official website.

### **Open offer Process**

#### **1. Appointment of Manager to the offer**

Prior to making of a public announcement, the acquirer shall appoint Merchant Banker registered with the Board, who is not an associate of the acquirer, as manager to the offer.

#### **2. The public announcement of the open offer for acquiring shares required under these regulations shall be made by the acquirer through such manager to the open offer.**

#### **3. Public announcement.**

SEBI (SAST) Regulation, 2011 provides that whenever Acquirer acquires the shares or voting rights of the Target Company in excess of the limits prescribed under Regulation 3 and 4, then the Acquirer is required to give a Public Announcement of an Open Offer to the shareholders of the Target Company. During the process of making the Public Announcement of an Open Offer, the Acquirer is required to give Public Announcement and publish Detailed Public Statement. The regulations have prescribed the separate timeline for Public Announcement as well as for Detailed Public Statement. The details of time line can be referred at Lesson 7 of 'Secretarial Audit, Compliance Management and Due Diligence'.

### **Filing Draft Letter of offer (Regulation 16)**

Within 5 working days of publication DPS, the acquirer through the manager to the offer is required to file a draft letter of offer with SEBI for its observations.

The Board shall give its comments on the draft letter of offer as expeditiously as possible but not later than fifteen working days of the receipt of the draft letter of offer and in the event of no comments being issued by the Board within such period, it shall be deemed that the Board does not have comments to offer:

Provided that in the event the Board has sought clarifications or additional information from the manager to the open offer, the period for issuance of comments shall be extended to the fifth working day from the date of receipt of satisfactory reply to the clarification or additional information sought.

Provided further that in the event the Board specifies any changes, the manager to the open offer and the acquirer shall carry out such changes in the letter of offer before it is dispatched to the shareholders.

### **Escrow account (Regulation 17)**

Escrow Account means a bank account which is required to be opened by an acquirer who proposes to make public announcement of offer in pursuance of regulation 3, 4, 5 and 6 of SEBI (SAST) Regulations, 2011. The Regulations have made detailed provisions regarding the Escrow Account. These provisions are contained in regulation 17 of SEBI (SAST) Regulations, 2011. Regulation 17(1) of SEBI (SAST) Regulations, 2011 provides that "Not later than two working days prior to the date of the detailed public statement of open offer for acquiring shares, the acquirer shall create an escrow account towards security for performance of his obligations under these regulations, and deposit in escrow account such aggregate amount as specified. The purpose of these provisions is to ensure that the acquirer has sufficient funds to pay the consideration under the offer and he has secured sufficient financial arrangement.

**I. Timing of opening of Escrow Account: [Regulation 17(1)]**

The Acquirer shall open an escrow account *atleast two working days* prior to the date of Detailed Public Statement.

**II. Amount to be deposited in Escrow Account: [Regulation 17(1)]**

<i>Sl. No.</i>	<i>Consideration payable under the Open Offer</i>	<i>Escrow Amount</i>
a.	On the first Rs. 500 Crores	25% of the consideration
b.	On the balance consideration	An additional amount equal to 10%

It is further provided that where offer is made conditional upon minimum level of acceptance, then higher of following two shall be deposited in the Escrow Account:

Hundred percent of the consideration payable in respect of minimum level of acceptance	Fifty per cent of the consideration payable under the open offer
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If the Acquirer makes any upward revision in the open offer, whether by way of increase in offer price, or of the offer size, then the Acquirer shall make corresponding increases to the amount kept in escrow account prior to making such revision. [Regulation 17(2)]

**III. Mode of Deposit in Escrow Account: [Regulation 17(3)]**

- (a) **Cash Deposit** with any scheduled commercial bank
- (b) **Bank guarantee** issued in favor of the manager to the open offer by any scheduled commercial bank
- (c) Deposit of **frequently traded and freely transferable equity shares** or other freely transferable securities with appropriate margin subject to compliance with regulation 9(2).

**Important Points:**

<i>Applicable Regulation</i>	<i>Details</i>	
17(4)	Bank Guarantee or Deposit of Security	Deposit at least 1% of the total consideration payable in cash with schedule commercial bank as part of Escrow Account.
17(5)	Cash deposit	Empower the manager to the open offer to instruct the bank to issue a banker's cheque or demand draft or to make payment of the amounts lying to the credit of the escrow account lying to the credit of the escrow account
17(6)	Bank Guarantee	The bank guarantee shall be in the favor of manager to the offer



		and shall be kept valid throughout the offer period and additional 30 days after the payment to the shareholders who have tendered their shares have been made.
17(7)	Securities	<p>Manager to the Open Offer shall be empowered to realize the value of escrow account by way of sale or otherwise.</p> <p>Further in case of any shortfall in the amount in the escrow account, such shortfall shall be made good by the Manager.</p>

#### **IV. Release of amount from Escrow Account [Regulation 17(10)]**

The amount lying in escrow account can be released in the following cases only:

1. In case of withdrawal of offer, the entire amount can be released only after certification by the managers to the open offer.
2. The amount deposited in special escrow account is transferred to special bank account opened with the Bankers to an issue; however the amount so transferred shall not exceed 90% of the cash deposit.
3. The balance 10% is released to the acquirer on the expiry of thirty days from the completion of all obligations under the offer.
4. The entire amount to the acquirer on the expiry of thirty days from the completion of all obligations under the offer where the open offer is for exchange of shares or other secured instruments.
5. In the event of forfeiture of amount, the entire amount is distributed in the following manner:
  - 5.1 One third of the amount to Target Company;
  - 5.2 One third of the escrow account to the Investor Protection and Education Fund established under SEBI (Investor Protection and Education Fund) Regulations, 2009;
  - 5.3 Residual one third is to be distributed to the shareholders who have tendered their shares in the offer.

#### **Draft Letter of offer to Target Company and stock exchanges [Regulation 18(1)]**

Simultaneously with the filing of the draft letter of offer with the Board under sub-regulation (1) of regulation 16, the acquirer shall send a copy of the draft letter of offer to the target company at its registered office address and to all stock exchanges where the shares of the target company are listed.

#### **Dispatch of letter of offer to share holders [Regulation 18(2)]**

The letter of offer shall be dispatched to the shareholders whose names appear on the register of members of the target company as of the identified date, not later than seven working days from the receipt of comments from the Board or where no comments are offered by the Board, within seven working days from

the expiry of the stipulated period in sub-regulation (4) of regulation 16:

Provided that where local laws or regulations of any jurisdiction outside India may expose the acquirer or the target company to material risk of civil, regulatory or criminal liabilities in the event the letter of offer in its final form were to be sent without material amendments or modifications into such jurisdiction, and the shareholders resident in such jurisdiction hold shares entitling them to less than five per cent of the voting rights of the target company, the acquirer may refrain from dispatch of the letter of offer into such jurisdiction:

Provided further that every person holding shares, regardless of whether he held shares on the identified date or has not received the letter of offer, shall be entitled to tender such shares in acceptance of the open offer.

### **Letter of offer to the custodian of shares underlying depository receipts (Regulation 18(3))**

Simultaneously with the dispatch of the letter of offer in terms of sub-regulation (2), of regulation 18 the acquirer shall send the letter of offer to the custodian of shares underlying depository receipts, if any, of the target company.

### **Offer Price**

Offer price is the price at which the acquirer announces to acquire shares from the public shareholders under the open offer. The offer price shall not be less than the price as calculated under regulation 8 of the SEBI (SAST) Regulations, 2011 for frequently or infrequently traded shares.

### **Revision of offer price [Regulation 18(4&5)]**

Irrespective of whether a competing offer has been made, an acquirer may make upward revisions to the offer price, and subject to the other provisions of these regulations, to the number of shares sought to be acquired under the open offer, at any time prior to the commencement of the last three working days before the commencement of the tendering period.

In the event of any revision of the open offer, whether by way of an upward revision in offer price, or of the offer size, the acquirer shall,—

- (a) make corresponding increases to the amount kept in escrow account under regulation 17 prior to such revision;
- (b) make an announcement in respect of such revisions in all the newspapers in which the detailed public statement pursuant to the public announcement was made; and
- (c) simultaneously with the issue of such an announcement, inform the Board, all the stock exchanges on which the shares of the target company are listed, and the target company at its registered office.

### **Size of an Open Offer**

An open offer, other than a voluntary open offer under Regulation 6, must be made for a minimum of 26% of the target company's share capital. The size of the voluntary open offer under Regulation 6 must be for at least 10% of the target company's share capital. Further the offer size percentage is calculated on the fully diluted share capital of the target company taking into account potential increase in the number of outstanding shares as on 10<sup>th</sup> working day from the closure of the open offer.

### **Disclosure of acquisition during offer period [Regulation 18(6)]**

The acquirer shall disclose during the offer period every acquisition made by the acquirer or persons acting

in concert with him of any shares of the target company in such form as may be specified, to each of the stock exchanges on which the shares of the target company are listed and to the target company at its registered office within twenty-four hours of such acquisition, and the stock exchanges shall forthwith disseminate such information to the public:

Provided that the acquirer and persons acting in concert with him shall not acquire or sell any shares of the target company during the period between three working days prior to the commencement of the tendering period and until the expiry of the tendering period.

### **Advertisement before the tendering period [Regulation 18(6)]**

The acquirer shall issue an advertisement in such form as may be specified, one working day before the commencement of the tendering period, announcing the schedule of activities for the open offer, the status of statutory and other approvals, if any, whether for the acquisition attracting the obligation to make an open offer under these regulations or for the open offer, unfulfilled conditions, if any, and their status, the procedure for tendering acceptances and such other material detail as may be specified:

Provided that such advertisement shall be,—

- (a) published in all the newspapers in which the detailed public statement pursuant to the public announcement was made; and
- (b) simultaneously sent to the Board, all the stock exchanges on which the shares of the target company are listed, and the target company at its registered office.

### **Offer period and tendering period**

The term 'offer period' pertains to the period starting from the date of the event triggering open offer till completion of payment of consideration to shareholders by the acquirer or withdrawal of the offer by the acquirer as the case may be.

The term 'tendering period' refers to the 10 working days period falling within the offer period, during which the eligible shareholders who wish to accept the open offer can tender their shares in the open offer.

### **Tenure of tendering period [Regulation 18(8)]**

The tendering period shall start not later than twelve working days from date of receipt of comments from the Board under sub-regulation (4) of regulation 16 and shall remain open for ten working days.

### **Tendered shares shall not be withdrawn [Regulation 18(9)]**

Shareholders who have tendered shares in acceptance of the open offer shall not be entitled to withdraw such acceptance during the tendering period.

### **Completion of requirements [Regulation 18(10&11)]**

The acquirer shall, within ten working days from the last date of the tendering period, complete all requirements under these regulations and other applicable law relating to the open offer including payment of consideration to the shareholders who have accepted the open offer.

The acquirer shall be responsible to pursue all statutory approvals required by the acquirer in order to complete the open offer without any default, neglect or delay:

Provided that where the acquirer is unable to make the payment to the shareholders who have accepted the open offer within such period owing to non-receipt of statutory approvals required by the acquirer, the Board may, where it is satisfied that such non-receipt was not attributable to any willful default, failure or neglect on the part of the acquirer to diligently pursue such approvals, grant extension of time for making payments, subject to the acquirer agreeing to pay interest to the shareholders for the delay at such rate as may be specified:

Provided further that where the statutory approval extends to some but not all shareholders, the acquirer shall have the option to make payment to such shareholders in respect of whom no statutory approvals are required in order to complete the open offer.

### **Post offer Advertisement [Regulation 18(12)]**

The acquirer shall issue a post offer advertisement in such form as may be specified within five working days after the offer period, giving details including aggregate number of shares tendered, accepted, date of payment of consideration.

(b) Such advertisement shall be,—

- (i) published in all the newspapers in which the detailed public statement pursuant to the public announcement was made; and
- (ii) simultaneously sent to the Board, all the stock exchanges on which the shares of the target company are listed, and the target company at its registered office.

### **Conditional offer (Regulation 19)**

An offer in which the acquirer has stipulated a minimum level of acceptance is known as a 'conditional offer'.

'Minimum level of acceptance' implies minimum number of shares which the acquirer desires under the said conditional offer. If the number of shares validly tendered in the conditional offer, are less than the minimum level of acceptance stipulated by the acquirer, then the acquirer is not bound to accept any shares under the offer.

In a conditional offer, if the minimum level of acceptance is not reached, the acquirer shall not acquire any shares in the target company under the open offer or the Share Purchase Agreement which has triggered the open offer.

### **Competing offer (Regulation 20)**

Competitive offer is an offer made by a person, other than the acquirer who has made the first public announcement. A competitive offer shall be made within 15 working days of the date of the Detailed Public Statement (DPS) made by the acquirer who has made the first PA.

If there is a competitive offer, the acquirer who has made the original public announcement can revise the terms of his open offer provided the revised terms are favorable to the shareholders of the target company. Further, the bidders are entitled to make revision in the offer price up to 3 working days prior to the opening of the offer. The schedule of activities and the offer opening and closing of all competing offers shall be carried out with identical timelines.

**Payment of consideration: (Regulation 21)**

The acquirer shall complete payment of consideration whether in the form of cash, or as the case may be, by issue, exchange/transfer of Securities, to all shareholders who have tendered shares in acceptance of the open offer within 10 working days of the expiry of the tendering period, by transferring the consideration to a Special Escrow Account.

**Withdrawal of open offer (Regulation 23)**

An open offer once made cannot be withdrawn except in the following circumstances:

- Statutory approvals required for the open offer or for effecting the acquisitions attracting the obligation to make an open offer have been refused subject to such requirement for approvals having been specifically disclosed in the DPS and the letter of offer;
- Any condition stipulated in the SPA attracting the obligation to make the open offer is not met for reasons outside the reasonable control of the acquirer, subject to such conditions having been specifically disclosed in the DPS and the letter of offer;
- Sole acquirer being a natural person has died;
- Such circumstances which in the opinion of SEBI merit withdrawal of open offer.

**Obligations of the acquirer.(Regulation 25)**

(1) Prior to making the public announcement of an open offer for acquiring shares under these regulations, the acquirer shall ensure that firm financial arrangements have been made for fulfilling the payment obligations under the open offer and that the acquirer is able to implement the open offer, subject to any statutory approvals for the open offer that may be necessary.

(2) In the event the acquirer has not declared an intention in the detailed public statement and the letter of offer to alienate any material assets of the target company or of any of its subsidiaries whether by way of sale, lease, encumbrance or otherwise outside the ordinary course of business, the acquirer, where he has acquired control over the target company, shall be debarred from causing such alienation for a period of two years after the offer period:

Provided that in the event the target company or any of its subsidiaries is required to so alienate assets despite the intention to alienate not having been expressed by the acquirer, such alienation shall require a special resolution passed by shareholders of the target company, by way of a postal ballot and the notice for such postal ballot shall inter alia contain reasons as to why such alienation is necessary.

(3) The acquirer shall ensure that the contents of the public announcement, the detailed public statement, the letter of offer and the post-offer advertisement are true, fair and adequate in all material aspects and not misleading in any material particular, and are based on reliable sources, and state the source wherever necessary.

(4) The acquirer and persons acting in concert with him shall not sell shares of the target company held by them, during the offer period.

(5) The acquirer and persons acting in concert with him shall be jointly and severally responsible for fulfillment of applicable obligations under these regulations.

**Obligations of the target company.(Regulation 26)**

(1) Upon a public announcement of an open offer for acquiring shares of a target company being made, the

board of directors of such target company shall ensure that during the offer period, the business of the target company is conducted in the ordinary course consistent with past practice.

(2) During the offer period, unless the approval of shareholders of the target company by way of a special resolution by postal ballot is obtained, the board of directors of either the target company or any of its subsidiaries shall not,—

- (a) alienate any material assets whether by way of sale, lease, encumbrance or otherwise or enter into any agreement therefor outside the ordinary course of business;
- (b) effect any material borrowings outside the ordinary course of business;
- (c) issue or allot any authorised but unissued securities entitling the holder to voting rights:

Provided that the target company or its subsidiaries may,—

- (i) issue or allot shares upon conversion of convertible securities issued prior to the public announcement of the open offer, in accordance with pre-determined terms of such conversion;
- (ii) issue or allot shares pursuant to any public issue in respect of which the red herring prospectus has been filed with the Registrar of Companies prior to the public announcement of the open offer; or
- (iii) issue or allot shares pursuant to any rights issue in respect of which the record date has been announced prior to the public announcement of the open offer;
- (d) implement any buy-back of shares or effect any other change to the capital structure of the target company;
- (e) enter into, amend or terminate any material contracts to which the target company or any of its subsidiaries is a party, outside the ordinary course of business, whether such contract is with a related party, within the meaning of the term under applicable accounting principles, or with any other person; and
- (f) accelerate any contingent vesting of a right of any person to whom the target company or any of its subsidiaries may have an obligation, whether such obligation is to acquire shares of the target company by way of employee stock options or otherwise.

(3) In any general meeting of a subsidiary of the target company in respect of the matters referred to in sub-regulation (2), the target company and its subsidiaries, if any, shall vote in a manner consistent with the special resolution passed by the shareholders of the target company.

(4) The target company shall be prohibited from fixing any record date for a corporate action on or after the third working day prior to the commencement of the tendering period and until the expiry of the tendering period.

(5) The target company shall furnish to the acquirer within two working days from the identified date, a list of shareholders as per the register of members of the target company containing names, addresses, shareholding and folio number, in electronic form, wherever available, and a list of persons whose applications, if any, for registration of transfer of shares are pending with the target company:

Provided that the acquirer shall reimburse reasonable costs payable by the target company to external agencies in order to furnish such information.

(6) Upon receipt of the detailed public statement, the board of directors of the target company shall constitute a committee of independent directors to provide reasoned recommendations on such open offer, and the

target company shall publish such recommendations:

Provided that such committee shall be entitled to seek external professional advice at the expense of the target company.

(7) The committee of independent directors shall provide its written reasoned recommendations on the open offer to the shareholders of the target company and such recommendations shall be published in such form as may be specified, at least two working days before the commencement of the tendering period, in the same newspapers where the public announcement of the open offer was published, and simultaneously, a copy of the same shall be sent to,—

- (i) the Board;
- (ii) all the stock exchanges on which the shares of the target company are listed, and the stock exchanges shall forthwith disseminate such information to the public; and
- (iii) to the manager to the open offer, and where there are competing offers, to the manager to the open offer for every competing offer.

(8) The board of directors of the target company shall facilitate the acquirer in verification of shares tendered in acceptance of the open offer.

(9) The board of directors of the target company shall make available to all acquirers making competing offers, any information and co-operation provided to any acquirer who has made a competing offer.

(10) Upon fulfillment by the acquirer, of the conditions required under these regulations, the board of directors of the target company shall without any delay register the transfer of shares acquired by the acquirer in physical form, whether under the agreement or from open market purchases, or pursuant to the open offer.

#### **Obligations of the manager to the open offer.(Regulation 27)**

(1) Prior to public announcement being made, the manager to the open offer shall ensure that,—

- (a) the acquirer is able to implement the open offer; and
- (b) firm arrangements for funds through verifiable means have been made by the acquirer to meet the payment obligations under the open offer.

(2) The manager to the open offer shall ensure that the contents of the public announcement, the detailed public statement and the letter of offer and the post offer advertisement are true, fair and adequate in all material aspects, not misleading in any material particular, are based on reliable sources, state the source wherever necessary, and are in compliance with the requirements under these regulations.

(3) The manager to the open offer shall furnish to the Board a due diligence certificate along with the draft letter of offer filed under regulation 16.

(4) The manager to the open offer shall ensure that market intermediaries engaged for the purposes of the open offer are registered with the Board.

(5) The manager to the open offer shall exercise diligence, care and professional judgment to ensure compliance with these regulations.

(6) The manager to the open offer shall not deal on his own account in the shares of the target company during the offer period.

(7) The manager to the open offer shall file a report with the Board within fifteen working days from the expiry

of the tendering period, in such form as may be specified, confirming status of completion of various open offer requirements.

## DEFENSE STRATEGIES TO TAKEOVER BIDS

A hostile tender offer made directly to a target company's shareholders, with or without previous overtures to the management, has become an increasingly frequent means of initiating a corporate combination. As a result, there has been considerable interest in devising defense strategies by actual and potential targets.

Defenses can take the form of fortifying one self, i.e., to make the company less attractive to takeover bids or more difficult to take over and thus discourage any offers being made. These include, inter alia, asset and ownership restructuring, anti-takeover constitutional amendments, adoption of poison pill rights plans, and so forth. Defensive actions are also resorted to in the event of perceived threat to the company, ranging from early intelligence that a "raider" or any acquirer has been accumulating the company's stock to an open tender offer. Adjustments in asset and ownership structures may also be made even after a hostile takeover bid has been announced.

### Defensive Measures

#### *Adjustments in Asset and Ownership Structure*

Firstly, consideration has to be given to steps, which involve defensive restructuring that create barriers specific to the bidder. These include purchase of assets that may cause legal problems, purchase of controlling shares of the bidder itself, sale to the third party of assets which made the target attractive to the bidder, and issuance of new securities with special provisions conflicting with aspects of the takeover attempt.

A second common theme is to create a consolidated vote block allied with target management.

Thus, securities were issued through private placements to parties friendly or in business alliance with management or to the management itself. Moreover, another method can be to repurchase publicly held shares to increase an already sizable management-allied block in place.

A third common theme is the dilution of the bidder's vote percentage through issuance of new equity claims. However, this option in India is strictly regulated vide Section 81A and Regulation 23 of the Takeover Code, 1997. A hostile bidder in these circumstances usually fails in the bid if the bidder has resource constraints in increasing its interest proportionately.

#### *The "Crown Jewel" Strategy*

The central theme in such a strategy is the divestiture of major operating unit most coveted by the bidder—commonly known as the "crown jewel strategy". Consequently, the hostile bidder is deprived of the primary intention behind the takeover bid. A variation of the "crown jewel strategy" is the more radical "scorched earth approach". Vide this novel strategy, the target sells off not only the crown jewel but also properties to diminish its worth. Such a radical step may however be, self-destructive and unwise in the company's interest. However, the practice in India is not so flexible. The Companies Act, 1956 has laid down certain restrictions on the power of the Board. Vide Section 293(1), the Board cannot sell the whole or substantially the whole of its undertakings without obtaining the permission of the company in a general meeting. However, the SEBI (Substantial Acquisitions and Takeover) Regulations, 1997 vide Regulation 23 prescribes general obligations for the Board of Directors of the target company. Under the said regulation, it will be difficult for any target company to sell, transfer, encumber or otherwise dispose of or enter into an agreement to sell, transfer, encumber or for dispose of assets once the predator has made a public announcement. Thus, the above defense can only be used before the predator/bidder makes the public announcement of its intention to takeover the target company.



### *The “Packman” Defence*

This strategy, although unusual, is called the packman strategy. Under this strategy, the target company attempts to purchase the shares of the raider company. This is usually the scenario if the raider company is smaller than the target company and the target company has a substantial cash flow or liquidable asset.

### *Targeted Share Repurchase or “Buyback”*

This strategy is really one in which the target management uses up a part of the assets of the company on the one hand to increase its holding and on the other it disposes of some of the assets that make the target company unattractive to the raider. The strategy therefore involves a creative use of buyback of shares to reinforce its control and detract a prospective raider. But “buyback” the world over is used when the excess money with the company neither gives it adequate returns on reinvestment in production or capital nor does it allow the company to redistribute it to shareholders without negative spin offs.

An example that demonstrates this contention is the distribution of high dividends in a particular year if not followed in the next sends the share prices spiraling down. Also the offer once made cannot be withdrawn unlike a public offer under the Takeover Regulations. This means that if the raider withdraws its public offer it would imply that the target company would still have to go through with the buyback. This is an expensive proposition if the only motivation to go for the buyback was to dissuade the raider.

### *“Golden Parachutes”*

Golden parachutes refer to the “separation” clauses of an employment contract that compensate managers who lose their jobs under a change-of-management scenario. The provision usually calls for a lump-sum payment or payment over a specified period at full and partial rates of normal compensation. The provisions which would govern a “golden parachute” employment contract in India would be Sections 318-320 of the Companies Act, 1956 which govern the provisions compensation for loss of office. Thus, a perusal of the said provisions would show that payments as compensation for the loss of office is allowed to be made only to the managing director, a director holding an office of manager or a whole time director. Therefore, “golden parachute” contracts with the entire senior management, as is the practice in the U.S., is of no consequence in India. Moreover, payment of compensation is expressly disallowed if in the case of a director resigning as a consequence of reconstruction of the company, or its amalgamation with any other corporate bodies. Furthermore, there exists a maximum limit as to the quantum of the compensation, subject to the exclusionary categories, to the total of the remuneration the director would have earned for the unexpired residue of term of office, or three years, whichever is less.

### *Anti-takeover amendments or “shark repellants”*

An increasingly used defense mechanism is anti-takeover amendments to the company’s constitution or articles of association, popularly called “shark repellants”. Thus, as with all amendments of the charter/articles of association of a company, the anti-takover amendments have to be voted on and approved by the shareholders. The practice consists of the companies changing the articles, regulations, bye-laws etc. to be less attractive to the corporate bidder.

Anti takeover amendments generally impose new conditions on the transfer of managerial control of the firm through a merger, tender offer, or by replacement of the Board of Directors. In India every company has the clear power to alter its articles of association by a special resolution as provided under Section 31 of the Companies Act. The altered articles will bind the members just in the same way as did the original articles. But that will not give the altered articles a retrospective effect. The power of alteration of the articles as conferred by Section 31 is almost absolute. It is subject only to two restrictions. In the first place, the alteration must not be in contravention of the provisions of the Act, i.e. should not be an attempt to do

something that the Act forbids. Secondly, the power of alteration is subject to the conditions contained in the memorandum of association i.e. alter only the articles of the company as relate to the management of the company but not the very nature and constitution of the company. Also the alteration should not constitute a 'fraud on the minority'.

### Types of Anti-Takeover Amendments

There are four major types of anti-takeover amendments.

#### *Supermajority Amendments*

These amendments require shareholder approval by at least two thirds vote and sometimes as much as 90% of the voting power of outstanding capital stock for all transactions involving change of control. In most existing cases, however, the supermajority agreements have a board-out clause which provides the board with the power to determine when and if the supermajority provisions will be in effect. Pure or inflexible supermajority provisions would seriously limit the management's scope of options and flexibility in takeover negotiations.

#### *Fair-Price Amendments*

These are supermajority provisions with a board out clause and an additional clause waiving the supermajority requirement if a fair-price is paid for the purchase of all the shares. The fair price is normally defined as the highest price paid by the bidder during a specified period. Thus, fair-price amendments defend against two-tier tender offers that are not approved by the target's board.

#### *Classified Boards*

Another major type of anti-takeover amendments provides for a staggered, or classified, Board of Directors to delay effective transfer and control in a takeover. The much touted management rationale in proposing a classified board is to ensure continuity of policy and experience. In the United States, the legal position of such classified or staggered boards is quite flexible. An ideal example is when a nine-member board may be divided into 3 classes, with only three members standing for election to a three year term each, such being the modalities of the retirement by rotation. Thus, a new majority shareholder would have to wait for at least two annual general meetings to gain control of the Board of Directors. In the Indian company law regime, the scope for such amendments is highly restricted. Section 255 of the Companies Act, 1956 is designed to eradicate the mischief caused by perpetual managements. At an AGM only one-third of the directors of the company, whose offices are determinable by retirement, will retire. Therefore putting the example in the Indian context, in case of 9 directors, 3 can be made permanent directors by amending the articles i.e. one-third can be given permanent appointment, under Section 255. Thus the acquirer would have to wait for atleast three annual general meetings before he gains control of the board. But this is subject to Section 284, which provides that the company may by an ordinary resolution, remove a director before the expiration of his period of office. Thus any provision in the articles of the company or any agreement between a director and a company by which the director is rendered irremovable from office by an ordinary resolution would be void, being contrary to the Act. Therefore, to ensure domination of the board of the target management, there needs to be strength to defeat an ordinary resolution.

#### *Authorization of Preferred Stock*

Vide such provisions, the Board of Directors is authorized to create a new class of securities with special voting rights. This security, typically preferred stock, may be issued to a friendly party in a control contest. Thus, this device is a defense against hostile takeover bids, although historically it was used to provide the Board of Directors with flexibility in financing under changing economic conditions.

## Refusal to Register Transfer of Shares

Refusal by the Board of Directors to register a transfer is an important strategy to avert a takeover.

## Poison Pill Defenses

A controversial but popular defense mechanism against hostile takeover bids is the creation of securities called “poison pills”. These pills provide their holders with special rights exercisable only after a period of time following the occurrence of a triggering event such as a tender offer for the control or the accumulation of a specified percentage of target shares. These rights take several forms but all are difficult and costly to acquire control of the issuer, or the target firm. Poison pills are generally adopted by the Board of Directors without shareholder approval. Usually the rights provided by the poison pill can be altered quickly by the board or redeemed by the company anytime after they become exercisable following the occurrence of the triggering event. These provisions force the acquirer to negotiate directly with the target company's board and allow some takeover bids to go through. Proponents of the poison pill argue that poison pills do not prohibit all takeovers but enhance the ability of the Board of Directors to bargain for a “fair price”.

## Legal Issues Concerning Poison Pill Devices

The legality of poison pills has been questioned in courts of law because they alter the relationships among the principals (shareholders) without their approval by vote. In most poison pills, the agents (Board of Directors) adopt rights plans which treat shareholders of the same class unequally in situation involving corporate control. Thus poison pills have been vulnerable to court review especially in the United States.

Corporate restructuring through the M&A route is here to stay. The defenses mentioned above are only enumerative of the fast evolving corporate practice in this regard. This kind of corporate synergy requires that the legal paradigm so adjust itself, that it is in a position to optimize the benefits that accrue from such restructuring.

Globalization of the Indian economy started changing the landscape of the Indian industry. Following economic reforms, there was a discernible trend among promoters and established corporate groups towards consolidation of market share and diversification into new areas, in a limited way through acquisition of companies, but in a more pronounced manner through mergers and amalgamations.

Perhaps the biggest facilitators for Indian businessmen were the most flexible norms and terms announced by the Indian government, which had announced that the companies with a proven track would be allowed to make acquisitions abroad in non-related areas as well as their major fields. In addition, the government removed the \$100 million cap on foreign investment by Indian companies and raised it to the net worth of the companies. The Reserve Bank of India (RBI), also stipulated that the local companies could raised external commercial borrowings for overseas direct investments in their joint ventures and wholly owned subsidiaries, including mergers and acquisitions overseas.

As a direct result of such liberal regulations, Indian companies, including branches of multinational, became more adventurous in their business forays.

## CROSS BORDERS TAKEOVERS

Cross Border Takeover is a much sort after term in recent years. Competitiveness among the domestic firms forces many businesses to go global. There are various factors which motivate firms to go for global takeovers. Apart from personal glory, global takeovers are often driven by market consolidation, expansion or corporate diversification motives. Also, financial, accounting and tax related matters inspire such takeovers.

The firms engaged in Cross borders takeovers can be of three types:

- First, firm incorporated in one country listed in different countries including its own e.g. ARCELOR.
- Second, firm incorporated in one country listed exclusively in a foreign country e.g. TELVENT.
- And lastly, firms incorporated in one country listed in more than one foreign country e.g. EADS.

Expansion and diversification are one of the primary reasons to cross the border as the domestic markets usually do not provide the desired growth opportunities. One has to look outside its boundaries and play out in the global arena to seek new opportunities and scale new heights. Such companies have already improved profitability through better cost management and diversification at the national field.

Another main reason for cross border takeovers is to attain monopoly. Acquirer company is always on the look out for companies which are financially vulnerable but have untapped resources or intellectual capital that can be exploited by the purchaser.

Globalization has certainly helped in the recent spurt in cross border takeovers. The key feature of globalization is that it integrates world economies together. Many nations have opened their economies and made laws and regulations that attract new companies to come into the country.

What are the legal implications to a cross border merger and takeover? International law prescribes that in a cross-border merger, the target firm becomes a national of the country of the acquirer. Among other effects, the change in nationality implies a change in investor protection, because the law that is applicable to the newly merged firm changes as well. More generally, the newly created firm shares features of the corporate governance systems of the two merging firms. Therefore, Cross-border mergers provide a natural experiment to analyse the effects of changes-both improvements and deteriorations, in corporate governance on firm value.

There are various benefits of cross border takeovers. Firstly, they provide newer and better technology. It also provides employment opportunities as the firm is bigger than before and more employees are to be inducted in the merged company. It generally enhances the market capitalization of the combined entity.

Global takeovers are complex processes. Despite some harmonized rules, taxation issues are mainly dealt within national rules, and are not always fully clear or exhaustive to ascertain the tax impact of a cross-border merger or acquisition. This uncertainty on tax arrangements sometimes require seeking of special agreements or arrangements from the tax authorities on an ad hoc basis, whereas in the case of a domestic deal the process is much more deterministic.

Gross-border takeover bids are complex transactions that may involve the handling of a significant number of legal entities, listed or not, and which are often governed by local rules (company law, market regulations, self regulations, etc.). Not only a foreign bidder might be hindered by a potential lack of information, but also some legal complexities might appear in the merger process resulting in a deadlock, even though the bid would be 'friendly'. This legal uncertainty may result in a significant execution risk and act as a major hurdle to cross-border consolidation.

There are various challenges to cross border takeovers. Global takeovers may result into a skyrocketing share prices because merger and acquisition have a substantial effect on the whole economy. Management also faces a big challenge as there is explosion of new services, new products, new industries and new markets and new technological innovations as well.

But the biggest challenge to a cross border merger and takeover are the cultural issues. According to KPMG study, "83% of all the mergers and acquisitions failed to produce any benefit for the shareholders and over half actually destroyed value". Interviews of over 100 senior executives involved in these 700 deals over a two year period revealed that the overwhelming cause of failure is the people and the cultural differences. So, the cultural issues are to be aptly dealt with.

It is expected that the cross borders takeovers will increase in the near future. The companies will have to keep in mind that global takeovers are not only business proposals but also a corporate bonding for which both the entities have to sit and arrive at a meaningful and deep understanding of all the issues as mentioned above. It will also help them to get meaningful solutions.

There has been a substantial increase in the quantum of funds flowing across nations in search of takeover candidates. The UK has been the most important foreign investor in the USA in recent years, with British companies making large acquisitions. With the advent of the Single Market, the European Union now represents the largest single market in the world. European as well as Japanese and American companies have sought to increase their market presence by acquisitions.

Many cross-border deals have been in the limelight. The biggest were those of Daimler Benz-Chrysler, BP-Amoco, Texas Utilities-Energy Group, Universal Studios-Polygram, Northern Telecom-Bay Networks and Deutsche Bank-Bankers Trust. Nearly 80 per cent of the transactions were settled in stock rather than through cash.

The going global is rapidly becoming Indian Company's mantra of choice. Indian companies are now looking forward to drive costs lower, innovate speedily, and increase their International presence. Companies are discovering that a global presence can help insulate them from the vagaries of domestic market and is one of the best ways to spread the risks. Indian Corporate sector has witnessed several strategical acquisitions. Tata Motors acquisition of Daewoo Commercial Vehicle Company, Tata Steel acquisition of Singapore's NatSteel, Reliance's acquisition of Flag is the culmination of Indian Company's efforts to establish a presence outside India.

**Students may note that the economic, accounting, taxation, financial, stamp duty aspects are explained in Chapter 3.**



### Activities to do

1. Reading and referring to open offer document filed with SEBI/published in the news paper
2. Reading various case studies on Indian and overseas takeovers.
3. Reading of SEBI (SAST) Regulation 2011 and SEBI FAQs on takeovers.

## LESSON ROUND UP

- Takeover is a corporate device whereby one company acquires control over another company, usually by purchasing all or a majority of its shares.
- Takeovers may be classified as friendly takeover, hostile takeover and bail out takeover.
- Takeover bids may be mandatory, partial or competitive bids.
- Consideration for takeover could be in the form of cash or in the form of shares.
- When a company intends to take over another company through acquisition of 90% or more in value of the shares of that company, the procedure laid down under Section 395 of the Act could be beneficially utilised.
- Transferor and transferee companies are required to take care of the check points as specified in the chapter.

- Takeover of companies whose securities are listed on one or more stock exchanges is regulated by the provisions of listed agreements and SEBI (Substantial Acquisition of Shares and Takeovers) Regulation, 2011.
- Financial, accounting, taxation and legal aspects are vital in planning a takeover and hence covered in detail in the chapter.
- An increasingly used defense mechanism is anti takeover amendments, which is called “Shark Repellants”.

## SELF TEST QUESTIONS

(These are meant for recapitulation only. Answers to these questions are not required to be submitted for evaluation).

1. What do you mean by the term 'Takeover'? What are the objectives which takeover seeks to achieve?
2. Explain the meaning of and different types of takeover bids.
3. Can unlisted companies affect takeovers? If so, how?
4. "SEBI has formulated a comprehensive code for takeover of listed companies" Do you agree?
5. What are the general obligations of 'Acquirer' and 'Merchant Banker' as under SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011?
6. What does the term 'offer price' and 'persons acting in concert' mean under SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011?

[illegible]

# Lesson 10

## Funding of Mergers and Takeovers

### LESSON OUTLINE

At the end of lesson, you should be able to understand:

- Financial alternatives
- Considerations for the selection of financial package
- Process of funding
- Funding through
  - Equity shares
  - Preference shares
  - Options and securities with differential rights
  - Swaps
  - Employees stock option scheme
  - External commercial borrowings (ECBs)
  - Financial institutions and banks
  - Rehabilitation finance
  - Leveraged buyouts

### LEARNING OBJECTIVES

Financing of mergers and takeovers involve payment of consideration money to the acquire shares for acquiring the undertaking or assets or controlling power of the shareholders as per valuation done and exchange ratio between shares of acquiring and merging company arrived at. Payment of consideration by the acquiree company to the acquirer company amounts to be the investment which is done on commercial basis with an aim to optimize return and to keep the cost of investment minimum. Care should be taken to select an optimum mix of the available modes of payment of purchase consideration such that the financial package chosen suits the financial structures of both the acquirer and acquiree companies, and also provide a desirable gearing level thereby proving economical to the acquirer. After reading this lesson you will be able to understand the various funding alternatives available for mergers.

## FINANCIAL ALTERNATIVES

Selection of financial package shall depend upon many factors as mentioned below:

- (i) It should suit to the financial structures of both the acquirer and the acquiree companies.
- (ii) It should provide a desirable gearing level which may suit to the financial structure of the acquirer.
- (iii) The package should be found acceptable by the vendors.
- (iv) The package should also prove economical to the acquirer.

### Financial Package

The acquirer can select a suitable financial package to make payment of consideration to acquiree from the following alternatives:

- (i) Payment of cash or by issue of securities.
- (ii) Financial package of loans etc. involving financial institutions and banks.
- (iii) Rehabilitation finance.
- (iv) Leveraged buy-outs.

## PROCESS OF FUNDING

Mergers and takeovers may be funded by a company (i) out of its own funds, comprising increase in paid up equity and preference share capital, for which shareholders are issued equity and preference shares or (ii) out of borrowed funds, which may be raised by issuing various financial instruments. (iii) A company may borrow funds through the issue of debentures, bonds, deposits from its directors, their relatives, business associates, shareholders and from public in the form of fixed deposits, (iv) external commercial borrowings, issue of securities, loans from Central or State financial institutions, banks, (v) rehabilitation finance provided to sick industrial companies under the Sick Industrial Companies (Special Provisions) Act, etc.

Form of payment may be selected out of any of the modes available such as (a) cash payment, (b) issue of equity shares, (c) mix of equity and cash, (d) debt or loan stock, (e) preference shares, convertible securities, junk bonds etc.

Well-managed companies make sufficient profits and retain them in the form of free reserves, and as and when their Board of Director propose any form of restructuring, it is financed from reserves, i.e. internal accruals.

Where available funds are inadequate, the acquirer may resort any one or more of the options available for the purpose of raising the required resources. The most prominent routes are the borrowing and issue of securities. The required funds could be raised from banks and financial institutions or from public by issue of debentures or by issue of shares depending upon the quantum and urgency of their requirements.

Generally a cash rich company use their surplus funds for taking over the control of other companies, often in the same line of business, to widen their product range and to increase market share.

## FUNDING THROUGH VARIOUS TYPES OF FINANCIAL INSTRUMENTS

### A. FUNDING THROUGH EQUITY SHARES

Equity share capital can be considered as the permanent capital of a company. Equity needs no servicing as



a company is not required to pay to its equity shareholders any fixed amount return in the form of interest which would be the case if the company were to borrow issue of bonds or other debt instruments. In issue of shares, the commitment will be to declare dividends consistently if profits permit. Raising moneys from the public by issue of shares to them is a time consuming and costly exercise. The process of issuing equity shares or bonds/debentures by the company takes a lot of time. It would require several things to be in place and several rounds of discussion would take place between the directors, and key promoters having the controlling stake, between the Board of Directors and consultants, analysts, experts, company secretaries, chartered accountants and lawyers. Moreover it requires several legal compliances. Therefore planning an acquisition by raising funds through a public issue may be complicated and a long drawn process. One cannot think of raising moneys through public issue without identifying the company to be acquired.

## **B. PREFERENTIAL ALLOTMENT**

Private placement in the form of a preferential allotment of shares is possible and such issues could be organized in a much easier way rather than an issue of shares to public.

## **C. FUNDING THROUGH PREFERENCE SHARES**

Another source of funding a merger or a takeover may be through the issue of preference shares, but unlike equity capital, issue of preference share capital as purchase consideration to shareholder of merging company involves the payment of fixed preference dividend (like interest on debentures or bonds or) at a fixed rate. Therefore, before deciding to raise funds for this purpose, by issue of preference shares, the Board of directors of a company has to make sure that the merged company or the target company would be able to yield sufficient profits for covering discharging the additional liability in respect of payment of preference dividend.

### *Burden of preference dividend*

A company funding its merger or takeover proposal through the issue of preference shares is required to pay dividend to such shareholders as per the agreed terms. While raising funds through this mode, the management of the company has to take into consideration the preference dividend burden, which the profits of the company should be able to service.

## **D. FUNDING THROUGH OPTIONS OR SECURITIES WITH DIFFERENTIAL RIGHTS**

Companies can restructure its capital through derivatives and options as a means of raising corporate funds. Indian companies are allowed to issue derivatives or options as well as shares and quasi-equity instruments with differential rights as to dividend and/or voting.

Companies may also issue non-voting shares or shares with differential voting rights to the shareholders of transferor company. Such issue gives the companies an additional source of fund without interest cost and without an obligation to repay, as these are other forms of equity capital. The promoters of companies may be interested in this form of consideration as it does not impose any obligation and there is no loss of control in the case of non-voting shares.

## **E. FUNDING THROUGH SWAPS OR STOCK TO STOCK MERGERS**

In stock swap mergers, or stock-for-stock mergers, the holders of the target company's stock receive shares of the acquiring company's stock. The majority of mergers during the past few years have been stock-for-stock deals. A merger arbitrage specialist will sell the acquiring company's stock short, and will purchase a long position in the target company, using the same ratio as that of the proposed transaction. (If the purchasing firm is offering a half share of its stock for every share of the target company, then the merger

arbitrageur will sell half as many shares of the purchasing firm as he or she buys of the target company.) By going long and short in this ratio, the manager ensures that the number of shares for which the long position will be swapped is equal to the number of shares sold short. When the deal is completed, the manager will cover the short and collect the spread that has been locked in.

As with all mergers, stock swap mergers may involve event risk. In addition to the normal event risks, stock swap mergers involve risks associated with fluctuations in the stock prices of the two companies.

The terms of the deal involve an exchange of shares and are predicted on the prices of the two companies' stock at the time of the announcement, drastic changes in the shares prices of one or both of the companies can cause the entire deal to be re-evaluated. Merger arbitrageurs derive returns from stock swap mergers when the spread or potential return justifies the perceived risk of the deal's failing.

## **F. FUNDING THROUGH EMPLOYEES STOCK OPTION SCHEME**

This option may be used along with other options. The share capital that may be raised through a Scheme of Employees' Stock Option can only be a fraction of the entire issue. Hence no company can imagine of funding any scheme of merger or takeover entirely through this route. Merits and demerits of funding of merger or takeover through the equity issue have already been discussed earlier under the heading "Funding through equity issue".

Employees' stock option scheme is a voluntary scheme on the part of a company to encourage its employees to have a higher participation in the company. Stock option is the right (but not an obligation) granted to an employee in pursuance of a scheme, to apply for the shares of the company at a pre-determined price. Suitable percentage of reservation can be made by a company for its employees or for the employees of the promoter company or by the promoter company for employees of its subsidiaries, as the need may arise. Equitable distribution of shares among the employees will contribute to the smooth working of the scheme.

*Only bona-fide employees of the company are eligible for shares under scheme*

The offer of shares to the employees on preferential basis has been misused by some companies by allotting shares to non-employees or in the joint names of employees and non-employees.

The companies are therefore, advised to ensure that the shares reserved under the employees' quota be allotted only to the bona fide employees, subject to the SEBI guidelines issued in this regard and the shares remaining unsubscribed by the employees may be offered to the general public through prospectus in terms of the issue, if any [Press release dated 30.1.1996]. The option granted to any employee is not transferable to any person.

## **SEBI (ESOP & ESPS) Guidelines, 1999**

The Securities and Exchange Board of India (SEBI) has issued the Securities and Exchange Board of India (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999, which are applicable to companies whose shares are listed on any recognised stock exchange in India.

As per the guidelines, no employee stock option scheme (ESOS) shall be offered unless the company constitutes a compensation committee for administration and superintendence of the ESOS. The Compensation Committee has to be a committee of the Board of Directors consisting of a majority of independent directors.

The lock in period and rights of the option holder are as specified in the guidelines.

The Board of Directors have to inter alia, disclose either in the Directors' Report or in the annexure to the Directors' Report, the details of the ESOS, as specified in the regulations.

As a safeguard, the regulations provide that no ESOS can be offered to the employee of a company unless the *shareholders of the company approve ESOS by passing a special resolution* in a general meeting.

### **Issue of Sweat Equity Shares**

A company whose shares are listed on a recognised stock exchange can also issue sweat equity shares in accordance with the provisions of Section 79A of the Companies Act, 1956 and the Securities and Exchange Board of India (Issue of Sweat Equity) Regulations, 2002.

## **G. FUNDING THROUGH EXTERNAL COMMERCIAL BORROWINGS (ECBs)**

At present, Indian companies are allowed to access funds from abroad in the following methods:

- (a) External Commercial Borrowings (ECB) refer to commercial loans in the form of bank loans, buyers' credit, suppliers' credit, securitized instruments (e.g. floating rate notes and fixed rate bonds, non-convertible, optionally convertible or partially convertible preference shares) availed of from non-resident lenders with a minimum average maturity of 3 years.
- (b) Foreign Currency Convertible Bonds (FCCBs) mean a bond issued by an Indian company expressed in foreign currency, and the principal and interest in respect of which is payable in foreign currency. Further, the bonds are required to be issued in accordance with the scheme viz., "Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depositary Receipt Mechanism) Scheme, 1993", and subscribed by a non-resident in foreign currency and convertible into ordinary shares of the issuing company in any manner, either in whole, or in part, on the basis of any equity related warrants attached to debt instruments. The ECB policy is applicable to FCCBs.
- (c) Preference shares (i.e. non-convertible, optionally convertible or partially convertible) for issue of which, funds have been received on or after May 1, 2007 would be considered as debt and should conform to policy. Accordingly, all the norms applicable for ECBs, viz. eligible borrowers, recognised lenders, amount and maturity, end use stipulations, etc. shall apply. Since these instruments would be denominated in Rupees, the rupee interest rate will be based on the swap equivalent of LIBOR plus the spread as permissible for ECBs of corresponding maturity.
- (d) Foreign Currency Exchangeable Bond (FCEB) means a bond expressed in foreign currency, the principal and interest in respect of which is payable in foreign currency, issued by an Issuing Company and subscribed to by a person who is a resident outside India, in foreign currency and exchangeable into equity share of another company, to be called the Offered Company, in any manner, either wholly, or partly or on the basis of any equity related warrants attached to debt instruments.

## **ENTRY ROUTES**

ECB can be accessed under two routes, viz., (i) Automatic Route and (ii) Approval Route).

### **(A) AUTOMATIC ROUTE**

The following types of proposals for ECBs are covered under the Automatic Route

#### **(i) Eligible Borrowers**

- (a) Corporates, including those in the hotel, hospital, software sectors (registered under the Companies Act, 1956) and Infrastructure Finance Companies (IFCs) except financial intermediaries, such as

banks, financial institutions (FIs), Housing Finance Companies (HFCs) and Non-Banking Financial Companies (NBFCs), other than those specifically allowed by Reserve Bank, are eligible to raise ECB. Individuals, Trusts (other than those engaged in Micro-finance activities) and Non-Profit making organizations are not eligible to raise ECB.

- (b) Units in Special Economic Zones (SEZ) are allowed to raise ECB for their own requirement. However, they cannot transfer or on-lend ECB funds to sister concerns or any unit in the Domestic Tariff Area (DTA).
- (c) Non-Government Organizations (NGOs) engaged in micro finance activities are eligible to avail of ECB.
- (d) Micro Finance Institutions (MFIs) engaged in micro finance activities are eligible to avail of ECBs. MFIs registered under the Societies Registration Act, 1860, MFIs registered under Indian Trust Act, 1882, MFIs registered either under the conventional state-level cooperative acts, the national level multi-state cooperative legislation or under the new state-level mutually aided cooperative acts (MACS Act) and not being a co-operative bank, Non-Banking Financial Companies (NBFCs) categorized as 'Non Banking Financial Company-Micro Finance Institutions' (NBFC-MFIs) and complying with the certain norms prescribed and Companies registered under Section 25 of the Companies Act, 1956 and are involved in micro finance activities.
- (e) NGOs engaged in micro finance and MFIs registered as societies, trusts and co-operatives and engaged in micro finance (i) should have a satisfactory borrowing relationship for at least 3 years with a scheduled commercial bank authorized to deal in foreign exchange in India and (ii) would require a certificate of due diligence on 'fit and proper' status of the Board/ Committee of management of the borrowing entity from the designated AD bank.
- (f) Small Industries Development Bank of India (SIDBI) can avail of ECB for on-lending to MSME sector, as defined under the Micro, Small and Medium Enterprises Development (MSMED) Act, 2006.

## ***(ii) Recognised Lenders***

Borrowers can raise ECB from internationally recognized sources, such as (a) international banks, (b) international capital markets, (c) multilateral financial institutions (such as IFC, ADB, CDC, etc.)/regional financial institutions and Government owned development financial institutions, (d) export credit agencies, (e) suppliers of equipments, (f) foreign collaborators and (g) foreign equity holders [other than erstwhile Overseas Corporate Bodies (OCBs)].

NGOs engaged in micro finance and MFIs registered as societies, trusts and co-operatives can avail of ECBs from (a) international banks, (b) multilateral financial institutions, (c) export credit agencies (d) overseas organisations and (e) individuals.

NBFC-MFIs will be permitted to avail of ECBs from multilateral institutions, such as IFC, ADB etc./regional financial institutions/international banks/foreign equity holders and overseas organizations.

Companies registered under Section 25 of the Companies Act, 1956 and are engaged in micro finance will be permitted to avail of ECBs from international banks, multilateral financial institutions, export credit agencies, foreign equity holders, overseas organizations and individuals.

A "foreign equity holder" to be eligible as "recognized lender" under the automatic route would require minimum holding of paid-up equity in the borrower company as set out below:

- (i) For ECB up to USD 5 million - minimum paid-up equity of 25 per cent held directly by the lender,

- (ii) For ECB more than USD 5 million - minimum paid-up equity of 25 per cent held directly by the lender and ECB liability-equity ratio not exceeding 4:1

Besides the paid-up capital, free reserves (including the share premium received in foreign currency) as per the latest audited balance sheet shall be reckoned for the purpose of calculating the 'equity' of the foreign equity holder in the term ECB liability-equity ratio. Where there are more than one foreign equity holder in the borrowing company, the portion of the share premium in foreign currency brought in by the lender(s) concerned shall only be considered for calculating the ECB liability-equity ratio for reckoning quantum of permissible ECB.

For calculating the 'ECB liability', not only the proposed borrowing but also the outstanding ECB from the same foreign equity holder lender shall be reckoned.

Overseas organizations and individuals providing ECB need to comply with the following safeguards:

- (i) Overseas Organizations proposing to lend ECB would have to furnish to the AD bank of the borrower a certificate of due diligence from an overseas bank, which, in turn, is subject to regulation of host-country regulator and adheres to the Financial Action Task Force (FATF) guidelines. The certificate of due diligence should comprise the following (i) that the lender maintains an account with the bank for at least a period of two years, (ii) that the lending entity is organised as per the local laws and held in good esteem by the business/local community and (iii) that there is no criminal action pending against it.
- (ii) Individual Lender has to obtain a certificate of due diligence from an overseas bank indicating that the lender maintains an account with the bank for at least a period of two years. Other evidence /documents such as audited statement of account and income tax return which the overseas lender may furnish need to be certified and forwarded by the overseas bank. Individual lenders from countries wherein banks are not required to adhere to Know Your Customer (KYC) guidelines are not eligible to extend ECB.
- (iii) Amount and Maturity
  - (a) The maximum amount of ECB which can be raised by a corporate other than those in the hotel, hospital and software sectors is USD 750 million or its equivalent during a financial year.
  - (b) Corporates in the services sector viz. hotels, hospitals and software sector are allowed to avail of ECB up to USD 200 million or its equivalent in a financial year for meeting foreign currency and/ or Rupee capital expenditure for permissible end-uses. The proceeds of the ECBs should not be used for acquisition of land.
  - (c) NGOs engaged in micro finance activities and Micro Finance Institutions (MFIs) can raise ECB up to USD 10 million or its equivalent during a financial year. Designated AD bank has to ensure that at the time of drawdown the forex exposure of the borrower is fully hedged.
  - (d) SIDBI can avail of ECB to the extent of 50 per cent of their owned funds including the outstanding ECB, subject to a ceiling of USD 500 million per financial year.
  - (e) ECB up to USD 20 million or its equivalent in a financial year with minimum average maturity of three years. An illustration of average maturity period calculation is provided at Annex VI.
  - (f) ECB above USD 20 million or equivalent and up to USD 750 million or its equivalent with a minimum average maturity of five years.

- (g) ECB up to USD 20 million or equivalent can have call/put option provided the minimum average maturity of three years is complied with before exercising call/put option.
- (h) All eligible borrowers can avail of ECBs designated in INR from 'foreign equity holders' as per the extant ECB guidelines.
- (i) NGOs engaged in micro finance activities can avail of ECBs designated in INR, from overseas organizations and individuals as per the extant guidelines.

## **(B) APPROVAL ROUTE**

### ***(i) Eligible Borrowers***

The following types of proposals for ECB are covered under the Approval Route:

- (a) On lending by the EXIM Bank for specific purposes will be considered on a case by case basis.
- (b) Banks and financial institutions which had participated in the textile or steel sector restructuring package as approved by the Government are also permitted to the extent of their investment in the package and assessment by the Reserve Bank based on prudential norms. Any ECB availed for this purpose so far will be deducted from their entitlement.
- (c) ECB with minimum average maturity of 5 years by Non-Banking Financial Companies (NBFCs) from multilateral financial institutions, reputable regional financial institutions, official export credit agencies and international banks to finance import of infrastructure equipment for leasing to infrastructure projects.
- (d) Infrastructure Finance Companies (IFCs) i.e. Non-Banking Financial Companies (NBFCs), categorized as IFCs, by the Reserve Bank, are permitted to avail of ECBs, including the outstanding ECBs, beyond 50 per cent of their owned funds, for on-lending to the infrastructure sector as defined under the ECB policy, subject to their complying with the certain conditions:
- (e) Foreign Currency Convertible Bonds (FCCBs) by Housing Finance Companies satisfying the following minimum criteria: (i) the minimum net worth of the financial intermediary during the previous three years shall not be less than Rs. 500 crore, (ii) a listing on the BSE or NSE, (iii) minimum size of FCCB is USD 100 million and (iv) the applicant should submit the purpose/plan of utilization of funds.
- (f) Special Purpose Vehicles, or any other entity notified by the Reserve Bank, set up to finance infrastructure companies/projects exclusively, will be treated as Financial Institutions and ECB by such entities will be considered under the Approval Route.
- (g) Multi-State Co-operative Societies engaged in manufacturing activity and satisfying the following criteria i) the Co-operative Society is financially solvent and ii) the Co-operative Society submits its up-to-date audited balance sheet.
- (h) SEZ developers can avail of ECBs for providing infrastructure facilities within SEZ, as defined in the extant ECB policy like (i) power, (ii) telecommunication, (iii) railways, (iv) roads including bridges, (v) sea port and airport, (vi) industrial parks, (vii) urban infrastructure (water supply, sanitation and sewage projects), (viii) mining, exploration and refining and (ix) cold storage or cold room facility, including for farm level pre-cooling, for preservation or storage of agricultural and allied produce, marine products and meat.
- (i) Developers of National Manufacturing Investment Zones (NMIZs) can avail of ECB for providing

infrastructure facilities within SEZ, as defined in the extant ECB policy like (i) power, (ii) telecommunication, (iii) railways, (iv) roads including bridges, (v) sea port and airport, (vi) industrial parks, (vii) urban infrastructure (water supply, sanitation and sewage projects), (viii) mining, exploration and refining and (ix) cold storage or cold room facility, including for farm level pre-cooling, for preservation or storage of agricultural and allied produce, marine products and meat.

- (j) Eligible borrowers under the automatic route other than corporates in the services sector viz. hotel, hospital and software can avail of ECB beyond USD 750 million or equivalent per financial year.
- (k) Corporates in the services sector viz. hotels, hospitals and software sector can avail of ECB beyond USD 200 million or equivalent per financial year.
- (l) Service sector units, other than those in hotels, hospitals and software, subject to the condition that the loan is obtained from foreign equity holders. This would facilitate borrowing by training institutions, R & D, miscellaneous service companies, etc.
- (m) Small Industries Development Bank of India (SIDBI) is eligible to avail of ECB for on-lending to MSME sector, as defined under the Micro, Small and Medium Enterprises Development (MSMED) Act, 2006, beyond 50 per cent of their owned funds, subject to a ceiling of USD 500 million per financial year provided such on-lending by SIDBI shall be to the borrowers' for permissible end-use and having natural hedge by way of foreign exchange earnings. SIDBI may on-lend either in INR or in foreign currency (FCY). In case of on-lending in INR, the foreign currency risk shall be fully hedged by SIDBI.
- (n) Low Cost Affordable Housing Projects: Developers/builders/Housing Finance Companies (HFCs)/National Housing Bank (NHB) may avail of ECB for low cost affordable housing projects
- (o) Corporates Under Investigation: All entities against which investigations/adjudications/appeals by the law enforcing agencies are pending, may avail of ECBs as per the current norms, if they are otherwise eligible, notwithstanding the pending investigations/adjudications/appeals, without prejudice to the outcome of such investigations/adjudications/appeals. Accordingly, in case of all applications where the borrowing entity has indicated about the pending investigations/adjudications/appeals, the Reserve Bank of India while approving the proposal shall intimate the concerned agencies by endorsing the copy of the approval letter.
- (p) Cases falling outside the purview of the automatic route limits and maturity period are indicated at paragraph A (iii).

## ***(ii) Recognised Lenders***

- (a) Borrowers can raise ECB from internationally recognised sources, such as (i) international banks, (ii) international capital markets, (iii) multilateral financial institutions (such as IFC, ADB, CDC, etc.)/ regional financial institutions and Government owned development financial institutions, (iv) export credit agencies, (v) suppliers' of equipment, (vi) foreign collaborators and (vii) foreign equity holders (other than erstwhile OCBs).
- (b) A "foreign equity holder" to be eligible as "recognized lender" under the approval route would require minimum holding of paid-up equity in the borrower company as set out below:
  - (i) For ECB up to USD 5 million - minimum paid-up equity of 25 per cent held directly by the lender,
  - (ii) For ECB more than USD 5 million - minimum paid-up equity of 25 per cent held directly by the

lender and ECB liability-equity ratio not exceeding 7:1

- (c) ECB from indirect equity holders provided the indirect equity holding by the lender in the Indian company is at least 51 per cent;
- (d) ECB from a group company provided both the borrower and the foreign lender are subsidiaries of the same parent.

Besides the paid-up capital, free reserves (including the share premium received in foreign currency) as per the latest audited balance sheet shall be reckoned for the purpose of calculating the 'equity' of the foreign equity holder in the term ECB liability-equity ratio. Where there are more than one foreign equity holder in the borrowing company, the portion of the share premium in foreign currency brought in by the lender(s) concerned shall only be considered for calculating the ECB liability-equity ratio for reckoning quantum of permissible ECB.

For calculating the 'ECB liability', not only the proposed borrowing but also the outstanding ECB from the same foreign equity holder lender shall be reckoned.

The total outstanding stock of ECBs (including the proposed ECBs) from a foreign equity lender should not exceed seven times the equity holding, either directly or indirectly of the lender (in case of lending by a group company, equity holdings by the common parent would be reckoned).

### ***(iii) Amount and Maturity***

Eligible borrowers under the automatic route other than corporates in the services sector viz. hotel, hospital and software can avail of ECB beyond USD 750 million or equivalent per financial year. Corporates in the services sector viz. hotels, hospitals and software sector are allowed to avail of ECB beyond USD 200 million or its equivalent in a financial year for meeting foreign currency and/ or Rupee capital expenditure for permissible end-uses. The proceeds of the ECBs should not be used for acquisition of land.

Indian companies which are in the infrastructure sector, as defined under the extant ECB guidelines, can avail of ECBs in Renminbi (RMB), subject to an annual ceiling of USD one billion for the entire sector, pending further review.

**For further details please refer to Master Circular 2013 dated 01 July 2013 issued by RBI on External Commercial Borrowings and Trade Credits.**

## **H. DEPOSITORY RECEIPTS (DRs)**

A DR is a foreign currency denominated instrument tradeable on a stock exchange generally in Europe or U.S.A. The major benefit that accrues to an investor from DRs is the collection of issue proceeds in foreign currency which may be utilized for meeting foreign exchange component of project cost, repayment of foreign currency loans, meeting commitments overseas and similar purposes.

The other benefits accruing to an investor from GDR issue are firstly, that investor does not have to bear any exchange risk as a GDR is denominated in US dollar with equity shares comprised in each GDR denominated in Rupees. Secondly, investor reserves the right to exercise his option to convert the GDR and hold the equity shares instead.

It facilitates raising of funds of market related prices of minimum cost as compared to a domestic issue and permits raising of further equity on a future date for funding of projects like expansion or diversification through mergers and takeovers etc. It also helps to expand investor base with multiple risk preferences,



improves marketability of the issue, and enhances prestige of the company and credibility with international investors.

## **I. FUNDING THROUGH FINANCIAL INSTITUTIONS AND BANKS**

Funding of a merger or takeover with the help of loans from financial institutions, banks etc, has its own merits and demerits. Takeover of a company could be achieved in several ways and while deciding the takeover of a going concern, there are matters such as the capital gains tax, stamp duty on immovable properties and the facility for carrying forward of accumulated losses. With parameters playing a critical role, the takeover should be organized in such a way that best suits the facts and circumstances of the specific case and also it should meet the immediate needs and objectives of the management. While discussing modes of acquisition, certainly there would be a planning for organizing the necessary funding for the acquisition. If borrowings from domestic banks and financial institutions have been identified as the inevitable choice, all the financial and managerial information must be placed before the banks and financial institutions for the purpose of getting the necessary resources.

The advantage of funding is that the period of such funds is definite which is fixed at the time of taking such loans. Therefore, the Board of the company is assured about continued availability of such funds for the pre-determined period. On the negative side, the interest burden on such loans, is quite high which must be kept in mind by the Board while deciding to use borrowed funds from financial institution. Such funding should be thought of and resorted to only when the Board is sure that the merged company or the target company will, give adequate returns i.e., timely payment of periodical interest on such loans and re-payment of the loans at the end of the term for which such loans have been taken.

However, in the developed markets, funding of merger or takeover is not a critical issue. There are various sources of finance available to an acquirer. In the Indian market, it was not easy to obtain takeover finance from financial institutions and banks because they are not forthcoming to finance securities business. Takeover involves greater risk. There is no other organised sector to provide finance for takeover by a company.

*Justice P.N. Bhagwati Committee on takeovers in its report of May 2002 has recommended that Banks/Financial Institutions are to be encouraged to consider financial takeovers.*

*There are two aspects in it.* (i) The first one relates to cost of acquiring ownership over the assets. If it is a going concern, the shares of the company could be purchased. In that process, the acquired entity might become a wholly owned subsidiary. Funding the acquisition would mean the funds required for paying up the consideration payable to the sellers of those shares. This will be worked on the basis of the net worth of the acquired entity. In addition to the said cost, there might be a huge requirement for funding the operations, modernization, upgradation, installing balancing equipments, removal of bottlenecks and a host of other requirements. Hence the borrowings would be required for meeting such cost also.

The acquisition may also require a rehabilitation or restructuring scheme implying a meeting with existing secured creditors and major unsecured creditors. As a whole, borrowing would be a major exercise involving a lot of study of the actual financial support needed. Care must be taken to ensure that the existing revenue streams are not affected due to the proposed acquisition. The combined net worth, combined financial projections and revenue streams might also be needed for persuading the banks and financial institutions to pick up a stake in the acquisition.

## **J. FUNDING THROUGH REHABILITATION FINANCE**

Sick industries get merged through BIFR with healthy units with financial package to the acquirer from the

financial institutions and banks having financial stakes in the acquiree company to ensure rehabilitation and recovery of dues from the acquirer. BIFR has been arranging such takeover from time to time in which creditor financial institutions and banks have been providing consortium financial packages in promoting mergers.

Merger or takeover may be provided for in a scheme of rehabilitation under the Sick Industrial Companies (Special Provisions) Act, 1985.

The Sick Industrial Companies (Special Provisions) Act, 1985 provides for reference to the Board for Industrial and Financial Reconstruction (BIFR) of a sick industrial company. Once a reference is made, BIFR will cause an enquiry, appoint an operating agency for determination of measures necessary for rehabilitation of the sick company, direct the preparation of a rehabilitation scheme, which may provide, inter alia, for

- (i) rehabilitation finance for the sick company;
- (ii) merger of the sick company with a healthy company or merger of a healthy company with the sick company;
- (iii) takeover of the sick company by a healthy company;
- (iv) such other preventive, ameliorative and remedial measures as may be appropriate.

The scheme is prepared by the operating agency, and after the same is sanctioned becomes operative and binding on all the concerned parties including the sick company and other companies – amalgamating, merging, the amalgamated or the merged companies.

## **K. FUNDING THROUGH LEVERAGED BUYOUTS**

A leveraged buyout (LBO), is the acquisition of a company or division of another company, financed with a substantial portion of borrowed funds. The acquirer resorts to a combination of a small investment and a large loan to fund the acquisition. Typically, the loan capital is availed through a combination of repayable bank facilities and/or public or privately placed bonds, which may be classified as high-yield debt. The debt will appear on the acquiring company's balance sheet and the acquired company's free cash flow will be used to repay the debt. Otherwise, the acquiring company could float a Special Purpose Vehicle ("SPV") as a 100% subsidiary with a minimum equity capital. The SPV can leverage this equity to gear up significantly higher debt to buyout the target company. The target company's assets can be used as collaterals for availing the loan and once the debt is redeemed, the acquiring company has the option to merge with the SPV. The debt will be paid off by the SPV using the cash flows of the target company. The purpose of leveraged buyouts is to allow companies to make large acquisitions without having to commit a lot of capital.

## **LESSON ROUND UP**

- Mode of payment for mergers and acquisition to be selected from an optimum mix of available modes of payment of consideration.
- Selection of financial package depend on many considerations such as: to suit the financial structure of acquirer and acquiree, to provide a desirable gearing level, to be acceptable to vendors. Further it should prove economic to acquirer.
- Funding through preference share capital, unlike equity share capital, involves the payment of fixed preference dividend like interest on debentures or bonds or a fixed rate of dividend.
- Funding through shares with differential voting rights gives the companies an additional source of fund without interest cost and without an obligation to repay, as these are other form of equity capital.

- Funding can also be done through swaps and employees stock option scheme. The share capital that may be raised through the scheme of employees stock option can only be a fraction of the entire issue.
- External commercial borrowings are permitted by the Government as a source of finance for Indian corporates for expansion of existing capacity as well as for fresh investment.
- The other modes of funding are through financial institutions and banks, rehabilitation finance and management and leveraged buy outs. All these have got its own merits and demerits.

## SELF TEST QUESTIONS

*(These are meant for recapitulation only. Answers to these questions are not required to be submitted for evaluation).*

1. 'Financing of mergers and acquisitions is a crucial exercise requiring utmost care'. Elaborate.
2. Discuss funding through Rehabilitation Finance as a source of finance for mergers/takeovers.
3. Describe a takeover that has opted for 'leveraged buy out ' for the funding.
4. Describe Depository Receipts as a funding options for merger..

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# Lesson 11

## Financial Restructuring

### LESSON OUTLINE

- Need for financial restructuring
- Reorganisation of capital
- Reduction of share capital
- Buyback of shares – concept and objects
- Provisions of buy back under Companies Act, 2013 read with Companies (Share Capital and Debentures) Rules, 2014.
- SEBI (Buy back of Securities) Regulations, 1998
- Companies (Court) Rules (for reduction of Capital).

### LEARNING OBJECTIVES

Financial restructuring of a company involves rearrangement of its financial structure so as to make the company's finances more balanced., ie the company should be neither overcapitalized nor undercapitalized. Reduction of Capital, reorganization of capital through consolidation, sub-division, buy back of shares, further issue of shares etc., are various forms of financial restructuring.

The Provisions relating to alteration of Share Capital and of buy-back of Shares has already been notified under Companies Act, 2013. However, the provisions relating to reduction of capital is not yet notified as it involves approval of National Company Law Tribunal. Accordingly the lesson covers provisions of Companies Act 2013 relating to buy-back of shares and provisions of Companies Act, 1956 for reduction of capital.

After reading this lesson you will be able to understand the legal and procedural aspects relating to reduction and re organization of capital, buy-back of shares by listed and unlisted companies including aspects as to quantum, sources, restrictions etc.

**The Provisions relating to alteration of Share Capital and of buy-back of Shares have already been notified under Companies Act, 2013. However, the provisions relating to reduction of capital are not yet notified as it involves approval of National Company Law Tribunal. Accordingly the lesson covers provisions of Companies Act 2013 relating to buy-back of shares and provisions of Companies Act, 1956 for reduction of capital.**

## INTRODUCTION

Companies have access to a range of sources from which they finance business. These funds are called 'Capital'. The sources of capital can be divided into two categories; internally generated funds and funds provided by third parties. Whichever form of capital is used, it will fall into one of the two categories – debt or equity.

### Determination of the proportion of own funds and borrowed funds

Internally generated funds are an important component of a company's capital structure but it would be unusual for a company to grow at a fast pace only through internal generation of funds. The deficit between the funds which a company requires to fund its growth and the funds which are generated internally, is funded by provision of capital from third parties.

### Cost of various types of capital

Equity capital is the permanent capital of the company, which does not require any servicing in the form of interest. However, the return to the equity capital is in the form of dividend paid to the equity shareholders out of the profits earned by the company. The ideal capital structure would be to raise money through the issue of equity capital.

Debt is essentially an obligation, the terms of which are, *inter alia*, the repayment of the principal sum within a specific time together with periodic interest payments. Perhaps the easiest form of capital for a company to raise is, a loan from a bank. This form of loan capital may be comparatively expensive than equity.

However, as regards servicing of capital there are advantages of issuing debt instruments. Dividend is not a deductible expense when calculating a company's taxable profit; it is on the contrary an appropriation of profits. On the other hand, interest paid by a company on debt finance is an allowable expense when calculating a company's tax, thereby reducing its taxable profit.

Broadly speaking, the financial structure of a company comprises its

- (i) paid up equity and preference share capital;
- (ii) various reserves;
- (iii) all borrowings in the form of –
  - (a) long-term loans from financial institutions;
  - (b) working capital from banks including loans through commercial papers;
  - (c) debentures;
  - (d) bonds;
  - (e) credits from suppliers;

- (f) trade deposits;
- (g) public deposits;
- (h) deposits/loans from directors, their relatives and business associates;
- (i) deposits from shareholders;
- (j) Global Depository Receipts, American Depository Receipts and Foreign Currency Convertible Bonds;
- (k) funds raised through any other loan instrument.

A company may require any one or more of the above keeping in view its financial requirements at a particular point of time. A dynamic Board should constantly review the financial structure of the company and effect financial restructuring and reorganisation whenever the need arises.

### NEED FOR FINANCIAL RESTRUCTURING

A company is required to balance between its debt and equity in its capital structure and the funding of the resulting deficit. The targets a company sets in striking this balance are influenced by business conditions, which seldom remain constant.

When, during the life time of a company, any of the following situations arise, the Board of Directors of a company is compelled to think and decide on the company's restructuring:

- (i) necessity for injecting more working capital to meet the market demand for the company's products or services;
- (ii) when the company is unable to meet its current commitments;
- (iii) when the company is unable to obtain further credit from suppliers of raw materials, consumable stores, bought-out components etc. and from other parties like those doing job work for the company.
- (iv) when the company is unable to utilise its full production capacity for lack of liquid funds.

Financial restructuring of a company involves rearrangement of its financial structure so as to make the company's finances more balanced.

### Let us understand the meaning of over capitalization and under capitalization.

A company is said to be over-capitalized, if its earnings are not sufficient to justify a fair return on the amount of share capital and debentures that have been issued. Otherwise, it is said to be *over capitalized* when total of owned and borrowed capital exceeds its fixed and current assets i.e. when it shows accumulated losses on the assets side of the balance sheet.

If the owned capital of the business is much less than the total borrowed capital than it is said to be under capitalization. We may say that the owned capital of the company is disproportionate to the scale of its operation and the business is dependent more upon borrowed capital.

#### Let us remember

Under capitalization may be the result of excess volume of trading and over capitalization may be due to insufficient volume of trading.

### Restructuring of under-capitalized Company

An under-capitalized company may restructure its capital by taking one or more of the following corrective steps:

- (i) injecting more capital whenever required either by resorting to rights issue/preferential issue or additional public issue.
- (ii) resorting to additional borrowings from financial institutions, banks, other companies etc.
- (iii) issuing debentures, bonds, etc. or
- (iv) inviting and accepting fixed deposits from directors, their relatives, business associates and public.

### Restructuring of over-capitalized company

If a company is over-capitalized, its capital also requires restructuring by taking following corrective measures:

- (i) Buy-back of own shares.
- (ii) Paying back surplus share capital to shareholders.
- (iii) Repaying loans to financial institutions, banks, etc.
- (iv) Repaying fixed deposits to public, etc.
- (v) Redeeming its debentures, bonds, etc.

**State whether the following statement is true or false.**

A over capitalized company can resort to buy- back of shares.

**Ans:** True

## ALTERATION OF CAPITAL

### Power of limited company to alter its share capital (Section 61)

According to section 61 of the Companies Act 2013 a limited company having a share capital derives its power to alter its share capital through its articles of association. As per the section the company may alter its memorandum in its general meeting to—

- (a) increase its authorised share capital by such amount as it thinks expedient;
- (b) consolidate and divide all or any of its share capital into shares of a larger amount than its existing shares.

The proviso to Section 61(1)(b) clarifies that No consolidation and division which results in changes in the voting percentage of shareholders shall take effect unless it is approved by the Tribunal on an application made in the prescribed manner **(This proviso yet to be notified)**.

- (c) convert all or any of its fully paid-up shares into stock, and reconvert that stock into fully paid-up shares of any denomination;
- (d) sub-divide its shares, or any of them, into shares of smaller amount than is fixed by the



memorandum, so, however, that in the sub-division the proportion between the amount paid and the amount, if any, unpaid on each reduced share shall be the same as it was in the case of the share from which the reduced share is derived;

- (e) cancel shares which, at the date of the passing of the resolution in that behalf, have not been taken or agreed to be taken by any person, and diminish the amount of its share capital by the amount of the shares so cancelled. The cancellation of shares shall not be deemed to be a reduction of share capital.

## REORGANISATION OF CAPITAL

In accordance with Section 390(b) Companies Act 1956, the expression “arrangement” includes a re-organisation of the share capital of the Company by the consolidation of shares of different classes or by division of shares of one class into shares of different classes or by both these methods.

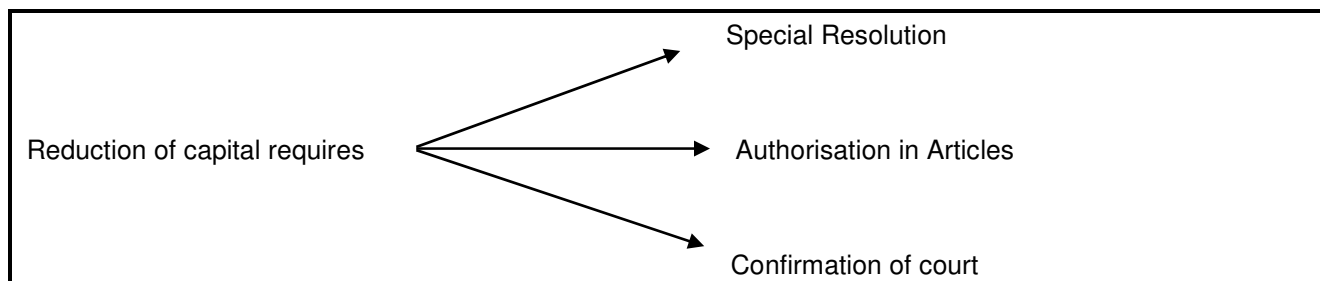
Accordingly, as per Section 390(b), the reorganization of share capital of a company may take place—

- (1) by the consolidation of shares of different classes, or
- (2) by the division of shares of one class into shares of different classes, or
- (3) by both these methods [Section 390(b)].

Besides, a company may reorganize its capital in different ways, such as – (a) reduction of paid-up share capital; (b) conversion of one type of shares into another etc.,

## REDUCTION OF SHARE CAPITAL

Reduction of capital means reduction of issued, subscribed and paid-up capital of the company.



The need for reduction of capital may arise in various circumstances such as

- trading losses
- heavy capital expenses and assets of reduced or doubtful value.

As a result, the original capital may either have become lost or a company may find that it has more resources than it can profitably employ. In either case, the need may arise to adjust the relation between capital and assets [*Indian National Press (Indore) Ltd., In re.* (1989) 66 Com Cases 387, 392 (MP)].

### Do you know?

Section 100 Companies Act 1956 is applicable to a company limited by shares or a company limited by guarantee and having share capital. An unlimited company can reduce the share capital in the manner specified in the Articles and Memorandum of the company, as Section 100 Companies Act 1956 is not applicable.

## MODES OF REDUCTION

The mode of reduction, as laid down in Section 100 of the Companies Act, is as follows:

A company limited by shares or a company limited by guarantee and having a share capital may, if authorised by its articles, by special resolution, and subject to its confirmation by the Court on petition, reduce its share capital in any way and in particular:

- (a) by reducing or extinguishing the liability of members in respect of uncalled or unpaid capital e.g., where the shares are of Rs. 100 each with Rs. 75 paid-up, reduce them to Rs. 75 fully paid-up shares and thus relieve the shareholders from liability on the uncalled capital of Rs. 25 per share;
- (b) by paying off or returning paid-up capital not wanted for the purposes of the company, e.g., where the shares are fully paid-up, reduce them to Rs. 75 each and pay back, Rs. 25 per share;
- (c) by paying off the paid-up capital on the conditions that it may be called up again so that the liability is not extinguished;
- (d) by following a combination of any of the preceding methods;
- (e) by writing off or canceling the capital which has been lost or is under represented by the available assets e.g. a share of Rs. 100 fully paid-up is represented by Rs. 75 worth of assets. In such a situation reality can be re-introduced by writing off Rs. 25 per share. This is the most common method of reduction of capital. The assets side of the balance sheet may include useless assets which are cancelled. On the other side i.e. on the liability side share capital is reduced.

### Case Laws on Reduction of Capital

#### 1. Can appeal against order of Single Judge allowing reduction, by a sole public shareholder, be allowed, when there is no fault in reasoning of Single Judge?

Where a company, reducing its share capital by cancelling and extinguishing some equity shares held by its subsidiary and some shares held by the public, passes the requisite resolution approving the reduction by a special majority in an extraordinary general meeting called for in this regard, and there is no fault in the reasoning given by the Single Judge approving the same, and also the valuation of shares, the appeal by a sole shareholder objecting to the said reduction is liable to be dismissed.

*(Chander Bhan Gandhi v. Reckitt Benckiser (India) Ltd. [2012] 107 CLA 511 (Del.))*

#### 2. Whether the role of the court, while approving scheme of reduction of capital is limited to the extent of ensuring that the scheme is not unconscionable or illegal or unfair or unjust?

The role of the court, while approving scheme of reduction of capital, is limited to the extent of ensuring that the scheme is not unconscionable or illegal or unfair or unjust. Merely because the determination of the share exchange ratio or the valuation of shares is done by a different method which might result in a different conclusion would not justify interference of the court, unless found to be unfair. The court does not have the expertise nor the jurisdiction to delve into the deep commercial wisdom exercised by the creditors and members of the company who have approved the scheme by the requisite majority. Thus, where the valuer has used widely accepted methodologies, i.e., the discounted cash flow methodology and the comparable companies methodology which inter alia include the P/E multiple analysis for valuation of shares, there is no reason why the valuation report of the valuer, which is fair, reasonable and based on cogent reasoning, and which has also been accepted by a majority of the non-promoter shareholders of the company, should not be accepted by the court.

Rejecting the objections of the interveners/objectors that the fair value of shares arrived at by the valuer is not in the interest of the promoter shareholders, the High Court approved the valuation of shares and allowed the petition confirming reduction of share capital.

*Wartsila India Ltd.v. Janak Mathuradas and Others*[2010] 99 CLA 463 (Bom.)

### 3. Can the share premium account be utilized for reducing share capital?

The capital was proposed to be reduced by utilization of the Securities Premium Account and General Reserve. There was to be no diminution of liabilities or repayment of paid up capital. No reduction of issued, subscribed or paid up capital was involved. The Court said that the proposed reduction not being prejudicial in any manner was, therefore to be allowed.

*(Alembic Ltd., Re (2008) 144 Com Cases 105 :(2009)89 SCL 19(Guj)*

### 4. Can the reduction result in extinguishment of class of shares?

A scheme of amalgamation and arrangement involved reduction of share capital by extinguishment of shares of a particular class. The reduction was approved by majority of shareholders and creditors of transferee company. The court approved the reduction and extinguishment of portion of shares was held to be permissible as no one was prejudicially affected.

*Siel Ltd., Re (2008) 144 Com Cases 469 :(2009)89 SCL 434(Del)*

## **Reduction of share capital without sanction of the Court**

The following are cases which amount to reduction of share capital but where no confirmation by the Court is necessary:

- (a) *Surrender of shares* – “Surrender of shares” means the surrender of shares already issued to the company by the registered holder of shares. Where shares are surrendered to the company, whether by way of settlement of a dispute or for any other reason, it will have the same effect as a transfer in favour of the company and amount to a reduction of capital. But if, under any arrangement, such shares, instead of being surrendered to the company, are transferred to a nominee of the company then there will be no reduction of capital [*Collector of Moradabad v. Equity Insurance Co. Ltd.*, (1948) 18 Com Cases 309: AIR 1948 Oudh 197]. Surrender may be accepted by the company under the same circumstances where forfeiture is justified. It has the effect of releasing the shareholder whose surrender is accepted for further liability on shares.

The Companies Act contains no provision for surrender of shares. Thus surrender of shares is valid only when Articles of Association provide for the same and:

- (i) where forfeiture of such shares is justified; or
- (ii) when shares are surrendered in exchange for new shares of same nominal value.

Both forfeiture and surrender lead to termination of membership. However, in the case of forfeiture, it is at the initiative of company and in the case of surrender it is at the initiative of member or shareholder.

- (b) *Forfeiture of shares* – A company may if authorised by its articles, forfeit shares for non-payment of calls and the same will not require confirmation of the Court.

- (c) *Diminution of capital* – Where the company cancels shares which have not been taken or agreed to be taken by any person .
- (d) Redemption of redeemable preference shares.
- (e) Purchase of shares of a member by the company..
- (f) Buy-back of its own shares.

***Does buy back of shares requires court's confirmation as prescribed under Section 100?***

***Ans : No***

### ***Equal Reduction of Shares of One Class***

Where there is only one class of shares, *prima facie*, the same percentage should be paid off or cancelled or reduced in respect of each share, but where different amounts are paid-up on shares of the same class, the reduction can be effected by equalizing the amount so paid-up. [*Marwari Stores Ltd. v. Gouri Shanker Goenka* (1936) 6 Com Cases 285]. The same principle is to be followed where there are different classes of shares.

It is, however, not necessary that extinguishment of shares in all cases should necessarily result in reduction of share capital. Accordingly, where reduction is not involved, Section 100 would not be attracted. [*Asian Investment Ltd. Re.* (1992) 73 Com Cases 517, 523 (Mad)].

### ***Restructuring of Debts and reduction of capital-***

The petitioner-company was referred to the corporate debt restructuring ('CDR') forum for re-scheduling and restructuring its debt. As per restructuring package, as approved by CDR forum, for every 10 equity shares the company would cancel 4 equity shares and in lieu of such cancellation, 4 non-cumulative preference shares would be allotted and the existing equity shareholders would continue to hold remaining 6 shares without any alteration of rights. When the petitioner-company moved to the High Court for confirmation of its restricting package, the objector opposed the scheme on the ground that it would suffer financial loss. Taking an overall view and considering the proposed scheme of reduction of share capital in larger perspective, the High Court found no reason not to confirm the proposed action of the company to reduce its share capital. The High Court observed that the proposal is likely to improve the financial resources of the company, and to increase the share of profit available for expansion and growth of the company. Moreover, the proposal does not involve diminution of any liability in respect of unpaid capital or the payment to any shareholder of any paid-up capital.

*Essar Steel Ltd Re*(2005)59SCL 457:(2006) 130 Com cases 123(Guj)

### ***Creditors' Right to Object to Reduction***

After passing the special resolution for the reduction of capital, the company is required to apply to the Court by way of petition for the confirmation of the resolution under Section 101 Companies Act 1956. Where the proposed reduction of share capital involves either (i) diminution of liability in respect of unpaid share capital, or (ii) the payment to any shareholder of any paid-up share capital, or (iii) in any other case, if the Court so directs, the following provisions shall have effect:

The creditors having a debt or claim admissible in winding up are entitled to object. To enable them to do so, the Court will settle a list of creditors entitled to object. If any creditor objects, then either his consent to the

proposed reduction should be obtained or he should be paid off or his payment be secured. The Court, in deciding whether or not to confirm the reduction will take into consideration the minority shareholders and creditors.

A Company might decide to return a part of its capital when its paid-up share capital is in excess of its needs. It is not simply handed over to shareholders in proportion to their holdings. Their class rights will be considered with the Court treating the reduction as though it was analogous to liquidation. Therefore, the preference shareholders who have priority to return of capital in liquidation will be the first to have their share capital returned to them in a share capital reduction, even if they prefer to remain members of the company.

There is no limitation on the power of the Court to confirm the reduction except that it must first be satisfied that all the creditors entitled to object to the reduction have either consented or been paid or secured [*British and American Trustee and Finance Corp. v. Couper*, (1894) AC 399, 403: (1991-4) All ER Rep 667].

When exercising its discretion, the Court must ensure that the reduction is fair and equitable. In short, the Court shall consider the following, while sanctioning the reduction:

- (i) The interests of creditors are safeguarded;
- (ii) The interests of shareholders are considered; and
- (iii) Lastly, the public interest is taken care of.

### **Confirmation and Registration**

Section 102 of the Companies Act 1956 states that if the Court is satisfied that either the creditors entitled to object have consented to the reduction, or that their debts have been determined, discharged, paid or secured, it may confirm the reduction.

The Court may also direct that the words “and reduced” be added to the company’s name for a specified period, and that the company must publish the reasons for the reduction and the causes which led to it, with a view to giving proper information to the public.

Section 103 states that the Court’s order confirming the reduction together with the minutes giving the details of the company’s share capital, as altered, should be delivered to the Registrar who will register them. The reduction takes effect only on registration of the order and minutes, and not before. The Registrar will then issue a certificate of registration which will be a conclusive evidence that the requirements of the Act have been complied with and that the share capital is now as set out in the minutes. The Memorandum has to be altered accordingly.

### **Conclusiveness of certificate for reduction of capital**

Where the Registrar had issued his certificate confirming the reduction, the same was held to be conclusive although it was discovered later that the company had no authority under its articles to reduce capital [*Re Walkar & Smith Ltd.*, (1903) 88 LT 792 (Ch D)]. Similarly, in a case where the special resolution for reduction was an invalid one, but the company had gone through with the reduction, the reduction was not allowed to be upset [*Ladies’s Dress Assn. v. Pulbrook*, (1900) 2 QB 376].

### **Let us remember!!!!**

**The effective date of reduction of capital is the date on which the Registrar of Companies registers the order of the court and the minutes approved by the court.**

### ***Liability of Members in respect of Reduced Share Capital***

On the reduction of share capital, the extent of the liability of any past or present member or any call or contribution shall not exceed the difference between the amount already paid on the share, or the reduced amount, if any, which is deemed to have been paid thereon by the member, and the amount of the shares fixed by the scheme of the reduction.

If, however any creditor entitled to object to the reduction of share capital is not entered in the list of creditors by reason of his ignorance of the proceedings for reduction and, after the reduction the company is unable to pay his debt or claim, then:

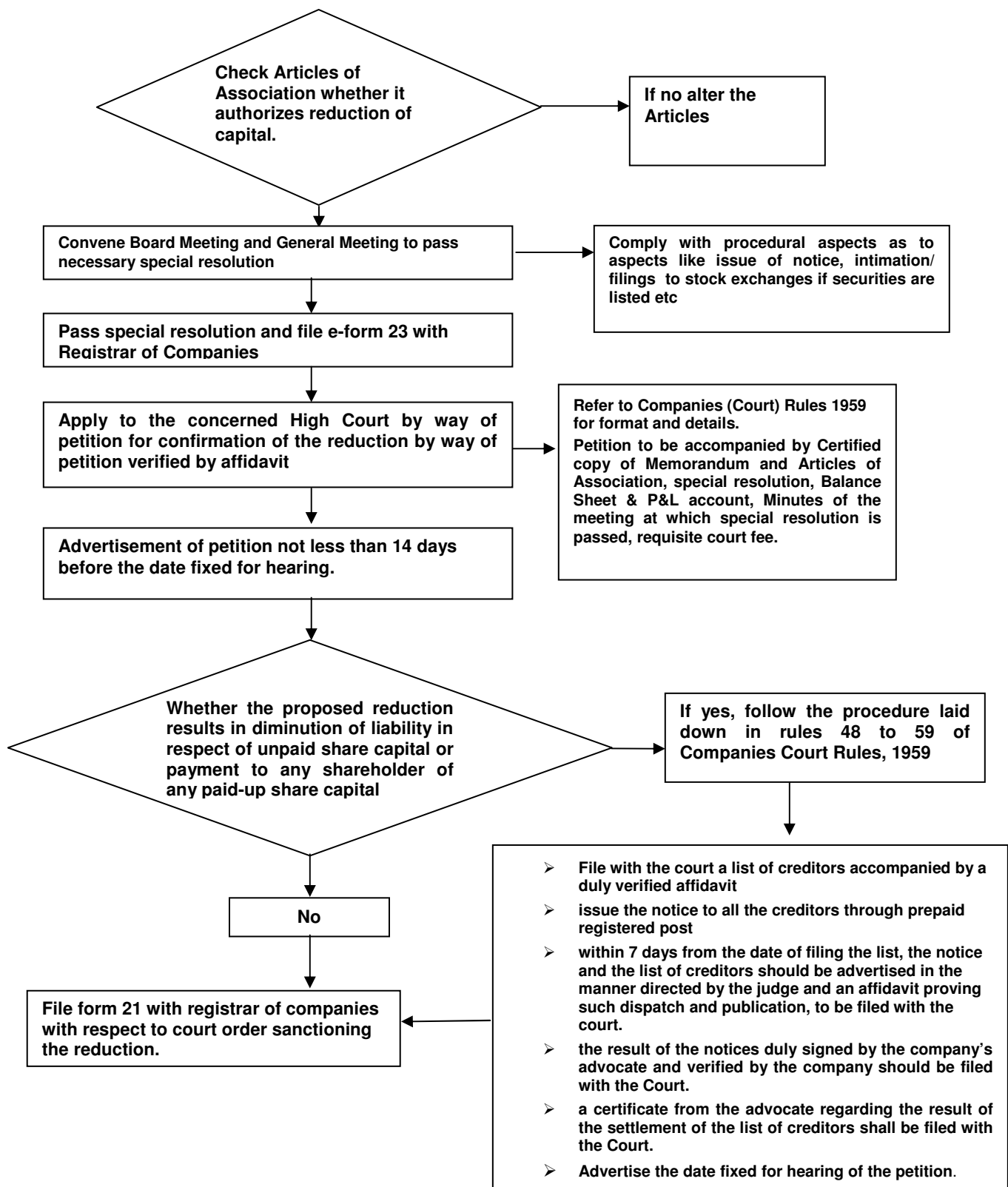
- (a) every member at the time of registration of the Court's order for reduction is liable to contribute for the payment of the debt or claim, an amount not exceeding the amount which he would have contributed on the day before registration of the order and minutes; and
- (b) if the company is wound up, the Court on the application by the creditor and on proof of his ignorance, may settle a list of contributories and make and enforce calls and orders on the contributories, settled on the list, as if they were ordinary contributories in a winding up.

It is further provided that, if any officer of the company knowingly conceals the name of any creditor entitled to object to the reduction; or knowingly misrepresents the name or amount of the debt or claim of any creditor; or abets or is privy to any such concealment or misrepresentation as aforesaid, he shall be liable to be punishable with imprisonment upto one year, or with fine or with both (Section 105).

### ***Reduction of Share Capital And Scheme Of Compromise Or Arrangement***

Arrangement includes 'a reorganisation of share capital of the company' and reorganisation can involve reduction of share capital. However, as part of the scheme of compromise or arrangement, distinct formalities as prescribed under section 100 do not have to be observed [*Maneckchowk and Ahmedabad Mfg. Co.Ltd., Re* (1970) 2 Comp LJ 300 (Guj); also *Vasant Investment Corporation Ltd. v. Official Liquidator* (1981) 51 Comp Cas 20 (Bom); *McLeod & Co.Ltd. v. S.K. Ganguly* (1975) 45 Comp Cas 563 (Cal)]. It may however be noted that, in all such cases involving reduction of share capital in the scheme of compromise or arrangement, the petition seeking confirmation of the court with respect to the scheme must also expressly mention that the company is also seeking, at the same time, the confirmation of the court with respect to the reduction of share capital, and that, while seeking the consent of the members to the scheme, the consent of the members with respect to the reduction of share capital had also been obtained.

The power of court to give to creditors an opportunity of raising objections to the reduction of capital is discretionary. In an appropriate case, for example, where the interests of creditors are duly and fully protected, the court may exercise its discretion against calling upon the creditors to raise objections.

**Procedure for reduction of capital – a Flow Chart**

## BUY BACK OF SHARE

According to Section 68(1) of the Companies Act, 2013 a company whether public or private, may purchase its own shares or other specified securities (hereinafter referred to as “buy-back”) out of:

- (i) its free reserves; or
- (ii) the securities premium account; or
- (iii) the proceeds of any shares or other specified securities.

However, no buy-back of any kind of shares or other specified securities can be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.

Thus, the company must have at the time of buy-back, sufficient balance in any one or more of these accounts to accommodate the total value of the buy-back.

“Specified securities” as referred to in the explanation to the section includes employees’ stock option or other securities as may be notified by the Central Government from time to time.

“Free reserves” as referred to in the explanation includes securities premium account.

## Authorisation

The primary requirement is that the articles of association of the company should authorise buyback. In case, such a provision is not available, it would be necessary to alter the articles of association to authorise buy-back. Buy-back can be made with the approval of the Board of directors at a meeting and/or by a special resolution passed by shareholders in a general meeting, depending on the quantum of buy back. In case of a listed company, approval of shareholders shall be obtained only by postal ballot.

## Quantum of Buyback

- (a) Board of directors can approve buy-back up to 10% of the total paid-up equity capital and free reserves of the company and such buy back has to be authorized by the board by means of a resolution passed at the meeting.
- (b) Shareholders by a special resolution can approve buy-back up to 25% of the total paid-up capital and free reserves of the company. In respect of any financial year, the shareholders can approve by special resolution upto 25% of total equity capital in that year.

## Post buy-back debt-equity ratio

The ratio of the aggregate of secured and unsecured debts owed by the company after buy-back is not more than twice the paid-up capital and its free reserves i.e the ratio shall not exceed 2:1. However, the Central Government may, by order, notify a higher ratio of the debt to capital and free reserves for a class or classes of companies;

All the shares or other specified securities for buy-back are to be fully paid-up.

## Buyback by listed/unlisted companies

- The buy-back of the shares or other specified securities listed on any recognised stock exchange is in accordance with the regulations made by the Securities and Exchange Board in this behalf; and



- The buy-back in respect of shares or other specified securities other than listed securities is in accordance with such rules made under Chapter IV of the Companies Act, 2013.

### Time gap

No offer of buy-back under this sub-section shall be made within a period of one year reckoned from the date of the closure of the preceding offer of buy-back, if any.

### Explanatory statement

The notice of the meeting at which the special resolution is proposed to be passed shall be accompanied by an explanatory statement stating—

- (a) a full and complete disclosure of all material facts;
- (b) the necessity for the buy-back;
- (c) the class of shares or securities intended to be purchased under the buy-back;
- (d) the amount to be invested under the buy-back; and
- (e) the time-limit for completion of buy-back.

*(Rule 17 of Companies (Share Capital and Debentures) Rules 2014 (hereinafter called the rules))*

Additionally the Rules provide for following disclosures in explanatory statement with respect to private companies and unlisted public companies:

- (a) the date of the board meeting at which the proposal for buyback was approved by the board of directors of the company;
- (b) the objective of the buy-back;
- (c) the class of shares or other securities intended to be purchased under the buy-back;
- (d) the number of securities that the company proposes to buyback;
- (e) the method to be adopted for the buy-back;
- (f) the price at which the buy-back of shares or other securities shall be made;
- (g) the basis of arriving at the buy-back price;
- (h) the maximum amount to be paid for the buy-back and the sources of funds from which the buy-back would be financed;
- (i) the time-limit for the completion of buy-back;
- (j) (i) the aggregate shareholding of the promoters and of the directors of the promoter, where the promoter is a company and of the directors and key managerial personnel as on the date of the notice convening the general meeting;
- (ii) the aggregate number of equity shares purchased or sold by persons mentioned in sub-clause (i) during a period of twelve months preceding the date of the board meeting at which the buy-back was approved and from that date till the date of notice convening the general meeting;
- (iii) the maximum and minimum price at which purchases and sales referred to in sub-clause (ii) were made along with the relevant date;
- (k) if the persons mentioned in sub-clause (i) of clause (j) intend to tender their shares for buy-back –

- (i) the quantum of shares proposed to be tendered;
- (ii) the details of their transactions and their holdings for the last twelve months prior to the date of the board meeting at which the buy-back was approved including information of number of shares acquired, the price and the date of acquisition;
- (l) a confirmation that there are no defaults subsisting in repayment of deposits, interest payment thereon, redemption of debentures or payment of interest thereon or redemption of preference shares or payment of dividend due to any shareholder, or repayment of any term loans or interest payable thereon to any financial institution or banking company;
- (m) a confirmation that the Board of directors have made a full enquiry into the affairs and prospects of the company and that they have formed the opinion-
  - (i) that immediately following the date on which the general meeting is convened there shall be no grounds on which the company could be found unable to pay its debts;
  - (ii) as regards its prospects for the year immediately following that date, that, having regard to their intentions with respect to the management of the company's business during that year and to the amount and character of the financial resources which will in their view be available to the company during that year, the company shall be able to meet its liabilities as and when they fall due and shall not be rendered insolvent within a period of one year from that date; and
  - (iii) the directors have taken into account the liabilities(including prospective and contingent liabilities), as if the company were being wound up under the provisions of the Companies Act, 2013
- (n) a report addressed to the Board of directors by the company's auditors stating that-
  - (i) they have inquired into the company's state of affairs;
  - (ii) the amount of the permissible capital payment for the securities in question is in their view properly determined;
  - (iii) that the audited accounts on the basis of which calculation with reference to buy back is done is not more than six months old from the date of offer document; and
  - (iv) the Board of directors have formed the opinion as specified in clause (m) on reasonable grounds and that the company, having regard to its state of affairs, shall not be rendered insolvent within a period of one year from that date.

### **Procedure**

According to Rule 17(2) the company which has been authorized by a special resolution shall, before the buy-back of shares, file with the Registrar of Companies a letter of offer in Form No.SH-8, along with the fee as prescribed. Such letter of offer shall be dated and signed on behalf of the Board of directors of the company by not less than two directors of the company, one of whom shall be the managing director, where there is one.

### **Filing Declaration of Solvency with SEBI/ROC [Rule 17(3)]**

When a company proposes to buy-back its own shares or other specified securities under this section in pursuance of a special resolution or board resolution as the case may be, it shall, before making such buy-back, file with the Registrar and the Securities and Exchange Board(in case of listed companies), a declaration of solvency in Form SH-9 signed by at least

two directors of the company, one of whom shall be the managing director, if any, in such form as may be prescribed and verified by an affidavit as specified in said form.

#### **Dispatch of letter of Offer [Rule 17(4)]**

The letter of offer shall be dispatched to the shareholders or security holders immediately after filing the same with the Registrar of Companies but not later than 21 days from its filing with the Registrar of Companies.

The letter of offer shall contain true, factual and material information and shall not contain any misleading information and must state that the directors of the company accept the responsibility for the information contained in such document; [Rule 17(1)]

#### **Validity [Rule 17(5)]**

The offer for buy-back shall remain open for a period of not less than 15 days and not exceeding 30 days from the date of dispatch of the letter of offer.

#### **Acceptance on proportional basis [Rule 17(6)]**

In case the number of shares or other specified securities offered by the shareholders or security holders is more than the total number of shares or securities to be bought back by the company, the acceptance per shareholder shall be on proportionate basis out of the total shares offered for being bought back.

#### **Time limit for verification: [Rule 17(7)]**

The company shall complete the verifications of the offers received within 15 days from the date of closure of the offer and the shares or other securities lodged shall be deemed to be accepted unless a communication of rejection is made within 21 days from the date of closure of the offer.

#### **Payment of consideration/returning of share certificates**

The company shall within seven days of the time limit of verification:

- (a) make payment of consideration in cash to those shareholders or security holders whose securities have been accepted, or
- (b) return the share certificates to the shareholders or security holders whose securities have not been accepted at all or the balance of securities in case of part acceptance .

#### **Separate Account [Rule 17(8)]**

The company shall immediately after the date of closure of the offer, open a separate bank account and deposit therein, such sum, as would make up the entire sum due and payable as consideration for the shares tendered for buy-back.

The company shall confirm in its offer the opening of a separate bank account adequately funded for this purpose and to pay the consideration only by way of cash. [Rule 17(10)]

#### **Other conditions [Rule 17(10)]**

The rules further provide that the company shall ensure that—

- (a) the company shall not withdraw the offer once it has announced the offer to the shareholders;
- (b) the company shall not utilize any money borrowed from banks or financial institutions for the purpose of buying back its shares; and

- (c) the company shall not utilize the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities for the buy-back.

#### **Time limit for completion of buyback [Section 68(4)]**

Every buy-back shall be completed within a period of one year from the date of passing of the special resolution, or as the case may be, the resolution passed by the Board.

#### **Methods of buy-back [Section 68(5)]**

The buy-back may be—

- (a) from the existing shareholders or security holders on a proportionate basis;
- (b) from the open market;
- (c) by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

#### **Extinguishment of securities bought back [Section 68(7)]**

When a company buys back its own shares or other specified securities, it shall extinguish and physically destroy the shares or securities so bought back within seven days of the last date of completion of buy-back.

#### **Prohibition of further issue of shares or securities [Section 68(8)]**

When a company completes a buy-back of its shares or other specified securities it shall not make a further issue of the same kind of shares or other securities including allotment of new shares under clause (a) of sub-section (1) of section 62 or other specified securities within a period of six months except by way of a bonus issue or in the discharge of subsisting obligations such as conversion of warrants, stock option schemes, sweat equity or conversion of Preference shares or debentures into equity shares.

#### **Register of buy-back [Section 68(9)]**

When a company buys back its shares or other specified securities, it shall maintain a register of the shares or securities so bought, the consideration paid for the shares or securities bought back, the date of cancellation of shares or securities, the date of extinguishing and physically destroying the shares or securities and such other particulars as may be prescribed.

According to the rules the register of shares or securities bought back shall be maintained in Form SH-10, at the registered office of the company and shall be kept in the custody of the secretary of the company or any other person authorized by the board in this behalf. Entries in the register shall be authenticated by the secretary of the company or by any other person authorized by the Board for the purpose. [Rule 17(12)(a)]

#### **Return of buyback [Section 68(10)]**

A company shall, after the completion of the buy-back under this section, file with the Registrar and the Securities and Exchange Board (in case of listed companies) a return containing such particulars relating to the buy-back within thirty days of such completion, as may be prescribed.

The company shall file with the Registrar, and in case of a listed company with the Registrar and the SEBI, a return in the Form No. SH-11 along with the 'fee'. There shall be annexed to the return filed with the Registrar in Form No. SH-11, a certificate in Form No. SH-15 signed by two directors of the company including the managing director, if any, certifying that the buy-back of securities has been made in compliance with the provisions of the Act and rules made thereunder. [Rule 17(13) and Rule 17(14)]

### **Penal Provisions [Section 68(11)]**

If a company makes any default in complying with the provisions of this section or any regulation made by the Securities and Exchange Board, in case of listed companies, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to three years or with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees, or with both.

### **Transfer to and application of Capital Redemption Reserve Account: (Section 69)**

When a company purchases its own shares out of free reserves or securities premium account, a sum equal to the nominal value of the shares so purchased shall be transferred to the capital redemption reserve account and details of such transfer shall be disclosed in the balance sheet. The capital redemption reserve account may be applied by the company, in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.

### **Circumstances prohibits buy-back**

Under Section 70 of the Companies Act, 2013, no company shall directly or indirectly purchase its own shares or other specified securities—

- through any subsidiary company including its own subsidiary companies;
- through any investment company or group of investment companies; or
- if a default, is made by the company, in the repayment of deposits accepted either before or after the commencement of this Act, interest payment thereon, redemption of debentures or preference shares or payment of dividend to any shareholder, or repayment of any term loan or interest payable thereon to any financial institution or banking company: However, the buy-back is not prohibited, if the default is remedied and a period of three years has lapsed after such default ceased to subsist.
- No company shall, directly or indirectly, purchase its own shares or other specified securities in case such company has not complied with the provisions of sections 92(Annual Return), 123(Declaration of Dividend), 127(punishment for failure to distribute dividend) and section 129 (Financial Statement).

### **INCOME TAX ASPECTS**

Section 46A of the Income Tax Act, 1961 provides that any consideration received by a security holder from any company on buy back shall be chargeable to tax on the difference between the cost of acquisition and the value of consideration received by the security holder as capital gains.

The computation of capital gains shall be in accordance with the provisions of Section 48 of the Income Tax Act, 1961.

In respect of Foreign Institutional Investors (FIIs), as per the provisions of Section 196D(2) of the Income Tax Act, 1961 no deduction of tax at source shall be made before remitting the consideration for equity shares tendered under the offer by FIIs as defined under Section 115AD of the Income Tax Act, 1961. NRIs, OCBs and other non-resident shareholders (excluding FIIs) will be required to submit a No Objection Certificate (NOC) or tax clearance certificate obtained from the Income Tax authorities under the Income Tax Act. In case the aforesaid NOC or tax clearance certificate is not submitted, the company should deduct tax at the maximum marginal rate as may be applicable to the category of shareholders on the entire consideration amount payable to such shareholders.

## BUY-BACK PROCEDURE FOR LISTED SECURITIES

All the listed companies are required to comply with SEBI (Buy Back of Securities) Regulations 1998 and as amended from time to time, in addition to the provisions of the companies Act. These regulations broadly cover the following aspects.

1. Special Resolution and its additional disclosure requirements
2. Methods of buy back including buy back through reverse book building , from existing shareholders through tender offer etc.,
3. Filing of offer documents, public announcement requirements.
4. offer procedure/opening of escrow account etc.,
5. General obligations of company, merchant banker etc

### Special Resolution and its additional disclosure requirements (Regulation 5)

Sub-regulation (1) of Regulation 5 of the Regulations, lays down that for the purposes of passing a special resolution the explanatory statement to be annexed to the notice for the general meeting shall contain disclosures as specified in Schedule II Part A to the Regulations.

Sub-regulation (2) provides that a copy of the above resolution shall be filed with SEBI and the stock exchanges where the shares or other specified securities of the company are listed, within seven days from the date of passing of the resolution.

### *In case of Board approval*

As per, Regulation 5A of the Regulations, provides a company, authorized by a resolution passed by the Board of Directors at its meeting to buy back its shares or other specified securities, shall file a copy of the resolution, with the SEBI and the stock exchanges, where the shares or other specified securities of the company are listed, within two working days of the date of the passing of the resolution.

### Disclosures under Schedule II Part A

An explanatory statement containing full and complete disclosure of all the material facts and the following disclosures prescribed in Schedule II Part A of the Regulations should be annexed to the notice where the buy-back is pursuant to shareholders' approval.

- (i) Date of the Board meeting at which the proposal for buy back was approved by the Board of Directors of the company;
- (ii) Necessity for the buy back;
- (iii) Maximum amount required under the buy back and its percentage of the total paid up capital and free reserves;
- (iv) Maximum price at which the shares or other specified securities are proposed be bought back and the basis of arriving at the buyback price;
- (v) Maximum number of securities that the company proposes to buy back;
- (vi) Method to be adopted for buyback as referred in sub-regulation (1) of regulation 4;
- (vii) (a) the aggregate shareholding of the promoter and of the directors of the promoters, where the promoter is a company and of persons who are in control of the company as on the date of the notice convening the General Meeting or the Meeting of the Board of Directors;

- (b) aggregate number of shares or other specified securities purchased or sold by persons including persons mentioned in (a) above from a period of six months preceding the date of the Board Meeting at which the buyback was approved till the date of notice convening the general meeting;
- (c) the maximum and minimum price at which purchases and sales referred to in (b) above were made along with the relevant dates;
- (viii) Intention of the promoters and persons in control of the company to tender shares or other specified securities for buy-back indicating the number of shares or other specified securities, details of acquisition with dates and price;
- (ix) A confirmation that there are no defaults subsisting in repayment of deposits, redemption of debentures or preference shares or repayment of term loans to any financial institutions or banks;
- (x) A confirmation that the Board of Directors has made a full enquiry into the affairs and prospects of the company and that they have formed the opinion-
  - (a) that immediately following the date on which the General Meeting or the meeting of the Board of Directors is convened there will be no grounds on which the company could be found unable to pay its debts;
  - (b) as regards its prospects for the year immediately following that date that, having regard to their intentions with respect to the management of the company's business during that year and to the amount and character of the financial resources which will in their view be available to the company during that year, the company will be able to meet its liabilities as and when they fall due and will not be rendered insolvent within a period of one year from that date; and
  - (c) in forming their opinion for the above purposes, the directors shall take into account the liabilities as if the company were being wound up under the provisions of the Companies Act, 1956 (including prospective and contingent liabilities);
- (xi) A report addressed to the Board of Directors by the company's auditors stating that-
  - (i) they have inquired into the company's state of affairs;
  - (ii) the amount of the permissible capital payment for the securities in question is in their view properly determined; and
  - (iii) the Board of Directors have formed the opinion as specified in clause (x) on reasonable grounds and that the company will not, having regard to its state of affairs, will not be rendered insolvent within a period of one year from that date.

## **METHODS OF BUY-BACK**

According to Regulation 4 of the Regulations, a company may buy back its own shares or other specified securities by any one of the following methods:

- (a) from the existing security-holders on a proportionate basis through the tender offer;
- (b) from the open market through:
  - (i) book-building process,
  - (ii) stock exchange
- (c) from odd-lot holders.

It may be noted that no offer of buy back for 15% or more of paid up capital and free reserves, shall be made from the open market.

In terms of Regulation 4(4) a company shall not make any offer of buy-back within a period of one year reckoned from the date of closure of the preceding offer of buy-back, if any."

**Can a company buy back its shares or any specified securities through negotiated deal on or of the stock exchange?**

No, Regulation 4(2) does not permit buy back through negotiated deals(of and on stock exchange), private arrangement, spot transactions.

**Buy-back from existing security-holders through tender offer**

According to Regulation 6 of the Regulations, a company may buy back its securities from its existing security-holders on a proportionate basis in accordance with the provisions of the Regulations. It may be noted that fifteen percent of the number of securities which the company proposes to buy back or number of securities entitled as per their shareholding, whichever is higher, shall be reserved for small shareholders.

***Additional Disclosures.***

In addition to disclosure required under Schedule II Part A, regulation 7 requires the following disclosures to be made to the explanatory statement.

- (a) the maximum price at which the buy-back of shares or other specified securities shall be made and whether the Board of Directors of the company are being authorised at the general meeting to determine subsequently the specific price at which the buy-back may be made at the appropriate time;
- (b) if the promoter intends to offer their shares or other specified securities,
  - (i) the quantum of shares or other specified securities proposed to be tendered, and
  - (ii) the details of their transactions and their holdings for the last six months prior to the passing of the special resolution for buy-back including information of number of shares or other specified securities acquired, the price and the date of acquisition.

***Public announcement and Filing of offer documents (Regulation 8)***

The company which has been authorised by a special resolution or a resolution passed by the Board of Directors at its meeting shall make a public announcement within two working days from the date of resolution in at least one English National Daily, one Hindi National Daily and a Regional language daily all with wide circulation at the place where the Registered office of the company is situated and shall contain all the material information as specified in Schedule II, Part A.

A copy of the public announcement along with the soft copy, shall also be submitted to the Board simultaneously through a merchant banker.

The company shall within five working days of the public announcement file with the Board a draft-letter of offer, along with soft copy, containing disclosures as specified in Schedule III through a merchant banker who is not associated with the company.

The Board may give its comments on the draft letter of offer not later than seven working days of the receipt



of the draft letter of offer. In the event the Board has sought clarifications or additional information from the merchant banker to the buyback offer, the period of issuance of comments shall be extended to the seventh working day from the date of receipt of satisfactory reply to the clarification or additional information sought.

In the event the Board specifies any changes, the merchant banker to the buyback offer and the company shall carryout such changes in the letter of offer before it is dispatched to the shareholders.

The company shall file along with the draft letter of offer, a declaration of solvency in the prescribed form and in a manner prescribed in the Companies Act.

### ***Offer procedure (Regulation 9)***

- (1) A company making a buyback offer shall announce a record date for the purpose of determining the entitlement and the names of the security holders, who are eligible to participate in the proposed buyback offer.
- (2) The letter of offer along with the tender form shall be dispatched to the security holders who are eligible to participate in the buyback offer, not later than five working days from the receipt of communication of comments from the Board.
- (3) The date of the opening of the offer shall be not later than five working days from the date of dispatch of letter of offer.
- (4) The offer for buy back shall remain open for a period of ten working days.
- (5) The company shall accept shares or other specified securities from the security holders on the basis of their entitlement as on record date.
- (6) The shares proposed to be bought back shall be divided in to two categories; (a) reserved category for small shareholders and (b) the general category for other shareholders, and the entitlement of a shareholder in each category shall be calculated accordingly.
- (7) After accepting the shares or other specified securities tendered on the basis of entitlement, shares or other specified securities left to be bought back, if any in one category shall first be accepted, in proportion to the shares or other specified securities tendered over and above their entitlement in the offer by security holders in that category and thereafter from security holders who have tendered over and above their entitlement in other category.

### ***Escrow account***

Regulation 10 of the SEBI Regulations provides that-

1. the company should as and by way of security for performance of its obligations under the Regulations, on or before the opening of the offer, deposit in an escrow account the sum as specified in Sub-regulation (2).
2. the escrow amount is payable in the following manner:
  - (i) if the consideration payable does not exceed Rs 100 crores—25 per cent of the consideration payable;
  - (ii) if the consideration payable exceeds Rs 100 crores—25 per cent upto Rs 100 crores and 10 per cent thereafter;
3. the escrow account referred to above shall consist of:

- (a) cash deposited with a scheduled commercial bank, or
  - (b) bank guarantee in favour of the merchant banker, or
  - (c) deposit of acceptable securities with appropriate margin, with the merchant banker, or
  - (d) a combination of (a), (b) and (c) above;
4. where the escrow account consists of deposit with a scheduled commercial bank, the company while opening the account, should empower the merchant banker to instruct the bank to issue a banker's cheque or demand draft for the amount lying to the credit of the escrow account, as provided in the Regulations;
  5. where the escrow account consists of bank guarantee, such bank guarantee shall be in favour of the merchant banker and valid until thirty days after the closure of the offer;
  6. where the escrow account consists of securities, the company should empower the merchant banker to realise the value of such escrow account by sale or otherwise. If there is any deficit on realisation of the value of the securities, the merchant banker shall be liable to make good any such deficit;
  7. in case the escrow account consists of bank guarantee or approved securities, these shall not be returned by the merchant banker till the completion of all obligations under the Regulations;
  8. where the escrow account consists of bank guarantee or deposit of approved securities, the company is also required to deposit with the bank in cash, a sum of at least one per cent of the total consideration payable, as and by way of security for fulfilment of the obligations under the Regulations by the company;
  9. on payment of consideration to all the security-holders who have accepted the offer and after completion of all the formalities of buy-back, the amount, guarantee and securities in the escrow, if any, should be released to the company;
  10. SEBI, in the interest of the security-holders, may, in case of non-fulfillment of obligations under the Regulations by the company forfeit the escrow account either in full or in part;
  11. the amount so forfeited may be distributed pro rata amongst the security-holders who accepted the offer and the balance, if any, shall be utilised for investor protection.

### ***Payment to the Security holders***

Regulation 11 of the Regulations lays down that—

1. The company should immediately after the date of closure of the offer, open a special account with a SEBI registered banker to an issue and deposit therein, such sum as would, together with the amount lying in the escrow account make up the entire sum due and payable as consideration for the buy-back and for this purpose, may transfer the funds from the escrow account.
2. The company shall complete the verifications of offers received and make payment of consideration to those security holders whose offer has been accepted or return the shares or other specified securities to the security holders within seven working days of the closure of the offer.

### ***Extinguishing of bought-back securities (Regulation 12)***

The company shall extinguish and physically destroy the security certificates so bought back in the presence of a Registrar to issue or the Merchant Banker and the Statutory Auditor within fifteen days of the date of

acceptance of the shares or other specified securities. The company shall also ensure that all the securities bought - back are extinguished within seven days of the last date of completion of buy – back.

The shares or other specified securities offered for buy-back if already dematerialised shall be extinguished and destroyed in the manner specified under the Securities and Exchange Board of India (Depositories and Participants) Regulations, 1996, and the bye-laws framed thereunder.

The company shall, furnish a certificate to the Board certifying compliance as specified above and duly certified and verified by -

- (i) the registrar and whenever there is no registrar by the merchant banker;
- (ii) two directors of the company one of whom shall be a managing director where there is one;
- (iii) the statutory auditor of the company,

The certificate shall be furnished to the Board on a monthly basis by the seventh day of the month succeeding the month in which the securities certificates are extinguished and destroyed.

The company shall furnish, the particulars of the security certificates extinguished and destroyed, to the stock exchanges where the shares of the company are listed on a monthly basis by the seventh day of the month succeeding the month in which the securities certificates are extinguished and destroyed. The company shall also maintain a record of security certificates which have been cancelled and destroyed as prescribed in the Companies Act.

### **Buy-back from Open Market**

Regulation 14 of the Regulations lays down that a buy-back of shares or other specified securities from the open market may be in any one of the following methods:

- (i) Through stock exchange.
- (ii) Book-building process.

The company shall ensure that atleast 50% of the amount earmarked for buy back, as specified in resolutions (Board/special resolution) is utilized for buying back shares and other specified securities

The company shall ensure that atleast fifty per cent of the amount earmarked for buy-back, as specified in resolutions ( Board/Special Resolution ) is utilized for buying-back shares or other specified securities.”

### **Buy-back through the stock exchange (Regulation 15)**

Regulation 15 of the Regulations provides that a company should buy-back its specified securities through the stock exchange as provided hereunder:

- the special resolution/ board resolution as under Regulation 5 and 5A respectively, should specify the maximum price at which the buy-back will be made;
- the buy-back of securities should not be from the promoters or persons in control of the company;
- the company should appoint a merchant banker and make a public announcement as referred to in Regulation 8 within seven days from the date of passing the resolution under Regulation 5 and 5A;
- the public announcement shall be made within 7 working days from the date of passing special resolution;

- simultaneously with the issue of such public announcement, the company shall file a copy of the public announcement with the Board.
- the company shall submit the information regarding the shares or other specified securities bought-back, to the stock exchange on a daily basis in such form as may be specified by the Board and the stock exchange shall upload the same on its official website immediately;"
- the company shall upload the information regarding the shares or other specified securities bought-back on its website on a daily basis;"
- the buy-back offer shall open not later than seven working days from the date of public announcement and shall close within six months from the date of opening of the offer."
- the buy-back should be made only on stock exchanges having Nationwide Trading Terminal facility and only through the order matching mechanism except 'all or none' order matching system;
- the company shall submit information regarding the shares or other specified securities bought back, to the stock exchange on daily basis in such form as may be specified by the board;
- the identity of the company as a purchaser would appear on the electronic screen when the order is placed.
- The company shall upload the information regarding the shares or other specified securities bought back, on its website on daily basis.

#### **Buy –Back of physical shares or other specified securities (Rule 15 B)**

A company shall buy-back its shares or other specified securities in physical form through open market method as provided hereunder:

- (a) a separate window shall be created by the stock exchange, which shall remain open during the buy-back period, for buy-back of shares or other specified securities in physical form.
- (b) the company shall buy-back shares or other specified securities from eligible shareholders holding physical shares through the separate windows specified in clause (a), only after verification of the identity proof and address proof by the broker.
- (c) the price at which the shares or other specified securities are bought back shall be the volume weighted average price of the shares or other specified securities bought-back, other than in the physical form, during the calendar week in which such shares or other specified securities were received by the broker:

Provided that the price of shares or other specified securities tendered during the first calendar week of the buy-back shall be the volume weighted average market price of the shares or other specified securities of the company during the preceding calendar week.

Explanation: In case no shares or other specified securities were bought back in the normal market during calendar week, the preceding week when the company has last bought back the shares or other specified securities may be considered.

#### **Escrow account (Rule 15 B)**

- (1) The Company shall, before opening of the offer, create an escrow account towards security for performance of its obligations under these regulations, and deposit in escrow account 25 per cent of the amount earmarked for the buy-back as specified in the resolutions.

- (2) The escrow account referred to in sub-regulation (1) may be in the form of,—
- (a) cash deposited with any scheduled commercial bank; or
  - (b) bank guarantee issued in favour of the merchant banker by any scheduled commercial bank.
- (3) For such part of the escrow account as is in the form of a cash deposit with a scheduled commercial bank, the company shall while opening the account, empower the merchant banker to instruct the bank to make payment of the amounts lying to the credit of the escrow account, to meet the obligations arising out of the buy-back.
- (4) For such part of the escrow account as is in the form of a bank guarantee:
- (a) the same shall be in favour of the merchant banker and shall be kept valid for a period of thirty days after the closure of the offer or till the completion of all obligations under these regulations, whichever is later.
  - (b) the same shall not be returned by the merchant banker till completion of all obligations under the regulations.
- (5) Where part of the escrow account is in the form of a bank guarantee, the company shall deposit with a scheduled commercial bank, in cash, a sum of at least 2.5 per cent of the total amount earmarked for buy-back as specified in the resolutions referred to in regulation 5 or regulation 5A. as and by way of security for fulfillment of the obligations under the regulations by the company.
- (6) The escrow amount may be released for making payment to the shareholders subject to atleast 2.5% of the amount earmarked for buy-back as specified in the resolutions referred to in regulation 5 or regulation 5A remaining in the escrow account at all points of time.
- (7) On fulfilling the obligation specified at sub regulation (3) of Regulation 14, the amount and the guarantee remaining in the escrow account, if any, shall be released to the company.
- (8) In the event of non-compliance with sub-regulation (3) of regulation 14, except in cases where,—
- a. volume weighted average market price (VWAMP) of the shares or other specified securities of the company during the buy-back period was higher than the buy-back price as certified by the Merchant banker based on the inputs provided by the Stock Exchanges.
  - b. inadequate sell orders despite the buy orders placed by the company as certified by the Merchant banker based on the inputs provided by the Stock Exchanges.
  - c. such circumstances which were beyond the control of the company and in the opinion of the Board merit consideration, the Board may direct the merchant banker to forfeit the escrow account, subject to a maximum of 2.5 per cent of the amount earmarked for buy-back as specified in the resolutions.
- (9) In the event of forfeiture for non-fulfillment of obligations specified in sub regulation (8), the amount forfeited shall be deposited in the Investor Protection and Education Fund of Securities and Exchange Board of India.

### Extinguishment of certificates (Rule 16)

Subject to the provisions of sub-regulation (2) and sub regulation (3), the provisions of regulation 12 pertaining to extinguishment of certificates shall be applicable mutatis mutandis.

- (2) The company shall complete the verification of acceptances within fifteen days of the payout.

(3) The company shall extinguish and physically destroy the security certificates so bought back during the month in the presence of a Merchant Banker and the Statutory Auditor, on or before the fifteenth day of the succeeding month:

Provided that the company shall ensure that all the securities bought-back are extinguished within seven days of the last date of completion of buyback.

### ***Buy-back through book-building (Regulation 17)***

A company can buy-back its securities through the book-building process as provided hereunder:

1. (a) The special regulation as in Regulation 5 or 5A, should specify the maximum price at which the buy-back will be made.
- (b) The company should appoint a merchant banker.
- (c) A public announcement as referred to in Regulation 8 shall be made at least seven days prior to the commencement of the buy-back.
- (d) Subject to the provisions of Sub-clauses (i) and (ii), the provisions of Regulation 10 regarding escrow account are applicable:
  - (i) The deposit in the escrow account should be made before the date of the public announcement.
  - (ii) The amount to be deposited in the escrow account should be determined with reference to the maximum price as specified in the public announcement containing detailed methodology of the book-building process, manner of acceptance, format of acceptance to be sent by the security-holders pursuant to public announcement and details of bidding centres.
- (e) A copy of the public announcement must be filed with SEBI within two days of the announcement along with the fees as specified in Schedule IV to the Regulations. The Public announcement shall also contain the detailed methodology of the book building process, the manner of acceptance, the format of acceptance to be sent by the security holders pursuant to the public announcement and the details of bidding centres.
- (f) The book-building process should be made through an electronically linked transparent facility.
- (g) The number of bidding centres should not be less than thirty and there should be at least one electronically linked computer terminal at all the bidding centres.
- (h) The offer for buy-back should be kept open to the security-holders for a period of not less than fifteen days and not exceeding thirty days.
- (i) The merchant banker and the company should determine the buy-back price based on the acceptances received and the final buy-back price, which should be the highest price accepted should be paid to all holders whose securities have been accepted for the buy-back.

### **Obligations of the company**

According to Regulation 19 of the Regulations,

The company shall ensure that:

- (a) the letter of offer, the public announcement of the offer or any other advertisement, circular, brochure, publicity material contains true, factual and material information and does not contain any

misleading information and must state that the directors of the company accept the responsibility for the information contained in such documents;

- (b) the company shall not issue any specified securities including by way of bonus till the date of closure of the offer is made under these Regulations;
- (c) the company shall pay consideration only by cash;
- (d) the company shall not withdraw the offer to buy-back after the draft letter of offer is filed with the SEBI or public announcement of the offer to buy-back is made;
- (e) the promoter or the person shall not deal in the specified securities of the company in the stock exchange or off market, including inter-se transfer of shares among the promoters during the period "from the date of passing the resolution under regulation 5 or regulation 5A till the closing of the offer.
- (f) the company shall not raise further capital for a period of one year from the closure of buy-back offer, except in discharge of its subsisting obligations.

No public announcement of buy-back shall be made during the pendency of any scheme of amalgamation or compromise or arrangement pursuant to the provisions of the Companies Act.

The company should nominate a compliance officer and investors service centre for compliance with the buy-back regulations and to redress the grievances of the investors [Sub-regulation (3)].

The particulars of the said security certificates extinguished and destroyed should be furnished by the company to the stock exchanges where the securities of the company are listed, within seven days of extinguishment and destruction of the certificates [Sub-regulation (4)].

The company should not buy-back the locked-in securities and non-transferable securities till the pendency of the lock-in or till the securities become transferable [Sub-regulation (5)].

The company should issue, within two days of the completion of buy-back, a public advertisement in a national daily, *inter alia*, disclosing the following:

- (i) number of securities bought;
- (ii) price at which the securities were bought;
- (iii) total amount invested in the buy-back;
- (iv) details of the security-holders from whom securities exceeding one per cent of the total securities were bought-back; and
- (v) the consequent changes in the capital structure and the shareholding pattern after and before the buy-back.

### **Obligations of the merchant banker**

Regulation 20 provides that the merchant banker should ensure that:

- (a) the company is able to implement the offer;
- (b) the provision relating to escrow account has been made;

- (c) firm arrangements for monies for payment to fulfil the obligations under the offer are in place;
- (d) the public announcement of buy-back is made and the letter of offer has been filed in terms of the Regulations;
- (e) the merchant banker should furnish to SEBI, a due diligence certificate which should accompany the draft letter of offer;
- (f) the merchant banker should ensure that the contents of the public announcement of offer as well as the letter of offer are true, fair and adequate and quoting the source wherever necessary.
- (g) the merchant banker should ensure compliance of Section 77A and Section 77B of the Companies Act, and any other applicable laws or rules in this regard;
- (h) upon fulfillment of all obligations by the company under the Regulations, the merchant banker should inform the bank with whom the escrow or special amount has been deposited to release the balance amount to the company and send a final report to SEBI in the specified form, within 15 days from the date of closure of the buy-back offer.

### LESSON ROUND UP

- According to section 61 of the Companies Act 2013 a limited company having a share capital derives its power to alter its share capital through its articles of association.
- In accordance with Section 390(b) Companies Act 1956, the expression “arrangement” includes a re-organisation of the share capital of the Company by the consolidation of shares of different classes or by division of shares of one class into shares of different classes or by both these methods
- A company limited by shares or a company limited by guarantee and having a share capital may, if authorised by its articles, by special resolution, and subject to its confirmation by the Court on petition, reduce its share capital.
- “Surrender of shares” means the surrender of shares already issued to the company by the registered holder of shares. Where shares are surrendered to the company, whether by way of settlement of a dispute or for any other reason, it will have the same effect as a transfer in favour of the company and amount to a reduction of capital.
- Diminution of capital, the company cancels shares which have not been taken or agreed to be taken by any person.
- According to Section 68(1) of the Companies Act, 2013 a company whether public or private, may purchase its own shares or other specified securities out of:(i) its free reserves; or(ii) the securities premium account; or (iii) the proceeds of any shares or other specified securities.
- When a company buys back its shares or other specified securities , it shall maintain a register of the shares or securities so bought, the consideration paid for the shares or securities bought back, the date of cancellation of shares or securities, the date of extinguishing and physically destroying the shares or securities and such other particulars as may be prescribed.
- Section 46A of the Income Tax Act, 1961 provides that any consideration received by a security holder from any company on buy back shall be chargeable to tax on the difference between the cost of acquisition and the value of consideration received by the security holder as capital gains.
- All the listed companies are required to comply with SEBI (Buy Back of Securities) Regulations 1998 and as amended from time to time, in addition to the provisions of the Companies Act, 2013.



## SELF TEST QUESTIONS

*(These are meant for recapitulation only. Answers to these questions are not required to be submitted for evaluation).*

1. Briefly explain the need of financial restructuring and highlight reasons in the context of over capitalised and under capitalised companies.
2. What do you mean by 'buy-back' of shares or specified securities as under the Companies Act, 2013? Explain the relevant provisions of the Act.
3. What are the different alternatives available to a public company for 'buy-back'?
4. Enumerate the provisions relating to Escrow account and offer procedure as under SEBI (Buy-back of Securities) Regulations, 1998.
5. Discuss the obligation of Merchant Banker under SEBI (Buy-back of Securities) Regulations, 1998.

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# Lesson 12

## Post Merger Re-Organisation

### LESSON OUTLINE

- Factors in Post Merger Reorganization.
- Impact of post merger reorganisation
- Integration of business and operation.
- Post Merger Success and Valuation.
- Human and Cultural factors
- Cultural Factors and post merger – examples
- Measuring Post-Merger Efficiency.

### LEARNING OBJECTIVES

Corporate restructuring leads to significant changes in the organization touching various tangible as well as intangible aspects. Apart from various considerations involved in any restructuring and the benefits sought to be achieved there from, it is important that each concerned is aware of post facto actions that need to be completed to ensure smooth working of the organization post restructure.

The actions that need attention in the post restructure scenario find their roots somewhere in the beginning of the whole process. It is imperative that the team involved in the restructure understands the logical ends to each of the steps and sub-steps at the time when an organization is planning for the restructuring. Certain decisions taken in terms of the overall structuring plan, methodology adopted for specific actions forming part of the restructure could be irreversible or may have very little scope to make changes and therefore, it is essential to keep the end objective in mind while planning for the restructure. After reading this lesson you would be able to understand the issues and challenges involved generally after merger, which are to be carried out in conjunction with the strategic planning of merger, measuring post merger efficiency etc.,

## INTRODUCTION

Post-merger reorganisation' is a wide term which encompasses the reorganisation of each and every aspect of the company's functional areas to achieve the objectives planned and aimed at. The parameters of post merger reorganisation are to be established by the management team of every amalgamating company differently depending upon its requirements, objectives of merger and management corporate policy.

A merger can join two cultures, two sets of procedures and protocols, two sets of policies and change the employment environment and prospects of several hundreds of employees, who have been the bed rock of past successes and the key to future value. Timely integration of systems, applications and data provide the corporate information needed to achieve the post-merger objectives.

The relevance of Post-merger organisation and integration cannot be overstated. Continuous appraisal and improvement are the basic elements in the success of a merger or an acquisition. Due to the complexity of numerous activities and occurrence of many unanticipated events, it is quite possible that the process gets off the track and results are not realized.

In fact the main reason, why so many mergers either fail or fall short of expectations is a lack of adequate efforts to integrate the purchased company into the buyer's existing operations. It should be realised that once the deal is put through, the 'real' work has only begun. Often, the buying company underestimates as to how long it will take to get the two companies to act as one. Therefore, where importance is placed on whether it is a good idea to purchase a company and figure out the right price, it is equally essential to understand the target company with an eye to post-merger efforts.

## FACTORS IN THE POST MERGER REORGANISATION

It would not be inappropriate to divide all actions in the restructuring process in three stages viz. before, during and after, to ensure all actions are covered and put in right buckets to ensure proper planning for each of these actions. Post-restructure actions envisage actions required to be taken after the approval from the Court is obtained in case of a merger of two or more companies. In other words, these are the actions put in the third and final bucket where all prior actions before and during the restructure would flow down.

Restructure could be in the nature of merger, amalgamation, acquisition, de-merger, internal organizational restructuring, financial restructuring, realignment of business segments etc. The points stated below would at best apply to a merger/ amalgamation scenario. Some of these points may apply to other scenarios also. One will need to give a thought about the applicability of the points stated below to the relevant type of business restructuring.

### 1. Change of name and logo

If the restructure is going to result in change of name or where the Board of Directors decide to change the name of the entity post restructuring, the company will need to plan implementation of change of name on all name boards, letterheads, all branches/ locations where name of the Company has been posted/displayed, including company's website/internet. Similarly, actions need to be taken to modify the corporate logo, if the same is going to change as well.

If the company proposes to adopt a new branding strategy to impress its new logo in the minds of people, it will need to undertake suitable advertisement campaign for the same. Some time back HERO group advertized changes in its name and logo.

## 2. Revised organization chart

The company will need to work on updating its organization chart at all levels. It will need to reflect the new vision/mission, new thinking post restructure. In case of takeover, the organization chart may not change significantly; however the acquired entity may need to align its organization structure with the acquiring entity. Current trends add up to dotted line/ multiple reporting to complicate it further. Also, changes may be necessitated by vertical/ horizontal structures in the organization.

## 3. Communication

The company should provide proper and timely communication about the restructuring in the organization to all its employees, which would provide updated status, bring clarity on what's happening at the organizational level and avoid miscommunication.

Also, it would be useful to send a communication regarding changes in company policies as well. The company should also consider sending appropriate communication to bankers, auditors, advisors, etc. upon formal completion of the restructuring activity.

## 4. Employee compensation, benefits and welfare activities

Companies need to be sensitive with regard to terms and conditions of employment. Usually, courts would uphold terms of employment to be no less favorable than existing terms and conditions. Post acquisition, the parent company may want the acquired company to adopt compensation structure of the parent entity. It would result in re-aligning the structure as well as pay scales of existing employees. The company will have to carefully handle such sensitive areas to ensure employee satisfaction and comfort, which pays in the long run in building an image apart from preventing or reducing low employee turnout. Additionally, company would need to consider any prevailing fringe benefits and amenities provided to employees and the feasibility of continuing the same in the new set up (post restructure). The company may re-negotiate insurance premium for employee related insurance policies (life, accident, medical as applicable) depending on the conditions of existing policy or the preferred insurance vendor recommended by acquiring entity.

## 5. Aligning company policies

The company would need to align/ amend its internal policies to reflect the organization in the post restructure scenario. This may not apply in all types of restructuring. Particularly in case of takeover, the acquiring entity is likely to insist all its policies on the acquired entity to bring consistency in the groups' policies. Specific changes to group policies may be needed depending on nature and size of business, location, applicability of relevant State laws. The challenge continues further in terms of implementing changes in the policies e.g. if acquired company has a policy to use laptops/ computers manufactured by DELL. If the acquiring company uses laptops/ computers manufactured by HP, the company would need to take decision to implement the group policy or make an exception till the time the existing laptops/ computers consume expected life and new ones are due for procurement. Similarly, it would be appropriate to revisit policies with respect to employee uniforms, mobile phones provided by the company, tie up with insurance agents to provide cover as per the terms and conditions acceptable to the parent company, HR-policies that impact office timings, leaves and so on.

## 6. Aligning accounting and internal database management systems

Besides passing appropriate accounting entries to capture the merger/ acquisition/ financial structure, the company may need to adopt accounting policies, practices based on those followed by its new parent organization post acquisition. The company needs to understand any reporting and database requirements of acquiring company or merged entity to provide relevant data to the new management and to align existing systems with those of the parent/ merged entity. This may involve providing suitable training to concerned personnel and understanding issues, if any, to avoid incorrect reporting.

## **7. Re-visiting internal processes**

The company which is subjected to restructuring will need to align its internal processes with that of the merged entity/ acquired entity e.g. domestic travel process, reimbursement of expenses process. Company's current process may involve issue of cheques to employees against expenses claimed; whereas merged/ acquiring entity credits its employee claims to a bank account maintained for the purpose. Accordingly, the company will need to open bank account (expense reimbursement account) for all its employees. Company will also need to create e-mail ids for employees of merging entity and ensure access to their previous data as well. In case of an acquisition, acquiring company may insist on changing the mail ids of acquired entity to ensure consistency with its internal requirements.

## **8. Re-allocation of people**

Restructuring typically would entail re-allocation of persons operating on various positions/ grades in similar functions. At times, allocation in support functions becomes a challenge as now two persons handle the similar profile e.g. personnel in HR, finance, administration etc. This would require re-allocation of responsibilities or re-defining the responsibilities to specific geography/ line of business/ business units. In addition, a situation may arise where new positions get created to fit into the new organization structure post restructure. A careful planning is needed to avoid overlapping, underutilization of staff and to take care of career progression.

## **9. Engagement with statutory authorities**

This is one of the important areas that deals with legal requirements and is close to the company secretary. It is essential to identify government authorities that need to be intimated formally about the merger/ amalgamation/takeover e.g. SEBI, Stock Exchange....etc.

Restructuring is also likely to require reflection of the changes to various government permissions, licenses, approvals granted in the past e.g. under labour and industrial laws, sales tax and service tax registrations, permissions under SEZ/STPI requirements where a unit of a merging entity now becomes part of the merged entity. Appropriate steps need to be carried out for updating registration of vehicles owned by merging entity prior to merger.

## **10. Record keeping**

Maintenance of records of merging entity and making suitable entries in the records (e.g. registers under Companies Act reflecting changes in shareholding, directors etc. as applicable) of merged entity is a must. One will need to dive deep to ensure maintenance of all past records including statutory and non-statutory registers, original copies of various forms, returns, certificates, approvals, litigation and property records. Company may need to relocate the records to centralized storage maintained by the merged/new entity.

## **11. Immoveable Property**

A restructuring may cause changes in property records e.g. consequent to merger if merging entity ceases to exist, merged entity would need to take steps to ensure that property records are updated to reflect the name of the merged (new) entity.

If a company is occupying leased premises, one should check conditions under the lease agreement and complete necessary formalities such as intimation to landlord or the like.

If a company has borrowed money against mortgage of property, the company will need to inform bank about the restructure and check if any formalities need to be completed as per bank's policies. While the

order of the Hon'ble Court is sufficient to bring legal effect to a merger/ amalgamation, the bank may require formal intimation in the prescribed form within 7 days or so.

## **12. Expansion of existing teams to support larger organization**

A restructuring is likely to put pressure on support staff, which was supporting employee strength before amalgamation e.g. in-house training department was probably handling technical training for 2000 employees. Post amalgamation with another company, the training function needs to cater to training requirements for 5000 employees. It is further likely that the amalgamating entity had an independent training department or had a sophisticated training module to conduct on-line trainings, which the amalgamated entity may not have; which would require further deliberations to implement better practices in the new organization.

## **13. Revised ISO certification and similar other certifications**

Restructuring could lead to changes in existing certifications such as ISO or similar other certifications. With the addition to locations or changes in organization structure, suitable changes need to be reflected to the certifications obtained e.g. post acquisition, the acquiring company may decide to close down a branch of acquired company located in Bangalore, since acquiring company may have a large set up in Bangalore; which would require intimation to concerned bodies and completing necessary formalities to ensure all locations/ Functions in new set up are certified.

## **14. Re-visiting past decisions/government approvals/ compliances**

Restructuring is not always about future decisions or actions. One would need to take a look at past decisions or approvals which were conditional and insist for re-visiting earlier decisions e.g. assuming that the Board of Directors of a company had passed a resolution for not paying any remuneration to nonexecutive directors. However, acquiring entity pays certain percentage of its profits to non-executive directors. Post acquisition and to fit into group policy, company would need to pass another resolution for payment of remuneration to non-executive directors. Take another example, where a company had obtained permission from Reserve Bank of India stating a condition that the permission is subject to condition that foreign shareholding in the company does not exceed X%. If post acquisition, the percentage of foreign shareholding passes stipulated percentage, the company would need to refer the matter to RBI and seek appropriate sanction. There would be a few issues which are disputable where the order of Court would operate and no formal process needs to be followed. However, it is recommended that a company should take appropriate steps to avoid multiple interpretation or possible non-compliance in such cases. Additionally, a company may be subjected to compliance with Operational Challenges Post Corporate Restructuring certain laws of requirements as a result of restructure e.g. a non-listed company acquires a listed company to make the listed company as its subsidiary. Certain provisions of listing agreement/ SEBI regulations would apply which apply to a holding company of a listed company, which was so far not applicable to such a non-listed company. Or where a merging entity had a unit in SEZ; now the merged entity would need to ensure compliances under regulations applicable to SEZ unit. Assume a company has obtained 100 software licenses required as a part of internal system used for a particular project. Post merger, if the size of such team increases to 150 members, company would need to procure additional licenses.

## **15. Contracts**

It is a onerous exercise to check provisions in the existing contracts having connection to any form of restructuring. While order of the Hon'ble Court would prevail and shall ensure that the contracts entered by the merging entity shall continue to be transferred in the name of merged entity as if merged entity was the signing party from the relevant date, provisions contained in a contract with third party may require company to inform about such merger or may give rise to the other party to terminate the contract.

A lease agreement having committed period clause (providing for minimum period of lease during which the lease contract is not terminable by the landlord) may release the landlord from such restriction in the event of a restructure of the lessee entity. Likewise, the company may lose the benefits/ concessions under existing contract, unless company is able to re-negotiate those terms to its favor. Or a contract may provide for lifting the restrictions around fixed fees say for a period of three years, consequent to restructure. It is now imperative for the merged entity to check all such provisions triggering from a restructure rather than criticizing how badly the contract was negotiated by merging entity.

Further, the merged entity would need to check various rights and obligations spelt out in the contracts with third parties and should allocate teams to identify and ensure compliance of those requirements. A loan agreement may insist on the borrower company

to obtain prior permission from the Bank. Restructuring is likely to trigger termination rights for other party to the contract, which could turn out to be dangerous from business continuity perspective.

## 16. Miscellaneous

A restructure would require changes to data displayed on the website of the company/ new entity as the case may be. It would require bringing appropriate changes in company's branding strategy, marketing material, employee visiting cards, employee identity cards, changes to any power of attorneys issued by the erstwhile entity, consolidation of existing bank accounts with the same bank, any action related to existing bank guarantees and other miscellaneous items such as crockery bearing company's logo, etc.

There could be many more aspects to a restructure beyond those stated above, depending on the peculiarities of restructuring by a company. A company should plan for a restructure and try to cover as many aspects as possible to ensure smooth transition and taking necessary actions to complete the restructuring process to its logical end.

## IMPACT OF POST MERGER REORGANISATION

### 1. GAIN OR LOSS TO STAKEHOLDERS

In mergers and acquisitions it largely depends upon the terms and conditions of the merger and the track record of the transferee or acquirer company. Based on the cardinal principle, every buyer, in other words transferee or acquirer has to pay more than the book value of the transferor or target company. However, the terms and conditions of the transaction depend upon their present operations and past historical records. Some instances of the effect of acquisitions to small shareholders worth mentioning are as under:

1. On the announcement of merger of ICICI Ltd. with ICICI Bank, share prices jumped from ₹ 47.70 and ₹ 77.00 on 25.9.2001 to ₹ 56.10 and ₹98.00 on 24.10.2001 respectively.
2. AV Birla group acquired 14.5% shares of Larsen & Toubro Ltd. (L&T) from Reliance Industries Ltd. at ₹ 309 per share. For increasing the stake up to 34.5% the Birla group's open offer at ₹ 190 per share is under protest by the Investors Grievances Forum and the Financial Institutions (FIs). The L&T script surged to close at ₹ 189 from ₹172 on 16.10.2002. FIs collectively hold over 36% shares in L&T. They demanded ₹340 per share. The open offer has been stayed and was under review by the SEBI on 18.10.2002. National Association of Small Investors (NASI) said that a section of Grasim shareholders will approach the Supreme Court asking the company to increase the offer price for acquisition of L&T to ₹350/- per share. As such, the small shareholders of L&T will be provided with an exit opportunity at a price higher than the ruling market price.
3. AV Birla group open offer for 25.5% shares in Indian Aluminium Ltd. (Indal) at ₹120/- per share



opened on 14.10.2002 did not receive favourable response in view of Sterlite's offer at ₹ 221/- per share made in 1998 against which the shareholders tendered their shares. There is a good chance for upward revision in the offer price or a strategic deal between Sterlite and AV Birla group. It may also be beneficial to the small shareholders.

4. The takeover by Mr. Arun Bajoria for Bombay Dyeing provided a golden opportunity to the small shareholders to exit at ₹ 110/- per share against the market price ruling between ₹ 60-75 per share.
5. The takeover bid by Mr. Abhishek Dalmia for the GESCO Corporation resulted in upward revision in offer price to ₹ 45/- after acquiring 45% shares at ₹ 27/- per share. The Dalmias sold their entire 10.5% stake at ₹ 54 per share to Sheth Mahiaha combine.
6. The takeover bids for Ahmedabad Electricity Company (AEC) by Gujarat Torrent group and the Bombay Dyeing resulted in increasing the offer price from ₹ 65/- per share to ₹ 132/- per share and at this price Gujarat Torrent Group acquired AEC; undoubtedly, the small shareholders were benefited prior to acquisition of AEC.
7. Similarly, the takeover bid of Mr. Arun Bajoria for Ballarpur Industries resulted in a surge of the scrip price from around ₹ 50/- to ₹ 68/- when it was made public.

From the above it is evidently clear that such acquisition attempts cause an increase in share price, which benefits the share holders of the target company. For the post acquisition or merger achievements, reorganisational efforts of the acquirer or merged company are very important. Improving the acquisition integration process is one of the most compelling challenge facing businesses today. The results are dependent on the actions suggested by the consultants and merchant bankers and the actions taken by the finance executives, operational heads, HRD head and legal advisors.

## 2. IMPLEMENTATION OF OBJECTIVES

We have so far discussed various objectives, motives, reasons and purposes which are to be achieved and accomplished by implementing them after completion of merger, amalgamation or acquisition. Much of the senior management's attention must be focused on developing a 'post-transaction' strategy and integration plan that will generate the revenue enhancements and cost savings that initially prompted the merger or acquisition. After merger or acquisition, the resources of two or more companies should be put together for producing better results through savings in operating costs because of combined management of production, marketing, purchasing, resources etc. These economies are known as synergistic operative economies. Synergy is also possible in the areas of Research and Development function of the combined company for optimum utilization of technological development, which could not be taken up by the separate companies for want of resources.

A key challenge in mergers and acquisitions is their effective implementation as there are chances that mergers and acquisitions may fail because of slow integration. The key is to formulate in advance integration plans that can effectively accomplish the goals of the M&A processes. Since time is money and competitors do not stand still, integration must not only be done well but also done expeditiously.

To implement the objectives of mergers or acquisitions, there are various factors, which are required to be reorganized in the post merged or acquired company. Such factors can be grouped in the followed heads:

### (i) Legal Requirements

Fulfilment of legal requirements in post-merger reorganisation of any amalgamating company becomes essential for an effective and successful venture. The quantum of such obligations will depend upon the size of company, debt structure and profile of its creditors, compliances under the corporate laws, controlling

regulations, distribution channels and dealers network, suppliers relations, labour etc. In all or in some of these cases legal documentation would be involved. If foreign collaborators are involved, their existing agreements would need a mandatory documentation to protect their interests if their terms and conditions so require. Secured debenture holders and unsecured creditors would also seek legal protection to their rights with new or changed management of the amalgamating company. Regulatory bodies like the RBI, Stock Exchanges, the SEBI, etc. would also ensure adherence to their respective guidelines, regulations or directives. In this way, the legal counsel of the amalgamating company or its consultant would have to ensure that the company meets its legal obligations in all related and requisite areas. Issuing shares and other securities to the shareholders of the transferor company and preservation of the books and papers of that company are also the functions required to be carried out after merger.

### **(ii) Combination of operations**

The amalgamating company has to consolidate the operations of the transferor company's operations with its own. This covers not only the production process, adoption of new technology and engineering requirements in the production process but also covers the entire technical aspects like technical know-how, project engineering, plant layout, schedule of implementation, product designs, plant and equipment, manpower requirements, work schedule, pollution control measures, etc. in the process leading to the final product.

Integrating two different technological systems for complex business entities while continuing to run the business can be a massive challenge. It requires proper planning for phased transitions, extensive preparation and intensive testing. It is necessary to define workable implementation plans as to what needs to be integrated, when it should happen and how it can be done successfully.

### **(iii) Top Management Changes**

The takeover or merger of one company with another affects the senior managerial personnel. A cohesive team is required both at the board level as well as at senior executive level. The reorganisation would involve induction of the directors of the transferor company on the Board of the amalgamating company, or induction of reputed and influential persons from outside who have expertise in directing and policy planning to broad base the Board for public image as well as smooth functioning of the company. Selection of directors, finalising their term of holding the office as directors, managerial compensation and other payments or reimbursements of expenses etc. are issues to be sorted out.

At the senior executive level also, changes are required particularly in respect of compensation depending upon the terms and conditions of merger, amalgamation or takeover and to adjust in suitable positions the top executives of the amalgamated company to create a congenial environment and cohesive group leadership within the organisation. Understanding different cultures and where and how to integrate them properly is vital to the success of an acquisition or a merger. Important factors to be taken note of would include the mechanism of corporate control particularly encompassing delegation of power and power of control, responsibility towards accounting, management information system, to and fro communication channels, interdivisional and intra-divisional harmony and achieving optimum results through changes and motivation.

### **(iv) Management of financial resources**

Takeover, merger, amalgamation or demergers facilitate the attainment of the main objectives of achieving growth of the company's operations. Growth is dependent upon the expansion, modernization or renovation or restructuring. Generally, the management plans in advance about the financial resources which would be available to the company to finance its post-merger plans. Such preplanning is based on certain assumptions which might change post-merger depending upon the volatility of a variety of factors involved. Therefore, it is

important to revamp the financial resources of the company to ensure optimum utilisation of the financial resources available and the liquidity requirements. Better debtors' realisation is also important as it improves financial resources and reduces finance costs.

Even in those cases where merger is arranged by the BIFR for revival of a sick unit, the scheme would spell out the financing plans, terms of loans from financial institutions and banks, promoters contribution, etc. but sometimes on happening of certain uncontrollable events these financing plans have got to be verified, reviewed and changed depending upon the change in pre-planned technology adaptation, acceptance or deletion of foreign collaboration or participation, eliminating borrowings from institutions by going public for raising equity and *vice-versa* etc.

### **(v) Financial Restructuring**

Financial restructuring becomes essential in post merger reorganisation. Financial restructuring is characterised by liquidity crisis, 'abnormal' balance sheets and negative equity. The 'clean-up' must happen fast. Replacement of costlier fundings by cheaper borrowings on a long and short term basis as per requirement is one of the several ways and means of financial restructuring for a company. This being an important aspect concerns most of the top management, creditors, bankers, shareholders, regulatory bodies like stock exchange, SEBI as well as the government where provisions of corporate laws are attracted and their permissions or approvals for planned changes are required. Generally, financial restructuring is done as per the scheme of arrangement, merger or amalgamation approved by the shareholders and creditors but in those cases where takeover or acquisition of an undertaking is made by one company of the other through acquiring financial stake by way of acquisition of shares, e.g. IPCL by RIL, reorganisation of financial structure would be a post-merger event which might compel the company to change its capital base, revalue its assets and reallocate reserves. Decisions have to be made regarding raising owners funds or resorting to borrowed funds as per debt bearing capacity of the company or going in for leasing options. These steps are taken in consultation with the financial consultant and auditors of the company.

### **(vi) Rationalisation of Labour Cost**

Post merger reorganisation needs rationalisation of labour cost as it forms the primary factor of prime cost of any product and service. The combined labour force available to the transferee company is to be reviewed in accordance with the requirements of the combined operational functions. With technological upgradation, reduction in labour costs through providing on the job training, motivation, and labour cut by way of voluntary retirement schemes or otherwise forms part of post merger function. This will help in better productivity and higher return on capital employed. The judgement of the Supreme Court of India announced on 30<sup>th</sup> August, 2002 on the petition of Steel Authority of India Limited (SAIL) has cleared a major hurdle to several Public Sector Undertakings (PSUs) which were not employing contract labour due to the fear of having to absorb them in regular jobs. The five judges Bench has relaxed contract labour laws for PSUs by quashing a 1976 notification and held that there will not be automatic absorption of contract labour.

### **(vii) Production and marketing management**

With regard to the size of the company and its operational scale, its product mix should be adjusted during post-merger period. Management has to choose from various alternatives like adding or dropping out products. Decisions are taken on the basis of feasibility studies done by experts covering technoeconomic aspect, cost-benefit analysis of production process, identification of market, customers and their preferences, fixing price of product with targeted mark-up, required rate of return and competitive strength. Decisions are generally taken on the recommendations covering economic analysis based on incremental reasoning, fine-perspective, opportunity cost, etc. Another aspect closely related to production is to improve productivity and

cost-reduction without affecting product quality. This demands attention to the following aspects:

1. Efficiency of management
2. Degree of technological adaptation
3. Size of plant
4. Rate of output and utilisation of existing capacity of fixed assets
5. Productivity and quality of input factors including manpower and material management.

The important economic tools which are used for cost reduction includes the following:

- (1) Short-run and long-run cost analysis techniques.
- (2) Break-even chart is also a tool which is used for adjusting fixed and variable cost to profit volume for desired cost reductions.
- (3) Inventory analysis.
- (4) Linear programming, a recent technique, used in cost reduction by taking into consideration the opportunity cost factor.
- (5) Reviewing input materials in view of substitutes made available and other options.
- (6) Technological improvements.

To tone up production, it is also necessary that available resources are properly allocated for prudent and planned programme for utilisation of scarce and limited resources available to an enterprise so as to direct the production process to result into optimal production and operational efficiency. Resource allocation can be accomplished by a company using the following techniques:

- (a) Production function analysis with one or two or more variables;
- (b) Input output analysis;
- (c) Linear programming when there are more than two variables in the production activity;
- (d) Examining the available options, substitutes and alternative processes.

Revamping of marketing strategy becomes essential, which is accomplished on the basis of market surveys, and recommendation of marketing experts. Marketing surveys may cover both established as well as new products. Pricing policy also deserves attention for gaining competitive strength in the different market segments. Reorganisation of marketing network and rationalisation of marketing strategy is equally important.

### **(viii) Corporate planning and control**

Corporate planning to a large extent is governed by the corporate policy. The management's attitude and promoter's inclinations are amply reflected in the expressions directed towards achievement of corporate goals. Corporate policy prescribes guidelines that govern the decision making process and regulates the implementation of the decisions. Corporate planning is to be done in consonance with the corporate policy which might prescribe the broader frame within which activity is to be restricted, minimum returns to be obtained, optimal utilisation of financial, human and material resources is to be made, delegation and de-centralisation of authority is effected, corporate plan made and implemented, and plans and policies formulated prior to the merger or acquisition reviewed.

Other factors to be considered may, *inter alia*, include the existing and prospective market segments, the product and production activity and the nature of demand. All these factors indicate the future of the concern and the commitments to be fulfilled.

The company planning is associated with the management control so that deviations in the planned targets and achievements are recorded and their causes are traced out for remedial measures. In other words, control, as an activity of management, involves comparison of performance with predetermined standards, ascertaining causes for deviations and prescribing corrective action to reinforce the planned programme. In each area of corporate activities whether it is personnel management, material management, real estate management or financial management, planning is associated with control.

Control techniques which are used by the corporate units would require changes from traditional to modern control techniques.

The traditional control techniques include (1) Budgeting control; (2) Standard costing; (3) Financial ratios; (4) Internal audit, whereas the modern control techniques are: (1) Performance budgeting; (2) Zero Base Budgeting; (3) Programme Planning & Budgeting System (PPBS); (4) Programme Evaluation and Review Technique (PERT) and (5) Critical Path Method (CPM). All these techniques are now computer based for which softwares are easily available.

Review of the control techniques could be better done if responsibility centres are defined. In an organisation there may be four responsibility centres viz. Revenue centres, expense centres, profit centres and investment centres. In revenue centres, the output is measured in monetary terms. These centres relate to marketing activities and sales budget focuses main attention on control systems. In expenses centres, inputs are measured in monetary and quality terms. Profit centres which measure both input and output in terms of expenses and revenue respectively, are created when manufacturing and marketing is done by the same organisation.

These decisions about management structure, key roles, reporting relationships, restructuring, etc. should be made, announced and implemented as soon as possible after the deal is signed. Creeping changes, uncertainty and anxiety that last for months are debilitating and start to drain value from an acquisition.

It would be relevant to mention some of the leading common mistakes, made by the corporates, leading to pitfalls in mergers and acquisition:

1. Ego problems on both sides – buyer and seller – rear up very frequently and resulting clashes make bad situations worse. Trying to have two chiefs is a formula for disaster.
2. Attempt to hasten the integration between both the parties raises the likelihood of making serious errors. Sudden and radical changes such as relocating the company's entire production operations should be carefully considered before implementation.
3. Many buyers assert their ownership by moving quickly to convert the acquired company. This does not always work in the right direction.
4. A cautious approach should be applied to competitor end runs. While the company is focussed on integration, it furnishes an ideal time for competitors to make a run on the market.
5. Unless the acquired business is in the exact same field, different dynamics might apply.
6. One of the most common and damaging mistakes is to lay off crucial employees from the acquired company. This is a very complicated, delicate matter and even the seller might not have an accurate idea as job titles can be misleading.

### 3. INTEGRATION OF BUSINESSES AND OPERATIONS

Recognizing the importance of mergers in the success of a company, it is important to discuss some critical aspects that should be taken into account in the integration stage of a M&A deal:

- Focus on people and their incentives:

Innovation is not a mechanical process but depends on key employees and the incentive structure to which they are subject. These, which are perhaps the most important assets of the firm, are nonetheless not automatically part of the deal but need to be co-opted into it. Just maintaining the R&D budget will not necessarily do the trick. Subtle changes in the vision, leadership or organization of the newly-formed firm can have important effects on how potential innovators perceive the relevant costs and benefits.

- Integrate selectively:

It may make sense to integrate the distribution operations of two employees. It hardly makes sense to integrate their creative units. Competition has to be maintained in the areas where innovation is more important and intense. The areas where the processes are more standardized and less human capital-intensive are in general more amenable to integration.

- Do not delay decisions and communicate clearly the new rules:

As any other economic activity, the efforts put into innovation critically depend on the expected rewards. Delaying or ineffectively communicating the new rules of the game unnecessarily brings additional uncertainty into the process. Highly mobile human capital may well not be very patient.

Suppressing competition with coordination and control may not be a win-win proposition after all. Constant innovation and adaptation is critical for the long-term survival of an organization. Without competition- the fear to fall behind — there is not much rationale for constant re-invention. This fact must be taken into account in the way that the various parts of the new organization are integrated.

#### 4. POST MERGER SUCCESS AND VALUATION

Every merger is not successful. The factors which are required to measure the success of any merger are briefly discussed below.

1. The earning performance of the merged company can be measured by return on total assets and return on net worth. It has been found that the probability of success or failure in economic benefits was very high among concentric mergers. Simple vertical and horizontal mergers were found successful whereas the performance of concentric mergers was in between these two extremes i.e. failure and success.
2. Whether the merged company yields larger net profit than before, or a higher return on total funds employed or the merged company is able to sustain the increase in earnings.
3. The capitalisation of the merged company determines its success or failure. Similarly, dividend rate and payouts also determines its success or failure.
4. Whether merged company is creating a larger business organisation which survives and provides a basis for growth.
5. Comparison of the performance of the merged company with the performance of similar sized company in the same business in respect of (i) Sales, (ii) assets, (iii) net profit, (iv) earning per share and (v) market price of share.

In general, growth in profit, dividend payouts, company's history, increase in size provides base for future growth and are also the factors which help in determining the success or failure of a merged company.

6. Fair market value is one of the valuation criteria for measuring the success of post merger company. Fair market value is understood as the value in the hands between a willing buyer and willing seller, each having reasonable knowledge of all pertinent facts and neither being under pressure or compulsion to buy or sell. Such valuation is generally made in pre merger cases.
7. In valuing the whole enterprise, one must seek financial data of comparable companies in order to determine ratios that can be used to give an indication of the company position. The data is analyzed to estimate reasonable future earnings for the subject company.

The following information must be made available and analyzed for post-merger valuation:

- (i) All year-end balance sheets and income statements, preferably audited, for a period of five years and the remaining period upto the valuation date.
- (ii) All accounting control information relating to the inventory, sales, cost, and profit contribution by product line or other segment; property cost and depreciation records; executives and managerial compensation; and corporate structure.
- (iii) All records of patents, trademarks, contracts, or other agreements.
- (iv) A history of the company, including all subsidiaries.

Analysis of these items provides data upon which forecasts of earnings, cash flow, etc. can be made.

8. Gains to shareholders have so far been measured in terms of increase or decrease in share prices of the merged company. However, share prices are influenced by many factors other than the performance results of a company. Hence, this cannot be taken in isolation as a single factor to measure the success or failure of a merged company.
9. In some mergers there is not only increase in the size of the merged or amalgamated company in regard to capital base and market segments but also in its sources and resources which enable it to optimize its end earnings.
10. In addition to the above factors, a more specific consideration is required to be given to factors like improved debtors realisation, reduction in non-performing assets, improvement due to economies of large scale production and application of superior management in sources and resources available relating to finance, labour and materials.

## 7. HUMAN AND CULTURAL ASPECTS

The merger is a period of great uncertainty for the employees of the merging organizations. The uncertainty relates to job security and status within the company leading to fear and hence low morale among the employees. It is natural for employees to fear the loss of their revenue or change in their status within the company after a merger since many of these employees literally invest their whole lives in their jobs. Hence the possibility of a change in their position is likely to be viewed with fear and resentment. The possibility of a change in compensation and benefits also creates a feeling of insecurity and unease. The influx of new employees into the organisation can create a sense of invasion at times and ultimately leads to resentment. Further, the general chaos which follows any merger results in disorientation amongst employees due to ill defined role and responsibilities. This further leads to frustrations resulting into poor performance and low productivity since strategic and financial advantage is generally a motive for any merger. Top executives very often fail to give attention to the human aspects of mergers by neglecting to manage the partnership in human terms. By failing to give attention to the problems faced by their employees, they fail to fully develop their companies' collaborative advantage.

In such cases what is normally forgotten is the centrality of cultural integration. The issues of cultural integration and the issues of human behaviour need to be addressed simultaneously if not well before the issues of financial and legal integration are considered. Implementation of structural nature may be financially and legally successful. But if cultural issues are ignored, the success may only be transient. Culture of an organisation means the sum total of things the people do and the things the people do not do. Behavioral patterns get set because of the culture. These patterns create mental blocks for the people in the organization. Pre-merger survey and summarization of varying cultures of different companies merging, needs to be carried out. People belonging to the each defined culture need to be acquainted with other cultures of other merging companies. They need to be mentally prepared to adopt the good points of other cultures and shed the blockades of their own cultures. Such an open approach will make the fusion of cultures and ethos easy and effective.

The successful merger demands that strategic planners are sensitive to the human issues of the organizations. For the purpose, following checks have to be made constantly to ensure that:

- sensitive areas of the company are pinpointed and personnel in these sections carefully monitored;
- serious efforts are made to retain key people;
- a replacement policy is ready to cope with inevitable personnel loss;
- records are kept of everyone who leaves, when, why and to where;
- employees are informed of what is going on, even bad news is systematically delivered. Uncertainty is more dangerous than the clear, logical presentation of unpleasant facts;
- training department is fully geared to provide short, medium and long term training strategy for both production and managerial staff;
- likely union reaction be assessed in advance;
- estimate cost of redundancy payments, early pensions and the like assets;
- comprehensive policies and procedures be maintained up for employee related issues such as office procedures, new reporting, compensation, recruitment and selection, performance, termination, disciplinary action etc.;
- new policies to be clearly communicated to the employees specially employees at the level of managers, supervisors and line manager to be briefed about the new responsibilities of those reporting to them;
- family gatherings and picnics be organized for the employees and their families of merging companies during the transition period to allow them to get off their inhibitions and breed familiarity.

### **Cultural Factors and post merger –examples**

#### **1. Acquisition of Wellcome group by Glaxo.**

The classic examples of effective human resource management is the acquisition of Wellcome group by Glaxo.

Wellcome and Glaxo were profoundly different companies, both structurally as well as culturally. Wellcome was more of an academic culture and Glaxo more of a commercial, business driven culture. Everything was different between the companies, from finance to information technology, the structure of sales representatives to legal side. Less diplomatic Glaxo staff saw Wellcome as an over-centralised organisation



with employees who were unrealistic in their expectations for the business's financial success. Academia-like penny-pinching officials had saddled Wellcome with out-of-date information technology.

Wellcome staff, in contrast, saw Glaxo as overly commercial mercenaries assaulting their worthy enterprise and driven by cash. They argued, in its enthusiasm for the latest high-tech research gadgetry the Glaxo officials refused to study tropical diseases where sufferers could not afford western prices.

To try to combat such sentiments, management declared that both old companies were history and decreed that a new company was to be built in its place. But, the most difficult aspect of merger was to lay off staff both on account of closing down of certain manufacturing units as well as to cut down on excess costs. To overcome the difficulties, management offered a very lucrative package. The solution was expensive but unavoidable, given that Glaxo management was trying not to give the impression that it was steamrolling Wellcome.

In France, the company established an organisation called Competence Plus, comprising employees who had been made redundant. They were guaranteed up to 15 months on full salary and given training courses on everything from "networking" to new skills. They were also the first to be interviewed for any vacancies that arose within the new group during that period. Employees hired by other companies for trial periods had their salaries paid by Glaxo-Wellcome. For those who remained, there were improvements too. Glaxo staff worked a 39-hour week, whereas Wellcome did 37 hours. Now Glaxo-Wellcome people work 37 hours. "We were concerned not to make mistakes in the social sphere," said Mangeot, the Chairman of Glaxo-Wellcome, France.

## **2. Hindustan Lever Ltd. (HLL) and Tomco merger**

In Hindustan Lever Ltd. (HLL) and Tomco merger case, HLL had been known for its result oriented, systems driven work environment, where a strong emphasis is placed on performance. Accordingly, it always has/had and strives for a team of high performing and high profile executives, carefully selected from the best management institutes. Discussing product profitability and target achievement is the only language that its managers understand. The work culture is very demanding and only the best survive. In fact, about 100 managers at that time for Unilever group companies had quit their jobs, as they were unable to cope with the demanding work culture.

It was felt that the more difficult part would be the management of the two very different work cultures and ethos, after the merger. In TOMCO the employee productivity was only 60% of HLL. It was opined that HLL would have to rationalize TOMCO's work force. HLL itself had launched a voluntary retirement package, in order to get rid of about 500 workers, however only a few resigned. However TOMCO employees had been assured that their employment conditions were to be protected and service conditions would be honoured. All the employees of TOMCO were to be absorbed as HLL employees.

It is probably not an exaggeration to assert that most cross-border deals run into difficulties because of failures in the integration process. What is acquisition integration? First and foremost, it is the process of realizing the strategic benefits of a merger. In other words, it is everything merging companies must do to achieve synergies and position the new firm for growth. It requires effective interaction and coordination between merging firms to realize the strategic potential of the deal at the same time that it necessitates special attention to human resource concerns. Stated in this way, it is a tall order, and indeed seems absolutely critical to M&A success.

Differences among management and workers can sometimes spiral into broader community and political problems. Such was the case in the 1988 acquisition of Rowntree, headquartered in York, England by Nestle, the Swiss foods giant. Concerns about the future of Rowntree workers, facilities, and even the town

of York itself created uproar in the UK, involving Members of Parliament, political parties, and the Archbishop of York. In the end, Nestle was forced to make several concessions to public opinion in its integration of Rowntree, including retaining York facilities and making certain guarantees with respect to the job security of Rowntree workers.

## 8. MEASURING POST-MERGER EFFICIENCY

The criterion to judge a successful merger differs in different conditions. Different factors may be considered for making value judgements such as growth in profit, dividend, company's history, increase in size, base for growth etc. Several studies suggest different parameters to assess the success of mergers:

- (i) Successful merger creates a larger industrial organization than before, and provides a basis for growth [Edith Perirose].
- (ii) In Arthur Dewing's study, three criteria were considered viz. (a) merger should give a larger net profit than before (b) merger should provide a higher return on total funds (c) there should be a sustained increase in earnings.
- (iii) Earnings on capitalization and dividend records determine the success of merger [Shaw L.].

During the studies in late 1960s, two types of efficiency improvements were expected to result from mergers: (1) improvements due to economies of large scale production (2) application of superior management skills to a larger organisation. Some other researches in the seventies and eighties, measure efficiency based on stock market measures, labour productivity or total factor productivity etc. These improvements pointed towards market dominance, but for gauging efficiency, resultant profitability was accepted as a benchmark. In order to ensure progress, a conscious and concerted effort to keep track of several key elements is required, alongwith answers to the following questions:

1. What impact is the integration (merger/acquisition) having on key indicators of business performance? Whether synergies which were hypothesized during the valuation are being realized?
2. Are the activities and milestones developed with the integration process on target?
3. What are the major issues emerging during the integration, requiring considerable attention?
4. What important facts have emerged during the merger or acquisition that can be used to improve subsequent mergers or acquisition?

## MEASURING KEY INDICATORS

The main purpose of a merger or acquisition is to deliver the expected financial results namely earnings and cash flow. However, there are certain other measures that serve as key indicators and they also need to be measured. The indicators may be grouped as:

- (i) Financial outcomes.
- (ii) Component measures of these outcomes namely revenues, costs, net working capital and capital investments.
- (iii) Organisational indicators such as customers, employees and operations.

All the areas being integrated and both the acquirer and target, or in a merger, both partners, should be brought within the ambit of continuous appraisal. Also, the appraisal should be based on benchmarks to ensure that merger or acquisition are yielding the financial and strategic objective so intended and are not resulting in value leakage.

There are broadly four possible reasons for business growth and expansion which is to be achieved by the merged company. These are (1) Operating economies, (2) Financial economies, (3) Growth and diversification, and (4) Managerial effectiveness. These are explained in detail below:

### 1. Operating Economies

Whenever two or more firms combine, certain economies are likely to be realised as a result of larger volume of operations resulting in economies of scale. These economies may arise due to better utilisation of production capacities, distribution network, engineering services, research and development facilities and so on. The operating economies (economies of scale) would be the maximum in the case of horizontal mergers where intensive utilisation of production capacities will result in benefits for the merged firm.

On the other hand, in the case of vertical mergers, the benefits would accrue from better co-ordination of facilities, both backward and forward, reduction in inventory levels and higher market power of the combined firms. Operating economies in the form of reduction or elimination of certain overhead expenses may also arise even in the case of conglomerate mergers. The net result of realising economies of scale would be a decrease in the cost of production. But if the scale of operations or size of the merged firm becomes too large and unwieldy, then 'dis-economies' of scale may also arise and the unit cost of production would show a rising trend.

### 2. Financial Economies

Merger of two or more firms brings about the following financial advantages for the merged firm:

#### (a) *Relief under the Income Tax Act*

Under Section 72A of the Income Tax Act, 1961 carry forward and setting off of accumulated losses and unabsorbed depreciation of the amalgamating company is allowed against the future profits of the amalgamated company in order to encourage revival of sick units.

#### (b) *Higher Debt Capacity*

The merged firm would enjoy higher debt capacity because the combination of two or more firms provide greater stability to the earnings level. This is an important consideration for the lenders since the possibility of default in repayment of loan and interest is reduced to a great extent. A higher debt capacity if utilised, would mean greater tax advantage for the merged firm leading to higher value of the firm.

#### (c) *Reduction in Floatation Costs*

Whenever the merged firm raises funds from the market through public issue of shares or debentures, it can reduce the floatation costs as compared to the similar amount being raised independently by the merging firms. Such reduction in the floatation costs represents a real benefit to the merged firm.

Apart from the above, earnings and cash flows are primary financial outcomes that need to be tracked since valuation are built on them. Particular attention should be given to the components of these measures, namely, revenue, costs, investments and net working capital. The extent to which these components show progress will determine whether value is being created or not.

### 3. Growth and Diversification

As stated earlier, merger/amalgamation of two or more firms has been used as a dominant business strategy to seek rapid growth and diversification. The merger improves the competitive position of the merged firm as it can command an increased market share. It also offers a special advantage because it enables the merged firm to leap several stages in the process of expansion. In a saturated market, simultaneous expansion and replacement through merger/takeover is more desirable than creating additional capacities through expansion.

A merger proposal has a very high growth appeal, and its desirability should always be judged in the ultimate analysis in terms of its contribution to the market price of the shares of the merged firm.

The merged firm can also seek reduction in the risk levels through diversification of the business operations. The extent to which risk is reduced, however, depends on the correlation between the earning of the merging (combining) firms. A negative correlation between the combining firms is less risky whereas a positive correlation is more risky.

The business firm may pursue the objective of diversification with maximum advantage under the following circumstances:

- (1) If a firm is saddled with problems which can lead to bankruptcy or jeopardise its very existence, then its merger with another firm can save it from such undesirable consequences. Indian industrial sector is faced with the problems of the creation of splintered capacities. As a result, many firms with minimum economic size, such as manufacturers of light commercial vehicles, mini steel plants, mini paper plants, mini dry cell battery plants, mini sponge iron plants, mini cement plants, etc. were created. Many of these units have either closed down or are incurring substantial losses. A few of them, though earning profits today, may fall sick in future due to the increasing competition. In such a situation mergers and takeovers can bring about consolidation of capacities, lead to the revival of sick units and also prevent the occurrence of sickness.
- (2) If the shares of one of the combining firms are not traded at the stock exchange then creative diversification would be the only feasible route to reduce the level of risk for the investment in these firms.

#### **4. Managerial Effectiveness**

It has been pointed out by various studies that incompetency of management has been the most important reason for firms becoming sick. If a sick firm is merged with another well managed company, it will lead to better co-ordination of human resources of both the companies. Managerial effectiveness can also bring substantial gains to the merging firms if two well managed firms combine together to take advantage of valuable human resources.

##### *Customer Reactions*

It is necessary to ensure that customers are not adversely affected during a merger or acquisition as losing either profitable customers or a percentage of their business may have a negative impact on earnings and cash flows, especially if the customer represents a large percentage of company's revenues and profits. Several indicators may be deployed such as customer satisfaction, retention, acquisition, market share etc. Keeping track of market value and sales volume of each segment is also useful. Often during mergers and acquisitions competitors attempt to disrupt the relationship between an acquirer and its customers. This implies that a company needs to do more than just maintain customer relationships. It has to make an extra effort to ensure that its business does not erode.

##### *Employee Reactions*

Employees are capable of having an impact on productivity and customer satisfaction, especially in service business. Employee assessments made at multiple times and with relevant measures may allow better changes to take place. It should be analysed whether employees understand the expected contribution to be made to new organization; the view of employees towards various aspects of organisation and leadership; commitment to the newly formed organization; performance and productivity expected etc.

Successfully integrating two or more organizations after a merger requires many things, but above all, it requires strong effective leadership, a plan, and a commitment to ongoing evaluation and adaptation. It must be ensured that both the integration process and the programmatic work of the organization continue to move forward in tandem.

An integration plan is also essential. Leaders with experience in integrating two or more organizations emphasise the need for a plan than almost any other factor for success in integration. It was concluded in a series of interviews conducted with leaders who had been through a merger that a integration plan was a key factor for success.

Lastly, an organization and its leadership must be proactive in evaluating progress throughout the integration process. Its desired outcomes and outcome targets must be regularly revisited and progress against them must be measured. A thoughtful leader will be responsive to such ongoing evaluation, and adapt both the integration plan and the organization's course of action accordingly.

A successful integration 'moulds' not only the various technical aspects of the businesses but also the different cultures. The best way to do so is to get people working together quickly to solve business problems and accomplish results that could not have been achieved before.

Thus, the aspect of post-merger reorganisation is not exhaustive and the parameters of the same would have to be established by the management of the companies, depending upon the organisational requirements, corporate policies and plans and the objectives of the merger etc. sought to be met.

### LESSON ROUND UP

- 'Post-merger reorganization' is a wide term which encompasses the reorganization of each and every aspect of the company's functional areas to achieve the objectives planned and aimed at.
- There are certain parameters to measure post merger efficiency. Some of them are - successful merger creates a larger organization than before, net profit is more, there is sustained increase in earnings, continuous dividend distribution etc.
- There are broadly four possible reasons for business growth and expansion which is to be achieved by the merged company. These are (1) Operating economies, (2) Financial economies, (3) Growth and diversification, and (4) Managerial effectiveness.
- There is a spurt of mergers and acquisitions in the last two to three years as is evident from the recent acquisition of Anglo Dutch steel company Corus by India based Tata Steel. Other recent examples are suitably discussed under the chapter.
- To implement the objectives of mergers or acquisitions, some factors are required to be considered for post merger integration – legal requirements, combination of operations, top management changes, management of financial resources, rationalization of labour cost, production and marketing management and corporate planning and control.
- Human and cultural integration is central to the success of any merger.
- Fair market value is one of the valuation criteria for measuring the success of post merger company. In valuing the whole enterprise, one must seek financial data of comparable companies in order to determine ratios that can be used to give an indication of the company's position.
- The earning performance of the merged company can be measured by return on total assets and return on net worth.
- In general, growth in profit, dividend payouts, company's history and increase in size provides the base for future growth and are also the factors which help in determining the success or failure of a merged company.

## SELF TEST QUESTIONS

(These are meant for recapitulation only. Answers to these questions are not required to be submitted for evaluation).

1. Enumerate the main objectives which companies seek to attain, from mergers.
2. What are the factors to be kept in mind for a post merger reorganisation?
3. How can post merger efficiency be measured? Enumerate the main parameters involved.
4. Briefly explain the factors relevant for post-merger evaluation and analyse its success.

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# Lesson 13

## Case Studies

### LESSON OUTLINE

- Demerger –L&T
- Overseas Acquisition – Tata Corus deal
- Merger of ICICI with ICICI Bank
- Slump sale – Piramal to abbott
- Dr Reddy Laboratories- Multiple restructuring strategies.
- Leveraged buy- out – Bharti-Zain
- Overseas Acquisition – Daiichi RanBoxy
- Acquisition – Patni by IGate.

### LEARNING OBJECTIVES

Restructuring may make in various forms depending upon various factors like profitability, availability of resources, management of competition and such forms may be acquisition, merger, takeovers, leveraged buy outs, slump sale, overseas acquisition etc., The case studies discussed in this lesson would enable the students to understand the purpose, issues, operational mechanism in general of different types of restructuring strategies that would ultimately results in better conceptual understanding of different strategies, benefits, purpose its synergies etc.,

## CASE STUDIES

### 1. DEMERGER - LARSEN & TOUBRO LIMITED

#### Introduction

L&T was established in 1942. Within a span of fifty years L&T became a leading manufacturer and engineer in turnkey projects having diversified activities in electrical and electronics; construction projects; cement manufacturing; medical equipment; shipping; earthmoving equipment; heavy engineering and information technology. From the year 2000, the company was planning to restructure some of its business divisions through demerger and consolidation in order to concentrate more on infrastructure and turnkey businesses.

#### Why demerger?

Grasim Industries Ltd. (GIL) a flagship company of Aditya Birla Group was trying to take over control in L&T management by purchasing shares of L&T from the open market. The company first acquired 15 percent stake in L&T and also made an open offer to L&T shareholders to increase its stake which does not succeed. In the year 2004, shareholders approved the demerger of L&T's cement division with a resulting entity named UltraTech CemCo Ltd. (UCL).

#### Demerger: The Three phases

##### *First Phase*

It was decided that in the first phase L&T would spin off the cement business into a new company, UltraTech CemCo Ltd. (UCL), where L&T would hold 20 percent and the balance of 80 percent would be held by existing shareholders of L&T.

##### *Second Phase*

In the second phase, GIL would buy 8.5 percent of UCL from L&T @ ₹ 342.60 per share and make an open offer to other shareholders of another 30 percent at the same price. It would take GIL's stake to 51 percent in UCL, if this offer was fully subscribed, and on the sale of its stake in UCL, L&T would realize ₹ 3.62 billion.

##### *Third Phase*

In the third phase, L&T Employee Welfare Foundation would acquire the GILs 15.3 percent stake in the residual engineering company.

Hence, after the demerger, GIL gave an open offer to UCL shareholders and purchased the shares to cover a 51 percent hold in UCL. Immediately after the acquisition, GIL finally changed the name from UltraTech CemCo Ltd. to UltraTech Cement Ltd.

#### The demerger ratio

As per the demerger ratio, for every 2 shares (of face value ₹ 10) held in L&T, the shareholder was given 1 share (face value ₹ 2) in the New L&T.

At the same time for every 5 shares held in L&T, the shareholder was given 2 shares in the demerged cement company – Ultra Tech CemCo.



**Benefits of Demerger to L&T**

- Lead to immediate realization of value from cement business;
- Create two distinct listed entities for (a) engineering and (b) cement;
- Enable L&T to become focussed Engineering, Construction and Technology Company

**Benefits of Demerger to Grasim**

- Economies of scale and overall competitiveness
- Multi-functional synergies in the areas of procurement, marketing, logistics and cost reductions
- Combined resource pool
- Cross leverage financial strengths to access domestic and international markets
- Increased Capacity.

**2. OVERSEAS ACQUISITION – TATA - CORUS DEAL**

This acquisition of Corus Group Plc by Tata Steel Limited (TSL), was the biggest overseas acquisition by an Indian company. TSL emerged as the fifth largest steel producer in the world after the acquisition. The acquisition gave Tata Steel access to Corus' strong distribution network in Europe.

Tata Steel had first offered to pay 455 pence per share of Corus, to close the deal at US\$ 7.6 billion on October 17, 2006. CSN then counter offered 475 pence per share of Corus on November 17, 2006. Within hours of Tata Steel increasing its original bid for Corus to 500 pence per share, Brazil's CSN made its formal counter bid for Corus at 515 pence per share in cash, 3% more than Tata Steel's Offer.

Finally, an auction was initiated on January 31, 2007, and after nine rounds of bidding, TSL could finally clinch the deal with its final bid 608 pence per share, almost 34% higher than the first bid of 455 pence per share of Corus. The deal (between Tata & Corus) was officially announced on April 2nd, 2007 at a price of 608 pence per ordinary share in cash.

Indian Steel Giant Tata Steel Limited (TSL) finally acquired the Corus Group Plc (Corus), European steel giant for US\$ 13.70 billion. The merged entity, Tata-Corus, employed 84,000 people across 45 countries in the world. It had the capacity to produce 27 million tons of steel per annum, making it the fifth largest steel producer in the world as of early 2007.

**Tata Corus Deal Synergy**

1. Tata was one of the lowest cost steel producers in the world and had self sufficiency in raw material. Corus was fighting to keep its productions costs under control and was on the look out for sources of iron ore.
2. Tata had a strong retail and distribution network in India and South East Asia and was a major supplier to the Indian auto industry and hence there would be a powerful combination of high quality developed and low cost high growth markets.
3. Technology transfer and enhanced R&D capabilities between the two companies that specializes in different areas of the value chain.
4. There was a strong culture fit between the two organizations both of which highly emphasized on continuous improvement and ethics, i.e. 'The Corus Way' with the core values and code of ethics, integrity, creating value in steel, customer focus, selective growth and respect for people etc. were strong synergies.

## **BANKING SECTOR MERGER**

### **3. MERGER OF ICICI WITH ICICI BANK**

#### ***ICICI Limited***

ICICI Limited was basically a Development Financial Institution providing medium-term or long-term project finance to industries in India. It was formed in 1955 at the initiative of the World Bank, the Government of India and representatives of Indian industry. Initially it focused on project finance, and providing long-term funds to a variety of industrial projects. Subsequently, it diversified into venture capital financing, commercial banking asset management and management of mutual funds brokering and marketing, internet stock trading, housing finance etc.

#### ***ICICI Bank***

ICICI Bank was originally promoted in 1994 by ICICI Limited, an Indian financial institution, and was its wholly-owned subsidiary. ICICI's shareholding in ICICI Bank was reduced to 46% through a public offering of shares in India in fiscal 1998, and an equity offering in the form of ADRs listed on the NYSE in fiscal 2000,

#### ***RBI Announcement***

The RBI announced in April, 2001 that it would consider proposals from Development Financial Institutions wishing to transform themselves into banks.

#### ***The Merger***

After consideration of various corporate structuring alternatives in the context of the emerging competitive scenario in the Indian banking industry, and the move towards universal banking, the managements of ICICI and ICICI Bank formed the view that the merger of ICICI with ICICI Bank would be the optimal strategic alternative for both entities, and would create the optimal legal structure for the ICICI group's universal banking strategy. The merger would enhance value for ICICI shareholders through the merged entity's access to low-cost deposits, greater opportunities for earning fee-based income and the ability to participate in the payments system and provide transaction-banking services. The merger would enhance value for ICICI Bank shareholders through a large capital base and scale of operations, seamless access to ICICI's strong corporate relationships built up over five decades, entry into new business segments, higher market share in various business segments, particularly fee-based services, and access to the vast talent pool of ICICI and its subsidiaries

In October 2001, the Board of Directors of ICICI and ICICI Bank approved the merger of ICICI and two of its wholly-owned retail finance subsidiaries, ICICI Personal Financial Services Limited and ICICI Capital Services Limited, with ICICI Bank.

The merger was approved by shareholders of ICICI and ICICI Bank in January 2002, by the High Court of Gujarat at Ahmedabad in March 2002, and by the High Court of Judicature at Mumbai and the Reserve Bank of India in April 2002.

Consequent to the merger, the ICICI group's financing and banking operations, both wholesale and retail, have been integrated in a single entity.

### **4. SLUMP SALE (BUSINESS TRANSFER) – BY PIRAMAL TO ABBOTT**

Slump sale means the transfer of one or more undertakings as a result of the sale, for a lump sum consideration, without values being assigned to the individual assets and liabilities.

The acquisition of the domestic formulations business by Abbott Healthcare Private Limited (“**AHPL**”), an Indian subsidiary of Abbott Laboratories, USA (“**Abbott Lab**”), from Piramal Healthcare Limited (“**PHL**”). During May 2010 PHL declared the execution of definitive agreements with Abbott Lab for the sale of its Formulation Business to AHPL by way of a business transfer as a going concern. The acquisition of the Formulation Business was done for a total consideration of USD 3.72 billion. The assets transferred include PHL’s manufacturing facilities at Baddi, Himachal Pradesh and rights to approximately 350 brands and trademarks.

The transaction for sale of the Formulation Business was structured as a slump sale/Business Transfer under Section 293(1)(a) of the Companies Act pursuant to a Business Transfer Agreement dated May 21, 2010 entered into between PHL and AHPL. The said Business Transfer involves the transfer of all the assets and liabilities of the Formulation Business excluding cash and cash equivalents and any liability relating to indebtedness of the Company, taxes, employee and other claims, environmental matters and any actual or potential litigation.

The Business Transfer has been undertaken for an all cash consideration of USD 3.72 billion. Out of the said amount USD 2.12 billion would be payable by AHPL to Piramal Healthcare on closing of the sale and a further USD 400 million payable upon each of the subsequent four anniversaries of the closing commencing in 2011.

### **Business Transfer requires approval of the shareholders only and not the high court**

Section 293(1)(a) of the Companies Act mandates every company to obtain prior approval of its shareholders to undertake a sale of whole or substantial part of its undertaking. Such an approval has to be obtained by way of an ordinary resolution (simple majority). Besides, the Companies (Passing of the Resolution by Postal Ballot) Rules, 2001, makes it mandatory for all listed companies to obtain such approval of shareholders by way of a postal ballot and not in any ordinary meeting of shareholders. Further Transfer of business undertaking need not be approved by the High Courts. Accordingly, pursuant to the approval of the board of directors of the Company on May 21, 2010, necessary steps were taken to seek the approval of equity shareholders of Piramal Healthcare vide postal ballot. The results of the said postal ballot were announced on June 25, 2010 and both the resolutions mentioned above were approved by the shareholders of Piramal Healthcare by an overwhelming majority.

### **Non-Compete clause**

The business transfer agreement has a Non-Compete clause which prohibits Piramal Enterprises, Piramal Healthcare and their respective associates from engaging in any business that competes with the Formulation Business either in India or in the emerging markets for a period of eight years from the date of closing of the Business Transfer.

### **Slump sale – Tax liability is more**

In comparison to demerger, slump sale is not generally tax efficient as the transfer of assets could be subject to capital gains tax in the hands of the transferor. Where the undertaking being transferred was held for more than 3 years prior to the date of the slump sale, the gains from such a sale would qualify as long-term capital gains, and the effective rate of tax would be 20%. If the undertaking had been held for 3 years or any period lesser than that, prior to the date of slump sale, then the income would be taxable as short-term capital gains, the effective rate of which is currently 30%. Also, any distribution by the company to its shareholders could attract dividend distribution tax.

## 5. MULTIPLE CORPORATE RESTRUCTURING – REDDY LABORATORIES LIMITED

### Introduction

Established in 1984, Dr. Reddy's Laboratories (NYSE: RDY) is an emerging global pharmaceutical company.

As a fully integrated pharmaceutical company, the purpose is to provide affordable and innovative medicines through three core businesses:

- Pharmaceutical Services and Active Ingredients, comprising Active Pharmaceuticals and Custom Pharmaceuticals businesses;
- Global Generics, which includes branded and unbranded generics; and
- Proprietary Products, which includes New Chemical Entities (NCEs), Differentiated Formulations, and Generic Biopharmaceuticals.

The products are marketed globally, with a focus on India, US, Europe and Russia.

Its strong portfolio of businesses, geographies and products gives it an edge in an increasingly competitive global market and allows to provide affordable medication to people across the world, regardless of geographic and socio-economic barriers. Its Restructuring process over a period of decade has resulted in financial and geographic expansion, market leadership etc.

**The following table provides the chronology of growth through various restructuring Strategies.**

	<i>Event</i>	<i>Year</i>
1	Incorporation	1984
2	Became Public Limited Company	1985
3	IPO	1986
4	Acquires Benzex Laboratories Pvt. Limited to expand its Bulk Actives business	1988
5	Makes a GDR issue of USD 48 million	1994
6	Acquisition of Controlling Stakes at American Remedies Limited	1999
7	Listing on NewYork Stock Exchange	2001
8	First overseas acquisition-Meridian Healthcare	2002
9	Acquires Trigenesis gives access to drug delivery technology platforms	2004
10	Key acquisition: Falcon (Mexico)	2005
11	Key acquisition: betapharm (Germany)	2006
12	Acquisition of Dowpharma's Small Molecules business associated at Mirfield and Cambridge sites in UK	2008
13	Acquisition of BASF's facility at Shreveport, US	2008
14	Announces strategic alliance with GlaxoSmithKline plc to develop and market select products across emerging markets outside India.	2009
15	Reorganizes Drug Discovery Operations to merge into Aurigene, a wholly owned independent subsidiary of Dr. Reddy's	2009

The analysis of above chronology of restructuring events reveals that the restructuring has taken in the following forms.

- Domestic Acquisitions
- Overseas acquisitions
- Domestic and overseas Listing
- Internal reorganization etc.

## 6. LEVERAGED BUY-OUT – BHARTI - ZAIN DEAL

A leveraged buyout, is an acquisition of a company or its division majorly financed with borrowed funds. The acquirer resorts to a combination of a small investment and a large loan to fund the acquisition. The loan capital is availed through a combination of repayable bank facilities and/or public or privately placed bonds. Alternatively, the acquiring company could float a Special Purpose Vehicle (“SPV”) as a 100% subsidiary with a minimum equity capital. The SPV can leverage this equity to gear up significantly higher debt to buyout the target company. The target company's assets can be used as collaterals for availing the loan and once the debt is redeemed, the acquiring company has the option to merge with the SPV. The debt will be paid off by the SPV using the cash flows of the target company. The purpose of leveraged buyouts is to allow companies to make large acquisitions without having to commit a lot of capital.

Bharti started its telecom services business by launching mobile services in Delhi (India) in 1995. Since then there has been no looking back and Bharti Airtel, the group's flagship company, has emerged as one of top telecom companies in the world and is amongst the top five wireless operators in the world. Through its global telecom operations Bharti group has presence in 21 countries across Asia, Africa and Europe. Over the past few years, the group has diversified into emerging business areas in the fast expanding Indian economy.

Zain was established in 1983 in Kuwait as the region's first mobile operator. It is a public company engaged, together with its subsidiaries, in the provision of mobile telecommunication and data services, including operation, purchase, delivery, installation, management and maintenance of mobile telephones and paging systems in Kuwait and 21 other countries in the Middle East and North Africa. Its wholly owned subsidiaries include; Mobile Telecommunications Company Lebanon (MTC) SARL, Lebanon, and Sudanese Mobile Telephone (Zain) Company Limited, Sudan. Wholly owned subsidiary of Zain, incorporated in Netherlands and held the African operations of Zain. The company was originally named Celtel which was acquired by Zain in 2005 and renamed as Zain International BV. The same has been acquired by Bharti Airtel now through Bharti Airtel Netherlands BV.

During the first quarter of 2010, Bharti Airtel announced that it had entered into exclusive agreement with Mobile Telecommunications Company KSC (“Zain”) for the acquisition of Zain Africa International BV (“Zain Africa”) and thereby the entire African operations of Zain, excluding the operations in Sudan and Morocco. The deal makes Bharti Airtel the seventh largest mobile group in the world by subscriber connections and the second-largest African operator, behind MTN for an offer of USD 10.7 billion. In the Indian telecom space, the deal is the second largest after the USD 11.2 billion (approximately) Vodafone Hutchison transaction in 2007.

### Funding through Special Purpose Vehicles

The acquisition deal was structured as a leveraged buyout and the loan for financing the transaction has been availed by the two Special Purpose Vehicles created in Netherlands and Singapore for this purposes. These SPVs, whose dealings will be guaranteed by Bharti, will own the African assets of Kuwait's Zain.

SPVs, which mostly feature in large acquisitions, are often used to convey the impression to investors that companies are not taking huge dollops of debt. In this instance, the SPV has to repay the debt from the cashflows of the African business. But Bharti will have to step in case of a default. Thus, Bharti Airtel has structured the acquisition strategically and routed it through the SPVs keeping Bharti Airtel's standalone financials intact. However, that does not absolve Bharti Airtel from overall responsibility of a borrower since it has provided a guarantee to bankers for the loan that will be in the SPV's books.

## 7. OVERSEAS ACQUISITION – DAIICHI - RANBAXY

Ranbaxy Laboratories Limited., India's largest pharmaceutical company, is an integrated, research based, international pharmaceutical company producing a wide range of quality, affordable generic medicines, trusted by healthcare professionals and patients across geographies. Ranbaxy's continued focus on R&D has resulted in several approvals in developed markets and significant progress in New Drug Discovery Research. The Company's foray into Novel Drug Delivery Systems has led to proprietary 'Platform technologies' resulting in a number of products under development. The Company is serving its customers in over 125 countries and has an expanding international portfolio of affiliates, joint ventures and alliances, ground operations in 49 countries and manufacturing operations in 11 countries.

Daiichi Sankyo Company was established in 2005 through the merger of two leading Japanese pharma companies. This integration created a more robust organization that allows for continuous development of novel drugs that enrich the quality of life for patients around the world. A central focus of Daiichi Sankyo's research and development are thrombotic disorders, diabetes, hypertension etc.

Ranbaxy and the Singh family, the largest and controlling shareholders of Ranbaxy (the "Sellers"), entered into a binding Share Purchase and Share Subscription Agreement (the "SPSSA") with Daiichi Sankyo, pursuant to which, Daiichi Sankyo to acquire the entire shareholding of the Sellers in Ranbaxy and further seek to acquire the majority of the voting capital of Ranbaxy at a price of Rs 737 per share with the total transaction value expected to be between US\$3.4 bn to US\$4.6 bn. On the post closing basis, the transaction would value Ranbaxy at US\$8.5 bn.

### Highlights of the Acquisition

- To take the Company to a new orbit and a higher growth trajectory
- To catapult the combined entity as the World's 15th biggest drug maker
- To become the largest generic Company in Japan, the world's second largest pharma market
- Complementary business model • Global reach covering mature and emerging markets
- Strong growth potential
- Cost competitiveness

### Acquisition stages

<i>Date</i>	<i>Particulars</i>
June 11, 2008	Signing of Agreement by Daiichi with Ranbaxy and its Promoters
June 14, 2008	Public announcement by Daiichi to the shareholders of Ranbaxy to acquire additional 20% equity shares at ₹737 per share under the Takeover Code.

June 27, 2008	Submission of draft letter of offer by Daiichi to SEBI for its observations.
July 15, 2008	Approval of preferential allotment of equity shares and warrants to Daiichi by the shareholders of Ranbaxy.
August 16, 2008	Opening of open offer
September 4, 2008	Closing of open offer
October 15, 2008	Acquisition of 20% equity stake by Daiichi pursuant to open offer
October 20, 2008	Ranbaxy becomes subsidiary of Daiichi upon increase in Daiichi's stake to 52.5% (including preferential allotment and transfer of 1st tranche shares from Promoters)
November 7, 2008	Daiichi acquires balance 11.42% shares from the Promoters off the stock market and the deal is concluded. Daiichi's equity stake in Ranbaxy reached up to 63.92%

### Approvals Obtained

Ministry of Finance mandates prior approval of FIPB, if the foreign investor is already having an existing joint venture or technology transfer / trademark agreement in the 'same' field, as on January 12, 2005. Since Daiichi was already holding equity stake in Uni-Sankyo Limited, a company engaged in 'same' business as Ranbaxy, prior approval of FIPB was obtained. As this foreign investment required prior approval of Cabinet Committee on Economic Affairs (CCEA), the clearance was received from CCEA by Daiichi in the month of October, 2008.

### Synergies

The Synergies are

1. Their respective presence in the developed and emerging markets. Ranbaxy's strengths in the 21 emerging generic drug markets can allow Daiichi Sankyo to tap the potential of the generics business,
2. Both Daiichi Sankyo and Ranbaxy possess significant competitive advantages, and have profound strength in striking lucrative alliances with other pharmaceutical companies.
3. R&D perhaps playing the most important role in the success of these two players.
4. The patent perspective of the merger clearly indicates the intentions of both companies in filling the respective void spaces of the other and emerge as a global leader in the pharmaceutical industry.

According to Ranbaxy newsletter it will provide a new and stronger platform to harness Ranbaxy's capabilities in drug discovery/development, manufacturing and global reach, helping it establish a significant milestone in the Company's mission of becoming a '*Research based International Pharmaceutical Company*'.

This transaction will create significant long-term value for all stakeholders through:

- A complementary business combination that provides sustainable growth by diversification, that spans the full spectrum of the pharmaceutical business;
- An expanded global reach that enables leading market positions in both mature and emerging markets with proprietary and nonproprietary products;

- Strong growth potential by effectively managing opportunities across the full pharmaceutical life cycle, cost competitiveness by optimizing usage of R&D and manufacturing facilities of both companies, especially in India.
- Ranbaxy will be able to leverage its extensive front-end presence through a larger product flow and ascend the pharma value chain by enhancing drug discovery capabilities. It will also widen the scale and scope of the biosimilars opportunity.

Ranbaxy has also established the 'Synergy Office' in July 2009 which has the task of promoting synergies and thereby helping maximize the opportunities for Ranbaxy and Daiichi Sankyo to expand their global operations.

Pharmaceutical companies are working together on a number of areas including drug discovery and development, marketing and manufacturing. Surely a healthy trend, it will go a long way in addressing the growing imperative of the global pharmaceutical industry to lower the cost of medicines while addressing availability challenges around the world.

### SPECIFIC ISSUES IN SPECIFIC CASES

A. Whether any person other than the shareholders and creditors have right to intervene in the proceedings concerning scheme of arrangement / reconstruction?

Mumbai High Court ruled that a person who is neither a shareholder nor a creditor of the company has no right to appear in the proceeding under Section 391/ 394. The court held that the basic principle underlying in the provisions under Section 394 is that the scheme has the approval of the prescribed majority of the company's shareholders and creditors should not also be unfair, contrary to public policy, unconscionable or against law. Once the court finds that the parameters set out in Section 394 have been met, the court would have no further jurisdiction to sit in appeal over the commercial wisdom of the class of persons who with their eyes open have given their approval even if, in the view of the court a better scheme could have been adopted. The anxiety of the court should be that the scheme is approved by all classes and that the company is permitted to continue its corporate existence [*Shree Niwas Girni Kamagar Kruti Samiti v. Ranganath Basudev Somani* (2005) 68 CLA 351 (Bom)].

B. Can shareholders seek an amendment to the swap ratio in a scheme of merger?

The Mumbai High Court held that the swap ratio forms integral part of a scheme of amalgamation and the procedural provisions embodied in the Companies (Court) Rules, 1959 give effect to this basic purpose and object. The exchange ratio is a matter of expert determination. Since it constitutes the foundation of the scheme of amalgamation any amendment to it will nullify that basis. Hence the chairman of the meeting is justified in ruling that any amendment to the swap ratio that was proposed at the meeting by a member was not in order. [*Dinesh Veajlal Lakhani v. Parke Davis (India) Ltd.* [2005] 66 CLA 91 (Bom)].

### ACQUISITION OF PATNI BY IGATE

In this acquisition, the acquirers were Pan-Asia iGate Solutions, a company incorporated under the laws of the Republic of Mauritius and iGate Global Solutions Limited, a company incorporated under the Companies Act, 1956; Person acting in concert was iGate Corporation, which was incorporated under the laws of Pennsylvania; The size of this deal was US\$ 1.22 billion, which made it the second largest deal in the Indian IT space. The deal was interesting as Patni was two and half times bigger than iGate and iGate had taken a debt of around US\$ 700 million to finance it.

The following agreements (Share/Securities (American Depository Shares) purchase agreement) triggered



the open offer.

1. As per the share purchase agreement between the promoters of Patni computers ltd and the acquirer, the acquirers to acquire 6,00,91,202 shares representing 45.64% of current equity capital of the target company at Rs.503.50 per share from the promoters of patni.
2. As per the securities purchase agreement between PanAsia iGate Solutions and PE investor General Atlantic Mauritius Limited, a company incorporated under the laws of Mauritius, the acquirer to acquire 20161867 American Depository shares, representing 1 underlying share amounting to 15.31% of share capital at Rs.503.50.
3. As per the Share purchase agreement by Panasia iGate Solutions Limited and the General Atlantic Mauritius Limited, the acquirer to acquire 2752081 equity shares representing to 2.09% of share capital at Rs. 503.50.
4. Consequent to this, a public announcement for open offer was made on January 11, 2011 in all national dailies and vernacular language as required, to acquire 2, 70, 85, 565 shares of target company representing 20.6% of current equity capital at Rs.503.50.
5. Post offer public announcement was made on May 09, 2011 declaring the completion of offer. This has resulted in
  1. share acquired through share/securities purchase agreement 83005150 (i.e 61.29%)
  2. Shares acquired in the offer 27085565 (ie 20%)
  3. total shareholding by the acquirer 110090715 shares (ie 81.29%)
  4. Post offer shareholding by public 25337108 (i.e 18.71%)
6. As the public holding has gone below the minimum public holding, the company exercised reverse book building the shares of patni computers were delisted with effect from May 21, 2012.

### LESSON ROUND UP

- The study has dealt with various case studies which throw light on the latest trends in mergers, takeovers, amalgamations etc.
- Each case study is itself an experience.
- Illustrations enable the students to appreciate and apply various methods and strategies in different kinds of restructuring process.

### SELF TEST QUESTIONS

1. Discuss a case study on Leveraged Buy Out?
2. Discuss a case study on acquisition resulting in delisting.

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# Lesson 14

## Valuation Introduction and Techniques

### LESSON OUTLINE

- Introduction
- Need and purpose of valuation
- When valuation is required
- Valuation motives
- Factors influencing valuation
- General principles
- Preliminary steps in valuation
- Valuation methods
  - Assets based
  - Earning based
  - Market based
- Valuation standards

### LEARNING OBJECTIVES

There are a number of situations in which a business or a share or any other property may be required to be valued. Valuation is essential for (i) strategic partnerships, (ii) mergers or acquisitions of shares of a company and/or acquisition of a business. (iii) Valuation is also necessary for introducing employee stock option plans (ESOPs) and joint ventures. From the perspective of a valuer, a business owner, or an interested party, a valuation provides a useful base to establish a price for the property or the business or to help determine ways and means of enhancing the value of his firm or enterprise. The main objective in carrying out a valuation is conclude a transaction in a reasonable manner without any room for any doubt or controversy about the value obtained by any party to the transaction. After reading this lesson you will be able to understand the meaning, purpose and methods of valuation.

Section 230-240 of Companies Act, 2013 are not yet notified and accordingly the provisions of Companies Act, 1956 are dealt in this lesson.

## INTRODUCTION

Valuation is an exercise to assess the worth of an enterprise or a property. In a merger or amalgamation or demerger or acquisition, valuation is certainly needed. It is essential to fix the value of the shares to be exchanged in a merger or the consideration payable for an acquisition.

## NEED AND PURPOSE

There are a number of situations in which a business or a share or any other property may be required to be valued. Valuation is essential for (i) strategic partnerships, (ii) mergers or acquisitions of shares of a company and/or acquisition of a business. (iii) Valuation is also necessary for introducing employee stock option plans (ESOPs) and joint ventures. From the perspective of a valuer, a business owner, or an interested party, a valuation provides a useful base to establish a price for the property or the business or to help determine ways and means of enhancing the value of his firm or enterprise.

The main objective in carrying out a valuation is to conclude a transaction in a reasonable manner without any room for any doubt or controversy about the value obtained by any party to the transaction. Acquisition of Business or Investment in the Equity of an enterprise could be understood by the following two illustrations in this regard.

A Party who enters into a transaction with another for acquiring a business would like to acquire a business as a going concern for the purpose of continuing to carry the same business, he might compute the valuation of the target company on a going concern basis. On the other hand if the intention of the acquirer is to acquire any property such as land, rights, or brands, the valuation would be closely connected to the market price for such property or linked to the possible future revenue generation likely to arise from such acquisition. In every such transaction, therefore the predominant objective in carrying out a valuation is to put parties to a transaction in a comfortable position so that no one feels aggrieved.

### When Valuation is required?

The following are some of the usual circumstances when valuation of shares or enterprise becomes essential:

1. When issuing shares to public either through an initial public offer or by offer for sale of shares of promoters or for further issue of shares to public.
2. When promoters want to invite strategic investors or for pricing a first issue or a further issue, whether a preferential allotment or rights issue.
3. In making investment in a joint venture by subscription or acquisition of shares or other securities convertible into shares.
4. For making an 'open offer for acquisition of shares'.
5. When company intends to introduce a 'buy back' or 'delisting of share'.
6. If the scheme of merger or demerger involve issue of shares. In Schemes involving Mergers/Demerger, share valuation is resorted to in order to determine the consideration for the purpose of issue of shares or any other consideration to shareholders of transferor or demerged companies.
7. On Directions of Company Law Board or any other Tribunal or Authority or Arbitration Tribunals directs.

8. For determining fair price for effecting sale or transfer of shares as per Articles of Association of the Company.
9. As required by the agreements between two parties.
10. For purposes of arriving of Value of Shares for purposes of assessments under the Wealth Tax Act.
11. To determine purchase price of a 'block of shares', which may or may not give the holder thereof a controlling interest in the company.
12. To value the interest of dissenting shareholders under a scheme of Amalgamation merger or reconstruction.
13. Conversion of Debt Instruments into Shares.
14. Advancing a loan against the security of shares of the company by the Bank/Financial Institution.
15. As required by provisions of law such the Companies Act, 1956 or Foreign Exchange Management Act, 1999 or Income Tax Act, 1961 or the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 [the Takeover Code] or SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999 or SEBI (Buy Back of Securities) Regulations, 1998 or Delisting Guidelines.

### Valuation/Acquisition Motives

An important aspect in the merger/amalgamation/takeover activity is the valuation aspect. The method of valuation of business, however, depends to a great extent on the acquisition motives. The acquisition activity is usually guided by strategic behavioural motives. The reasons could be (a) either purely financial (taxation, asset-stripping, financial restructuring involving an attempt to augment the resources base and portfolio-investment) or (b) business related (expansion or diversification). The (c) behavioural reasons have more to do with the personnel ambitions or objectives (desire to grow big) of the top management. The expansion and diversification objectives are achievable either by building capacities on one's own or by buying the existing capacities. (Do a "make (build) or buy decision" of capital nature.

The decision criteria in such a situation would be the present value of the differential cash flows. These differential cash flows would, therefore, be the limit on the premium which the acquirer would be willing to pay. On the other hand, if the acquisition is motivated by financial considerations (specifically taxation and asset-stripping), the expected financial gains would form the limit on the premium, over and above the price of physical assets in the company. The cash flow from operations may not be the main consideration in such situations. Similarly, a merger with financial restructuring as its objective will have to be valued mainly in terms of financial gains. It would, however, not be easy to determine the level of financial gains because the financial gains would be a function of the use of which these resources are put.

The acquisitions are not really the market driven transactions, a set of non-financial considerations will also affect the price. The price could be affected by the motives of other bidders. The value of a target gets affected not only by the motive of the acquirer, but also by the target company's own objectives.

### FACTORS INFLUENCING VALUATION

Many factors have to be assessed to determine fair valuation for an industry, a sector, or a company. The key to valuation is finding a common ground between all of the companies for the purpose of a fair evaluation.

Determining the value of a business is a complicated and intricate process. Valuing a business requires the

determination of its future earnings potential, the risks inherent in those future earnings, Strictly speaking, a company's fair market value is the price at which the business would change hands between a willing buyer and a willing seller when neither are under any compulsion to buy or sell, and both parties have knowledge of relevant facts.

The question that then arises is "How do buyers and sellers arrive at this value?"

Arriving at the transaction price requires that a value be placed on the company for sale. The process of arriving at this value should include a detailed, comprehensive analysis which takes into account a range of factors including the past, present, and most importantly, the future earnings and prospects of the company, an analysis of its mix of physical and intangible assets, and the general economic and industry conditions.

The other salient factors include:

- (1) The stock exchange price of the shares of the two companies before the commencement of negotiations or the announcement of the bid.
- (2) Dividends paid on the shares.
- (3) Relative growth prospects of the two companies.
- (4) In case of equity shares, the relative gearing of the shares of the two companies.  
(‘gearing’ means ratio of the amount of Issued preference share capital and debenture stock to the amount of issued ordinary share capital.)
- (5) Net assets of the two companies.
- (6) Voting strength in the merged (amalgamated) enterprise of the shareholders of the two companies.
- (7) Past history of the prices of shares of the two companies.

Also the following key principles should be kept in mind:

- (1) There is no method of valuation which is absolutely correct. Hence a combination of all or some may be adopted.
- (2) If possible, the seller should evaluate his company before contacting potential buyers. In fact, it would be wiser for companies to evaluate their business on regular basis to keep themselves aware of its standing in the corresponding industry.
- (3) Go for a third party valuation if desirable to avoid over—valuation of the company which is a common tendency on the seller's part.
- (4) Merger and amalgamation deals can take a number of months to complete during which time valuations can fluctuate substantially. Hence provisions must be made to protect against such swings.

### **General Principles of Business valuation**

1. Value is determined at a specific point in time.
2. Value is prospective. It is equivalent to the present value, or economic worth, of all future benefits anticipated to accrue from ownership.
3. The market determines the required rate of return.
4. Value is influenced by liquidity.
5. The higher the underlying net tangible asset value base, the higher the going concern value.

### Preliminary Steps in Valuation

A business/corporate valuation involves analytical and logical application/analysis of historical/future tangible and intangible attributes of business. The preliminary study to valuation involves the following aspects:

1. Analysis of Business History
2. Profit trends
3. Goodwill/Brand name in the market
4. Identifying economic factors directly affecting business
5. Study of Exchange risk involved
6. Study of Employee morale
7. Study of market capitalization aspects
8. Identification of hidden liabilities through analysis of material contracts.

### METHODS OF VALUATION (VALUATION TECHNIQUES)

The most popular methods of valuation amongst other includes

1. Asset based valuation
2. Earnings based valuation
3. Market based valuation

#### I. Valuation based on assets

This valuation method is based on the simple assumption that adding the value of all the assets of the company and subtracting the liabilities, leaving a net asset valuation, can best determine the value of a business. However, for the purposes of the amalgamation the amount of the consideration for the acquisition of a business may be arrived at either by valuing its individual assets and goodwill or by valuing the business as a whole by reference to its earning capacity. If this method is employed, the fixed assets of all the amalgamating companies should preferably be valued by the same professional valuer on a going concern basis. The term 'going concern' means that a business is being operated at not less than normal or reasonable profit and valuer will assume that the business is earning reasonable profits when appraising the assets. If it is found when all the assets of the business, both fixed and current, have been valued that the profits represent more than a fair commercial return upon the capital employed in the business as shown by such valuation the capitalised value of the excess (or super profits) will be the value of the goodwill, which must be added to the values of the other assets in arriving at the consideration to be paid for the business. This method may be summarized thus: The procedure of arriving at the value of a share employed in the equity method is simply to estimate what the assets less liabilities are worth, that is, the net assets lying for a probable loss or possible profit on book value, the balance being available for shareholders included in the liabilities may be debentures, debenture interest, expenses outstanding and possible preference dividends if the articles of association stipulate for payment of shares in winding up.

However, although a balance sheet usually gives an accurate indication of short-term assets and liabilities. This is not the case of long-term ones as they may be hidden by techniques such as "off balance sheet financing". Moreover, a balance sheet is a historical record of previous expenditure and existing liabilities. As a valuation is a forward looking exercise, acquisition purchase prices generally do not bear any relation to published balance sheet. Nevertheless a company's net book value is still taken into account as net book

values have a tendency to become minimum prices and the greater the proportion of purchase price is represented by tangible assets, the less risky its acquisition is perceived to be.

Valuation of a listed and quoted company has to be done on a different footing as compared to an unlisted company. The real value of the assets may or may not reflect the market price of the shares; however, in unlisted companies, only the information relating to the profitability of the company as reflected in the accounts is available and there is no indication of the market price. Using existing public companies as a benchmark to value similar private companies is a viable valuation methodology.

The comparable public company method involves selecting a group of publicly traded companies that, on average, are representative of the company that is to be valued. Each comparable company's financial or operating data (like revenues, EBITDA or book value) is compared to each company's total market capitalization to obtain a valuation multiple. An average of these multiples is then applied to derive the company's value.

An asset-based valuation can be further separated into four approaches:

#### 1. *Book value*

The tangible book value of a company is obtained from the balance sheet by taking the adjusted historical cost of the company's assets and subtracting the liabilities; intangible assets (like goodwill) are excluded in the calculation.

Statutes like the Gift Tax Act, Wealth Tax Act, etc., have in fact adopted *book value* method for valuation of unquoted equity shares for companies other than an investment company. Book value of assets does help the valuer in determining the useful employment of such assets and their state of efficiency. In turn, this leads the valuer to the determination of rehabilitation requirements with reference to current replacement values.

In all cases of valuation on assets basis, except book value basis, it is important to arrive at current replacement and realization value. It is more so in case of assets like patents, trademarks, know-how, etc. which may possess value, substantially more or less than those shown in the books.

Using book value does not provide a true indication of a company's value, nor does it take into account the cash flow that can be generated by the company's assets.

#### 2. *Replacement cost*

Replacement cost reflects the expenditures required to replicate the operations of the company. Estimating replacement cost is essentially a make or buy decision.

#### 3. *Appraised value*

The difference between the appraised value of assets, and the appraised value of liabilities is the net appraised value of the firm.

This approach is most commonly used in a liquidation analysis because it reflects the divestiture of the underlying assets rather than the ongoing operations of the firm.

#### 4. *Excess earnings*

In order to obtain a value of the business using the excess earnings method, a premium is added to the appraised value of net assets. This premium is calculated by comparing the earnings of a business before a sale and the earnings after the sale, with the difference referred to as excess earnings.

In this approach, it is assumed that the business is run more efficiently after a sale; the total amount of



excess earnings is capitalized (e.g., the difference in earnings is divided by some expected rate of return) and this result is then added to the appraised value of net assets to derive the value of the business.

## II. Valuation based on earnings

The normal purpose of the contemplated purchase is to provide for the buyer the annuity for his outlay. He will expect yearly income, return great or small, stable or fluctuating but nevertheless some return which is commensurate with the price paid therefore. Valuation based on earnings based on the rate of return on capital employed is a more modern method being adopted. From the last earnings declared by a company, items such as tax, preference dividend, if any, are deducted and net earnings are taken.

An alternate to this method is the use of the price-earning (P/E) ratio instead of the rate of return. The P/E ratio of a listed company can be calculated by dividing the current price of the share by earning per share (EPS). Therefore, the reciprocal of P/E ratio is called earnings - price ratio or earning yield.

$$\text{Thus } P/E = \frac{P}{\text{EPS}}$$

Where P is the current price of the shares

The share price can thus be determined as

$$P = \text{EPS} \times P/E \text{ ratio}$$

## III. MARKET BASED APPROACH TO VALUATION

Market based methods help the strategic buyer estimate the subject business value by comparison to similar businesses. Where the company is listed market price method that helps in evaluating on the price on the secondary market. Average of quoted price is considered as indicative of the value perception of the company by investors operating under free market conditions. To avoid chances of speculative pressures, it is suggested to adopt the average quotations of sufficiently longer period. The valuer will have to consider the effect of issue of bonus shares or rights shares during the period chosen for average.

- (i) Market Price Method is not relevant in the following cases:
  - Valuation of a division of a company
  - Where the share are not listed or are thinly traded
  - In the case of a merger, where the shares of one of the companies under consideration are not listed on any stock exchange
  - In case of companies, where there is an intention to liquidate it and to realise the assets and distribute the net proceeds.
- (ii) In case of significant and unusual fluctuations in market price the market price may not be indicative of the true value of the share. At times, the valuer may also want to ignore this value, if according to the valuer, the market price is not a fair reflection of the company's underlying assets or profitability status. The Market Price Method may also be used as a back up for supporting the value arrived at by using the other methods.
- (iii) It is important to note that Regulatory bodies have often considered market value as one of the very important basis — Preferential allotment, Buyback, Open offer price calculation under the Takeover Code.
- (iv) In earlier days due to non-availability of data, while calculating the value under the market price method, high and low of monthly share prices were considered. Now with the support of

technology, detailed data is available for stock prices. It is now a usual practice to consider weighted average market price considering volume and value of each transaction reported at the stock exchange.

- (v) If the period for which prices are considered also has impact on account of Bonus shares, Rights Issue, etc., the valuer needs to adjust the market prices for such corporate events.

## MARKET COMPARABLES

This method is generally applied in case of unlisted entities. This method estimates value by relating the same to underlying elements of similar companies for past years. It is based on market multiples of 'comparable companies'. For example

- Earnings/Revenue Multiples (Valuation of Pharmaceutical Brands)
- Book Value Multiples (Valuation of Financial Institution or Banks)
- Industry Specific Multiples (Valuation of cement companies based on Production capacities)
- Multiples from Recent M&A Transactions.

Though this method is easy to understand and quick to compute, it may not capture the intrinsic value and may give a distorted picture in case of short term volatility in the markets. There may often be difficulty in identifying the comparable companies.

## Other aspects as to the methods of valuation

### Valuation based on super profits

This approach is based on the concept of the company as a going concern. The value of the net tangible assets is taken into consideration and it is assumed that the business, if sold, will in addition to the net asset value, fetch a premium. *The super profits are calculated as the difference between maintainable future profits and the return on net assets.* In examining the recent profit and loss accounts of the target, the acquirer must carefully consider the accounting policies underlying those accounts. Particular attention must be paid to areas such as deferred tax provision, treatment of extraordinary items, interest capitalisation, depreciation and amortisation, pension fund contribution and foreign currency translation policies. Where necessary, adjustments for the target's reported profits must be made, so as to bring those policies into line with the acquirer's policies. For example, the acquirer may write off all R&D expenditure, whereas the target might have capitalised the development expenditure, thus overstating the reported profits.

### Discounted cash flow valuation method

Discounted cash flow valuation is based upon expected future cash flows and discount rates. This approach is easiest to use for assets and firms whose cash flows are currently positive and can be estimated with some reliability for future periods.

Discounted cash flow valuation, relates the value of an asset to the present value of expected future cash flows on that asset. In this approach, the cash flows are discounted at a risk-adjusted discount rate to arrive at an estimate of value. The discount rate will be a function of the riskiness of the estimated cash flows, with lower rates for safe projects and higher rate for riskier assets.

This approach has its foundation in the 'present value' concept, where the value of any asset is the present value of the expected future cash flows on it. Essentially, DCF looks at an acquisition as a pure financial investment. The buyer will estimate future cash flows and discount these into present values. Why is future cash flow discounted? The reason is that a rupee in future is at risk of being worth less than a rupee now.

There are some business based real risks like acquired company loosing a contract, or new competitor entering the market or an adverse regulation passed by government, which necessitated discounting of cash flows.

The discounted cash flow (DCF) model is applied in the following steps:

1. Estimate the future cash flows of the target based on the assumption for its post-acquisition management by the bidder over the forecast horizon.
2. Estimate the terminal value of the target at forecast horizon.
3. Estimate the cost of capital appropriate for the target.
4. Discount the estimated cash flows to give a value of the target.
5. Add other cash inflows from sources such as asset disposals or business divestments.
6. Subtract debt and other expenses, such as tax on gains from disposals and divestments, and acquisition costs, to give a value for the equity of the target.
7. Compare the estimated equity value for the target with its pre-acquisition stand-alone value to determine the added value from the acquisition.
8. Decide how much of this added value should be given away to target shareholders as control premium.

### **Valuation by team of experts**

Valuation is an important aspect in merger and acquisition and it should be done by a team of experts keeping into consideration the basic objectives of acquisition. Team should comprise of financial experts, accounting specialists technical and legal experts who should look into aspects, of valuation from different angles.

Accounting expert has to foresee the impact of the events of merger on profit and loss account and balance sheet through projection for next 5 years and economic forecast. Using the accounting data he must calculate performance ratios, financial capacity analysis, budget accounting and management accounting and read the impact on stock values, etc. besides, installing accounting and depreciation policy, treatment of tangible and intangible assets, doubtful debts, loans, interests, maturities, etc.

Technician has its own role in valuation to look into the life and obsolescence of depreciated assets and replacements and adjustments in technical process, etc. and form independent opinion on workability of plant and machinery and other assets.

Legal experts advice is also needed on matters of compliance of legal formalities in implementing acquisition, tax aspects, review of corporate laws as applicable, legal procedure in acquisition strategy, laws affecting transfer of stocks and assets, regulatory laws, labour laws preparing drafts of documents to be executed or entered into between different parties, etc.

Nevertheless, the experts must take following into consideration for determining exchange ratio.

#### **A. Market Price of Shares**

If the offeree and offeror are both listed companies, the stock exchange prices of the shares of both the companies should be taken into consideration which existed before commencement of negotiations or announcement of the takeover bid to avoid distortions in the market price which are likely to be created by interested parties in pushing up the price of the shares of the offeror to get better deal and vice versa.

#### B. Dividend Payout Ratio (DPR)

The dividend paid in immediate past by the two companies is important as the shareholders want continuity of dividend income. In case offeree company was not paying dividend or its DPR was lower than the offeror's, then its shareholders would opt for share exchange for the growth company by sacrificing the current dividend income for prospects of future growth in income and capital appreciation.

#### C. Price Earning Ratio (PER)

Price earning ratios of both the offeror and offeree companies be compared to judge relative growth prospects. Company with lower PER show a record of low growth in earning per share which depresses market price of shares in comparison to high growth potential company. Future growth rate of combined company should also be calculated.

#### D. Debt Equity Ratio

Company with low gearing offers positive factor to investors for security and stability rather than growth potential with a geared company having capacity to expand equity base.

#### E. Net Assets Value (NAV)

Net assets value of the two companies be compared as the company with lower NAV has greater chances of being pushed into liquidation.

Having taken all the above factors into consideration, the final exchange ratio may depend upon factors representing strength and weakness of the firm in the light of merger objectives including the following:

Liquidity, strategic assets, management capabilities, tax loss carry overs, reproduction costs, investment values, market values (combined companies shares) book values, etc.

#### **Valuation by experts: effect**

It is well settled that the valuation of shares is a technical matter, requiring considerable skill and expertise. If the same has been worked out and arrived at by experts then the same should be accepted, more so, if the same has the approval of the shareholders. That is to say, where the valuation done by the company's auditors is approved by the majority of shareholders and is also confirmed by eminent experts, who are appointed by the court to examine the valuation so made, as fair, and the valuation is not shown to be patently unfair or unjust, it would be extremely difficult to hold that the valuation so made is unfair, and, then, the court shall have to be slow to set at naught the entire scheme of amalgamation. The court does not go into the matter of fixing of exchange ratio in great detail or to sit in appeal over the decision of the chartered accountant. If a chartered accountant of repute has given the exchange ratio as per valuation made by him and the same is accepted by the requisite majority of the shareholders, the court will only see whether there is any manifest unreasonableness or manifest fraud involved in the matter.

So, the exchange ratio of shares in the case of scheme of amalgamation, when supported by an opinion of accounting, technicians & legal experts and approved by a very large number of shareholders concerned, is prima facie to be accepted as fair, unless proved otherwise by the objectors. It is also well established, that there are number of bases on which valuation or the offered exchange ratio, which ultimately is a matter of opinion, can be founded and final determination can be made by accepting one of amalgamation of various consideration. It is also well settled by the Supreme Court in *Hindustan Lever Employees' Union v. Hindustan Lever Ltd.*, that mathematical precision is not the criterion for adjudging the fair exchange ratio.

Thus, now, the law has been well settled by the Supreme Court in *Miheer H. transferee company to be*

allotted to the holders of the transferor company has been worked out by a recognised firm of chartered accountants who are experts in the field of valuation, and if no mistake can be pointed out in the said valuation, it is not for the court to substitute its exchange ratio, especially when the same has been accepted without demur by the overwhelming majority of the shareholders of the two companies or to say that the shareholders in their collective wisdom should not have accepted the said exchange ratio on the ground that it will be detrimental to their interest. It is not the part of the judicial process, said the Supreme Court in *Hindustan Lever Employees' Union v. Hindustan Lever Ltd.*, to examine entrepreneurial activities to ferret out flaws. The court is least equipped for such oversights, nor indeed is it a function of the judges in our constitutional scheme. It cannot be said that the internal management, business activity or institutional operation of public bodies, can be subjected to inspection by the court. To do so is incompetent and improper and, therefore, out of bounds.

Where the determination of the market price has been entrusted to a reputed valuer, there no reason to doubt his competence unless mala fides are established against him. Allegations of mala fides are easy to make but difficult to substantiate. Unless the person who challenges the valuation satisfies the court that the valuation arrived at is grossly unfair, the court will not disturb the scheme of amalgamation which has been approved by the shareholders of two companies, who are, by and large well informed men of commercial world. It is difficult to set aside the valuation of experts in the absence of fraud or mala fides on the part of the experts.

### **Fair value of shares**

Valuation can be done on the basis of fair value also. However, resort to valuation by fair value is appropriate when market value of a company is independent of its profitability.

The fair value of shares is arrived at after consideration of different modes of valuation and diverse factors. There is no mathematically accurate formula of valuation. An element of guesswork or arbitrariness is involved in valuation. The following four factors have to be kept in mind in the valuation of shares. These are:

- (1) Capital cover,
- (2) Yield,
- (3) Earning capacity, and
- (4) Marketability.

For arriving at the fair value of share, three well-known methods are applied:

- (1) the manageable profit basis method (the earning per share method).
- (2) the net worth method or the break-up value method, and
- (3) the market value method.

The fair value of a share is the average of the value of shares obtained by the net assets method and the one obtained by the yield method. This is, in fact not a valuation, but a compromise formula for bringing the parties to an agreement.

The average of book value and yield-based value incorporates the advantages of both the methods and minimizes the demerits of both the methods. Hence, such average is called the fair value of share or sometimes also called the dual method of share valuation.

The fair value of shares can be calculated by using the formula:

$$\text{Fair value of shares} = \frac{\text{Value by net assets method} + \text{Value by yield method}}{2}$$

Valuation of equity shares must take note of special features, if any, in the company or in the particular transaction. These are briefly stated below:

*(a) Importance of the size of the block of shares:*

Valuation of the identical shares of a company may vary quite significantly at the same point of time on a consideration of the size of the block of shares under negotiation.

The holder of 75% of the voting power in a company can always alter the provisions of the articles of association; a holder of voting power exceeding 50% and less than 75% can substantially influence the operations of the company even to alter the articles of association or comfortably pass a special resolution.

A controlling interest therefore, carries a separate substantial value.

*(b) Restricted transferability:*

Along with principal consideration of yield and safety of capital, another important factor is easy exchangeability or liquidity. Holders of shares of unquoted public companies or of private companies do not enjoy easy marketability; therefore, such shares, however good, are discounted for lack of liquidity at rates, which may be determined on the basis of circumstances of each case.

The discount may be either in the form of a reduction in the value otherwise determined or an increase in the normal rate of return.

*(c) Dividends and valuation:*

Generally, companies paying dividends at steady rates enjoy greater popularity and the prices of their shares are high while shares of companies with unstable dividends do not enjoy confidence of the investing public as to returns they expect to get and, consequently, they suffer in valuation.

*(d) Bonus and rights issue:*

Share values have been noticed to go up when bonus or rights issues are announced, since they indicate an immediate prospect of gain to the holder although in the ultimate analysis, it is doubtful whether really these can alter the valuation.

*Statutory valuation*

Valuation of shares may be necessary under the provisions of various enactments like the Wealth tax Act, Companies Act, Income-tax Act, etc. e.g. valuation is necessary under the Companies Act in the case of an amalgamation and under the Income-tax Act for the purposes of capital gains.

Some of the other enactments have laid down rules for valuation of shares. The rules generally imply acceptance of open market price i.e. stock exchange price for quoted shares and asset based valuation for unquoted equity shares and average of yield and asset methods i.e. fair value, in valuing shares of investment companies.

**Free cash-flows (FCF)**

FCF is a financial tool mainly used in valuation of a business. It will be close to the profits after tax without taking into account depreciation. Depreciation is neither a source of money nor an application of the funds available at the disposal of a company. FCF of a company is determined by the after tax operating cash flow minus interest paid/payable duly taking into account the savings arising out of tax paid/ payable on interest and after providing for certain fixed commitments such as preference shares dividends, redemption commitments and investments in plant and machinery required to maintain cash flows. Please refer to *Annexure 3* for a case study involving the acquisition of a firm as a going concern where valuation has been done on the basis of estimated free cash flows.

## Valuation Standards

Valuation Standards aims to provide uniformity in valuation of various tangible and intangible classes of assets that provides consistent delivery of standards.

### The International Valuation Standards Council

The **International Valuation Standards Council** is the established international standard setter for valuation. Through the International Valuation Standards Board, the IVSC develops and maintains standards on how to undertake and report valuations, especially those that will be relied upon by investors and other third party stakeholders. The IVSC also supports the need to develop a framework of guidance on best practice for valuations of the various classes of assets and liabilities and for the consistent delivery of the standards by properly trained professionals around the globe.

The IVSC has published International Valuation Standards (IVS) since 1985.

Membership of IVSC is open to organisations of users, providers, professional institutes, educators, and regulators of valuation services. IVSC members appoint the IVSC Board of Trustees.

In nutshell, valuations of businesses, business ownership interests, securities, tangible or intangible assets may be performed for a wide variety of purposes including the following:

- Valuation for financial transactions such as acquisitions, mergers, leveraged buyouts, initial public offerings, employee stock ownership plans and other share based plans, partner and shareholder buy-ins or buyouts, and stock redemptions.
- Valuation for Dispute Resolution and/ or litigation/pending litigation relating to matters such as marital dissolution, bankruptcy, contractual disputes, owner disputes, dissenting shareholder and minority ownership oppression cases, employment disputes and intellectual property disputes.
- Valuation for Compliance-oriented engagements, for example:
  - (a) Financial reporting and
  - (b) Tax matters such as corporate reorganizations; income tax, Property tax, and Wealth tax compliance; purchase price allocations; and charitable contributions.
- Other purposes like valuation for planning, Internal use by the owners etc.

The same business may have different values if different standard of value is used and different approaches are adopted. The rising demand for valuation services has given new avenues for the finance professionals. Going forward more and more professional would be engaged in performing valuation services.

## LESSON ROUND UP

- There are a number of situations in which a business or a share or any other property may be required to be valued. Valuation is essential for (i) strategic partnerships, (ii) mergers or acquisitions of shares of a company and/or acquisition of a business. (iii) Valuation is also necessary for introducing employee stock option plans (ESOPs) and joint ventures. From the perspective of a valuer, a business owner, or an interested party, a valuation provides a useful base to establish a price for the property or the business or to help determine ways and means of enhancing the value of his firm or enterprise.
- The valuation methods can be divided into three broad categories viz., asset based, earning based and market based methods.
- Asset based valuation method is based on the simple assumption that adding the value of all the assets of the company and subtracting the liabilities, leaving a net asset valuation, can best determine the value of a

business. However, for the purposes of the amalgamation the amount of the consideration for the acquisition of a business may be arrived at either by valuing its individual assets and goodwill or by valuing the business as a whole by reference to its earning capacity.

- Valuation based on earnings based on the rate of return on capital employed is a more modern method being adopted. From the last earnings declared by a company, items such as tax, preference dividend, if any, are deducted and net earnings are taken.
- The Market Price Method evaluates the value on the basis of prices quoted on the stock exchange.

## SELF TEST QUESTIONS

1. What is the purpose of valuations?
2. What are the different types of valuation?
3. What is discounted cash flow method?
4. How do you carry out valuation exercise based on market comparables?

This image shows a blank sheet of white paper with horizontal black ruling lines. The lines are evenly spaced and run across the width of the page. There is a solid black header bar at the top of the page.



# Lesson 15

## Regulatory Aspects of Valuation With Reference to Corporate Strategies

### LESSON OUTLINE

- Regulatory aspects as regards valuation
  1. Valuation of shares under FDI policy
  2. Valuation of shares under SEBI Regulations
- Valuation of sweat equity shares
- Valuation under SEBI(SAST) Regulations 2011
- Valuation under ESOP guidelines
- Valuation under delisting regulations
- Valuation under SEBI(ICDR) Regulations

Taxation aspects

Valuation of different strategies

- Mergers & Acquisitions
- Demerger
- Slump sale
- Liquidation

### LEARNING OBJECTIVES

There are various methodologies for valuing a business, all having different relevance depending on the purpose of valuation. There are many methodologies that a valuer may use to value the Shares of a Company/Business. In practice, the valuer normally uses different methodologies of valuation and arrives at a fair value for the entire business by combining the values arrived using various methods. These methodologies includes asset based approach, earnings based approach and market based approach. The concepts of these approaches are dealt in the previous lesson. Besides regulatory aspects also impact valuation. For example there are regulatory prescriptions for valuation of shares under SEBI (SAST) Regulations, SEBI (ICDR) Regulations, SEBI(ESOP) Guidelines, FEMA/Consolidated FDI Policy, Income Tax Act 1961 etc., After reading this lesson you will be able to understand the regulatory aspects of valuation, different valuation methodologies for different strategies including taxation aspects.

***“Price is what you pay & Value is what you get”.***

***—Warren Buffet***

## INTRODUCTION

Understanding Corporate valuation is not only a pre-requisite during different types of restructuring phase of the company. It is required at frequent intervals to identify the economic value creation and any destruction if any occurred. It is also important to note that value is different from the price. The process of valuation includes a detailed and comprehensive analysis taking into account the past present and future earnings prospects and analysis of physical and intangible assets and general economic and industry conditions. Determination of realistic value of a firm is indeed a difficult process. Some times market price of the share of the company may be an approximate indication of the firm. Market price again depends on current earnings and the future growth. Market price of shares may not be feasible for unlisted company for which asset based approach of valuation might be a feasible option.

The Ministry of Corporate Affairs (the then Department of Company Affairs) has constituted an Expert Group in 2002 under the Chairmanship of Mr. Shardul S. Shroff to suggest guidelines on valuation of shares in connection with amalgamation, merger, de-merger, acquisition, buy-back, etc.,

The Expert Group is of the view that there are two circumstances under which the prescribed valuation guidelines may apply to the companies.

These are:

- (i) Circumstances under which a valuation from the Registered Valuer(s) is mandatory and
- (ii) Circumstances under which a valuation from the Registered Valuer(s) is recommended but not mandatory.

The Expert Group has adopted two basic principles for identifying the circumstances under which the mandatory valuation is required. These circumstances includes:

- (i) Whenever a shareholder's resolution, ordinary or special, is required to authorize the transaction under the Companies Act, 1956 ("Companies Act") or where the shareholders are required to take a decision on values which may have a bearing on or help in making the decision ; and
- (ii) All Related Party transactions described herein.

Without limiting the generality of the above, some of the specific circumstances under which the Expert Group opines that the company/Board of Directors should seek a mandatory valuation from a Registered Valuer(s) are:

- (i) All Schemes of Compromise and Arrangement under Sections 391 to 394 of the Companies Act.
- (ii) Sale of a business, including investment business and disposal of a controlling interest in an undertaking or a company, through disposal of shares, an undertaking or a substantial part thereof including a slump sale / itemised sale under Section 293(i)(a) of the Companies Act;
- (iii) All equity and equity linked investments where shareholders approval is required under Section 372A of the Companies Act;
- (iv) Purchases, Sales, combinations and restructuring entailing acquisition or disposal of business, an undertaking or part of an undertaking, securities, equity and preference capital, and outstanding debt and liabilities, where Related Parties are counterparties.

However, the valuation should not be mandatory for transactions, which are not material in nature.

The Expert Group is of the view that it cannot straightjacket the test of materiality either on a monetary test or a pro rata principle without reference to the context and purpose, e.g. the transfer of a small percentage may result in a change of control and would be considered material. Materiality may be in the context of liabilities, contingent liabilities or valuable transferred rights. While the test of materiality must therefore be applied in each case, due consideration should be given to asset/liability value, turnover and profit contribution in making this determination;

- (v) All preferential allotments made to Related Parties and persons Controlling the company under Section 81(1A) of the Companies Act; and
- (vi) Specified recapitalisation situations - whether effected through a buyback of shares under the SEBI (Buy-back of Securities) Regulations, 1998 or Open Offers by persons in management or promoters, or a capital reduction under Section 100 or in any other manner, which have the effect of 'squeezing out' minority shareholders, for enhancing the control of the promoters or persons in management beyond 90% or more of the issued share capital, or which have the declared or stated objective of delisting the company. Mandatory valuations are also recommended where persons in management or the promoters become shareholders of 90% or more of the issued share capital of the company and seek to negotiate the exit of minority shareholders, provided there is substantial minority interest in such a situation.

The Expert Group is of the view that under the following circumstances, a valuation opinion may not be prescribed as a company activity requiring disclosure to shareholders. These circumstances includes :

- (i) Capital reduction under Section 100 of the Companies Act, unless covered in paragraph 2.2.3 (v) above;
- (ii) Issue of shares to public through a public offering;
- (iii) Rights issue under the Companies Act;
- (iv) Disinvestment of Central and State Public Sector Undertaking; and
- (v) Family settlements.

## **VALUATION DOCUMENTATION**

Valuation exercise is based on observation, inspection, analysis and calculation. During this process, the valuer goes through various documents, records his observation, makes relevant calculation and records these calculation and analysis results. In this process a lot of documents are generated which forms the basis of his conclusion on the valuation of the subject matter. It is very necessary for his to preserve all such records so that these documents may help him in substantiate his conclusion on valuation. Moreover these documents also become a matter of reference in future.

## **Objectives of Documentation in Valuation Exercise**

Documentation is "an essential element" of Valuation quality. Valuation documentation provides the principal written record to support the following:

- The Valuer's report assertion that the valuation exercise was performed with due diligence and in accordance of generally accepted valuation principles and
- The Valuers' conclusions about Valuation of the subject matter of the Valuation exercise and other related aspects of valuation.

Valuation documentation must clearly demonstrate that the Valuation exercise was in fact performed in

compliance with generally accepted valuation principles and applicable standards. It must provide a clear link to valuation conclusions and must contain sufficient information, in sufficient detail, for a clear understanding of the following

- The nature, timing, and extent of the valuation exercise.
- The work performed;
- The purpose of the valuation
- The source of the information analyzed and supporting evidential matter obtained, examined, and evaluated; and
- The conclusions reached.

The following are the more specific purposes of documentation in Valuation exercise:

- Assisting Valuer to plan and perform the Valuation Exercise
- Assisting those responsible to direct, supervise, and review the work performed;
- Providing and demonstrating the accountability of those performing the work (i.e., compliance with applicable standards);
- Assisting quality-control reviewers to understand and assess how the engagement team reached and supported significant conclusions;
- Enabling internal and external inspection teams and peer reviewers to assess compliance with professional, legal, and regulatory standards and requirements; and
- Assisting successor Valuer.

Inadequate documentation makes it difficult or impossible to determine if the Valuation exercise was actually done.

## **LIST OF DOCUMENTS**

During the course of Valuation exercise, a valuation expert collects/prepares various documents. The documents so obtained or prepared may be different from assignment to assignment but an indicative list of documents to be maintained is as given

1. Documents pertaining to Basic information of client entity i.e. Details about Company Promoters, Key Management professional of the Company, Memorandum of Association, Article of Association, Prospectus, prior three years financial statement.
2. Copy of valuation engagement with the Client
3. Copy of Previous valuation report of the subject matter of valuation exercise if any.
4. Documents which are pertaining to Assumptions and limiting conditions in the valuation assignment.
5. Information gathered and analyzed to obtain an understanding of matters that may affect the value of the subject interest
6. Documents pertaining to selection of Valuation approach used in the valuation assignment including the rationale and support for their use
7. Any restriction or limitation on the scope of the Valuer's work or the data available for analysis
8. Basis for using any valuation assumption during the valuation engagement

9. Documents pertaining to any rule of thumb used in the valuation, source(s) of data used, and how the rule of thumb was applied

Other documentation considered relevant to the engagement by the Valuer

### **DOCUMENTATION RETENTION**

Generally Valuation exercise is done in connection of Statutory, legal or personal matters. It is necessary that documents pertaining to valuation should be maintained as per applicable legislation on subject matter of valuation.

Documentation pertaining to Valuation exercise needs to maintained at

1. Valuer's End
2. Client Party End in form of valuation report along with annexure and exhibits.

#### **Period for Retention of Documents at Valuers' end**

No legislation has been framed yet which specifies the period for documentation retention at valuer's end. However Government or professional Institute may bring guidelines about this matter. Standard on Auditing (SA) 230 on Audit documentation, an Auditor should retain the documentation pertaining to an Audit assignment for a period of 7 years.

#### **Period for Retention of Documents at Clients' end**

Retention period of Valuation document at Clients' party end would depend on the purpose of valuation exercise. If valuation has got carried on for the purpose of Companies Act, Companies (Preservation and Disposal of Records) Rules, 1966 will apply. Similarly If valuation has got carried on for the purpose of Income tax Act, provision relating to Income Tax Act, 1961 and Income Tax Rules, 1962 will apply.

### **Judicial Pronouncement on Valuation Principles/Valuation Reports**

Some of the salient dicta of Courts in relation to valuation principles and valuation reports are stated under:

In *Bahoo J. Coyajee v. Shanta Genevieve Prommeret Parulekar* [1991] (3) Bom. LR 319, the Court observed:

"If the thing complained of is a thing which in substance the majority of the company are entitled to do or if something has been done irregularly which the majority of the company are entitled to do regularly, or if something has been done illegally which the majority of the company are entitled to do legally, there can be no use in having litigation about it, the ultimate end of which is only that a meeting has to be called, and then ultimately the majority gets its wishes".

In *Miheer H. Mafatlal v. Mafatlal Industries Ltd.* [1996] 87 Comp. Cas. 792 (SC), the Hon'ble Supreme Court held:

"If Share Exchange Ratio is fixed by Chartered Accountant upon consideration of various factors and approved by majority of shareholders in meeting, the Court will not disturb ratio".

In *Re. Maknam Investments Ltd.* [1995] (4) Comp.LJ page 330, the Calcutta High Court observed:

"Court does not go into the matter of fixing of exchange ratios in great detail or to sit in appeal over the expert decision of concerned chartered accountant of repute. Court only sees whether there is any manifest unreasonableness or manifest fraud involved in the matter".

In *Hindustan Lever Employees Union v. Hindustan Lever Limited* [1995] (Supp.) (1) SCC 499 at 517(519), the Hon'ble Court stated:

"The valuation of shares is a technical matter. It requires considerable skill and experience. There are bound to be differences of opinion among accountants as to what is the correct value of the shares of a company. It was emphasized that more than 99% of the shareholders had approved the valuation. The test of fairness of this valuation is not whether the offer is fair to a particular shareholder.... who may have reasons of his own for not agreeing to the valuation of the shares, but the overwhelming majority of the shareholders have approved of the valuation. The Court should not interfere with such valuation".

The Hindustan Lever case also repelled the case that valuation particulars needed a proper disclosure as material facts in the Explanatory Statement. It confirmed the judgment of *Jitendra R. Sukhadia v. Alembic Chemical Works Co. Ltd.*, (1987) 3 Comp.L.J 141 (Guj) as follows:

"How this exchange ratio was worked out, however, was not required to be stated in the statement contemplated under Section 394(1)(a)".

The Hindustan Lever's judgment (1995) Supp. (1) SCC 499 at 502 noted:

"In the absence of it being shown to be vitiated by fraud and malafide, the mere fact that the determination done by slightly different method might have resulted in different conclusion would not justify interference of Court."

### **Regulatory aspects as to valuation**

#### **SEBI Regulations**

1. Pricing under SEBI (ICDR) Regulations 2009
2. Determination of offer price under SEBI (Delisting of Equity Shares) Regulations 2009
3. Offer Price under SEBI (SAST) Regulations
4. Price of sweat equity shares under SEBI (Issue of sweat equity) Regulations 2002
5. Valuation of stock options under SEBI (ESOP) Guidelines 1999

#### **Consolidated FDI policy 2013**

### **Pricing in Public Issue as per SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009**

#### **Pricing**

(1) An issuer may determine the price of specified securities in consultation with the lead merchant banker or through the book building process.

(2) An issuer may determine the coupon rate and conversion price of convertible debt instruments in consultation with the lead merchant banker or through the book building process.

#### **Differential pricing**

An issuer may offer specified securities at different prices, subject to the following:

- (a) retail individual investors or retail individual shareholders or employees of the issuer entitled for

reservation made under regulation 42 making an application for specified securities of value not more than one lakh rupees, may be offered specified securities at a price lower than the price at which net offer is made to other categories of applicants:

Provided that such difference shall not be more than ten per cent of the price at which specified securities are offered to other categories of applicant;

- (b) in case of a book built issue, the price of the specified securities offered to an anchor investor shall not be lower than the price offered to other applicants;
- (c) in case of a composite issue, the price of the specified securities offered in the public issue may be different from the price offered in rights issue and justification for such price difference shall be given in the offer document.

### **Price and price band**

(1) The issuer may mention a price or price band in the draft prospectus (in case of a fixed price issue) and floor price or price band in the red herring prospectus (in case of a book built issue) and determine the price at a later date before registering the prospectus with the Registrar of Companies:

Provided that the prospectus registered with the Registrar of Companies shall contain only one price or the specified coupon rate, as the case may be.

(2) If the floor price or price band is not mentioned in the red herring prospectus, the issuer shall announce the floor price or price band at least two working days before the opening of the bid (in case of an initial public offer) and at least one working day before the opening of the bid (in case of a further public offer), in all the newspapers in which the pre issue advertisement was released.

(3) The announcement shall contain relevant financial ratios computed for both upper and lower end of the price band and also a statement drawing attention of the investors to the section titled “basis of issue price” in the prospectus.

(4) The cap on the price band shall be less than equal to one hundred and twenty per cent of the floor price.

(5) The floor price or the final price shall not be less than the face value of the specified securities.

It may be noted that the “cap on the price band” includes cap on the coupon rate in case of convertible debt instruments.

### **Face value of equity shares**

(1) Subject to the provisions of the Companies Act, 1956 and the ICDR (Regulations), an issuer making an initial public offer may determine the face value of equity shares in the following manner:

- (a) if the issue price per equity share is five hundred rupees or more, the issuer shall have the option to determine the face value at less than ten rupees per equity share;

Provided that the face value shall not be less than one rupee per equity share;

- (b) if the issuer price per equity share is less than five hundred rupees, the face value of the equity shares shall be ten rupees per equity share:

The above mention criteria shall not apply to initial public offer made by any government company, statutory authority or corporation or any special purpose vehicle set up by any of them, which is engaged in infrastructure sector.

(2) The disclosure about the face value of equity shares (including the statement about the issue price being "X" times of the face value) shall be made in the advertisements, offer documents and application forms in identical font size as that of issue price or price band.

#### **(a) If listed for more than 6 months**

If the equity shares of the issuer have been listed on a recognised stock exchange for a period of six months or more as on the relevant date, the equity shares shall be allotted at a price not less than higher of the following:

- (a) The average of the weekly high and low of the closing prices of the related equity shares quoted on the recognised stock exchange during the six months preceding the relevant date; or
- (b) The average of the weekly high and low of the closing prices of the related equity shares quoted on a recognised stock exchange during the two weeks preceding the relevant date.

#### **(b) If listed for less than 6 months**

If the equity shares of the issuer have been listed on a recognised stock exchange for a period of less than six months as on the relevant date, the equity shares shall be allotted at a price not less than the higher of the following:

- (a) the price at which equity shares were issued by the issuer in its initial public offer or the value per share arrived at in a scheme of arrangement under sections 391 to 394 of the Companies Act, 1956, pursuant to which the equity shares of the issuer were listed, as the case may be;

or

- (b) the average of the weekly high and low of the closing prices of the related equity shares quoted on the recognised stock exchange during the period shares have been listed preceding the relevant date; or
- (c) the average of the weekly high and low of the closing prices of the related equity shares quoted on a recognised stock exchange during the two weeks preceding the relevant date.

This price shall be recomputed by the issuer on completion of six months from the date of listing on a recognised stock exchange with reference to the average of the weekly high and low of the closing prices of the related equity shares quoted on the recognised stock exchange during these six months and if such recomputed price is higher than the price paid on allotment, the difference shall be paid by the allottees to the issuer.

#### **Valuation for the purpose of Issue of Sweat Equity Shares**

Under the SEBI (Issue of Sweat Equity) Regulations, 2002, the price of sweat equity shares shall not be less than the higher of the following:

- (a) The average of the weekly high and low of the closing prices of the related equity shares during last six months preceding the relevant date; or
- (b) The average of the weekly high and low of the closing prices of the related equity shares during the two weeks preceding the relevant date.

"Relevant date" for this purpose means the date which is thirty days prior to the date on which the meeting of the General Body of the shareholders is convened, in terms of clause (a) of Sub-section (1) of Section 79A of the Companies Act.



1. If the shares are listed on more than one stock exchange, but quoted only on one stock exchange on the given date, then the price on that stock exchange shall be considered.
2. If the share price is quoted on more than one stock exchange, then the stock exchange where there is highest trading volume during that date shall be considered.
3. If shares are not quoted on the given date, then the share price on the next trading day shall be considered.

As per the sweat equity regulations, the intellectual property or the value addition in respect of which the company intends to issue the sweat equity should also be valued in accordance with the valuation requirements contained in the said regulations.

#### **Valuation of Stock Options under the SEBI (ESOP) Guidelines, 1999**

Under the Securities and Exchange Board of India (Employee Stock Option Scheme and Employee Stock Purchase Scheme), Guidelines, 1999, the fair value of a stock option is the price that shall be calculated for that option in an arm's length transaction between a willing buyer and a willing seller. The fair value shall be estimated using an option-pricing model (for example, the Black-Scholes\* or a binomial model) that takes into account as of the grant date the exercise price and expected life of the option, the current price in the market of the underlying stock and its expected volatility, expected dividends on the stock, and the risk-free interest rate for the expected term of the option.

#### **Valuation under SEBI (Delisting of equity shares) Regulations 2009**

(1) The offer price shall be determined through book building in the manner specified in Schedule II of these regulations, after fixation of floor price. The final offer price shall be determined as the price at which the maximum number of equity shares is tendered by the public shareholders. If the final price is accepted, then, the promoter shall accept all shares tendered where the corresponding bids placed are at the final price or at a price which is lesser than the final price. The promoter may, if he deems fit, fix a higher final price.

(2) The floor price shall not be less than,

- (a) where the equity shares are frequently traded in all the recognised stock exchanges where they are listed, the average of the weekly high and low of the closing prices of the equity shares of the company during the twenty six weeks or two weeks preceding the date on which the recognised stock exchanges were notified of the board meeting in which the delisting proposal was considered, whichever is higher, as quoted on the recognised stock exchange where the equity shares of the company are most frequently traded;
- (b) where the equity shares of the company are infrequently traded in all the recognised stock exchanges where they are listed, the floor price determined in accordance with the provisions of sub-regulation (3); or,
- (c) where the equity shares are frequently traded in some recognised stock exchanges and infrequently traded in some other recognised stock exchanges where they are listed, the highest of the prices arrived at in accordance with clauses (a) and (b) above.

It may be noted that equity shares shall be deemed to be infrequently traded, if on the recognised stock exchange, the annualised trading turnover in such shares during the preceding six calendar months prior to

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\*This formula is nothing but a mathematical formula suggested for being used to value the cost of issue of employee stock options. The said formula considers factors such as the volatility of returns on the underlying securities, the risk-free interest rate, the expected dividend rate, the relationship of the option price to the price of the underlying securities and the expected option life. This is scientific method deployed for arriving at the actual compensation cost.

month in which the recognised stock exchanges were notified of the board meeting in which the delisting proposal was considered, is less than five per cent. (by number of equity shares) of the total listed equity shares of that class and the term 'frequently traded' shall be construed accordingly.

(3) The floor price shall be determined by the promoter and the merchant banker taking into account the following factors:

- (a) the highest price paid by the promoter for acquisitions, if any, of equity shares of the class sought to be delisted, including by way of allotment in a public or rights issue or preferential allotment, during the twenty six weeks period prior to the date on which the recognised stock exchanges were notified of the board meeting in which the delisting proposal was considered and after that date upto the date of the public announcement; and,
- (b) other parameters including return on net worth, book value of the shares of the company, earning per share, price earning multiple vis-à-vis the industry average.

### **Valuation of Shares under the Sweat Equity Unlisted Companies (Issue of Shares) Rules, 2003**

Under the Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003, the price of sweat equity shares to be issued to employees and directors shall be at a fair price calculated by an independent valuer. The valuation of the intellectual property or of the know-how provided or other value addition to consideration at which sweat equity capital is issued, shall be carried out by a valuer. The valuer should consult such experts, as he may deem fit, having regard to the nature of the industry and the nature of the property or the value addition. The valuer should submit a valuation report to the company giving justification for the valuation. A copy of the valuation report of the valuer should be sent to the shareholders with the notice of the general meeting;

### **SEBI (SAST) Regulations 2011**

#### **Offer Price**

Offer price is the price at which the acquirer announces to acquire shares from the public shareholders under the open offer. The offer price shall not be less than the price as calculated under regulation 8 of the SAST Regulations, 2011 for frequently or infrequently traded shares.

If the target company's shares are frequently traded then the open offer price for acquisition of shares under the minimum open offer shall be highest of the following:

- Highest negotiated price per share under the share purchase agreement ("SPA") triggering the offer;
- Volume weighted average price of shares acquired by the acquirer during 52 weeks preceding the public announcement ("PA");
- Highest price paid for any acquisition by the acquirer during 26 weeks immediately preceding the PA;
- Volume weighted average market price for sixty trading days preceding the PA.

If the target company's shares are infrequently traded then the open offer price for acquisition of shares under the minimum open offer shall be highest of the following:

- Highest negotiated price per share under the share purchase agreement ("SPA") triggering the offer;
- Volume weighted average price of shares acquired by the acquirer during 52 weeks preceding the public announcement ("PA");

- Highest price paid for any acquisition by the acquirer during 26 weeks immediately preceding the PA;
- The price determined by the acquirer and the manager to the open offer after taking into account valuation parameters including book value, comparable trading multiples, and such other parameters that are customary for valuation of shares of such companies.

It may be noted that the Board may at the expense of the acquirer, require valuation of shares by an independent merchant banker other than the manager to the offer or any independent chartered accountant in practice having a minimum experience of 10 years.

### **Pricing under Consolidated FDI Policy 2013**

Price of shares issued to persons resident outside India under the FDI Policy, shall not be less than –

- (a) the price worked out in accordance with the SEBI guidelines, as applicable, where the shares of the company is listed on any recognised stock exchange in India;
- (b) the fair valuation of shares done by a SEBI registered Category - I Merchant Banker or a Chartered Accountant as per the discounted free cash flow method, where the shares of the company is not listed on any recognised stock exchange in India ; and
- (c) the price as applicable to transfer of shares from resident to non-resident as per the pricing guidelines laid down by the Reserve Bank from time to time, where the issue of shares is on preferential allotment.

However, where non-residents (including NRIs) are making investments in an Indian company in compliance with the provisions of the Companies Act, 1956, by way of subscription to its Memorandum of Association, such investments may be made at face value subject to their eligibility to invest under the FDI scheme.

#### **Strategies Requiring Valuation**

- Determining the consideration for Acquisition
- Determining the swap ratio for Merger/Demerger
- Sale/ Purchase of Intangible assets including brands, patents, copyrights, trademarks, rights.
- Determining the Fair value of shares for issuing ESOP.
- Disinvestment of PSU stocks by the Government
- Liquidation/Insolvency of company
- Takeover of Companies
- Other Corporate restructuring

### **What should be the content of valuation report for corporate strategies?**

The expert group of Ministry of Corporate Affairs(the then Department of Company Affairs), which was discussed about in the beginning of the chapter suggests the following coverage in the Valuation Report for Corporate Strategies.

#### **Contents of Summarized Valuation Report**

Considering the shareholders interest and the need for transparency and upholding corporate governance principles and after taking into consideration aspects of minority interest, transparency and corporate governance the Expert Group recommends that the following matters should compulsorily be covered in the summarized Valuation Report, in a clear, unambiguous and non-misleading manner, consistent with the

need to maintain confidentiality.

- Background Information
- Purpose of Valuation and Appointing Authority
- Identity of the valuer and any other experts involved in the valuation
- Disclosure of valuer Interest/Conflict, if any
- Date of Appointment, Valuation Date and Date of Report
- Sources of Information
- Procedures adopted in carrying out the Valuation
- Valuation Methodology
- Major Factors influencing the Valuation
- Conclusion
- Caveats, Limitations and Disclaimers.

### **1. Background Information**

The valuation report should briefly cover the following:

- Brief particulars of company or business which is the valuation subject
- Proposed Transaction
- Key historical financials
- Capital structure of the company, if relevant, and any changes as a result of the proposed transaction
- Shareholding pattern, any significant changes (Promoters/FIs), and any changes as a result of the transaction (Note – a table of before and after shareholding patterns ought to be disclosed)
- High/low/average market volumes/price for last six months, where applicable
- Related party issues with respect to the transaction.

### **2. Purpose of Valuation & Appointing Authority**

The context and purpose of the valuation and the appointing authority commissioning the exercise must be clearly stated e.g. the Management's decision to seek an advisory opinion should be disclosed, or, the Audit Committee Chairman's decision to appoint or the appointment of an independent valuer itself should be disclosed with the date of the decision.

### **3. Identity of the valuer and any other experts involved in the valuation**

Identity of the Registered Valuer (with his registration number) as well as organization doing the valuation and any other experts consulted in the process of valuation. The separation of the advisory team and details of the Chinese walls maintained between the independent valuer team and the advisory team, if appointed with particulars of the degree of strict separation and compliance of Chinese walls should be mentioned.

### **4. Disclosure of Valuer Interest/Conflict, if any**

The Expert Group also recommends that a valuer shall disclose in his Report, possible sources of conflict and material interests, including association or proposed association with the company, its associates, the counter-party to the transaction or its associates, in the form of auditor, lead advisor or in any other capacity, together with the nature of the fee arrangements for the same. If the valuer has a separate advisory engagement, the conflict disclosure should clearly record that neither the valuer or the members of the team working on the independent valuation have directly or indirectly, through the client or otherwise shared any

advisory perspective or have been influenced or undertaken advocating a management position in determining the value.

### **5. Date of Appointment, Valuation Date and Date of Report**

The Report should clearly state the date of the appointment of the valuer, Valuation Date (i.e. the date as of which the valuation assessment is done if this be other than the date of the report) and the date of the report.

### **6. Sources of Information**

The valuer should clearly indicate in the report the principal sources of information, both internal and external, which have been relied upon for the purpose of valuation.

### **7. Procedures adopted in carrying out the valuation**

Procedures adopted in carrying out a valuation may vary with circumstances, nature and purpose of valuation as well as information and time available. The principal procedures actually adopted by the valuer in carrying out the valuation should be set out briefly in the report. Such procedures may typically include:

- Review of Past Financials
- Review and Analysis of Financial Projections
- Industry Analysis
- SWOT Analysis
- Comparison with similar transactions
- Comparison with other similar listed companies
- Discussions with Management
- Review of principal agreements/documents etc.

The valuer should also include in his report:

- an affirmative statement that information provided and assumptions used by Management/Others in developing projections have been appropriately reviewed, enquiries made regarding basis of key assumptions in context of analysis of business being valued and the industry/economy; and
- an affirmative statement on adequacy of information and time for carrying out the valuations; with such modifications as may be appropriate and warranted. The affirmative statement shall not negate the professional liability for expertise applied in determining value and if the degree of inadequacy of information is severe, fundamental questions and information as assessed by the valuer as key for the appropriate stage of valuation needs to be disclosed.

### **8. Valuation Methodology**

Whereas one method may be more or less applicable to a particular case, they are often used in conjunction to arrive at the fair value of a company/asset/business. The following are some of the methods which are often used for valuations. The methods enumerated below are merely illustrative and not exhaustive.

- *Asset Approach*  
Book Value, Adjusted Book Value, and Liquidation Value
- *Income Approach*  
Capitalization of Earnings, Capitalization of Excess Earnings, and Discounted Future Earnings/Cash Flows.
- *Market Approach*  
Current Market Prices, Historical Market Prices, Price to Earnings, Price to Revenue, Price to Book Value, Price to Enterprise Value, etc.

- *Comparable Transactions/Valuations*

Comparable International and Domestic Transactions.

The valuation methodology adopted by the valuer has to be disclosed. The valuer should mention in the report the rationale and appropriateness for the adoption of a particular method or a combination of methods and emphasis/reliance placed on the chosen method/combination of methods in reaching the final conclusion.

## 9. Major Factors influencing the Valuation

The valuer should also mention any key factors which have a material impact on the valuation, including inter alia the size or number of the corporate assets or shares, its/their materiality or significance, minority or majority holding and changes on account of the transaction, any impacts on controlling interest, diminution or augmentation therein and marketability or lack thereof.

## 10. Conclusion

In conclusion, the report must contain a clear statement of the value ascribed to the business/assets in question.

## 11 Caveats, Limitations and Disclaimers

Any caveats, limiting condition or other disclaimers to the report must be clearly stated with appropriate specificity i.e. the valuer shall not disclaim liabilities for his expertise or deny his duty of care.

## Valuation Strategies for Mergers

A fair market valuation is an estimate or opinion of the theoretical worth of a company's equity based upon its underlying assets, income generating ability, and comparable transactions. There are accepted procedures, methods and formulae for preparing valuations. These accepted approaches and methods have been tested in tax, legal and other contentious matters. Different valuation approaches will frequently yield strikingly different results for a given company. It's the duty of the analyst or valuator to select the approach that is most appropriate given the facts and circumstances of the company. The asset approach might be most appropriate when valuing a capital intensive company with steady sales. The asset based approach may not be appropriate for a service industry. Further a combined approach may also be used in some strategies.

## RANBAXY LABORATORIES LIMITED – A CASE STUDY<sup>1</sup>

**Background:** Ranbaxy was founded in 1937 and derived its name from that of its founders – Ranjit Singh and Gurbax Singh. It started out as the Indian distributor of vitamins and anti tuberculosis drugs for a Japanese pharmaceutical company. After the Second World War, Ranbaxy continued its role as a distributor and ventured in manufacturing drugs by setting up its first plant in 1961. Ranbaxy's first real breakthrough came in 1969 with Calmpose, a copy of Roche patented Vellum tranquillizer. By 1971, Ranbaxy had extended its strong position in anti infectives in the Indian market and expanded manufacturing capacity to keep pace with sales.

### Strategic Shift

Due to the changing business conditions, it had become essential in 1993 to change the strategy of the company in order to tap rising opportunities. The senior management team of Ranbaxy underwent a strategic planning exercise called Vision 2003. Ranbaxy aimed to achieve two milestones by 2003; 1 billion in revenues and the development of one new therapeutic chemical molecule. The mission statement to become an international, research based pharmaceutical company was posed with many challenges at all levels of the company. The company had to redefine its product offerings and the markets it served. In

<sup>1</sup> Adapted from Mergers, Acquisitions and Corporate Restructuring – Strategies and Practices by Rabi Narayan Kar.

structuring the foreign ventures, Ranbaxy focused on the entire value chain to maximize margins. In February 2004, Ranbaxy crossed as \$1 billion mark in its turnover.

In 2003, a gain a strategic planning revival exercise took place with a new plan in place called Vision 2012:

- Aspire to be a \$ 5 billion company by 2012
- Become a top 5 global generics pharma company
- Significant income from the proprietary products

The company has decided to focus on the following therapeutic areas to meet its Vision 2012:

- Infectious Diseases (Anti-bacterial and Anti-fungals),
- Urology (Benign Prostatic Hyperplasia (BPH) and Urinary Incontinence),
- Metabolic Diseases (Type 2 Diabetes, Hyperlipidemia) and
- Inflammatory/Respiratory diseases (Asthma, Chronic Pulmonary Obstructive Disease and Rheumatoid Arthritis).

These choices allow Ranbaxy to enter large markets with significant unattended medical needs and to build on its research strengths. In 2008, Ranbaxy achieved a consolidated sale of \$ 1.7 billion. Its geographic and therapeutic sales break up is shown in Table 12.6 below:

**Table 1 – Geographic and Therapeutic Sales of Ranbaxy in 2008**

<i><b>Region</b></i>	<i><b>%</b></i>	<i><b>Major Therapy</b></i>	<i><b>%</b></i>
North America	27	Anti-infective	37
European Union	20	Cardiovascular	16
India	18	Gastrointestinal	NA
Asia (Excluding India)	6	Musculoskeletal	8
Russia and Ukraine	7	Central Nervous System	6
Africa and Latin Amarica	12	Respiratory	6

### **The Deal Value**

According to details of the deal, the enterprise value of Ranbaxy is estimated to be US \$ 8.5 billion at 737 price per share. The negotiated price of 737 represented a premium of 31.4% over the market price of Ranbaxy on the day of announcement. When the deal finally closed in November 2008, DIS had acquired 63.92% of the equity share capital of Ranbaxy as given below in table 2.

**Table 2. – Daiichi-Sankyo acquisition of Ranbaxy**

<i><b>Date of Acquisition</b></i>	<i><b>Particulars</b></i>	<i><b>Number of Shares</b></i>	<i><b>% of Shareholding</b></i>
October 15, 2008	Acquisition of Shares under Open Offer pursuant to Regulation 10 & 12 of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulation, 1997 @ 737 per share	92,519,126	22.01

October 20, 2008	Allotment of Shares on Preferential basis @ 737 per share	46,258,063	11.00
October 20, 2008	Acquisition of Shares from the then Promoters of the Company @ 737 per share (First tranche)	81,913,234	19.49
November 07, 2008	Acquisition of Shares from the then Promoters of the Company @ 737 per share (First tranche)	48,020,900	11.42
<b>Total</b>		<b>268,711,323</b>	<b>63.92</b>

**How much did Daiichi-Sankyo pay*****Nature of Transaction******Acquisition Consideration (in million yens)***

Open market share purchases	169,407
Share purchases from founding family (Gain of Promoters)	230,970
Share purchases by issuances of new shares (Money infused in Ranbaxy's balance sheet)	85,001
Direct acquisition related expenditures	<u>2,974</u>
Total	<u>488,352</u>

**How did Daiichi-Sankyo value Ranbaxy*****Assets and Liabilities******Value Attributed (Yen billions)***

Book value of assets and liabilities (Cash, Inventory etc.)	78.8	
Inventories (Increase in inventories in fair value)	2.0	
Tangible assets (Land)	10.0	
Intangible assets (Leasehold land)	5.9	
Intangible assets (Increase in current products, etc. to fair value)	41.0	
In-process R&D expenses	6.9	
Deferred tax liability	(20.0)	
Minority Interests	(45.0)	83.69
Goodwill	408.7	
Total consideration	<u>483.3</u>	

**Valuation of Ranbaxy Laboratories Ltd.**

Price paid per share by Daiichi	737
52 week high/low as on 11 <sup>th</sup> June 2008 for Ranbaxy share	593/300
Valuation of 63.92% stake by Daiichi	19804 crores
Valuation of 100% equity of Ranbaxy as per the deal	30982 crores
Enterprise Valuation of Ranbaxy (on a fully diluted basis)	\$8.5 billion
Market Capitalization of Ranbaxy as on 30 <sup>th</sup> May 2009 (Conclusion of Deal)	10434 crores



**Table 3 – Impact of Ranbaxy deal on Daiichi-Sankyo Balance Sheet<sup>1</sup>**

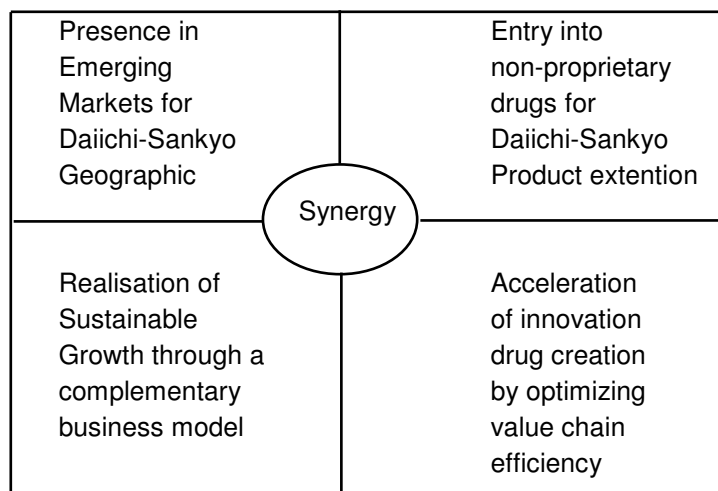
<i>Region</i>	<i>In Yens Billion</i>	<i>Remarks</i>
Net Profit/(Loss) for Daiichi-Sankyo in FY 2008	97.6	Recording of Y 351.3 billion in extraordinary losses due to a one-time write-off goodwill pertaining to the investment in Ranbaxy.
Net Profit/(Loss) for Daiichi-Sankyo in FY 2008	(215.5)	
Net cash used in investing activities in FY 2008	49.4	It is due to the cash acquisitions of shares in U3 Pharma and Ranbaxy, which entitled cash outflows
Net cash used in investing activities in FY 2009	413.8	
Short term bank loans in FY 2009	0.1	Borrowings for the acquisition of Ranbaxy's share Y + 240.0 billion
Short term bank loans in FY 2009	264.3	Increase by consolidation of Ranbaxy

**Financing of Deal**

Daiichi-Sankyo funded the acquisition through debt and existing cash reserves. Daiichi-Sankyo has taken a short and long term loans of 240 billion yens. That's almost 50% of the total funding requirement of the deal<sup>2</sup>.

**Strategic Reasons**

The acquisition shall pave this way for creating a new and complementary hybrid business model that provides sustainable growth by diversification that spans the full spectrum of pharma business. The expected synergistic benefits are summarized in the exhibit below:

**FIGURE 4**

1. Global down turn and financial crisis has made Daiichi take a huge hit on its balance sheet due to the acquisition of Ranbaxy.
2. the datas mentioned here in the case has been compiled from Ranbaxy annual report 2008, DIS annual report, websites of Ranbaxy and DIS.

While DIS grew at 4.7% in 2007 to \$7.12 billion, Ranbaxy grew at over 10% to \$ 1.6 billion. While the world pharma industry grew at 6%, the generic segment is growing at 11%. The pursuit of the hybrid business model would help DIS to improve its growth rate substantially. Daiichi would be able to extend its reach to 56 countries from 21 countries where they currently operate.

### **Benefits to Daiichi Sankyo**

In addition to the expected synergies, DIS will be benefited most by the low-cost manufacturing infrastructure and supply chain strengths of Ranbaxy. Further, DIS will be able to bring in efficiency in its operations by sourcing APIs<sup>6</sup> and finished dosage products from Ranbaxy's 9 manufacturing plants in India and many more in other countries.

The R&D facilities of Ranbaxy would be used by DIS to not only reduce some of its R&D expenses, but also use competencies of Ranbaxy scientists to faster new product development. DIS is also expected to get Zenotech's expertise in the areas of biologics, oncology and specialty injectibles. (i)

### **Benefits to Ranbaxy**

According to the promoters of Ranbaxy, the deal was meant to take it to the next level of growth. With India honouring the product Patent regime from 2005, Generic drug companies are finding it more difficult to make similar versions of innovative drugs. (ii) further, tough times ahead has forced global generic majors to merge or buy or become generic behemoths, e.g., Sandoz's acquisition of German company Hexal in 2005.

Besides, there was a strong feeling that perhaps the game is over for Indian drug companies unless they pull up their socks and strengthen their R&D. Analysts feel that promoters of Ranbaxy could visualize this in advance and got the best possible deal while the going was still good and made a very decent, honorable and attractive exit.

### **Risk Involved**

The Food and Drug Administration (FDA) issued two warning letters to Ranbaxy Laboratories and an Import Alert for generic drug produced by Ranbaxy's Dewas and Paonta Sahib plants in India on 16 September 2008. US officials could detain at the US border, any API and finished drugs manufactured at these plants. Analysts estimate the loss of business to Ranbaxy as a result of this development to be at \$40 million. This development has resulted in sharp fall of Ranbaxy share price by 6.6% on BSE.

Just a week after DIS announcement Ranbaxy announced the settlement of its protracted multi-country battle over Pfizer's \$12 billion cholesterol drug lipitor. Ranbaxy had entered into an agreement with Pfizer Inc. to settle most of the patent litigation worldwide over lipitor. After the announcement, Ranbaxy shares saw a dip by 7.7% as against Bombay Stock Exchange (B.S.E.) dip of 2.2%.

Analysts have expressed their doubt about the price paid for the acquisition as it was quite high compared to the present pricing of other Indian generic drug making companies. This may put severe strain on DIS's financials.

### **Notes:**

1. In October 03, 2007, Ranbaxy entered into share purchase agreement with the promoters of Zenotech Laboratories Ltd. (ZLL) for acquiring 27.35% shares of ZLL' at a price of 160 per share. On the completion of the above acquisition, Ranbaxy made the public announcement to the shareholders of ZLL' to acquire upto 20% shares at a price of 160 per share. On the completion of the above acquisition, Ranbaxy' holds 46.79% shares of ZLL. As on October 20, 2008, Ranbaxy held 46.85% shares of ZLL'. As a result of acquisition of Ranbaxy by DIS, DIS has indirectly

acquired 46.85% shares of ZLL'. In July, the Madurai bench of the Madras High Court had given stay on the open offer, following complaints made by minority shareholders. However, DIS got relief from the Supreme Court to go ahead with the offer.

2. India changed its policy of Patent regime from product to process in 1970 after enactment of Indian Patent Act. This has opened doors of reverse engineering to prepare formulations. This has helped Indian pharma companies in developing their capabilities at manufacturing low cost APIs, which global majors were selling at extremely high prices. In 2005, the wheel of patent perfection came a full circle as India amended the Patent Act, to recognize the product patent under the obligation of WTO regime.
3. Under the agreement, Ranbaxy will delay the start of its 180 days exclusivity period for a generic version of lipitor, until November 2011. While the settlement avoided further legal cost for Ranbaxy in fighting Pfizer, if it had won the case, Ranbaxy could have introduced generic version as early as March 2010.
4. DIS plans to record a valuation loss of \$3.99 billion on its shares in its India based subsidiary Ranbaxy Laboratories to reflect the decline in the market value of shares.

On a non correlated basis DIS plans to record a non-cash valuation loss of \$3.99 billion on its shares in Ranbaxy in its third quarter to reflect a more than 50% decline in market value of these securities versus the purchase price. The company said in a statement on the company's website.

DIS sees no impact on its forecasts for non-consolidated net-sales, operating income or ordinary income for the third-quarter as a result of these anticipated extraordinary losses. The company also sees no impact in cash flows. However, these items will have a significant negative impact on the company's consolidated financial results for the net income for the year 2008-09. Reacting to this news DIS shares fell 1.2% on the Tokyo stock exchange.

## **Valuation for liquidation/insolvency**

### **Net Realisable Value Method**

This method is generally used in case of liquidation. Where the business of the company is being liquidated, its assets have to be valued as if they were individually sold and not on a going concern basis. Liabilities are deducted from the liquidation value of the assets to determine the liquidation value of the business. One should also consider liabilities which will arise on closure such as retrenchment compensation, termination of critical contracts, etc. Tax consequences of liquidation should also be considered. Any distribution to the shareholders of the company on its liquidation, to the extent of accumulated profits of the company is regarded as deemed dividend. Dividend Distribution tax will have to be captured for such valuation.

### **Valuation of slump sale**

The concept of Slump Sale was incorporated in the Income tax Act, 1961 ('the IT Act') by the Finance Act, 1999 when Section 2(42C) was inserted defining the term 'slump sale' as transfer of one or more undertakings as a result of the sale for a lump sum consideration without values being assigned to the individual assets and liabilities. Prior to the insertion of Section 2(42C), Courts have held that slump sale is a sale of a business on a going concern basis where the lumpsum price cannot be attributed to individual assets or liabilities.

The undertaking has to be transferred as a result of sale. If an undertaking is transferred otherwise than by way of sale, say, by way of exchange, compulsory acquisition, extinguishment, inheritance by will, etc., the

transaction may not be covered by Section 2(42C). The consideration for transfer is a lump sum consideration. This consideration should be arrived at without assigning values to individual assets and liabilities.

As regards the valuation of slump sale it is appropriate to brief the provisions of Section 50B of the Income Tax Act, 1961.

Section 50B provides the mechanism for computation of capital gains arising on slump sale. Capital gains arising on slump sale are calculated as the difference between sale consideration and the net worth of the undertaking. Net worth is deemed to be the cost of acquisition and cost of improvement for the purpose of calculation of capital gains tax.

Net worth is defined in Explanation 1 to Section 50B as the difference between 'the aggregate value of total assets of the undertaking or division' and 'the value of its liabilities as appearing in books of account'

The 'aggregate value of total assets of the undertaking or division' is the sum total of :

1. WDV as determined u/s.43(6)(c)(i)(C) in case of depreciable assets.
2. The book value in case of other assets.

### **Valuation of Assets in a Demerger**

Valuation of demerger is based on Section 19AA of demerger under the Income Tax Act 1961.

As per Section 19AA "demerger", in relation to companies, means the transfer, pursuant to a scheme of arrangement under sections 391 to 394 of the Companies Act, 1956 (1 of 1956), by a demerged company of its one or more undertakings to any resulting company in such a manner that—

- (i) all the property of the undertaking, being transferred by the demerged company, immediately before the demerger, becomes the property of the resulting company by virtue of the demerger;
- (ii) all the liabilities relating to the undertaking, being transferred by the demerged company, immediately before the demerger, become the liabilities of the resulting company by virtue of the demerger;
- (iii) the property and the liabilities of the undertaking or undertakings being transferred by the demerged company are transferred at values appearing in its books of account immediately before the demerger;
- (iv) the resulting company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis;
- (v) the shareholders holding not less than three-fourths in value of the shares in the demerged company (other than shares already held therein immediately before the demerger, or by a nominee for, the resulting company or, its subsidiary) become share-holders of the resulting company or companies by virtue of the demerger, otherwise than as a result of the acquisition of the property or assets of the demerged company or any undertaking thereof by the resulting company;
- (vi) the transfer of the undertaking is on a going concern basis;
- (vii) the demerger is in accordance with the conditions, if any, notified under sub-section (5) of section 72A by the Central Government in this behalf.

*Explanation 1.*—For the purposes of this clause, "undertaking" shall include any part of an undertaking, or a unit or division of an undertaking or business activity taken as a whole, but does not include individual assets or liabilities or any combination thereof not constituting a business activity.

*Explanation 2.*—For the purposes of this clause, the liabilities referred to in sub-clause (ii), shall include—

- (a) the liabilities which arise out of the activities or operations of the undertaking;
- (b) the specific loans or borrowings (including debentures) raised, incurred and utilised solely for the activities or operations of the undertaking; and
- (c) in cases, other than those referred to in clause (a) or clause (b), so much of the amounts of general or multipurpose borrowings, if any, of the demerged company as stand in the same proportion which the value of the assets transferred in a demerger bears to the total value of the assets of such demerged company immediately before the demerger.

*Explanation 3.*—For determining the value of the property referred to in sub-clause (iii), any change in the value of assets consequent to their revaluation shall be ignored.

*Explanation 4.*—For the purposes of this clause, the splitting up or the reconstruction of any authority or a body constituted or established under a Central, State or Provincial Act, or a local authority or a public sector company, into separate authorities or bodies or local authorities or companies, as the case may be, shall be deemed to be a demerger if such split up or reconstruction fulfils 81[such conditions as may be notified in the Official Gazette 82, by the Central Government];

*As per Section 19AAA “demerged company” means the company whose undertaking is transferred, pursuant to a demerger, to a resulting company;*

A demerger scheme usually involves the allotment of shares in the transferee company to the shareholders of the transferor company, in lieu of their reduction of their interest in the transferee company having a mirror image of shareholdings. If post demerger as part of strategy, intention is to create holding subsidiary relationship or retain part stake than it is possible to allot shares of the transferee company to the transferor company.

In the context of a demerger scheme, a valuation exercise is mandatory in order to determine the number of shares to be issued to the shareholders of the transferor company in consideration for the spin off/demerger of the undertaking or undertakings. If demerger is going to be in ‘Shell Company’, then valuation is primarily to determine the capital structure of the Transferee/Resultant Company.

If the demerged and resulting companies belong to same group of management and shareholders are common, share exchange ratio based on Net Asset Based valuation model may be adopted. Any other business valuation method may also be adopted considering the same shareholding as it will not impact value for the shareholders in demerged company post-demerger. In ideal situation like the companies are profitable and shareholders are different, it is recommendable to use Profit Based Valuation model for deciding on the share exchange ratio. While demerging to the shell company, there is no value of the shell company. Therefore, any no of shares may be issued to the shareholders of the demerged company as there will not be any impact on the shareholders’ wealth.

There may be various situations and objectives wherein demerger schemes are implemented. Fair valuation only considers the status of the businesses and other macro factors but it also considers very big picture of implication of valuation/share exchange ratio. It does also consider costs such as stamp duty involved in adopting any valuation model.

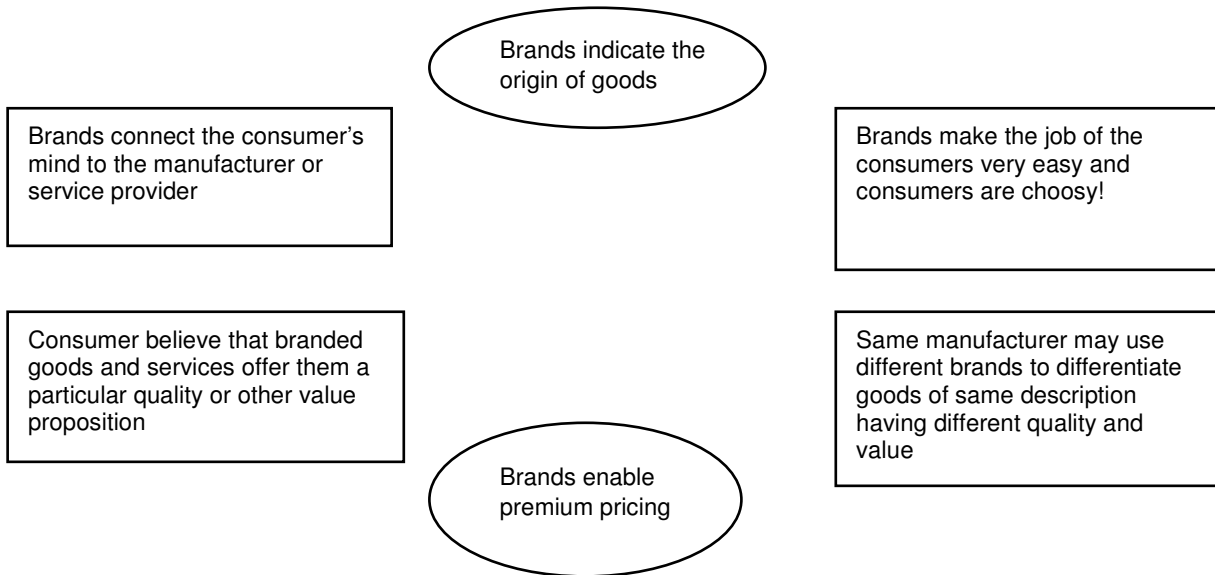
## **VALUATION OF BRANDS**

Black’s Dictionary defines it as a word, mark, symbol, design, term, or a combination of these, both visual and oral, used for the purpose of identification of some product or service.

It is the hallmark of a shrewd businessman to commence his business with a roadmap of his plans. In the

course of his business, he applies a unique mark or symbol or word to his goods. When his customer base increases, his goods acquire reasonable reputation and his customers begin identifying his goods by the unique mark or symbol or word he had so adopted, his goods earn the reputation of being branded goods. What applies to goods applies to services also. When brands take charge of consumers' minds, the name of its proprietor takes the backseat. There lies the power of brands.

### Functions of Brands



### The Importance of Brand valuation

Think for a moment as to how much investment one has to make by means of money and others resources to adopt, develop and popularize a brand or a mark during the course of his business. Brands/marks are a class of assets like human resource, knowledge etc. They create a value premium for the goods and services. Therefore, without the brand/mark, the goods/services may be address less. In order to market it or use this asset wisely valuing the same is essential. But remember, valuing a brand is a very difficult task. There is no prescribed manner to value a brand. But all knows that brands connect markets with products and thereby they create value.

Brands do not command any value unless they are able bring cash flows to the Company that has adopted the same. With incremental cash flows increasing, value of brand increases proportionately. Brands have to be constantly associated with good quality goods and services; they require proper show casing and servicing and they should remain active in appropriate markets.

### Protect the Value of the Brand

In order to sustain the valuation of the brand, there must a constant attempt from the Company on the following aspects:

- To secure registration of the Brand in all relevant classes.
- To secure registration of the Brand in all countries where there are opportunities to sell Branded Products of the Company.
- To set up a "surveillance team" within the Marketing Department of the Company so as to ensure that there is no dilution to the value of the Brand.

- To ensure that attempts to use fake brands that are similar or deceptively similar are challenged with full force so as to spread the message that the Company is conscious of the value of its brand and it will be aggressive in taking steps not only to put an end to such illegal, dishonest and unauthorized use but also to punish such users and claim exemplary damages from those who had passed off their goods to people and those who are found to be guilty of infringement.
- To ensure that there is always a budget allocation for promoting the brand and the Company should devise a continuous process for being present in the existing markets and prospective markets.
- To ensure that there is a conspicuous distinction in the description of the brand when it is used to sell premium products as opposed to use of the same brand for selling goods to the masses.
- To ensure that the extent of growth in the value of the brand very year is always higher than the depreciation or dent that existing or new competition may cause.
- To adopt a proper policy with regard to slogans and catchy phrases so that the Company does not knowingly cause any infringement of the industrial and intellectual property rights of any other person in any country or territory.
- To adopt a proper policy with regard to statements made in advertisements carrying the brand in order to ensure that those statements are not mere attractive words and they would stand the test of the market.
- To adopt a proper policy to augment IP profile of the Company and constantly update and upgrade the same.

For the purpose of valuation of brands, it may be necessary to make a through enquiry into the policies and business of the company to the extent they relate to brands. For such enquiry, the following questionnaire may prove to be helpful:

<i>Sl. No.</i>	<i>Query</i>
1.	What are the brands requiring valuation? Please mention all its variants and styles also.
2.	What is the date of adoption of each brand?
3.	Does the company use the brand owned by any third party?
4.	What are goods or products that are sold under those brands?
5.	For how long they have been in use?
6.	Whether the use of brands has been continuous?
7.	Whether use of any brand has been stopped?
8.	Whether the brands of the company have been registered under the Trademarks Act, 1999?
9.	Whether there has been any opposition to registration of the any of the Brands of your company?
10.	What are the Brands/Trademarks which have not yet been registered though necessary applications have been filed already with the Registrar of Trademarks?
11.	Whether the artistic works contained in the brands of the company have been registered under the Copyrights Act, 1957?
12.	Whether your company has adopted any slogan or catchy phrase to highlight the policy of your company or its branded goods?

13.	What is the turnover of the company from goods sold under brand? (Brand-wise data from three financial years may be provided)
14.	Whether the company has a website of its own? Give details.
15.	Whether the company has dealer/agent network?
16.	How does the company take its products to its ultimate customers?
17.	Has the company any brand adoption policy? Please furnish a copy of the policy.
18.	Has the company granted any permission to any party for brand use? Please provide a copy of Licence agreement if any.
19.	Has the company a marketing division of its own?
20.	Has there been any advertisement about the brands? Please furnish complete details regarding advertisements in the print media/electronic media?
21.	Whether there have been any radio commercial programmes of your company's brands?
22.	Has there been any use of the brand in any country other than India?
23.	What are the most prominent states in India where the branded goods of the company sell significantly?
24.	Can you give product wise turnover for three financial years?
25.	Can you furnish state wise turnover for three financial years?
26.	Can you furnish names of the States where the products of the Company are not sold at all?
27.	Can you furnish details of those products, which though manufactured by the company are sold without applying any brand?
28.	Can you furnish details of those goods that are sold by your company as branded goods even though they are simultaneously sold without applying those brands?
29.	Is there any product that the company gets manufactured through any other party (such as a sub-contractor) who puts the brand of the company upon those goods and delivers to the company?
30.	What is the budget of the company for its advertisement and publicity for three financial years? How much of the same could be related to brand promotion?
31.	Who are the major competitors of your company's goods? What are their brands? How those brands are superior or inferior to your company's brands?
32.	What is the total market India for the goods of your company? Please give details in value terms and in quantity terms if possible.
33.	What would the approximate market share of your company?
34.	Has the market share improved after introducing branded goods?
35.	In your opinion would the price of branded goods sold is higher than the price of same goods sold without brands? (You may consider a market place where two traders are selling the same or similar goods, your company selling those goods as branded goods and the other trader selling his goods without any brand).



36.	Do you think because of Brands the goods of your company have been commanding higher (premium) valuation?
37.	Do you think your company has not reached out to customers adequately in respect of any territory?
38.	Could you please provide financial projections for the next three financial years?
39.	Has there been any raid or criminal action against sale of spurious goods similar to your goods upon which the Brands of your company or any brand deceptively similar to the Brands of your company have been used?
40.	Has your company ever given any warning or caution notice about Brands of your company?
41.	Has your company at any time opposed the registration of any brand or trademarks of any other person?
42.	Has your company issued any legal notice to any party against misuse of any Brands of your company?
43.	Has there been any suit against any party for passing off or infringement of any of the Brands of your company?
44.	Has there been any legal notice or legal action against your company alleging copying or misuse of brands of others?
45.	Has there been any valuation of any of the Brands of your company at any time before this?

## VALUATION APPROACH

Basically in an enterprise, physical resources are of the following two types:

- Machinery, that work with applied force;
- Men who work.

Both the above assets are capable of being organized provided the two vital inputs are present; viz., money and knowledge.

Brands belong to a different species. While physical resources could be created easily if augmenting financial resources is not a problem, same is not the case of brands. That is why there is always a premium price for buying branded goods rather than the business or plants and equipments. In the case of Brands, the ability of the Company to leverage the same to bring revenues in other territories and markets is of paramount importance.

As already seen, the value of an enterprise could be estimated on a going-concern basis by computing the earning capacity. Net Asset Value method may not be ideal in the cases enterprises with depreciating assets unless the enterprise in question is asset intensive. For instance, in the case of company engaged in real estate sector, the lands in the hands of the company on ownership basis could be a stock in trade and they may be highly valuable. However, in the case of Brands, which form the lifeline of the Company, there has to be a different approach.

According to an Article that appeared in the Hindu Business Line (of Mr. G. Ramachandran, a financial analyst and Mr. R. Vijay Shankar, Director of SSN School of Management and Computer Applications) “the hands that hold a brand will determine how much value will be created. Therefore, a brand’s value is

inestimable. There are no commodity-like, normative valuation methods. Brands will defy any attempts aimed at valuing them. That is what makes brands mystical. They will trample upon the egos of those that are mechanistically minded. Mr. David Haigh, Chief Executive, Brand Finance, and Mr. M. Unni Krishnan, Country Manager, Brand Finance, are of the view that traditional measures of financial performance do not reveal fully the value of brands (Praxis, Business Line's Journal on Management, May 2005). Mr. Haigh and Mr. Krishnan bemoan the fact that earnings per share (EPS) and dividend yield look back rather than forward".

Cost Approach for valuation of Brands may not help. The cost incurred in the initial years would not have been very high as all resources should have been used up for setting up manufacturing facility and sales force to give customers high quality Products for value and to ensure that customers are happy. In the case of a premium brand, a company may be incurring expenditure in order to capitalize the position and expand the territories and to ward off competition. Therefore for every rupee incurred by the Company on an established brand, returns would be manifold. This enables the Company to introduce the brand for new products and new markets. In order to retain the ability of the Brand to reach an expanded customer base, it is essential that the company have adequate physical resources and a favourable industrial outlook. Thus depending upon the facts and circumstances of each case, suitable method of valuation of the brands should be adopted. In the case of a premium brand, the price of the products that are sold under the premium brand may command a premium price as compared to any other similar product that is sold under an ordinary brand or without any brand. The price differential between the goods carrying premium brand and other similar goods would show the extent of premium the branded goods command. Taking the said premium as an indicator, it is possible to evaluate the value of the brand using the usual cash flow model of valuation. Students should refer to the section on case studies to see a case of typical brand valuation.

Investors have become more active in protecting their value. Any transaction of purchase/ sale of business/ companies require determination of fair value for the transaction to satisfy stakeholders and/or Regulators. Business valuation is an unformulated and subjective process. Understanding the finer points of valuing a business is a skill that takes time to perfect. There are various methodologies for valuing a business, all having different relevance depending on the purpose of valuation. Key aspects of valuation along with various restructuring options have been explained hereunder:

A clear understanding of the purpose for which the valuation is being attempted is very important aspect to be kept in mind before commencement of the valuation exercise. The structure of the transactions also plays very important role in determining the value. For example, if only assets are being transferred out from a Company, valuation of equity shares is of no importance. The 'general purpose' value may have to be suitably modified for the special purpose for which the valuation is done. The factors affecting that value with reference to the special purpose must be judged and brought into final assessment in a sound and reasonable manner.

### LESSON ROUND UP

- Corporate valuation is not only a pre-requisite during different types of restructuring phase of the company. It is required at frequent intervals to identify the economic value creation and any destruction if any occurred.
- The process of valuation includes a detailed and comprehensive analysis taking into an account the past present and future earnings prospects and analysis of physical and intangible assets and general economic and industry conditions.
- The valuation of shares is a technical matter. It requires considerable skill and experience. There are bound to be differences of opinion among accountants as to what is the correct value of the shares of a company.

- 'Slump sale' as transfer of one or more undertakings as a result of the sale for a lump sum consideration without values being assigned to the individual assets and liabilities.
- Section 50B of the Income Tax Act, 1961 provides the mechanism for computation of capital gains arising on slump sale. Capital gains arising on slump sale are calculated as the difference between sale consideration and the net worth of the undertaking. Net worth is deemed to be the cost of acquisition and cost of improvement for the purpose of calculation of capital gains tax.
- Demerged company means the company whose undertaking is transferred, pursuant to a demerger, to a resulting company.
- A demerger scheme usually involves the allotment of shares in the transferee company to the shareholders of the transferor company, in lieu of their reduction of their interest in the transferee company having a mirror image of shareholders. If post demerger as part of strategy, intention is to create holding subsidiary relationship or retain part stake than it is possible to allot shares of the transferee company to the transferor company.
- Black's Dictionary defines brand as a word, mark, symbol, design, term, or a combination of these, both visual and oral, used for the purpose of identification of some product or service.

## SELF TEST QUESTIONS

1. Discuss the objective of corporate valuation in the emerging business environment.
2. Enumerate the content of valuation report for corporate strategies.
3. Critically examined the valuation of demerger under the Income Tax Act, 1961.
4. Explain the importance of Brand valuation.
5. Discuss briefly the functions of Brand.

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# Lesson 16

## Insolvency – Concepts and Evolution

### LESSON OUTLINE

- Insolvency/Bankruptcy-the concepts
- Historical developments of Insolvency Laws in India
- A Brief regulatory framework on corporate insolvency in India
- A brief on historical background of insolvency laws in UK
- The Existing Regulatory framework in UK
- The evolution of Insolvency Laws in the US along with timeline
- The current Bankruptcy code in the US

### LEARNING OBJECTIVES

The laws relating to insolvencies and bankruptcies in the earlier centuries were framed for penalizing the defaulting debtors and in the most of the cases with imprisonment. As the historical aspects relating to insolvencies evidences that the European insolvency framework, started in the 15th century was the preliminary base for countries that had developed insolvency framework in the subsequent centuries. There has been revamping shift in the global regulatory framework towards corporate insolvency. The principal focus of modern insolvency legislation and business debt restructuring practices are not liquidation and elimination of insolvent entities but on the remodeling of the financial and organizational structure of debtors experiencing financial distress so as to permit the rehabilitation and continuation of their business. Indeed, Chapter 11 of US bankruptcy code is considered to be one of the best insolvency frameworks in the global platform. After reading this lesson you will be able to understand the historical and emerging aspects of insolvency process in India, UK and USA.

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## INSOLVENCY/BANKRUPTCY – THE CONCEPT

Insolvency is when an individual, corporation, or other organization cannot meet its financial obligations for paying debts as they are due. Bankruptcy is not exactly the same as insolvency. Technically, bankruptcy occurs when a court has determined insolvency, and given legal orders for it to be resolved. Bankruptcy is a determination of insolvency made by a court of law with resulting legal orders intended to resolve the insolvency. Insolvency describes a situation where the debtor is unable to meet his/her obligations. Bankruptcy is a legal scheme in which an insolvent debtor seeks relief.

### Do you know the origin of the Word Bankruptcy?

The word bankruptcy is formed from the ancient Latin words 'bancus' (a bench or table), and 'ruptus' (broken). A "bank" originally referred to a bench, which merchants used when trading their goods. When a trader fails, he breaks his bank (or bench), to advertise to the public that he is no longer able to conduct business.

## Historical developments of Insolvency Laws in India

The law of Insolvency in India owes its origin to English law. Before the British came to India there was no indigenous law of Insolvency in the country.

The earliest rudiments of insolvency legislation can be traced to sections 23 and 24 of the Government of India Act, 1800, which conferred insolvency jurisdiction on the Supreme Court.

The passing of Statute 9 in 1828 (Geo. IV. c. 73) was passed, which can be said to be the beginning of the special insolvency legislation in India. Under this Act, the first insolvency courts for relief of insolvent debtors were established in the Presidency-towns. A further step in the development of Insolvency Law was taken when the law in 1848 (11 and 12 Viet. c. 21) was passed. The Provisions of the Indian Insolvency Act, 1848, were, however, found to be inadequate to meet the changing conditions. However, the Act of 1848 was in force in the Presidency-towns until the enactment in 1909 of the present Presidency-towns Insolvency Act, 1909. The Presidency Towns Insolvency Act, 1909 and Provisional Insolvency Act, 1920 are two major enactments that deal with personal insolvency and have parallel provisions and their substantial content is also similar but the two differ in respect of their territorial jurisdiction. While Presidency Towns Insolvency Act, 1909 applies in Presidency towns namely, Kolkata, Mumbai and Chennai, Provincial Insolvency Act, 1920 applies to all provinces of India. These two Acts are applicable to individuals as well as to sole proprietorships and partnership firms.

Under the Constitution of India 'Bankruptcy & Insolvency' is provided in Entry 9 List III - Concurrent List, (Article 246 –Seventh Schedule to the Constitution) i.e. both Center and State Governments make laws relating to this subject.

The Presidency Towns Insolvency Act, 1909 and Provisional Insolvency Act, 1920 are two major enactments that deal with personal insolvency.

## A Brief on the regulatory framework for corporate insolvency in India.

- The most relevant laws at present, governing corporate insolvency and bankruptcy in India are:
- The Companies Act of 1956. The Companies Act governs liquidation of a company in financial distress via: (i) voluntary winding-up; (ii) involuntary winding-up by the courts; or (iii) winding-up

subject to supervision by the courts which has been deleted by Companies (Amendment Act) 2002 and yet to be notified.

- The Sick Industrial Companies (Special Provisions) Act, 1985 (SICA). SICA was developed as India's version of a comprehensive bankruptcy framework for "sick" industrial companies and provides a program for the reconstruction of these companies under the supervision of the Board for Industrial and Financial Reconstruction (BIFR). SICA, however, only applies to "sick" companies in select industries that have been incorporated for at least five years, have at least 50 workers on any day in the preceding 12 months and have a factory license. Although technically, SICA has been repealed by the Sick Industrial Companies (Special Provisions) Repeal Act, 2003 (the Repealing Act), it still continues to be good law today because, to date, the Repealing Act has not yet come into force.
- The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests Act, 2002 (SARFAESIA). SARFAESIA empowers banks or financial institutions with a presence in India or which have been notified by the Government of India to recover on non-performing assets without court intervention. An asset is classified as non-performing if interest or installments of principal due remain unpaid for more than 180 days. SARFAESIA provides three alternative methods for recovery of non-performing assets, including taking possession, selling and leasing the assets underlying the security interests such as movable property (tangible or intangible, including accounts receivable) and immovable property without the intervention of the courts. The SARFESIA is not available to secured creditors, which are not Indian banks, or financial institutions notified.

### Reforms in Insolvency Law For Corporate Side

Over the last two decades, the Indian financial system has undergone tremendous transformation. Various financial sector reforms have been initiated aimed at promoting an efficient, well-diversified and competitive financial system with the ultimate objective of improving the allocative efficiency of resources so as to accelerate economic development. As India swiftly moves to the centre stage of world economy there has been a consistent effort by the policy makers to undertake comprehensive reforms in the laws and systems to bring them at par with international standards and incentivise the foreign investors to invest in the Indian economy.

### Justice Eradi Committee

In the year 1999, the Government of India set up a High Level Committee headed by Justice V.B.Eradi, to examine and make recommendations with regard to the desirability of changes in existing law relating to winding up of companies so as to achieve more transparency and avoid delays in the final liquidation of the companies; The Committee recognized after considering international practices that the law of insolvency should not only provide for quick disposal of assets but in Indian economic scene, it should first look at the possibilities of rehabilitation and revival of companies. The Committee also recommended that the jurisdiction, power and authority relating to winding up of companies should be vested in a National Company Law Tribunal instead of the High Court as at present. The Committee strongly recommended appointing Insolvency Professionals who are members of Institute of Chartered Accountant of India (ICAI), Institute of Company Secretaries of India (ICSI), Institute of Cost and Work Accountants of India (ICWAI), Bar Councils or corporate managers who are well versed in Corporate management on lines of U.K. Insolvency Act.

### Dr J J Irani Expert Committee on Company Law

Dr. J.J.Irani Expert Committee on Company Law was set up by the Government to recommend a new company law as a part of the on-going legal and financial sector reform process in the country. Committee submitted its report to the Government of India on 31 May 2005. The Committee has proposed significant changes in the law to make the restructuring and liquidation process speedy, efficient and effective.

### Provisions of Companies Bill 2012 Relating to Insolvency Administrators

- **Appointment as interim administrator**

The Tribunal may appoint an interim administrator or a company administrator from the panel of Company Secretaries, Advocates, CAs, CWAs, etc. maintained by the Central Government.

- **Company Liquidators**

The Tribunal may appoint Provisional Liquidator or the Company Liquidator from a panel maintained by the Central Government consisting of Company Secretaries, Chartered Accountants, Advocates and Cost and Works Accountants.

- **Professional assistance to Company Liquidator**

The Company Liquidator may, with the sanction of the Tribunal, appoint one or more professionals including Company Secretaries to assist him in the performance of his duties and functions under the Act.

### United Kingdom

#### A Brief on Historical background on UK insolvency framework

In England, the first bankruptcy law was enacted in 1542, being Statute 34 Henry VIII. Under this act a debtor was still looked upon as in a sense an offender, and the law was mainly for the benefit of creditors, providing for an equal distribution of the debtor's assets among his creditors, but not releasing the debtor from his debts. The early bankruptcy laws of England was exclusively an instrument of debt-collection: its finality was to seize the debtor's assets *against* the strong protections to private property offered by the Common law, since medieval times. The procedure thus worked rather as a continuation of private remedies, with different, collective, legal instruments.

#### The Current Regulatory Framework in UK

The 1982 Report of the Insolvency Law review Committee, *Insolvency Laws and Practice* (commonly known as "the Cork Report") recommended the adoption in the United Kingdom of Unified Insolvency legislation. Ultimately the *Insolvency Act, 1986 (UK)* was enacted and this encompasses both types of insolvency administrations, including corporate restructuring.

The existing UK insolvency framework is defined by the Insolvency Act 1986. According to the Act, failing companies are either liquidated or submitted to an insolvency process that may allow them to be rescued as going concerns.

The Insolvency Act, 1986 deals the insolvency of individuals and companies. The Act is divided into three groups and 14 Schedules as follows:

Group 1 deals with Company Insolvency

Group 2 deals with Insolvency of Individuals and

Group 3 deals with Miscellaneous Matters Bearing on both Company & Individual Insolvency



Basically, a company in financial difficulties may be made subject to any of five statutory procedures.

1. administration;
2. company voluntary arrangement;
3. scheme of arrangement;
4. receivership (including administrative receivership); and
5. liquidation (winding-up).

With the exception of schemes of arrangement, which fall within the ambit of the Companies Act, 2006, these are formal insolvency procedures governed by the Insolvency Act, 1986.

The administration procedure was introduced by the insolvency Act, 1986 and substantially revised by the Enterprise Act, 2002 to include a streamlined procedure allowing the company or (more often) its directors to appoint an administrator without the involvement of the Court subject to conditions.

Firms are in fact liquidated if they become the subject of a compulsory liquidation order obtained from the court by a creditor, shareholder or director. Alternatively, the company may itself decide to pass a liquidation resolution – subject to the approval of a creditors' meeting – for the company to be wound-up (a Creditors Voluntary Liquidation). Either way, the result of both these procedures is the winding-up of the company. Neither process makes any attempt to rescue or sustain the company as a legal entity.

The Insolvency Act 1986 also introduced three new procedures that held out the possibility of a company being brought back to life as a viable entity. These measures represented an attempt to emulate the 'rescue culture' that characterised the corporate sector in the US.

The first of these procedures – 'company voluntary arrangements' (CVAs) – provides a way in which a company in financial difficulty can come to a binding agreement with its creditors.

The second procedure – 'administration' – offers companies a breathing space during which creditors are restrained from taking action against them. During this period, an administrator is appointed by a court to put forward proposals to deal with the company's financial difficulties.

A third option – 'administrative receivership' – permits the appointment of a receiver by certain creditors (normally the holders of a floating charge) with the objective of ensuring repayment of secured debts.

The Enterprise Act 2002 attempted to embed a rescue culture by creating entry routes into administration that did not require a court order, and simplified the means by which a company could 'emerge' from administration. It also prohibited – with certain exceptions – the right of creditors to appoint an administrative receiver (which had previously blocked a company's ability to opt for administration).

In addition, the Act explicitly established a 'hierarchy of purposes' for the administration process. The primary duty of administrators was defined as rescuing the company as a going concern (a duty that does not exist for an administrative receiver). Only if this is not practicable – or not in the interests of creditors as a whole – is the administrator allowed to consider other options, such as realising the value of property in order to make a distribution to creditors.<sup>1</sup>

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<sup>1</sup> Inputs taken from Does the UK need Chapter 11 Written by Dr Roger Barker, Head CG at IOD.

## US Bankruptcy laws<sup>2</sup>

### The evolution of Insolvency Laws in US along with timeline

As we read earlier, England first established a bankruptcy law in 1542. Under the English law, bankruptcy was treated as a criminal act punishable by imprisonment or death. Only merchants were eligible for bankruptcy and only creditors could institute bankruptcy proceedings.

The English bankruptcy system was the model for bankruptcy laws in the English colonies in America and in the American states after independence from England in 1776.

Early American bankruptcy laws were only available to merchants and generally involved imprisonment until debts were paid or until property was liquidated or creditors agreed to the release of the debtor. The laws were enacted by each individual state and were inconsistent and discriminatory. For example, the laws and courts of one state might not enforce debts owed to citizens of other states or debts of certain types. The system was not uniform and some states became known as debtor's havens because of their unwillingness to enforce commercial obligations.

The lack of uniformity in bankruptcy and debt enforcement laws hindered business and commerce between the states. The United States Constitution as adopted in 1789 provides in Article I, Section 8, Clause 4 that the states granted to Congress the power to establish uniform laws on the subject of bankruptcies throughout the United States.

*To establish an uniform Rule of Naturalization, and uniform Laws on the subject of Bankruptcies throughout the United States;*

*Article I, Section 8, Clause 4 of US Constitution*

However, until 1898 there was no bankruptcy law in continuous effect in the United States. The Congress enacted temporary bankruptcy statutes in 1800, 1841 and 1867 to deal with economic downturns. However, those laws were temporary measures and were repealed as soon as economic conditions stabilized. The Act of 1800 was repealed in 1803. The Act of 1841 was repealed in 1843 and the Act of 1867 only lasted until 1878.

These early laws only permitted merchants, traders, bankers and factors to be placed in bankruptcy proceedings. The Acts of 1800 and 1841 vested jurisdiction in the federal district courts. The district court judges were given the power to appoint commissioners or assignees to take charge of and liquidate a debtor's property.

A permanent bankruptcy statute was not enacted until 1898. The National Bankruptcy Act of 1898 was based upon the liquidation of a debtor's non-exempt assets to pay creditors. In 1938 the law was amended to provide for the rehabilitation or reorganization of a debtor as an alternative to liquidation of assets. The Bankruptcy Act of 1898, together with its amendments, was known as the Bankruptcy Act. Under the Bankruptcy Act, the district court had jurisdiction over bankruptcy cases, but could appoint a referee in bankruptcy to oversee the administration of bankruptcy cases, the allowance of claims and the distribution of payments to creditors. The Bankruptcy Act governed bankruptcy in the United States for 80 years.

After a series of critical studies and review of the then existing law and practice, Congress passed the Bankruptcy Reform Act of 1978.

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<sup>2</sup> Some inputs in the given paragraphs were taken from the Article by History Of Bankruptcy Law In The United States, Prepared by J. Michael Deasy, United States Bankruptcy Judge, District of New Hampshire in May 2004

**Since 1978<sup>3</sup>**

The US Congress enacted the "Bankruptcy Code" in 1978. The Bankruptcy Code, which is codified as title 11 of the United States Code, has been amended several times since its enactment. It is the uniform federal law that governs all bankruptcy cases.

The procedural aspects of the bankruptcy process are governed by the Federal Rules of Bankruptcy Procedure (often called the "Bankruptcy Rules") and local rules of each bankruptcy court. The Bankruptcy Rules contain a set of official forms for use in bankruptcy cases. The Bankruptcy Code and Bankruptcy Rules (and local rules) set forth the formal legal procedures for dealing with the debt problems of individuals and businesses.

Six basic types of bankruptcy cases are provided for under the Bankruptcy Code.

- **Chapter 7** bankruptcy leading to liquidation. In this type of bankruptcy, a court-appointed trustee or administrator takes possession of any nonexempt assets, liquidates these assets (for example, by selling at an auction), and then uses the proceeds to pay creditors.
- **Chapter 9**, entitled Adjustment of Debts of a Municipality, provides essentially for reorganization. Only a "municipality" may file under chapter 9, which includes cities and towns, as well as villages, counties, taxing districts, municipal utilities, and school districts.
- **Chapter 11**, entitled Reorganization, ordinarily is used by commercial enterprises that desire to continue operating a business and repay creditors concurrently through a court-approved plan of reorganization..
- **Chapter 12** allows a family farmer or fisherman to continue to operate the business while the plan is being carried out.
- **Chapter 13**, enables individuals with regular income to develop a plan to repay all or part of their debts. Under this chapter, debtors propose a repayment plan to make installments to creditors over three to five years.
- **Chapter 15** is to provide effective mechanisms for dealing with insolvency cases involving debtors, assets, claimants, and other parties of interest involving more than one country.

**The Evolution of U.S. Bankruptcy Law- a time line<sup>4</sup>**

- **1787** - The U.S. Constitution (Article I, sec. 8) authorizes Congress to establish uniform bankruptcy laws throughout the nation..
- **Bankruptcy Act of 1800**, the first federal bankruptcy law, the Act authorizes district court judges to appoint nonjudicial commissioners to oversee and help administer bankruptcy proceedings.
- **1803**- Citing excessive costs and corruption, Congress repeals the Act of 1800.
- **Bankruptcy Act of 1841** grants district courts "jurisdiction in all matters and proceedings in bankruptcy," including developing rules for proceedings and appointing bankruptcy commissioners and assignees.
- **1843** High administrative costs, lack of state law exemptions, and creditor frustration lead to the 1841 Act's repeal.

<sup>3</sup> Compiled from <http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Process.aspx>

<sup>4</sup> Facts compiled from Federal Judicial Center – Washington DC

- **Bankruptcy Act of 1867**(14 Stat. 517) marks the first time Congress refers to district courts as “constituted courts of bankruptcy” with original jurisdiction in all bankruptcy matters.
- **1874** Congress amends the 1867 Act so that debtors can create a plan for distributing assets among creditors as a way to settle a case
- **1878** In response to abuses and excessive fees, Congress repeals the Acts of 1867 and 1874.
- **Bankruptcy Act of 1898**(30 Stat. 544), is the first long-term bankruptcy legislation. In effect for the next 80 years, the Act establishes the position of referee to oversee administration of bankruptcy cases. Referees are appointed to two-year terms by the district judge and can be removed only for incompetency, misconduct, or neglect of duty. They are paid a percentage of funds brought into the estate. Besides the referee position, the 1898 Act establishes the office of trustee (previously assignee) in bankruptcy. In general, the Act is perceived as pro-debtor, establishing relatively narrow exceptions to discharge. Corporations are ineligible for voluntary relief, but some can be involuntary debtors. (Amendments enacted in 1910 make corporations eligible for voluntary bankruptcy.
- **Chandler Act of 1938** (52 Stat. 840, 841), an overhaul of the 1898 Act, reworks previous reorganization amendments into “Chapters”:
- **Bankruptcy Reform Act of 1978** (92 Stat. 2657), superseding the 1898 Act, establishes bankruptcy courts in each district and allows for separate bankruptcy judges, appointed by the President and confirmed by the Senate, to serve 14-year terms beginning in 1984. While bankruptcy courts may now hear all matters arising in or related to bankruptcy cases, judges remain non- Article III adjuncts of the district courts. Also, a new Chapter 11 (replacing X, XI, and XII) and Chapter 13, which offers a “super” discharge, make filing and reorganizing easier for businesses and individuals.
- **Bankruptcy Reform Act of 1994**(Public Law 103-394) creates the second National Bankruptcy Commission to investigate changes in bankruptcy law. The Act expands bankruptcy courts’ ability to hold jury trials in some proceedings and encourages circuit councils to establish bankruptcy appellate panels.
- **Bankruptcy Abuse Prevention and Consumer Protection Act of 2005** attempts to overhaul 1978 code with specific reference to consumer protection, restoring personal responsibilities and integrity in the bankruptcy system.

## LESSON ROUND UP

- Insolvency is when an individual, corporation, or other organization cannot meet its financial obligations for paying debts as they are due. Bankruptcy is not exactly the same as insolvency.
- The Presidency Towns Insolvency Act, 1909 and Provisional Insolvency Act, 1920 are two major enactments that deal with personal insolvency.
- Corporate insolvencies in India are majorly governed by the Companies Act, SICA, The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests Act, 2002.
- In England, the first bankruptcy law was enacted in 1542, being Statute 34 Henry VIII.
- The existing UK insolvency framework is defined by the Insolvency Act 1986.
- The US Congress enacted the "Bankruptcy Code" in 1978.
- Six basic types of bankruptcy cases are provided for under the Bankruptcy Code.

- Chapter 7 bankruptcy leading to liquidation.
- Chapter 9, entitled Adjustment of Debts of a Municipality, provides essentially for reorganization.
- Chapter 11, entitled Reorganization, ordinarily is used by commercial enterprises that desire to continue operating a business.
- Chapter 12 allows a family farmer or fisherman to continue to operate the business while the plan is being carried out.
- Chapter 13, enables individuals with regular income to develop a plan to repay all or part of their debts.
- Chapter 15 is to provide effective mechanisms for dealing with insolvency cases involving debtors, assets, claimants, and other parties of interest involving more than one country.

## SELF TEST QUESTIONS

1. Explain about the corporate insolvency framework in India.
2. European insolvency framework has been taken as base in many countries. Explain.
3. Write briefly about the evolution of insolvency framework in the US.
4. Explain different modes of corporate insolvency under US bankruptcy code.

[illegible]



# Lesson 17

## Revival and Restructuring of Sick Companies

### LESSON OUTLINE

- Background –SICA
- Genesis-SICA
- Objectives, applicability etc of SICA
- Procedural Aspects under SICA
- Revival of sick companies – Companies Bill 2012.

### LEARNING OBJECTIVES

In the wake of the widespread industrial sickness during the eighties, the Government of India enacted a special legislation namely the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) for determining the preventive, ameliorative, remedial and other measures which were required to be taken in respect of sick industrial companies and for expeditious enforcement of the measures determined. The major constraint of the Act was that it was applicable only to sick industrial companies keeping away other companies which are in trading, service or other activities. Secondly the immunity was provided under Section 22 of SICA was being misused. Thus the legislative intent of revival and rehabilitation of sick companies could not be fulfilled. Hence Companies (Second Amendment) Act, 2002 brought certain amendments under which the powers of BIFR (Board for Industrial and Financial Reconstruction) were to be exercised by NCLT (National Company Law Tribunal) to be constituted under Section 10FB of Companies Act, 1956 and appeal against order of NCLT could be referred to NCLAT (National Company Law Appellate Tribunal) to be constituted under Section 10FR of Companies Act, 1956. However, these amendments are not yet notified.

Further, the Companies Bill 2012 provides for time bound rehabilitation or liquidation process and winding up is resorted only when the revival is not feasible. After reading this lesson you should be able to understand the existing law and procedure provided under Sick Industrial Companies Act, 1985, an over view of revival mechanism provided under the companies bill 2012.

## 1. Background SICA<sup>1</sup>

In the wake of sickness in the country's industrial climate prevailing in the eighties, the Government of India set up in 1981, a Committee of Experts under the Chairmanship of Shri T.Tiwari to examine the matter and recommend suitable remedies therefore. Based on the recommendations of the Committee, the Government of India enacted a special legislation namely, the Sick Industrial Companies (Special Provisions) Act, 1985 (1 of 1986) commonly known as the SICA.

The main objective of SICA is to determine sickness and expedite the revival of potentially viable units or closure of unviable units (unit here in refers to a Sick Industrial Company). It was expected that by revival, idle investments in sick units will become productive and by closure, the locked up investments in unviable units would get released for productive use elsewhere.

The Sick Industrial Companies (Special Provisions) Act, 1985 (hereinafter called the Act) was enacted with a view to securing the timely detection of sick and potential sick companies owning industrial undertakings, the speedy determination by a body of experts of the preventive, ameliorative, remedial and other measure which need to be taken with respect to such companies and the expeditious enforcement of the measures so determined and for matters connected therewith or incidental thereto.

The Board of experts named the Board for Industrial and Financial Reconstruction (BIFR) was set up in January, 1987 and functional with effect from 15<sup>th</sup> May 1987. The Appellate Authority for Industrial and Financial Reconstruction (AAIRFR) was constituted in April 1987. Government companies were brought under the purview of SICA in 1991 when extensive changes were made in the Act including, inter-alia, changes in the criteria for determining industrial sickness.

The major constraint of the SICA was that it was applicable only to sick industrial companies keeping away other companies which are in trading, service or other activities. The Act was modified in 1991 to include within its purview the Government companies by Industrial Companies (Special Provisions) Amendment Act, 1991 which came into force w.e.f. 28.12.91.

However, the overall experience was not satisfactory because of various factors including non-applicability of SICA to non industrial companies and small/ancillary companies, misuse of immunity provided under Section 22 of SICA etc. Hence vide Companies (Second Amendment) Act, 2002, the powers of BIFR (Board for Industrial and Financial Reconstruction) were to be exercised by NCLT (National Company Law Tribunal) to be constituted under Section 10FB of Companies Act, 1956 and appeal against order of NCLT could be referred to NCLAT (National Company Law Appellate Tribunal) to be constituted under Section 10FR of Companies Act, 1956. These provisions are yet to be notified. Further, Companies Bill 2012 also provides for speedy recovery of sick companies.

Students may note that though Companies(Amendment) Act 2002 have been passed by Parliament, SICA has not yet been repealed and also Part VI A consisting of Section 424A to 424L inserted by the Companies (Second Amendment) Act 2002 has not yet been made effective. Till SICA is repealed the sick companies (including government companies) will continue to be under BIFR.

<sup>1</sup> <http://bifr.nic.in/aboutus.htm>



**SICK INDUSTRIAL COMPANIES (SPECIAL PROVISIONS) ACT, 1985 [SICA]****The Genesis<sup>2</sup>**

- Industrial sickness had started right from the pre-Independence days.
- Government had earlier tried to counter the sickness with some ad-hoc measures.
- Nationalisation of Banks and certain other measures provided some temporary relief.
- RBI monitored the industrial sickness.
- A study group, came to be known as Tandon Committee was appointed by RBI in 1975.
- In 1976, H.N. Ray committee was appointed.
- In 1981, Tiwari Committee was appointed to suggest a comprehensive special legislation designed to deal with the problem of sickness laying down its basic objectives and parameters, remedies necessary for revival of sick Units.
- The committee submitted its report to the Govt. in September 1983 and suggested the following:
  - Need for a special legislation
  - Need for setting up of exclusive quasi-judicial body.
- Thus the SICA came into existence in 1985 and BIFR started functioning from 1987.

**The objectives**

The preamble of SICA reads as follows:

The Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) is an act which makes in public interest, special provisions, with a view to securing timely detection of sick and potentially sick companies owning industrial undertakings, speedy determination by a Board of experts of the preventive, ameliorative, remedial and other measures which need to be taken with respect to such companies and expeditious enforcement of measures so determined and for matters connected therewith or incidental thereto.

Supreme court in *Namit R Kamani v. R.R. Kamani* (1988) 4 SCC 387 (1989) 2 Comp LJ 391/AIR 1989 SC 9/(1989) 66 Comp Cas 132(SC) had explained the object of SICA as (a) affording maximum protection to employment (b) optimising the use of funds and available production assets (c) realising amounts due to banks, institutions, creditors and (d) providing efficient authority consisting of experts for expeditious determination of measures to avoid time consuming procedures.

The Statement of Objects and Reasons for enacting the Sick Industrial Companies (Special Provisions) Act, 1985, (SICA) stated that in order to fully utilise the productive industrial assets, to afford maximum protection of employment and optimise the use of the funds of the banks and financial institutions, it would be imperative to revive and rehabilitate the potentially viable, sick industrial companies as quickly as possible. It also stated that it would be also equally imperative to salvage any productive assets and realise the amounts due to the banks and financial institutions, to the extent possible, from the non-viable sick industrial companies.

**Applicability**

SICA applies to companies both in public and private sectors owning industrial undertakings:-

- (a) pertaining to industries specified in the First Schedule to the Industries (Development and Regulation) Act, 1951, (IDR Act) except the industries relating to ships and other vessels drawn by

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<sup>2</sup> <http://bifr.nic.in/aboutus.htm>

power and;

- (b) not being "small scale industrial undertakings or ancillary industrial undertakings" as defined in Section 3(j) of the IDR Act.
- (c) The criteria to determine sickness in an industrial company are (i) the accumulated losses of the company to be equal to or more than its net worth i.e. its paid up capital plus its free reserves (ii) the company should have completed five years after incorporation under the Companies Act, 1956 (iii) it should have 50 or more workers on any day of the 12 months preceding the end of the financial year with reference to which sickness is claimed. (iv) it should have a factory license.

### What is a 'Sick industrial company'?

#### *Under SICA*

According to Section 3(1)(o) of the Sick Industrial Companies (Special Provisions) Act, 1985, "sick industrial company" means an industrial company<sup>3</sup> (being a company registered for not less than five years), which has at the end of any financial year accumulated losses equal to or exceeding its entire net worth<sup>4</sup>.

### Do you know?

- Small scale industrial undertakings or ancillary industrial undertakings" as defined in Section 3(j) of the IDR Act are excluded from the definition of Sick Industrial Company under SICA.
- Only scheduled industries as specified in the first schedule of IDR Act are covered under SICA and not trading, service and other sectors.
- Small scale/ancillary, trading and service companies cannot be referred to BIFR, even it becomes a sick company and requires revival, as it is not covered under the definition of the sick company.

#### *Under the Companies Act, 1956*

According to Section (46AA) of the Companies Act, 1956 "sick industrial company" means an industrial company which has—

- (i) the accumulated losses in any financial year equal to fifty per cent or more of its average net worth during four years immediately preceding such financial year; or
- (ii) failed to repay its debts within any three consecutive quarters on demand made in writing for its repayment by a creditor or creditors of such company;

#### *Under Companies Bill 2012*

The concept of Industrial company/undertaking and criterion of Net Worth (as was there in SICA) has been dropped under this Companies Bill.

Sickness has been linked with cash flows and if any Company has failed to pay/secure/compound the debt within 30 days of notice to company, the secured creditors may file an application to Tribunal for determination of company as sick company.

<sup>3</sup> As per section 3(1)(e) industrial company means a company which owns one or more industrial undertaking. As per the definition of industrial undertaking in Section 3(1)(f), it is an industrial undertaking pertaining to a scheduled industry, excluding small scale industry and ancillary industry as defined in IDR Act.

<sup>4</sup> Net worth means sum total of the paid-up capital and free reserves.

## Operating agency

*Under SICA (Section 3(1)(i))*

“Operating agency” means any public financial institution, State level institution, scheduled bank or any other person as may be specified by general or special order as its agency by the Board for Industrial and Financial Reconstruction (BIFR).

*Under the Companies Act 1956(Section 31AA)*

(31AA) "operating agency" means any group of experts consisting of persons having special knowledge of business or industry in which the sick industrial company is engaged and includes public financial institutions, State level institution, scheduled bank or any other person as may be specified as the operating agency by the Tribunal

## SOME PROCEDURAL ASPECTS UNDER SICA

### Reference to the Board of Industrial and Financial Reconstruction (Section 15)

When an industrial company has become sick, the Board of Directors of the company shall, within 60 days from the date of finalization of duly audited accounts of the company for the financial year at the end of which the company has become sick, make a reference to the Board (BIFR) for determination of measures to be adopted with respect to the company. If the Board of Directors had sufficient reason even before such finalization to form opinion that the company had become a sick unit after the Board of Directors shall, within 60 days after it has formed such opinion, make a reference to the Board for determination of measures which shall be adopted in respect of the company.

Further, the Central Government or Reserve Bank or State Government or a public financial institution or a State level institution or a scheduled bank may provide sufficient reason that any industrial company has become sick industrial company, may make a reference to the Board for determination of measures which shall be adopted in respect of the company. However, the State Government can make a reference in respect of any industrial undertaking which are situated in such state only. Similarly, a public financial institution or state level institution or a scheduled bank can make a reference only if it has provided any financial assistance or some obligation rendered by it or undertaking by it in respect of the referred company.

*Where financial assets have been acquired by any securitization company or reconstruction company*

No reference shall be made to the Board for Industrial and Financial Reconstruction after the commencement of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, where financial assets have been acquired by any securitization company or reconstruction company under sub-section (1) of section 5 of that Act.

After the commencement of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, where a reference is pending before the Board for Industrial and Financial Reconstruction, such reference shall abate if the secured creditors, representing not less than three-fourth in value of the amount outstanding against financial assistance disbursed to the borrower of such secured creditors, have taken any measures to recover their secured debt under sub-section (4) of Section 13 of that Act.

## Inquiry into Working of Sick Industrial Companies – Section 16

The salient features of the inquiry into the status of sick industrial companies contained in Section 16 of SICA are as follows:

- BIFR, upon receipt of a reference with respect to such company under Section 15; or upon

information received with respect to such company or upon its own knowledge as to the financial condition of the company, may make such inquiry as it may deem fit for determining whether the industrial company has become a sick industrial company.

- BIFR may require, by order, any operating agency to enquire into and make a report and complete its inquiry as expeditiously as possible.
- Endeavour should be made to complete the inquiry within sixty days from the commencement of the inquiry.
- As per the explanation given under this section, an inquiry shall be deemed to have commenced upon the receipt by BIFR of any reference or information or upon its own knowledge reduced to writing by BIFR.
- BIFR has powers to appoint one or more persons to be a special director or special directors of the company if it deems it necessary to make an inquiry or to cause an inquiry as mentioned above to be made into any industrial company.
- BIFR may issue necessary directions to special directors for proper discharge of duties.
- The appointment of a special director referred to in Sub-section (4) shall be valid and effective notwithstanding anything to the contrary contained in the Companies Act, 1956, or in any other law for the time being in force or in the memorandum and articles of association or any other instrument relating to the industrial company.
- Any provision regarding share qualification, age limit, number of directorships, removal from office of directors and such like conditions contained in any such law or instrument aforesaid, shall not apply to any special director appointed by BIFR.
- The special director will hold office only during the pleasure of BIFR. He does not incur any obligation or liability by reason only of his being a director or for anything done or omitted to be done in good faith in the discharge of his duties as a director or anything in relation thereto. He is not liable to retirement by rotation and shall not be taken into account for computing the number of directors liable to such retirement. He is not liable to be prosecuted under any law for anything done or omitted to be done in good faith in the discharge of his duties in relation to the sick industrial company.

#### **Powers of Board to make suitable order on the completion of inquiry – Section 17**

If, after making an inquiry under Section 16, the Board is satisfied that a company has become a sick industrial company, the Board shall, after considering all the relevant facts and circumstances of the case, decides, whether it is practicable for the company to make its net worth exceed the accumulated losses within a reasonable time.

If the Board decides that it is practicable for a sick industrial company to make its net worth exceed the accumulated losses within a reasonable time, the Board, shall, by order in writing, give time to the company to make its net worth exceed the accumulated losses. What is reasonable time depends on the facts and circumstances of each case. A period of 7 to 10 years, within which the company should be able to wipe off its accumulated losses is normally regarded by the Board as a reasonable time. This is also the time within which under a sanctioned scheme of the Board, the sick industrial company can be expected to have been revived or rehabilitated.

If the Board decides under Sub-section (1) that it is not practicable for a sick industrial company to make its net worth exceed the accumulated losses within a reasonable time by order in writing, directs any operating agency specified in the order to prepare, a scheme for revival/rehabilitation of sick industrial company. The

operating agency would normally be a public financial institution notified as such by the Board through a general or special order.

### Preparation and sanction of scheme for revival – Section 18

If the Board appoints an operating agency under Section 17(3) of the Act, then the operating agency is required to prepare and submit a schedule in respect of the referred company by providing any or more of the following measures:

- (a) The financial reconstruction of the sick industrial company;
- (b) The proper management of the sick industrial company by change in, or takeover of, the management of the sick industrial company;
- (c) The amalgamation of—
  - (i) the sick industrial company with any other company, or
  - (ii) any other company with the sick industrial company.
- (d) the sale or lease of a part or whole of any industrial undertaking of the sick industrial company;
- (d) (a) the rationalisation of managerial personnel, supervisory staff and workmen in accordance with law;
- (e) such other preventive, ameliorative and remedial measures as may be appropriate;
- (f) such incidental, consequential or supplemental measures as may be necessary or expedient in connection with or for the purposes of the measures specified in clauses (a) to (e).

The Board may finalise the scheme after considering the views and suggestions of the company, the operating agency and the public by publishing the draft scheme in the newspaper and thereafter formally sanction the same which is referred to as the “sanctioned scheme”.

#### **Does the BIFR has the power for dilution of equity under section 18(2)(f) without following procedure prescribed under sections 81, 100 to 103 of the Companies Act?**

In case of *National Small Industries Corpn. Ltd(NSIC) v. Singer India Ltd(SIL)*. [2010] 103 SCL 385 (DELHI) NSIC was holding certain shares in SIL which fell into financial difficulties resulting in proceedings under Act and it was thereafter declared as a sick company by BIFR - BIFR also sanctioned draft rehabilitation scheme prepared by SIL. Effect of scheme, insofar as, NSIC as a shareholder was concerned, was that in view of subscribed and paid-up capital of SIL being reduced by 90 per cent by reduction of value of shares, there would be dilution of shareholding of NSIC - An appeal was filed against order of BIFR sanctioning said scheme on grounds that

- (i) BIFR had no power to provide for dilution of equity under section 18(2)(f) without following procedure prescribed under sections 81, 100 to 103 of Companies Act;
- (ii) that petitioner(NSIC) was a public financial institution within meaning of section 19(1) and, thus, there could be no dilution of equity without consent of petitioner in view of section 19(2);
- (iii) that SIL had not complied with section 18(3)(a) which requires publication of draft scheme as per directions of BIFR to enable stakeholders to file their objections –

Appellate Authority for Industrial and Financial Reconstruction (AAIFR) dismissed said appeal on following grounds.

- (i) Since power of reduction of shareholders' interest or rights in sick industrial company has been specifically conferred upon BIFR under section 18(2)(f) and BIFR has wide and ample powers for restructuring, with Act playing an overriding role in view of section 32, BIFR had acted within its

power in directing reduction of share capital and in issuing further capital at specified rates without going through process of special resolution

- (ii) Merely because NSIC was a Government company within meaning of Companies Act, which had invested in share capital of SIL, did not imply that petitioner was covered under section 19(1)
- (iii) Since publication of proposed scheme had taken place in a State level newspaper, it could be said that provisions of section 18(3)(a) had been complied with but direction passed by BIFR that salient features of scheme should be published in one leading newspaper and one State level vernacular newspaper could not be said to be complied with. However, such a technical defect should not now be made a reason to negate scheme when various parties had altered their positions in terms of aspect of reduction of shareholding and consequential acts .

### **Rehabilitation by giving financial assistance (Section 19)**

Where the scheme relates to preventive, ameliorative, remedial and other measures with respect to any sick industrial company, the scheme may provide for financial assistance by way of loans, advances or guarantees or reliefs or concessions or sacrifices from the Central Government, a State Government, any scheduled bank or other bank, a public financial institution or State level institution or any institution or other authority (here in after referred as person required by the scheme to provide financial assistance) to the sick industrial company.

Every scheme referred above shall be circulated to every person required by the scheme to provide financial assistance for his consent within a period of sixty days from the date of such circulation 2[or within such further period, not exceeding sixty days, as may be allowed by the Board, and if no consent is received within such period or further period, it shall be deemed that consent has been given.

Where in respect of any scheme the consent is given by every person required by the scheme to provide financial assistance, the Board may, as soon as may be, sanction the scheme and on and from the date of such sanction the scheme shall be binding on all concerned.

On the sanction of the scheme, the financial institutions and the banks required to provide financial assistance shall designate by mutual agreement a financial institution and a bank from amongst themselves which shall be responsible to disburse financial assistance by way of loans or advances or guarantees or reliefs or concessions or sacrifices agreed to be provided or granted under the scheme on behalf of all financial institutions and banks concerned.

The financial institution and the bank designated shall forthwith proceed to release the financial assistance to the sick industrial company in fulfilment of the requirement in this regard.

Where in respect of any scheme consent is not given by any person required by the scheme to provide financial assistance, the Board may adopt such other measures, including the winding up of the sick industrial company, as it may deem fit.

### **Arrangement for continuing operations, etc during inquiry (Section 19A)**

At any time before completion of the inquiry under section 16, the sick industrial company or the Central Government or the Reserve Bank or a State Government or a public financial institution or a State level institution or a scheduled bank or any other institution, bank or authority providing or intending to provide any financial assistance by way of loans or advances or guarantees or reliefs or concessions to the sick industrial company may make an application to the Board-

- (a) agreeing to an arrangement for continuing the operations of the sick industrial company; or

- (b) suggesting a scheme for the financial reconstruction of the sick industrial company.

The Board may, within sixty days of the receipt of the application under sub-section (1), pass such orders therein as it may deem fit.

### **Winding up of Sick Industrial Company – Section 20**

The salient features of Section 20 of SICA are as follows:

- After making necessary inquiry under Section 16 and after giving an opportunity to all concerned parties, if BIFR is of the opinion that the sick industrial company is not likely to make its net worth exceed the accumulated losses within a reasonable time and it is not likely to become viable in future and as such it is just and equitable to wind up the company, BIFR may record and forward its opinion to the concerned High Court.
- The High Court shall, on the basis of the opinion of the Board, order winding up of the sick industrial company and may proceed and cause to proceed with the winding up of the sick industrial company in accordance with the provisions of the Companies Act, 1956.
- In *Re. Anmol Diary Ltd.* (2002) 5 Comp LJ 43 (Tuj.) it was held by the High Court that the opinion of BIFR should be given due weightage but it is not binding on the High Court and High Court can go into the correctness of the opinion so submitted by the BIFR. The High Court independently decides as to whether it should proceed with the winding-up of sick industrial company.
- Once an order of winding up is made by the High Court under Section 20(2) of Sick Industrial Companies Act (SICA), acting on the opinion of BIFR under Section 20(1), the control and jurisdiction over the company, its affairs and assets passes over to the High Court and BIFR ceases to have any power to pass any orders or give any directions as held by division bench of High Court in *BPL Ltd., Bangalore v. Inter Modal Transport Technology Systems (Karnataka) Ltd., Bangalore* (in liquidation) & others (2001) (3) Kar LJ 622 (DB).
- For the purpose of winding up, the High Court may, with the consent of the operating agency, appoint any officer of the operating agency, as the liquidator and such officer, if appointed shall be deemed to be, and have all the powers of, the official liquidator under the Companies Act, 1956.
- When BIFR recommends the winding up of a sick industrial company pursuant to Section 20(1) of the SICA, 1985 and forwards its opinion to the connected High Court, the High Court is bound to order the winding up of the company on the basis of the opinion of BIFR.
- Once BIFR forwards its opinion to the connected High Court, the role of BIFR comes to an end in respect of the said sick industrial company.
- As per Sub-section (4) of Section 20, the BIFR has the power to direct the sale of assets of the sick industrial company in such manner as it may deem fit. The power of BIFR under sub-section is exercisable notwithstanding anything contained in Sub-section (2) or (3) of Section 20. The Supreme Court in *V.R. Ramaraju v. Union of India & others* [1997] 89 Comp Cas 609 (SC) in relation to Section 20(2) of SICA held that the High Court in deciding the question of winding up of the company has to take into account the opinion of BIFR forwarded to it and is not to abdicate its own function of determining the question of winding up.
- Adding clarity to the end of jurisdiction of BIFR and beginning of jurisdiction of High Court, the Division Bench of the Karnataka High Court in *BPL Limited, Bangalore v. Inter Modal Transport Technology Systems (Karnataka) Limited, Bangalore* (in liquidation) & others [2001] (3) Kar LJ 622 (DB); ILR 2001 Kar 5373 (DB) held that the scheme of SICA as contained in Sections 22, 22A, 20

and 32 of that makes it clear that from the date of commencement of an inquiry in regard to any reference received under Section 15, till passing of an order of winding up by the High Court under Section 20(2) of SICA, BIFR retains absolute control over the affairs of the company and can either prevent any sale or permit any sale and the sick industrial company is entirely governed by the provisions of SICA. On the other hand, once an order of winding up is made by the High Court under Section 20(2) of SICA, acting on the opinion of BIFR under Section 20(1), the control and jurisdiction over the company, its affairs and assets passes over to the High Court and BIFR ceases to have any power to pass any orders or give any directions.” The division bench further held that the company court does not sit in appeal over the orders of BIFR nor exercise power under Articles 226 and 227 of the Constitution.

- In the BPL Limited’s case cited above, the court held that the sale of assets of a company by a secured creditor as per directions of BIFR, prior to the date of winding up order, is not void for want of leave of the court and there is no question of obtaining any leave or permission of this court.
- In *National Organic Chemical Industries Limited and Ors. v. N.O.C.I.L. Employees Union* 2005 (126) Companies Cases 922, *Sharp Industries Limited* (2006) 131 Company Cases, 535 (Bom.) and in *Pharmaceutical Products of India Ltd. in re* (2006) 131 Company Cases 747, the Bombay High Court have held that during pendency of a reference before BIFR, a scheme under Section 319 could be sanctioned. However in *Ashok Organic Industries Ltd v. ARCIL*, [2008] 114 Comp Cas 144 (Bom.), the Bombay High Court had set aside all the above decisions and held that once the Industrial Company makes a reference under Section 15 of the SICA, the Company Court would have no jurisdiction for sanctioning the scheme of arrangement of compromise with its creditors and shareholders and neither will it have jurisdiction to take cognisance of such an application during the pendency of the reference.
- The High Court has no jurisdiction to sanction a scheme of arrangement presented by a sick company when the revival scheme of the company was pending before the AAIFR. [*Tata Motors Ltd. v. Pharmaceutical Products of India Ltd. & Anr.* (2008 ) 144 Comp Cas 178 (SC)].

### **Immunity from Certain Litigations – Section 22**

The protection under Section 22 of SICA is a superior protection as it operates notwithstanding anything contained in the Companies Act, 1956, or any other law or the memorandum and articles of association of the industrial company or any other instrument having effect under the said Act or other law.

The above protection is available in respect of an industrial company:

- when an inquiry under Section 16 is pending in relation to the said industrial company or
- when any scheme referred to under Section 17 is under preparation or consideration or a sanctioned scheme is under implementation or
- where an appeal under Section 25 relating to an industrial company is pending.
- Where the management of the sick industrial company is taken over or changed in pursuance of any scheme sanctioned under Section 18, notwithstanding anything contained in the Companies Act, 1956, or any other law or in the memorandum and articles of association of such company or any instrument having effect under the said Act or other law – (a) it shall not be lawful for the shareholders of such company or any other person to nominate or appoint any person to be a director of the company; (b) no resolution passed at any meeting of the shareholders of such company shall be given effect to unless approved by BIFR.



BIFR may by order declare with respect to the sick industrial company concerned that the operation of all or any of the contracts, assurances of property, agreements, settlements, awards, standing orders or other instruments in force, applicable to the sick industrial company in question shall remain suspended or that all or any of the rights, privileges, obligations, and liabilities accruing or arising thereunder before the said date, shall remain suspended or shall be enforceable with such adaptations and in such manner as may be specified by BIFR. Provided that such declaration shall not be made for a period exceeding two years which may be extended by one year at a time so, however, that the total period shall not exceed seven years in the aggregate. Any such declaration is valid and is protected notwithstanding anything contained in the Companies Act, 1956, or any other law or agreement or instrument or any decree or order of a court, Tribunal, officer or other authority or of any submission, settlement or standing order.

Accordingly, any remedy for the enforcement of any right, privilege, obligation and liability suspended or modified by such declaration, and all proceedings relating thereto pending before any court, Tribunal, officer or other authority shall remain stayed or be continued subject to such declaration. On the declaration ceasing to have effect – (i) any right, privilege, obligation or liability so remaining suspended or modified, shall become revived and enforceable as if the declaration had never been made; and (ii) any proceeding so remaining stayed shall be proceeded with, subject to the provisions of any law which may then be in force, from the stage which had been reached when the proceedings became stayed. Obviously from a perusal of the language contained in Section 22(1) of SICA, it is clear that Section 22 does not grant any immunity against criminal proceedings against the company or its directors.

The apex court *Maharashtra Tubes Limited v. State Industrial and Investment Corporation of Maharashtra Limited* [1993] 78 Comp Cas 803 (SC) held that the idea underlying Section 22(1) of SICA is that every such action (against the company or its guarantors for recovery of money or enforcement of security) should be frozen unless expressly permitted by the specified authority until the investigation for the revival of the industrial undertaking is finally determined. The apex court in *Patheja Bros. Forgings and Stamping v. ICICI Limited* AIR 2000 CLC 1492: (2000) 4 Comp LJ 9 (SC) held that the words Section 22 are clear and unambiguous and that they provide that no suit for the enforcement of a guarantee in respect of any loan or advance granted to the concerned industrial company will lie or can be proceeded with without the consent of BIFR or the appellate authority. When the words of a legislation are clear, the court must give effect to them as they stand and cannot demur on the ground that the legislature must have intended otherwise. The apex court clearly held that any suit for enforcement of the guarantee in respect of loans granted to a sick industrial company cannot be proceeded with unless consent as required under Section 22 of SICA is obtained.

In, *Sun Industries v. Sharda Synthetics (P.) Ltd.* [2010] 101 SCL 1 (BOM.) the petitioner-company filed winding up petition under section 433 of the 1956 Act against the respondent-company claiming unpaid price of goods sold. The respondent-company contended that it was entitled to protection under section 22 of the 1985 Act in view of the fact that a reference was registered before the BIFR. The petitioner contended that the orders for purchase of goods were placed by the respondent after the reference was registered with the BIFR and, therefore, the respondent must pay for the goods and then seek protection under section 22 of the 1985 Act.

It was held that the respondent-company was not entitled to invoke the protection of section 22 of the 1985 Act in respect of transactions for purchase of goods after the reference was registered with the BIFR. Indeed, section 22 of the 1985 Act cannot be used as a shield against the recovery of debts such as unpaid price of goods, particularly when the goods have been purchased after the reference has been registered since such transactions and the debts incurred thereon are outside the provisions which culminate in a scheme.

The contention of the respondent that the reference was registered with the BIFR on 15-12-2005 and the company had been declared to be a sick company in the year 2007, as yet no scheme had been framed and, therefore, unless the scheme was framed the debt could not be construed to be outside the scheme and,

therefore, the proceedings for winding up would not be tenable by virtue of section 22 of the 1985 Act appeared attractive, but it was not liable to be accepted having regard to the purpose of the law. [Para 7]

In *Unilab Chemicals and Pharmaceuticals v. Smith Stanistreet Pharma-ceuticals Ltd.* [2001] 103 Comp. Cas. 122 (Bom.) and *Vibgyar Ink Chem (P.) Ltd. v. Safe Pack Polymers Ltd.* [1998] 93 Comp. Cas. 407 (AP), the Courts have observed that no proceedings for the recovery, distress or the like should be permitted where a debt features in the sanctioned scheme because that would upset the arrangement made by the scheme. That is the real reason for the view that a debt which does not feature in the scheme would not attract the provisions of section 22 of the 1985 Act. The Courts have held that the bar of section 22 of the 1985 Act would have no application where in spite of proceedings under the 1985 Act and particularly where a scheme is framed, the company continues to incur the debts and liability and pleads the bar of section 22 to prevent recovery of dues under the transactions. In the circumstances, it was to be held that where a company has consciously entered into transactions, created liabilities and incurred debts, whether an enquiry is pending or whether the scheme has been framed under the 1985 Act, the bar under section 22 of the 1985 Act would not apply. There was, thus, no merit in the respondent's contention. In the result, the petition was to be allowed.

**Section 22 of SICA cannot be used as a shield against the recovery of debts such as unpaid price of goods particularly when the goods have been purchased after the reference has been registered.**

**Can a company make repeated references to BIFR to take shelter under Section 22 SICA?**

In case of *Alcatel - Lucent India (P) Ltd. vs Usha India Ltd*(2012).The petitioner had a monetary decree in its favour but had not been able to execute the same because of the protection enjoyed by the respondent under of the Sick Industrial Companies (Special Provisions) Act 1985. The respondent had been filing repeated references before the BIFR and getting for itself protection of the provisions of the Act. In a petition, the petitioner pleaded that the high court should lay down suitable guidelines directing the BIFR to perform a pre-registration scrutiny (as required in law) before registering future references filed by the respondent to ensure that there were new and genuine grounds entitling respondent to file the reference and that the reference was not based on the same grounds, which the BIFR and AAIFR had repeatedly disallowed. The high court, noting that the instant case appeared to be one where prima facie the provisions of Section 22 of the Act were taken undue advantage of, disposed of the petition with the direction that BIFR should formulate necessary Practice Directions within three months and issue the same for compliance.

**Direction against disposal of assets – Section 22A**

In the interest of the sick industrial company or creditors or shareholders or in the public interest, Section 22A of SICA empowers BIFR to order not to dispose off any assets of the company in the interest of creditors, shareholder or in public interest. Such order can be passed (a) during the period of preparation or consideration of the scheme under Section 18; and (b) during the period beginning with the recording of opinion by the board for winding up of the company under Sub-section (1) of Section 20 and upto commencement of the proceedings relating to the winding up before the concerned High Court.

**Revival and rehabilitation of Sick Companies Under the Companies Bill 2012**

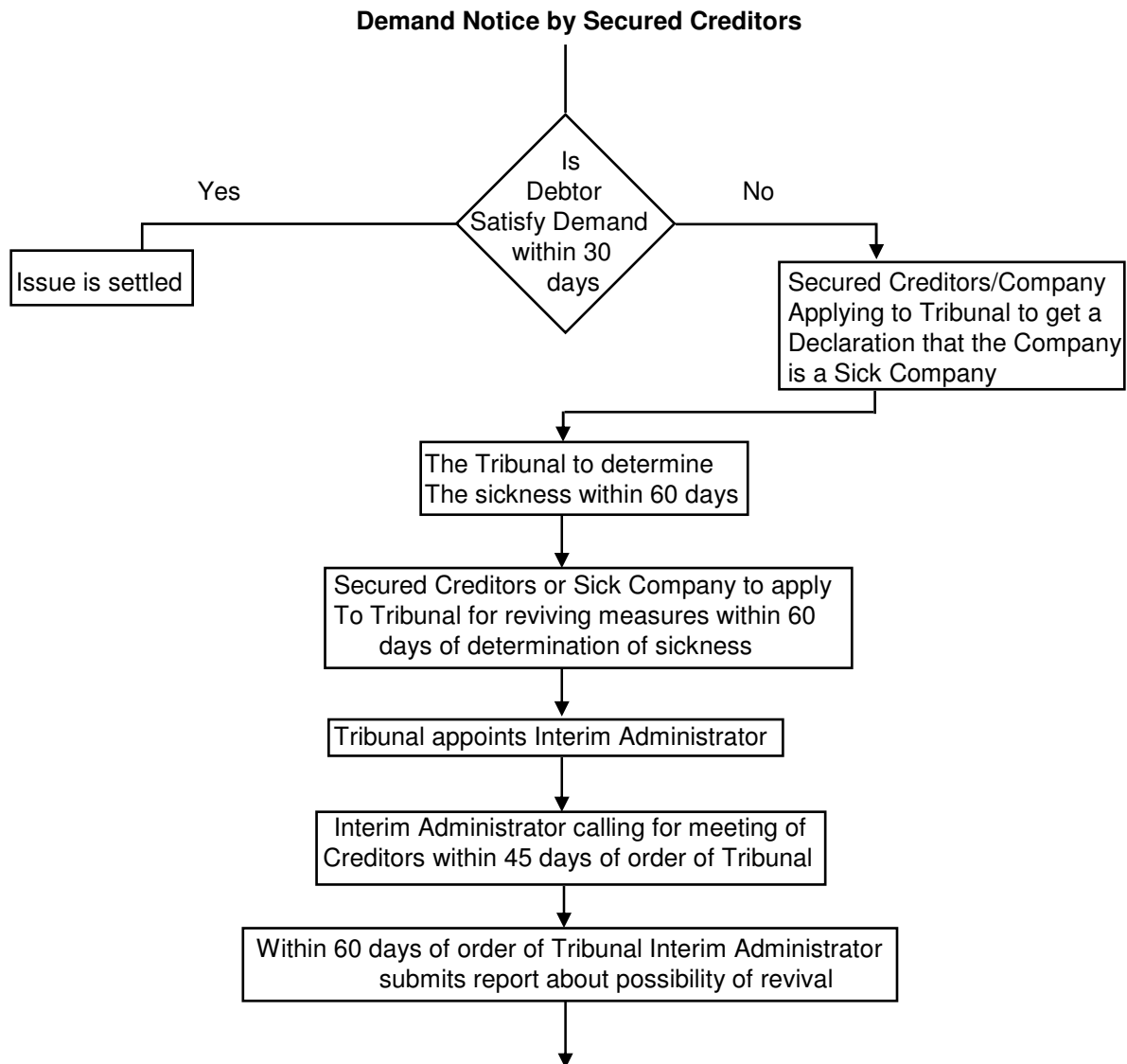
The concept of Industrial company/undertaking and criterion of Net Worth (as was there in SICA) has been dropped under this Companies Bill. Sickness has been linked with cash flows and the rights of majority Secured Creditors are being protected under these provisions. If any Company has failed to

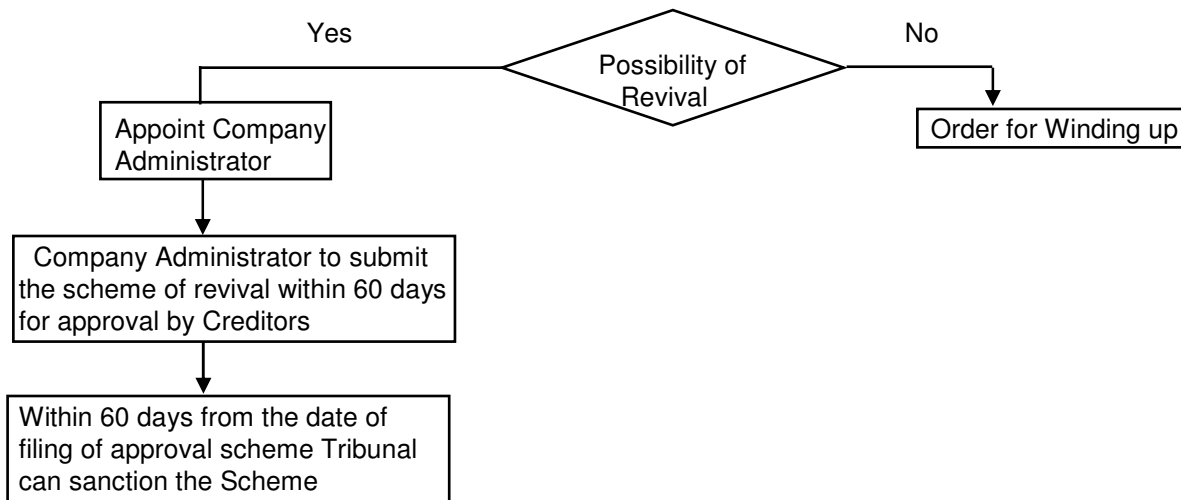
pay/secure/compound their debt within 30 days of notice to company, they may file an application to Tribunal for determination of company as sick company.

Where the Tribunal is satisfied that a company has become sick company, it shall after considering all the relevant facts and circumstances of the case, decide, as soon as may be, by an order in writing, whether it is practicable for the company to make the repayment of its debts within a reasonable time.

On the determination of sickness by the tribunal, the applicant shall make an application within 60 days of determination, for measures to be adopted for revival or rehabilitation.

Where the Tribunal determines the Company as Sick and where the company has no draft scheme for its revival and rehabilitation, the Tribunal may direct the Interim administrator who shall be appointed by Tribunal from a panel maintained by the Central Govt. When the interim administrator submits his report about the possibility of revival, then company administrator is appointed who undertakes the approval process by creditors and submits the same to the tribunal who would sanction the scheme within 60 days of approval by creditors. The process involved is depicted in the following flow chart for better clarity.





### LESSON ROUND UP

- SICA was enacted to evaluate the viability of sick industrial companies with a view to rehabilitate them and to protect the interest of employees as far as practicable.
- Once a company becomes sick, a reference is made to BIFR for determination of measures to be adopted with respect to company.
- Enquiry under Section 16 into working of sick industrial company is made. After being satisfied of sickness and if there is a scope to make the networth exceed the accumulated losses, it appoints an operating agency for preparation of scheme for revival under Section 18. Otherwise an opinion of Board is forwarded to High Court for winding up.
- Section 22, one of the important provisions of SICA, provides for immunity from certain litigations.
- The companies bill 2012 prescribes time bound rehabilitation process by Tribunal.

### SELF TEST QUESTIONS

*(These are meant for recapitulation only. Answers to these questions are not required to be submitted for evaluation).*

1. Briefly explain the salient features of Section 16 of SICA regarding inquiry into working of sick industrial companies.
2. Enumerate the External Causes of sickness of industrial companies?
3. 'SICA' was conceived well but it failed. Elucidate.
4. Write short notes on—
  - (a) Operating Agency
  - (b) Immunity to Sick Company (Section 22 of SICA).
  - (c) Reference to the Board (Section 15 of SICA).

# Lesson 18

## Securitization

### LESSON OUTLINE

- Introduction
- Scheme of the Act
- Constitutional validity of the Act
- Definitions of terms and expressions
- Important provisions
- Procedure for Registration
- Enforcement of security interest
- Measures for asset reconstruction
- Offences
- Securities Interest (Enforcement) Rules, 2002.

### LEARNING OBJECTIVES

The banks and financial institutions (FIs) were facing numerous problems in recovery of defaulted loans on account of delays in disposal of recovery proceedings. The Government, therefore, enacted the RDBFI Act in 1993 and SARFAESI Act in 2002 for the purpose of expeditious recovery of non-performing assets (NPAs) of the banks and FIs. Although these two acts have helped in reducing the NPAs, banks have sent certain suggestions for further strengthening of the secured creditor rights.

The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 enacted with a view to regulate securitisation and reconstruction of financial assets and enforcement of security interest and for matters connected therewith or incidental thereto. The Act enables the banks and financial institutions to realise long-term assets, manage problems of liquidity, asset liability mis-match and improve recovery by exercising powers to take possession of securities, sell them and reduce non-performing assets by adopting measures for recovery or reconstruction. The said Act further provides for setting up of asset reconstruction companies which are empowered to take possession of secured assets of the borrower including the right to transfer by way of lease, assignment or sale and realise the secured assets and take over the management of the business of the borrower. The Securities and Reconstruction of Financial assets and enforcement of Security Interest Act, 2002 was amended in 2004 and 2012 respectively.

The objective of the study lesson is to familiarize the students with the legal requirements stipulated under the SARFAESI Act.

## INTRODUCTION

In the traditional lending process, a bank makes a loan, maintaining it as an asset on its balance sheet, collecting principal and interest, and monitoring whether there is any deterioration in borrower's creditworthiness.

This requires a bank to hold assets till repayment of loan. The funds of the bank are blocked in these loans and to meet its growing fund requirement a bank has to raise additional funds from the market. Securitisation is a way of unlocking these blocked funds.

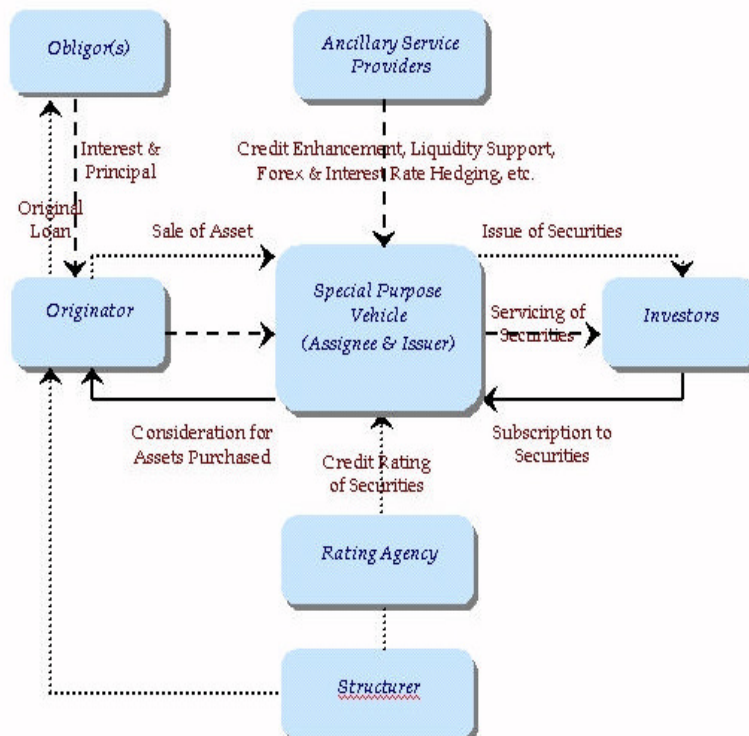
One of the most prominent developments in international finance in recent decades and the one that is likely to assume even greater importance in future, is securitisation. Securitisation is the process of pooling and repackaging of homogenous illiquid financial assets into marketable securities that can be sold to investors. Basically Securitisation is a method of raising funds by way of selling receivables for money.

The process leads to the creation of financial instruments that represent ownership interest in, or are secured by a segregated income producing asset or pool of assets. The pool of assets collateralises securities. These assets are generally secured by personal or real property (e.g. automobiles, real estate, or equipment loans), but in some cases are unsecured (e.g. credit card debt, consumer loans).



Securitisation is a method of raising funds by way of selling receivables for money.

### The Securitisation process



**Note:** Continuing flow of funds from the Obligor to the SPV is routed through the Originator in its capacity as administrator. Any other party appointed by the SPV/Trustee can also perform the role of administrator. It is also possible that the SPV receives the amounts directly from the Obligors.

Source: rbi.org.in

**Steps in securitisation:**

- (i) Acquisition of Financial Assets by Securitisation Company or Reconstruction Company (i.e SPVs) from the originator. Here financial assets are loans backed by properties. The originator is banks or FIs who has lent money to the original borrower.
- (ii) the SPV, with the help of an investment banker, issues security receipts which are distributed to investors; and
- (iii) the SPV pays the originator for the financial assets purchased with the proceeds from the sale of securities.

**Parties involved in Securitisation****Primary parties**

- The Originator (Banks/FIs who has lent loan against properties)
- SPVs (Securitisation Company or Reconstruction Company)
- Investors (To whom securities are issued, which is a participative interest against the pool of receivables which is bought by the SPVs from the originator)

Besides above parties the following are involved in the process of securitizations:

- The obligator (i.e. original borrower of the loan)
- Rating agency
- Administrator etc.

**How Securitisation gained importance?**

When a borrower, who is under a liability to pay to secured creditor, makes any default in repayment of secured debt or any instalment thereof, the account of borrower is classified as non-performing asset (NPA). NPAs constitute a real economic cost to the nation because they reflect the application of scarce capital and credit funds to unproductive uses. The money locked up in NPAs are not available for productive use and to the extent that banks seek to make provisions for NPAs or write them off, it is a charge on their profits. High level of NPAs impact adversely on the financial strength of banks who in the present era of globalization, are required to conform to stringent International Standards.

The public at large is also adversely affected because bank's main source of funds are deposits placed by public continued growth in NPA portfolio threatens the repayment capacity of the banks and erode the confidence reposed by them in the banks.

The banks had to take recourse to the long legal route against the defaulting borrowers beginning from filing of claims in the courts. A lot of time was usually spent in getting decrees and execution thereof before the banks could make some recoveries. In the meantime the promoters could seek the protection of BIFR and could also dilute the securities available to banks. The Debt Recovery Tribunals (DRTs) set up by the Govt. also did not prove to be of much help as these get gradually overburdened by the huge volume of cases referred to them. All along, the banks were feeling greatly handicapped in the absence of any powers for seizure of assets charged to them.

All these issues gave the passage for evolution of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 SARFAESI Act, 2002. SARFAESI Act, 2002, is a unique

piece of legislation which has far reaching consequences. This Act is having the overriding power over the other legislation and it shall go in addition to and not in derogation of certain legislation.

### **STATEMENT OF OBJECTS AND REASONS OF SARFAESI ACT**

It is necessary at the outset, to reiterate the statement of objects and reasons for the SARFAESI Act, which reads as under:

The financial sector has been one of the key drivers in India's efforts to achieve success in rapidly developing its economy. While the banking industry in India is progressively complying with the international prudential norms and accounting practices, there are certain areas in which the banking and financial sector do not have a level playing field as compared to other participants in the financial markets in the world. There is no legal provision for facilitating securitisation of financial assets of banks and financial institutions. Further, unlike international banks, the banks and financial institutions in India do not have power to take possession of securities and sell them. Our existing legal framework relating to commercial transactions has not kept pace with the changing commercial practices and financial sector reforms. This has resulted in slow pace of recovery of defaulting loans and mounting levels of non-performing assets of banks and financial institutions. Narasimham Committee I and II and Andhyarujina Committee constituted by the Central Government for the purpose of examining banking sector reforms have considered the need for changes in the level system in respect of these areas. These Committees, inter alia, have suggested enactment of a new legislation for securitisation and empowering banks and financial institutions to take possession of the securities and do sell them without the intervention of the court. Acting on these suggestions.

The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Ordinance, 2002 was promulgated on the 21st June, 2002 to regulate securitisation and reconstruction of financial assets and enforcement of security interest and for matters connected therewith or incidental thereto. The provisions of the Ordinance of liquidity, asset liability mismatches and improve recovery by exercising powers to take possession of securities, sell them and reduce non-performing assets by adopting measures for recovery or reconstruction."

*The main purpose of the SARFAESI Act is to enable and empower the secured creditors to take possession of their securities and to deal with them without the intervention of the court and also alternatively to authorise any securitisation or reconstruction company to acquire financial assets of any bank or financial institution.*

The SARFAESI Act, 2002 has empowered the Banks and Financial Institutions with vast power to enforce the securities charged to them. The Banks can now issue notices to the defaulters to pay up the dues and if they fail to do so within 60 days of the date of the notice, the banks can take over the possession of assets like factory, land and building, plant and machinery etc. charged to them including the right to transfer by way of lease, assignment or sale and realize the secured assets. In case the borrower refuses peaceful handing over of the secured assets, the bank can also file an application before the relevant Magistrate for taking possession of assets. The Banks can also take over the management of business of the borrower. The bank in addition can appoint any person to manage the secured assets the possession of which has been taken over by the the bank. Banks can package and sell loans via "Securitisation" and the same can be traded in the market like bonds and shares.

### **Apex Court Upheld Constitutional Validity of the Securitisation Act**

The Securitisation Act, 2002 was challenged in various courts on grounds that it was loaded heavily in favour of lenders, giving little chance to the borrowers to explain their views once recovery process is initiated under



the legislation. Leading the charge against the said Act was Mardia Chemicals in its plea against notice served by ICICI Bank. The Government had, however, argued that the legislation would bring about a financial discipline and reduce the burden of Non Performing Assets (NPAs) of banks and institutions.

In *Mardia Chemicals Ltd. v. UOI* [2004] 59 CLA 380 (SC), it was urged by the petitioner that

- (i) there was no occasion to enact such a draconian legislation to find a short-cut to realise non-performing assets ('NPAs') without their ascertainment when there already existed the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 ('Recovery of Debt Act') for doing so;
- (ii) no provision had been made to take into account lenders liability;
- (iii) that the mechanism for recovery under Section 13 does not provide for an adjudicatory forum of inter se disputes between lender and borrower; and
- (iv) that the appeal provisions were illusory because the appeal would be maintainable after possession of the property or management of the property was taken over or the property sold and the appeal is not entertainable unless 75 per cent of the amount claimed is deposited with the Debts Recovery Tribunal ('DRT').

The Hon'able Supreme Court held that though some of the provisions of the Act 2002 be a bit harsh for some of the borrowers but on those grounds the impugned provisions of the Act cannot be said to unconstitutional in the view of the fact that the objective of the Act is to achieve speedier recovery of the dues declared as NPAs and better availability of capital liquidity and resources to help in growth of economy of the country and welfare of the people in general which would sub-serve the public interest.

The Supreme Court observed that the Act provides for a forum and remedies to the borrower to ventilate his grievances against the bank or financial institution, inter alia, with respect to the amount of the demand of the secured debt. After the notice is sent, the borrower may explain the reasons why the measures may or may not be taken under Sub-section (4) of Section 13. The creditor must apply its mind to the objections raised in reply to such notice. There must be meaningful consideration by the Court of the objections raised rather than to ritually reject them and to proceed to take drastic measures under Sub-section (4) of Section 13. The court held that such a procedure/mechanism was conducive to the principles of fairness and that such a procedure was also important from the point of view of the economy of the country and would serve the purpose in the growth of a healthy economy. It would serve as guidance to secured debtors in general in conducting their affairs.

The court opined that the fairness doctrine, cannot be stretched too far, such communication is only for the purposes of the secured debtors knowledge and cannot give an occasion to the secured debtor to resort to any proceeding, which are not permissible under the provisions of the Act. Thus, a secured debtor is not allowed to challenge the reasons communicated or challenge the action likely to be taken by the secured creditor at that point of time unless his right to approach the DRT as provided under section 17 matures on any measure having been taken under Sub-section (4) of Section 13.

Moreover, another safeguard is also available to a secured borrower within the framework of the Act i.e. to approach the DRT under Section 17 though such a right accrues only after measures are taken under Sub-section (1) of Section 13.

The Hon'ble Supreme Court, however, found that the requirement of deposit of 75 per cent of the amount claimed before entertaining an appeal (petition) under Section 17 is an oppressive, onerous and arbitrary condition and against all the canons of reasonableness. Held this provision to be invalid and ordered that it was liable to be struck down.

## **ENFORCEMENT OF SECURITY INTEREST AND RECOVERY OF DEBTS LAWS (AMENDMENT) ACT, 2012**

Enforcement of Security Interest and Recovery of Debts Laws (Amendment) Act, 2012 amended the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act and Recovery of Debts due to Banks & Financial Institutions (RDBF) Act so as to strengthen the regulatory and institutional framework related to recovery of debts due to banks and financial institutions.

Amendment Act, 2012 enable banks to improve their operational efficiency, deploy more funds for credit disbursement to retail investors, home loan borrowers, etc. without fearing for recovery, thus bringing about equity. Further, mandatory registration of subsisting security interest (equitable mortgages) promote innovation in credit information.

Amendment Act, 2012 strengthen the ability of banks to recover debts due from the borrowers, enhance the ability of the banks to extend credit to both corporate and retail borrowers, reduce the cost of funds for banks and their customers and reduce the level of non-performing assets.

### **Salient features of Enforcement of Security Interest and Recovery of Debts Laws (Amendment) Act, 2012**

- provides for conversion of any part of debt into shares of a borrower company and such conversion shall be deemed always to have been valid as if the provisions of said conversion were in force at all material times;
- included the multi-State co-operative banks in the definition of 'bank' under clause (c) of section 2 of the said Act;
- increased the period of response to be sent by the banks or financial institutions to the representation of the borrower from seven days to fifteen days;
- empowers the banks or financial institutions to accept the immovable property in full or partial satisfaction of the claim of the bank against the defaulting borrower;
- enables the banks or any person to file a caveat so that before granting any stay, the bank or such person is heard by the Debts Recovery Tribunal;
- Provides for registration of transactions of securitisation, reconstruction or creation of security interest in the Central Registry, which are subsisting on or before the establishment of Central Registry and also to give powers to the Central Government to extend time for filing of such transaction with the Central Registry.

### **Definitions**

Section 2 of the The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 defines various terms used in the Act, as given under:

#### **“Bank”**

As per Section 2(1) (c) bank means-

- (i) a banking company; or
- (ii) a corresponding new bank; or
- (iii) the State Bank of India; or
- (iv) a subsidiary bank; or

- (iva) a multi-State co-operative bank; or
- (v) such other bank which the Central Government may, by notification, specify for the purposes of this Act;

### **"Securitisation"**

Securitisation under Section 2(1)(z) means acquisition of financial assets by any securitisation company or reconstruction company from any originator, whether by raising of funds by such securitisation company or reconstruction company from qualified institutional buyers by issue of security receipts representing undivided interest in such financial assets or otherwise;

### **Let us read the following terms to understand the process of securitisation**

- Financial Assets
- Securitisation Company
- Reconstruction Company
- Originator
- Security Receipts
- qualified institutional buyers.

### **"Financial Asset"**

Financial asset under Section 2(1)(l) means debt or receivables and includes—

- a claim to any debt or receivables or part thereof, whether secured or unsecured; or
- any debt or receivables secured by, mortgage of, or charge on, immovable property; or
- a mortgage, charge, hypothecation or pledge of movable property; or
- any right or interest in the security, whether full or part underlying such debt or receivables; or
- any beneficial interest in property, whether movable or immovable, or in such debt, receivables, whether such interest is existing, future, accruing, conditional or contingent; or
- any financial assistance;

### **"Securitization Company"**

Securitization company under Section 2(1)(za) means any company formed and registered under the Companies Act, 1956 (1 of 1956) for the purpose of securitisation;(in common parlance called Special Purpose Vehicle (SPV);

### **"Reconstruction Company"**

"Reconstruction company" under Section 2(1)(v) means a company formed and registered under the Companies Act, 1956 for the purpose of asset reconstruction;

### **"Asset Reconstruction"**

Asset reconstruction under Section 2(1)(b) means acquisition by any securitisation company or reconstruction company of any right or interest of any bank or financial institution in any financial assistance for the purpose of realisation of such financial assistance;

**“Originator”**

“Originator” under Section 2(1)(r) means the owner of a financial asset which is acquired by a securitisation company or reconstruction company for the purpose of securitisation or asset reconstruction;

**“Security Receipt”**

Security receipt under Section 2(1)(zg) means a receipt or other security, issued by a securitisation company or reconstruction company to any qualified institutional buyer pursuant to a scheme, evidencing the purchase or acquisition by the holder thereof, of an undivided right, title or interest in the financial asset involved in securitization;

**“Qualified Institutional Buyer”**

Qualified institutional buyer means a financial institution, insurance company, bank, State Financial Corporation, State Industrial Development Corporation, trustee or securitisation company or reconstruction company which has been granted a certificate of registration under sub-section (4) of section 3 or any asset management company making investment on behalf of mutual fund or a foreign institutional investor registered under the Securities and Exchange Board of India Act, 1992 (15 of 1992) or regulations made thereunder, or any other body corporate as may be specified by the Board;

**“Non-Performing Assets”**

As per Section 2(1)(o) Non-Performing Asset means an asset or account of a borrower, which has been classified by a bank or financial institution as sub-standard, doubtful or loss asset—

- (a) in case such bank or financial institution is administered or regulated by an authority or body established, constituted or appointed by any law for the time being in force, in accordance with the directions or guidelines relating to assets classifications issued by such authority or body;
- (b) in any other case, in accordance with the directions or guidelines relating to assets classifications issued by the Reserve Bank.

*Classification of Non-Performing Assets*

Banks are required to classify non-performing assets further into the following three categories based on the period for which the asset has remained non-performing and the realisability of the dues:

- (a) sub-standard assets,
- (b) doubtful assets, and
- (c) loss assets.

**Asset Reconstruction Companies [ARC]**

Reconstruction company means a company incorporated under provisions of Companies Act, 1956 for purpose of assets reconstruction.

The problem of non-performing loans created due to systematic banking crisis world over has become acute. Focused measures to help the banking systems to realise its NPAs has resulted into creation of specialised bodies called asset management companies which in India have been named asset reconstruction companies ('ARCs'). The buying of impaired assets from banks or financial institutions by ARCs will make their balance sheets cleaner and they will be able to use their time, energy and funds for development of

their business. ARCs may be able to mix up their assets, both good and bad, in such a manner to make them saleable.

The main objective of asset reconstruction company ('ARC') is to act as agent for any bank or financial institution for the purpose of recovering their dues from the borrowers on payment of fees or charges, to act as manager of the borrowers' asset taken over by banks, or financial institution, to act as the receiver of properties of any bank or financial institution and to carry on such ancillary or incidental business with the prior approval of Reserve Bank wherever necessary. If an ARC carries on any business other than the business of asset reconstruction or securitisation or the business mentioned above, it shall cease to carry on any such business within one year of doing such other business.

### **Registration of Securitisation or Asset Reconstruction Companies**

Section 3 of the SARFAESI Act provides for registration of securitisation or reconstruction companies. The procedure is as follows:

1. Every securitisation company or reconstruction company is required to make an application for registration to commence or carry on the business of securitisation or asset reconstruction, as the case may be to the Reserve Bank in such form and manner as it may by notification specify.
2. Securitisation company or reconstruction company (the company) cannot commence or carry on the business of securitisation or asset reconstruction without—
  - (a) obtaining a certificate of registration granted under this section; and
  - (b) having the owned fund of not less than two crore rupees or such other amount not exceeding fifteen per cent of total financial assets acquired or to be acquired by the securitisation company or reconstruction company, as the Reserve Bank may, by notification, specify.

It may be noted that the Reserve Bank may, by notification, specify different amounts of owned fund for different class or classes of securitisation companies or reconstruction companies.

3. The Reserve Bank may, for the purpose of considering the application is required to be satisfied, by an inspection of records or books of such securitisation company or reconstruction company, or otherwise, that the following conditions are fulfilled:
  - (a) that the securitisation company or reconstruction company has not incurred losses in any of the three preceding financial years;
  - (b) that such securitisation company or reconstruction, company has made adequate arrangements for realisation of the financial assets acquired for the purpose of securitisation or asset reconstruction and shall be able to pay periodical returns and redeem on respective due dates on the investments made in the company by the qualified institutional buyers or other persons;
  - (c) that the directors of securitisation company or reconstruction company have adequate professional experience in matters related to finance, securitisation and reconstruction;
  - (d) that the Board of directors of such securitisation company or reconstruction company does not consist of more than half of its total number of directors who are either nominees of any sponsor or associated in any manner with the sponsor or any of its subsidiaries;
  - (e) that any of its directors has not been convicted of any offence involving moral turpitude;
  - (f) that a sponsor, is not a holding company of the securitisation company or reconstruction company, as the case may be, or, does not otherwise hold any controlling interest in such securitisation company or reconstruction company;

- (g) that securitisation company or reconstruction company has complied with or is in a position to comply with prudential norms specified by the Reserve Bank.
- (h) that securitisation company or reconstruction company has complied with one or more conditions specified in the guidelines issued by the Reserve Bank for the said purpose."
- 4. The Reserve Bank may, after being satisfied that the conditions above are fulfilled, grant a certificate of registration to the securitisation company or the reconstruction company to commence or carry on business of securitisation or asset reconstruction, subject to such conditions, as it deems fit to impose. The conditions may vary from case to case.
- 5. The Reserve Bank may reject the application made, if it is satisfied that the conditions specified above are not fulfilled. However, before rejecting the application, the applicant shall be given a reasonable opportunity of being heard. The company who's application has been rejected is entitled to know the reasons for its rejection.

No Securitisation company or Reconstruction company can commence business without obtaining a Certificate of Registration from RBI.

### **Prior approval for substantial change**

Every securitisation company or reconstruction company, is required to obtain prior approval of the Reserve Bank for any substantial change in its management or change of location of its registered office or change in its name. The decision of the Reserve Bank, whether the change in management of a securitisation company or a reconstruction company is a substantial change in its management or not, shall be final.

The expression "substantial change in management" means the change in the management by way of transfer of shares or amalgamation or transfer of the business of the company.

### **Cancellation of Certificate of Registration**

Reserve Bank has the power under Section 4 of the Securitisation Act to cancel the Certificate of Registration issued by it to any ARC, If the Company

- (i) ceases to receive or hold any investment from qualified institutional buyer or
- (ii) ceases to carry on asset reconstruction business or
- (iii) it fails to comply with the conditions of registration.
- (iv) Fails to fulfill the conditions of Section 3(3)
- (v) Fails to comply with the directions of RBI
- (vi) Fails to maintain accounts
- (vii) Fails to submit documents on inspection by RBI
- (viii) Obtains approval from RBI for any substantial change in its management.

Before cancelling registration, Reserve Bank shall give an opportunity to such company on such terms as the Reserve Bank may specify for taking necessary steps to comply with such provisions or fulfilment of such conditions.

## Appeal

A securitisation company or reconstruction company aggrieved by the order of rejection or cancellation of certificate of registration may prefer an appeal, within a period of thirty days from the date on which such order of cancellation is communicated to it, to the Central Government.

It may be noted that before rejecting an appeal such company shall be given a reasonable opportunity of being heard.

A securitisation company or reconstruction company, which is holding investments of qualified institutional buyers and whose application for grant of certificate of registration has been rejected or certificate of registration has been cancelled shall, notwithstanding such rejection or cancellation, be deemed to be a securitisation company or reconstruction company until it repays the entire investments held by it (together with interest, if any) within such period as the Reserve Bank may direct.

## Acquisition of rights or interest in financial assets and effects of acquisition

Section 5 of the Act provides that notwithstanding anything contained in any agreement or any other law for the time being in force, any securitisation company or reconstruction company may acquire financial assets of any bank or financial institution,—

- (a) by issuing a debenture or bond or any other security in the nature of debenture, for consideration agreed upon between such company and the bank or financial institution, incorporating therein such terms and conditions as may be agreed upon between them; or
- (b) by entering into an agreement with such bank or financial institution for the transfer of such financial assets to such company on such terms and conditions as may be agreed upon between them.

If the bank or financial institution is a lender in relation to any financial assets acquired by the securitisation company or the reconstruction company, then on such acquisition, such securitisation company or reconstruction company shall be deemed to be the lender. All the rights of such bank or financial institution shall vest in such company in relation to such financial assets. All contracts, deeds, bonds, agreements, powers-of-attorney, grants of legal representation, permissions, approvals, consents or no-objections under any law or otherwise and other instruments which relate to the said financial asset and which are subsisting or having effect immediately before the acquisition of abovesaid financial asset shall be of as full force and effect against or in favour of the securitisation company or reconstruction company, as the case may be. Further, if there is any suit, appeal or other proceeding relating to the said financial asset which is pending by or against the bank or financial institution, save as provided in the third proviso to Sub-section (1) of Section 15 of the Sick Industrial Companies (Special Provisions) Act, 1985 the same shall not abate, or be discontinued or be, in any way, prejudicially affected by reason of the acquisition of financial asset by the securitisation company or reconstruction company, as the case may be, but the suit, appeal or other proceeding may be continued, prosecuted and enforced by or against the securitisation company or reconstruction company, as the case may be.

On acquisition of financial assets the securitisation company or reconstruction company, may with the consent of the originator, file an application before the Debts Recovery Tribunal or the Appellate Tribunal or any court or other Authority for the purpose of substitution of its name in any pending suit, appeal or other proceedings and on receipt of such application, such Debts Recovery Tribunal or the Appellate Tribunal or court or Authority shall pass orders for the substitution of the securitisation company or reconstruction company in such pending suit, appeal or other proceedings.

### **Transfer of pending applications to any one of Debts Recovery Tribunals in certain cases (Section 5A)**

- (1) If any financial asset, of a borrower acquired by a securitisation company or reconstruction company, comprise of secured debts of more than one bank or financial institution for recovery of which such banks or financial institutions has filed applications before two or more Debts Recovery Tribunals, the securitisation company or reconstruction company may file an application to the Appellate Tribunal having jurisdiction over any of such Tribunals in which such applications are pending for transfer of all pending applications to any one of the Debts Recovery Tribunals as it deems fit.
- (2) On receipt of such application for transfer of all pending applications under sub-section (1), the Appellate Tribunal may, after giving the parties to the application an opportunity of being heard, pass an order for transfer of the pending applications to any one of the Debts Recovery Tribunals.
- (3) Notwithstanding anything contained in the Recovery of Debts Due to Banks and Financial Institutions Act, 1993, any order passed by the Appellate Tribunal under sub-section (2) shall be binding on all the Debts Recovery Tribunals referred to in sub-section (1) as if such order had been passed by the Appellate Tribunal having jurisdiction on each such Debts Recovery Tribunal.
- (4) Any recovery certificate, issued by the Debts Recovery Tribunal to which all the pending applications are transferred under sub-section (2), shall be executed in accordance with the provisions contained in sub-section (23) of section 19 and other provisions of the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 shall, accordingly, apply to such execution

### **Measures for Asset reconstruction (Section 9)**

Asset Reconstruction Company or Securitisation Company can take the following measures for the purposes of asset reconstruction:

- Proper management of the business of the borrower, by change in, or take over of, the management of the business of the borrower.
- The sale or lease of a part or whole of the business of the borrower.
- Rescheduling of payment of debts payable by the borrower.
- Enforcement of security interest in accordance with the provisions of the Act.
- Settlement of dues payable by the borrower.
- Taking possession of secured assets in accordance with the provisions of the Act.
- To convert any portion of debt into share of a borrower company.

### **Other functions of Securitisation or Reconstruction Company**

Securitisation or Reconstruction Company may do the following functions also in accordance with Section 10 of the Act:

- (a) act as an agent for any bank or financial institution for the purpose of recovering their dues from the borrower on payment of such fees or charges as may be mutually agreed upon between the parties;
- (b) act as a manager referred to in clause (c) of Sub-section (4) of Section 13 on such fee as may be mutually agreed upon between the parties;
- (c) act as receiver if appointed by any court or Tribunal.



It may be noted that no securitisation company or Reconstruction Company shall act as a manager if acting as such gives rise to any pecuniary liability.

It is important to note here that securitisation company or reconstruction company which has been granted a certificate of registration cannot commence or carry on any business other than that of securitisation or asset reconstruction without prior approval of the Reserve Bank.

### **Enforcement of Security interest by a Creditors (Section 13)**

(1) Notwithstanding anything contained in section 69 or section 69A of the Transfer of Property Act, 1882, any security interest created in favour of any secured creditor may be enforced, without the intervention of the court or tribunal, by such creditor in accordance with the provisions of this Act.

(2) Where any borrower, who is under a liability to a secured creditor under a security agreement, makes any default in repayment of secured debt or any instalment thereof, and his account in respect of such debt is classified by the secured creditor as non-performing asset, then, the secured creditor may require the borrower by notice in writing to discharge in full his liabilities to the secured creditor within sixty days from the date of notice failing which the secured creditor shall be entitled to exercise all or any of the rights.

(3) The notice shall give details of the amount payable by the borrower and the secured assets intended to be enforced by the secured creditor in the event of non-payment of secured debts by the borrower. If, on receipt of the notice, the borrower makes any representation or raises any objection, the secured creditor shall consider such representation or objection and if the secured creditor comes to the conclusion that such representation or objection is not acceptable or tenable, he shall communicate within fifteen days of receipt of such representation or objection the reasons for non-acceptance of the representation or objection to the borrower. It may be noted that the reasons so communicated or the likely action of the secured creditor at the stage of communication of reasons shall not confer any right upon the borrower to prefer an application to the Debts Recovery Tribunal under section 17 or the Court of District Judge under section 17A : If, the management of whole of the business or part of the business is severable, the secured creditor shall take over the management of such business of the borrower which is relatable to the security for the debt.

(4) In case the borrower fails to discharge his liability in full within the period specified above, the secured creditor may take recourse to one or more of the following measures to recover his secured debt, namely :—

- (a) take possession of the secured assets of the borrower including the right to transfer by way of lease, assignment or sale for realising the secured asset;
- (b) take over the management of the business of the borrower including the right to transfer by way of lease, assignment or sale for realising the secured asset : It may be noted that the right to transfer by way of lease, assignment or sale shall be exercised only where the substantial part of the business of the borrower is held as security for the debt;
- (c) appoint any person (hereafter referred to as the manager), to manage the secured assets the possession of which has been taken over by the secured creditor;
- (d) require at any time by notice in writing, any person who has acquired any of the secured assets from the borrower and from whom any money is due or may become due to the borrower, to pay the secured creditor, so much of the money as is sufficient to pay the secured debt.

(5) Any payment made by any person to the secured creditor shall give such person a valid discharge as if he has made payment to the borrower.

(5A) Where the sale of an immovable property, for which a reserve price has been specified, has been

postponed for want of a bid of an amount not less than such reserve price, it shall be lawful for any officer of the secured creditor, if so authorised by the secured creditor in this behalf, to bid for the immovable property on behalf of the secured creditor at any subsequent sale.

(5B) Where the secured creditor, referred to in sub-section (5A), is declared to be the purchaser of the immovable property at any subsequent sale, the amount of the purchase price shall be adjusted towards the amount of the claim of the secured creditor for which the auction of enforcement of security interest is taken by the secured creditor, under sub-section (4) of section 13.

(5C) The provisions of section 9 of the Banking Regulation Act, 1949 shall, as far as may be, apply to the immovable property acquired by secured creditor under sub-section (5A).

(6) Any transfer of secured asset after taking possession thereof or take over of management, by the secured creditor or by the manager on behalf of the secured creditor shall vest in the transferee all rights in, or in relation to, the secured asset transferred as if the transfer had been made by the owner of such secured asset.

(7) Where any action has been taken against a borrower, all costs, charges and expenses which, in the opinion of the secured creditor, have been properly incurred by him or any expenses incidental thereto, shall be recoverable from the borrower and the money which is received by the secured creditor shall, in the absence of any contract to the contrary, be held by him in trust, to be applied, firstly, in payment of such costs, charges and expenses and secondly, in discharge of the dues of the secured creditor and the residue of the money so received shall be paid to the person entitled thereto in accordance with his rights and interests.

(8) If the dues of the secured creditor together with all costs, charges and expenses incurred by him are tendered to the secured creditor at any time before the date fixed for sale or transfer, the secured asset shall not be sold or transferred by the secured creditor, and no further step shall be taken by him for transfer or sale of that secured asset.

(9) In the case of financing of a financial asset by more than one secured creditors or joint financing of a financial asset by secured creditors, no secured creditor shall be entitled to exercise any or all of the rights conferred on him unless exercise of such right is agreed upon by the secured creditors representing not less than sixty per cent in value of the amount outstanding as on a record date and such action shall be binding on all the secured creditors :

However, in the case of a company in liquidation, the amount realised from the sale of secured assets shall be distributed in accordance with the provisions of section 529A of the Companies Act, 1956:

In the case of a company being wound up on or after the commencement of this Act, the secured creditor of such company, who opts to realise his security instead of relinquishing his security and proving his debt under proviso to sub-section (1) of section 529 of the Companies Act, 1956 (1 of 1956), may retain the sale proceeds of his secured assets after depositing the workmen's dues with the liquidator in accordance with the provisions of section 529A of that Act : The liquidator shall intimate the secured creditor the workmen's dues in accordance with the provisions of section 529A of the Companies Act, 1956 and in case such workmen's dues cannot be ascertained, the liquidator shall intimate the estimated amount of workmen's dues under that section to the secured creditor and in such case the secured creditor may retain the sale proceeds of the secured assets after depositing the amount of such estimated dues with the liquidator :

In case the secured creditor deposits the estimated amount of workmen's dues, such creditor shall be liable to pay the balance of the workmen's dues or entitled to receive the excess amount, if any, deposited by the

secured creditor with the liquidator: and that the secured creditor shall furnish an undertaking to the liquidator to pay the balance of the workmen's dues, if any.

- (a) "record date" means the date agreed upon by the secured creditors representing not less than sixty per cent in value of the amount outstanding on such date;
- (b) "amount outstanding" shall include principal, interest and any other dues payable by the borrower to the secured creditor in respect of secured asset as per the books of account of the secured creditor.

(10) Where dues of the secured creditor are not fully satisfied with the sale proceeds of the secured assets, the secured creditor may file an application in the form and manner as may be prescribed to the Debts Recovery Tribunal having jurisdiction or a competent court, as the case may be, for recovery of the balance amount from the borrower.

(11) Without prejudice to the rights conferred on the secured creditor under or by this section, the secured creditor shall be entitled to proceed against the guarantors or sell the pledged assets without first taking any of the measures specified in point not 4.

(12) The rights of a secured creditor under this Act may be exercised by one or more of his officers authorised in this behalf in such manner as may be prescribed.

(13) No borrower shall, after receipt of notice from the secured creditor transfer by way of sale, lease or otherwise (other than in the ordinary course of his business) any of his secured assets referred to in the notice, without prior written consent of the secured creditor.



In the case of *Nik-Nish Retail Pvt. Ltd & Anr. Versus Union Bank & Ors. G.A. 1380 of 2012 in W.P. 6 of 2010 25 June, 2012, Dipankar Datta, J*, the Calcutta High Court held that the scheme of the Act envisages grant of 60 days time to the defaulter for clearance of the liability or to raise objection. Even if the defaulting party falls short of paying Rs. 1/- of the amount specified in the demand notice within the permitted

period, its account would still be a 'non- performing asset' and continue to be treated as such and the secured creditor is, in the circumstances, entitled to initiate further action in terms of provisions of the Act including taking measures to take possession of the secured assets after the period of 60 days has expired if no objection is received in the meantime or the objection to the demand notice has been overruled. Question of waiver does not and cannot arise simply because certain payments had been credited in the cash credit account. The period of 60 days is the time limited for clearing the liability and if the liability does not stand cleared, notwithstanding part payment the secured creditor is well within its right to exercise power conferred by Section 13(4) of the Act.

### Accounting aspects

These companies should follow all the Accounting Standards issued by the Institute of Chartered Accountants of India as required under Sub-section (3A) of Section 211 of the Companies Act, 1956. They should also follow the guidelines and prudential norms/accounting standards issued by Reserve Bank from time to time.

### ARCs will be public financial institutions

All the ARCs who have obtained certificate of registration from Reserve Bank to carry on the business of asset reconstruction are public financial institution as defined under Section 4A of the Companies Act, 1956. This is a special status conferred by the Act on ARCs. The first proviso to Sub-section (3) of Section 67 permits a company to issue securities on a private placement basis to 50 persons only. However, this

proviso does not apply to a public financial institution. Therefore, the ARC can invite any number of qualified institutional buyers to subscribe to its debentures, bonds, units, etc., issued for financing the acquisition of assets of the defaulting borrowers of any bank/financial institution. It has to create a debentures redemption reserve for the redemption of debentures and adequate amount should be credited to such reserve from out of its profits every year until such debentures are redeemed, as provided in Section 117C of the Companies Act, 1956.

### **Assistance by Chief Metropolitan Magistrate or the District Magistrate**

Section 14 of the SARFAESI Act provides for assistance for taking possession of secured asset from the Chief Metropolitan Magistrate or the District Magistrate.

Where the possession of any secured asset is required to be taken by the secured creditor or if any of the secured asset is required to be sold or transferred by the secured creditor under the provisions of this Act, the secured creditor may, for the purpose of taking possession or control of any such secured asset, request, in writing, the Chief Metropolitan Magistrate or the District Magistrate within whose jurisdiction any such secured asset or other documents relating thereto may be situated or found, to take possession thereof, and the Chief Metropolitan Magistrate or, as the case may be, the District Magistrate shall, on such request being made to him-

- take possession of such asset and documents relating thereto; and
- forward such asset and documents to the secured creditor.

Any application by the secured creditor shall be accompanied by an affidavit duly affirmed by the authorised officer of the secured creditor, declaring that—

- (i) the aggregate amount of financial assistance granted and the total claim of the Bank as on the date of filing the application;
- (ii) the borrower has created security interest over various properties and that the Bank or Financial Institution is holding a valid and subsisting security interest over such properties and the claim of the Bank or Financial Institution is within the limitation period;
- (iii) the borrower has created security interest over various properties giving the details of properties above;
- (iv) the borrower has committed default in repayment of the financial assistance granted aggregating the specified amount;
- (v) consequent upon such default in repayment of the financial assistance the account of the borrower has been classified as a nonperforming asset;
- (vi) affirming that the period of sixty days notice as required by the provisions of sub-section (2) of section 13, demanding payment of the defaulted financial assistance has been served on the borrower;
- (vii) the objection or representation in reply to the notice received from the borrower has been considered by the secured creditor and reasons for non-acceptance of such objection or representation had been communicated to the borrower;
- (viii) the borrower has not made any repayment of the financial assistance in spite of the above notice and the Authorised Officer is, therefore, entitled to take possession of the secured assets under the provisions of sub-section (4) of section 13 read with section 14 of the principal Act;
- (ix) that the provisions of the Act and the rules made thereunder had been complied with.

On receipt of the affidavit from the Authorised Officer, the District Magistrate or the Chief Metropolitan Magistrate, as the case may be, shall after satisfying the contents of the affidavit pass suitable orders for the purpose of taking possession of the secured assets.

### **Manner and effect of takeover of Management**

Section 15 of the SARFAESI Act provides for the manner and effect of takeover of management. When the management of business of a borrower is taken over by a secured creditor it can appoint as many persons as it thinks fit to be the directors, where the borrower is a company, or the administrators of the business of the borrower, in any other case. The secured creditor is required to publish a notice in a newspaper published in English language and in a newspaper published in an Indian language in circulation in the place where the principal office of the borrower is situated.

On the publication of the notice all persons who were directors of the company or administrators of the business, as the case may be, are deemed to have vacated their office. It also has the effect of termination of all contracts entered into by the borrower with such directors or administrators.

Where the management of the business of a borrower, being a company as defined in the Companies Act, 1956, is taken over by the secured creditor, then, notwithstanding anything contained in the said Act or in the memorandum or articles of association of such borrower:

- It shall not be lawful for the shareholders of such company or any other person to nominate or appoint any person to be director of the company;
- No resolution passed at any meeting of the shareholders of such company shall be given effect to unless approved by the secured creditor;
- No proceeding for the winding up of such company or for the appointment of a receiver in respect thereof shall lie in any court, except with the consent of the secured creditor;

Where the management of the business of a borrower had been taken over by the secured creditor, the secured creditor shall, on realization of his debt in full, restore the management of the business of the borrower to him.

**The Change in or takeover of the Management of the business is subject to ‘The Change in or takeover of the Management of the business of the borrower by Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines 2010’.**

### **Highlights of the guidelines are as under:**

#### **(i) Eligibility**

- (a) Securitisation Company or Reconstruction Company(SC/AC) may effect change in or takeover the management of the business of the borrower, where the amount due to it from the borrower is not less than 25 per cent of the total assets owned by the borrower; and
- (b) Where the borrower is financed by more than one secured creditor (including SC/RC), secured creditors (including SC/RC) holding not less than 75 per cent of the outstanding security receipts agree to such action.

#### **(ii) Grounds for effecting change in or takeover of management**

Subject to the eligibility conditions specified above, SC/RC shall be entitled to effect change in management

or takeover the management of business of the borrower on any of the following grounds:

- (a) the borrower makes a wilful default in repayment of the amount due under the relevant loan agreement/s;
- (b) the SC/RC is satisfied that the management of the business of the borrower is acting in a manner adversely affecting the interest of the creditors (including SC/RC) or is failing to take necessary action to avoid any events which would adversely affect the interest of the creditors;
- (c) SC/RC is satisfied that the management of the business of the borrower is not competent to run the business resulting in losses/non-repayment of dues to SC/RC or there is a lack of professional management of the business of the borrower or the key managerial personnel of the business of the borrower have not been appointed for more than one year from the date of such vacancy which would adversely affect the financial health of the business of the borrower or the interests of the SC/RC as a secured creditor;
- (d) the borrower has without the prior approval of the secured creditors (including SC/RC), sold, disposed of, charged, encumbered or alienated 10 per cent or more (in aggregate) of its assets secured to the SC/RC;
- (e) there are reasonable grounds to believe that the borrower would be unable to pay its debts as per terms of repayment accepted by the borrower;
- (f) the borrower has entered into any arrangement or compromise with creditors without the consent of the SC/RC which adversely affects the interest of the SC/RC or the borrower has committed any act of insolvency;
- (g) the borrower discontinues or threatens to discontinue any of its businesses constituting 10 per cent or more of its turnover;
- (h) all or a significant part of the assets of the borrower required for or essential for its business or operations are damaged due to the actions of the borrower;
- (i) the general nature or scope of the business, operations, management, control or ownership of the business of the borrower are altered to an extent, which in the opinion of the SC/RC, materially affects the ability of the borrower to repay the loan;
- (j) the SC/RC is satisfied that serious dispute/s have arisen among the promoters or directors or partners of the business of the borrower, which could materially affect the ability of the borrower to repay the loan;
- (k) failure of the borrower to acquire the assets for which the loan has been availed and utilization of the funds borrowed for other than stated purposes or disposal of the financed assets and misuse or misappropriation of the proceeds;
- (l) fraudulent transactions by the borrower in respect of the assets secured to the creditor/s.

*Explanation A:* For the purpose of this paragraph, wilful default in repayment of amount due, includes—

- (a) non-payment of dues despite adequate cash flow and availability of other resources, or
- (b) 'routing of transactions through banks which are not lenders/consortium members' so as to avoid payment of dues, or
- (c) siphoning off funds to the detriment of the defaulting unit, or misrepresentation/falsification of records pertaining to the transactions with the SC/RC.

*Explanation B:* The decision as to whether the borrower is a wilful defaulter or not, shall be made by the SC/RC keeping in view the track record of the borrower and not on the basis of an isolated transaction/incident which is not material. The default to be categorized as wilful must be intentional, deliberate and calculated.

**(iii) Policy regarding change in or takeover of management**

- (A) Every SC/RC shall frame policy guidelines regarding change in or takeover of the management of the business of the borrower, with the approval of its Board of Directors and the borrowers shall be made aware of such policy of the SC/RC.
- (B) Such policy shall generally provide for the following :
  - (i) The change in or takeover of the management of the business of the borrower should be done only after the proposal is examined by an Independent Advisory Committee to be appointed by the SC/RC consisting of professionals having technical/finance/legal background who after assessment of the financial position of the borrower, time frame available for recovery of the debt from the borrower, future prospects of the business of the borrower and other relevant aspects shall recommend to the SC/RC that it may resort to change in or takeover of the management of the business of the borrower and that such action would be necessary for effective running of the business leading to recovery of its dues.
  - (ii) The Board of Directors including at least two independent directors of the SC/RC should deliberate on the recommendations of the Independent Advisory Committee and consider the various options available for the recovery of dues before deciding whether under the existing circumstances the change in or takeover of the management of the business of the borrower is necessary and the decision shall be specifically included in the minutes.
  - (iii) The SC/RC shall carry out due diligence, exercise and record the details of the exercise, including the findings on the circumstances which had led to default in repayment of the dues by the borrower and why the decision to change in or takeover of the management of the business of the borrower has become necessary.
  - (iv) The SC/RC shall identify suitable personnel/agencies, who can takeover the management of the business of the borrower by formulating a plan for operating and managing the business of the borrower effectively, so that the dues of the SC/RC may be realized from the borrower within the time-frame.
  - (v) Such plan will also include procedure to be adopted by the SC/RC at the time of restoration of the management of the business to the borrower in accordance with paragraph 3 above, borrower's rights and liabilities at the time of change in or takeover of management by the SC/RC and at the time of restoration of management back to the borrower, rights and liabilities of the new management taking over management of the business of the borrower at the behest of SC/RC. It should be clarified to the new management by the SC/RC that the scope of their role is limited to recovery of dues of the SC/RC by managing the affairs of the business of the borrower in a prudent manner.

*Explanation:* To ensure independence of members of Independent Advisory Committee (IAC), such members should not be connected with the affairs of the SC/RC in any manner and should not receive any pecuniary benefit from the SC/RC except for services rendered for acting as member of IAC.

**(iv) Procedure for change in or takeover of management**

- (a) The SC/RC shall give a notice of 60 days to the borrower indicating its intention to effect change in or takeover the management of the business of the borrower and calling for objections, if any.
- (b) The objections, if any, submitted by the borrower shall be initially considered by the IAC and thereafter the objections along with the recommendations of the IAC shall be submitted to the Board of Directors of the SC/RC. The Board of Directors of SC/RC shall pass a reasoned order within a period of 30 days from the date of expiry of the notice period, indicating the decision of the SC/RC regarding the change in or takeover of the management of the business of the borrower, which shall be communicated to the borrower.

**(v) Reporting**

SC/RCs shall report to the Bank all cases where they have taken action to cause change in or takeover the management of the business of the borrower for realization of its dues from the borrower in terms of circular DNBS (PD) CC. No. 12/SCRC/ 10.30.000/2008-09, dated September 26, 2008.

**Right to appeal**

Section 17 of the Act provides that any borrower or any other person aggrieved by the action of the secured creditors can file an appeal to the concerned Debt Recovery Tribunal (DRT).

Such appeal can also be filed by any person aggrieved by the action of the secured creditor without being required to deposit any amount with the DRT. Such provisions will take care of any third party interest in the secured assets which need to be considered before sale of securities. Any person aggrieved by the order of DRT, may prefer an appeal to the Appellate Tribunal within thirty days from the date of receipt of the order of Debt Recovery Tribunal.

**Appeal to Appellate Tribunal**

Section 18 provides that any person aggrieved, by any order made by the Debts Recovery Tribunal under section 17, may prefer an appeal to an Appellate Tribunal within thirty days from the date of receipt of the order of Debts Recovery Tribunal. The Appellate Tribunal shall, as far as may be, dispose of the appeal in accordance with the provisions of the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (51 of 1993) and rules made thereunder.

It may be noted that no appeal shall be entertained unless the borrower has deposited with the Appellate Tribunal fifty per cent. of the amount of debt due from him, as claimed by the secured creditors or determined by the Debts Recovery Tribunal, whichever is less. Appellate Tribunal may, for the reasons to be recorded in writing, reduce the amount to not less than twenty-five per cent. of debt referred above.

**Right to lodge a caveat**

Section 18C of the Act deals with Right to lodge a caveat. Section 18C (1) stated that where an application or an appeal is expected to be made or has been made under section 17 or section 17A or section 18 or section 18B, the secured creditor or any person claiming a right to appear before the Tribunal or the Court of District Judge or the Appellate Tribunal or the High Court, as the case may be, on the hearing of such application or appeal, may lodge a caveat in respect thereof.

***Where a caveat has been lodged:***

- (a) the secured creditor by whom the caveat (hereafter referred to as the caveator) has been lodged shall



serve notice of the caveat by registered post, acknowledgement due, on the person by whom the application has been or is expected to be made under sub-section (1);

(b) any person by whom the caveat has been lodged (hereafter referred to as the caveator) shall serve notice of the caveat by registered post, acknowledgement due, on the person by whom the application has been or is expected to be made under sub-section (1).

After a caveat has been lodged under subsection (1), any application or appeal is filed before the Tribunal or the court of District Judge or the Appellate Tribunal or the High Court, as the case may be, the Tribunal or the District Judge or the Appellate Tribunal or the High Court, as the case may be, shall serve a notice of application or appeal filed by the applicant or the appellant on the caveator.

Where a notice of any caveat has been served on the applicant or the Appellant, he shall periodically furnish the caveator with a copy of the application or the appeal made by him and also with copies of any paper or document which has been or may be filed by him in support of the application or the appeal.

Where a caveat has been lodged under sub-section (1), such caveat shall not remain in force after the expiry of the period of ninety days from the date on which it was lodged unless the application or appeal referred to in sub-section (1) has been made before the expiry of the said period.

### **Setting up of Central Registry**

Under Section 20 of the Act, the Central Government is empowered to setup by notification a registry to known as Central Registry with its own seal for the purpose of registration of transactions of securitisation and reconstruction of financial assets and creation of security interest under this Act. The head office and the branches of the central registry shall be at such places as the Central Government may specify. The territorial limits within which the registry can exercise its functions shall be specified by the Central Government. The Central Government will appoint a person called the Central Registrar who will exercise the powers granted to the Central Registry. Also the Central Government shall appoint other officials who shall discharge their functions under the directions of the Central Registrar.

### **Register of Securitisation, reconstruction and security interest transactions**

A register called the Central Register will be kept at the head office of the Central Registry for entering the particulars of the transactions relating to securitization and reconstruction of financial assets and creation of security interest under this Act. The Central Register may be maintained in electronic form in Floppies or Diskettes subject to such safe guards as may be prescribed. The Register will be kept under the control and management of the Central Registrar.

### **Filing of Particulars**

The particulars of every transaction of securitization asset reconstruction or creation of security interest is required to be filed with the Central Registrar in the manner and on payment of such fee as may be prescribed within 30 days after the date of such transaction or creation of security by the securitisation/reconstruction company or secured creditor as the case may be. The Central Registrar shall have the power to allow extension of 30 days on payment of such additional fee not exceeding 10 times the amount of such fee.

The particulars of any change in the terms and conditions or the extent or operation of the security interest registered under this chapter shall be sent to the Registrar by the securitisation/reconstruction company or secured creditor.

### **Satisfaction of Security interest**

As per section 25 the Central Registrar shall be intimated of any satisfaction or payment of any security interest relating to the securitisation/reconstruction company or secured creditors and requiring registration under this Act within 30 days of such payment or satisfaction. On receiving the intimation, the Central Registrar shall order that memorandum of satisfaction should be entered in the Central Register. If the concerned borrower gives intimation to Central Registry for not recording the payment or satisfaction, the Central Registry will issue a notice to the securitisation/ reconstruction company or secured creditors calling upon it to show cause with in time not exceeding 14 days specified in such notice as to why payment or satisfaction should not be recorded. In case no cause is shown the Central Registrar shall order that a memorandum of satisfaction shall be entered in the Central Register. If cause is shown the Central Registrar shall record a note to that effect in the Central Register and shall inform the borrower that he has done so.

### **Right to Inspect**

As per Section 26 of the Act, the Central Register maintained by the Central Registrar (both in electronic and non-electronic form) shall be open for inspection by any person during the business hours on payment of prescribed fee.

### **Penalties**

If a default is made in filing the particulars of every transaction of any securitisation or asset reconstruction or security interest created by a securitisation company or reconstruction company or secured creditor; or in sending the particulars of the modification or in giving intimation under Section 25, every company and every officer of the company or the secured creditor and every officer of the secured creditor who is in default shall be punishable with fine which may extend to five thousand rupees for every day during which the default continues.

### **Penalties for non-compliance of direction of Reserve Bank**

As per Section 28 of the Act, if any securitisation company or reconstruction company fails to comply with any direction issued by the Reserve Bank under Section 12 or Section 12A, such company and every officer of the company who is in default, shall be punishable with fine which may extend to five lakh rupees and in the case of a continuing offence, with an additional fine which may extend to ten thousand rupees for every day during which the default continues.

### **Offences**

Any person who contravenes the provisions of this Act or of any rules made thereunder shall be punishable with imprisonment for a term which may extend to one year, or with fine, or with both.

### **Non-Applicability in certain cases**

The provisions of this Act shall not apply to—

- (a) a lien on any goods, money or security given by or under the Indian Contract Act, 1872 or the Sale of Goods Act, 1930 or any other law for the time being in force;
- (b) a pledge of movables within the meaning of Section 172 of the Indian Contract Act, 1872;
- (c) creation of any security in any aircraft as defined in clause (1) of Section 2 of the Aircraft Act, 1934;
- (d) creation of security interest in any vessel as defined in clause (55) of Section 3 of the Merchant Shipping Act, 1958;

- (e) any conditional sale, hire-purchase or lease or any other contract in which no security interest has been created;
- (f) any rights of unpaid seller under Section 47 of the Sale of Goods Act, 1930;
- (g) any properties not liable to attachment (excluding the properties specifically charged with the debt recoverable under this Act)] or sale under the first proviso to Sub-section (1) of Section 60 of the Code of Civil Procedure, 1908;
- (h) any security interest for securing repayment of any financial asset not exceeding one lakh rupees;
- (i) any security interest created in agricultural land;
- (j) any case in which the amount due is less than twenty per cent of the principal amount and interest thereon.

### Civil Court Not to have jurisdiction

Section 34 provides that no civil court shall have jurisdiction to entertain any suit or proceeding in respect of any matter which a Debts Recovery Tribunal or the Appellate Tribunal is empowered by or under this Act to determine and no injunction shall be granted by any court or other authority in respect of any action taken or to be taken in pursuance of any power conferred by or under this Act or under the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (51 of 1993).



*In the case of **BPV Classic Tea Factory (P.) Ltd. v. Corporation Bank**, [2008] 87 SCL 14 (MAD.)* It was held that SARFAESI Act, 2002 is a special Act while Companies Act, 1956, is a general law and, therefore, with regard to enforcement of a security asset under section 34, provisions as contained in 2002 Act alone would apply with regard to sale of an immovable property by secured creditor and same cannot be challenged before company court under provisions of 1956 Act.

### Limitation Act (Section 36)

Limitation Act, 1963 is applicable to the claims made under this Act. Accordingly, no secured creditor shall be entitled to take all or any of the measures under Sub-section (4) of Section 13, unless his claim in respect of the financial asset is made within the period of limitation prescribed under the Limitation Act, 1963.

### Applicability of other Acts

Section 35 provides that the provisions of this Act shall have effect, notwithstanding anything inconsistent therewith contained in any other law for the time being in force or any instrument having effect by virtue of any such law.

In accordance with Section 37, the provisions of this Act or the rules made thereunder shall be in addition to and not in derogation of, the Companies Act, 1956, the Securities Contracts (Regulation) Act, 1956, the Securities and Exchange Board of India Act, 1992, the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 or any other law for the time being in force.

The combined affect of Sections 35 and 37 is that in cases of any conflict with these Acts or any other Act, then the SRFAESI Act, 2002 shall have the over riding effect over such Act or Acts. Therefore the provisions of the SRFAESI Act, 2002 have the binding power and cannot be put on hold because of conflict with any other legislation. Moreover as per the provisions of Section 34 of SRFAESI Act, 2002, no civil court shall have any jurisdiction to entertain any suit or proceeding in respect of any matter which a Debts Recovery Tribunal or the Appellate Tribunal is empowered by or under this Act (i.e. SRFAESI Act, 2002) to determine

and no injunction shall be granted by any court or any other authority in respect of any action taken or to be taken in pursuance of any power conferred by or under this Act or under the Recovery of Debts Due to Banks and Financial Institutions Act, 1993.

Therefore it shall not be possible to get any injunction from any Court of Law. Moreover SRFAESI Act, 2002 has also amended following legislations:

1. The Companies Act, 1956: The definition of Public Financial Institution under Section 4A has been altered and it now includes securitisation company or reconstruction Company.
2. The Securities Contract (Regulation) Act, 1956: Section 2 has been amended to include the definition of Security Deposit as defined in 2 (kg) of SRFAESI Act, 2002.
3. The Sick Industrial Companies (Special Provisions) Act, 1985 has been amended to the extent it provides that after the commencement of SRFAESI Act, 2002 and if the financial assets have been acquired by securitisation or reconstruction company, no reference shall be made to BIFR. Moreover, after the commencement of SRFAESI Act, 1956 and if the reference is pending, then the reference shall abate, if 75% of the Secured Creditors have taken measures to recover their Secured Debts.

### **Rule making power**

Under Section 38, the Central Government has power to make rules by notification for carrying out the provisions of this Act.

In exercise of the powers conferred by subsection (1) and CL (b) of sub-section (2) of Sec. 38 read with sub-sections (4), (10) and (12) of Sec. 13 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (54 of 2002), the Central Government hereby makes the Security Interest (Enforcement) Rules, 2002.

### **SECURITY INTEREST (ENFORCEMENT) RULES, 2002.**

#### **Demand notice**

Rule 3 (1) provides that the service of demand notice as referred to in sub-section (2) of section 13 of the SRFAESI Act shall be made by delivering or transmitting at the place where the borrower or his agent, empowered to accept the notice or documents on behalf of the borrower, actually and voluntarily resides or carries on business or personally works for gain, by registered post with acknowledgement due, addressed to the borrower or his agent empowered to accept the service or by Speed Post or by courier or by any other means of transmission of documents like fax message or electronic mail service.

However, where authorised officer has reason to believe that the borrower or his agent is avoiding the service of the notice or that for any other reason, the service cannot be made as aforesaid, the service shall be effected by affixing a copy of the demand notice on the outer door or some other conspicuous part of the house or building in which the borrower or his agent ordinarily resides or carries on business or personally works for gain and also by publishing the contents of the demand notice in two leading newspapers, one in vernacular language, having sufficient circulation in that locality.

Where the borrower is a body corporate, the demand notice shall be served on the registered office or any of the branches of such body corporate as specified under sub-rule (1).

Any other notice in writing to be served on the borrower or his agent by authorised officer, shall be served in the same manner as provided in this rule.

It may be noted that where there are more than one borrower, the demand notice shall be served on each borrower.

### **Reply to Representation of the borrower (Rule 3A)**

- (a) After issue of demand notice under sub-section (2) of section 13, if the borrower makes any representation or raises any objection to the notice, the Authorized Officer shall consider such representation or objection and examine whether the same is acceptable or tenable.
- (b) If on examining the representation made or objection raised by the borrower, the secured creditor is satisfied that there is a need to make any changes or modifications in the demand notice, he shall modify the notice accordingly and serve a revised notice or pass such other suitable orders as deemed necessary, within seven days from the date of receipt of the representation or objection.
- (c) If on examining the representation made or objection raised, the Authorized Officer comes to the conclusion that such representation or objection is not acceptable or tenable, he shall communicate within one week of receipt of such representation or objection, the reasons for non-acceptance of the representation or objection, to the borrower

### **Procedure after issue of notice (Rule 4)**

If the amount mentioned in the demand notice is not paid within the time specified therein, the authorised officer shall proceed to realise the amount by adopting any one or more of the measures specified in sub-section (4) of section 13 of the Act for taking possession of movable property, namely :—

- (1) Where the possession of the secured assets to be taken by the secured creditor are movable property in possession of the borrower, the authorised officer shall take possession of such movable property in the presence of two witnesses after a Panchnama drawn and signed by the witnesses as nearly as possible in Appendix I to these rules.
- (2) After taking possession under sub-rule (1) above, the authorised officer shall make or cause to be made an inventory of the property as nearly as possible in the form given in Appendix II to these rules and deliver or cause to be delivered, a copy of such inventory to the borrower or to any person entitled to receive on behalf of borrower.
- (3) The authorised officer shall keep the property taken possession under sub-rule (1) either in his own custody or in the custody of any person authorised or appointed by him, who shall take as much care of the property in his custody as an owner of ordinary prudence would, under the similar circumstances, take of such property:

Provided that if such property is subject to speedy or natural decay, or the expense of keeping such property in custody is likely to exceed its value, the authorised officer may sell it at once.

- (4) The authorised officer shall take steps for preservation and protection of secured assets and insure them, if necessary, till they are sold or otherwise disposed of.
- (5) In case any secured asset is:—
  - (a) a debt not secured by negotiable instrument; or
  - (b) a share in a body corporate;
  - (c) other movable property not in the possession of the borrower except the property deposited in or in the custody of any court or any like authority, the authorised officer shall obtain possession or recover the debt by service of notice as under :—

- (i) in the case of a debt, prohibiting the borrower from recovering the debt or any interest thereon and the debtor from making payment thereof and directing the debtor to make such payment to the authorised officer; or
- (ii) in the case of the shares in a body corporate, directing the borrower to transfer the same to the secured creditor and also the body corporate from not transferring such shares in favour of any person other than the secured creditor. A copy of the notice so sent may be endorsed to the concerned body corporate's Registrar to the issue or share transfer agents, if any;
- (iii) in the case of other movable property (except as aforesaid), calling upon the borrowers and the person in possession to hand over the same to the authorised officer and the authorised officer shall take custody of such movable property in the same manner as provided in sub-rules (1) to (3) above;
- (iv) movable secured assets other than those covered in this rule shall be taken possession of by the authorised officer by taking possession of the documents evidencing title to such secured assets.

#### **Valuation of movable secured assets (Rule 5)**

After taking possession under sub-rule (1) of rule 4 and in any case before sale, the authorised officer shall obtain the estimated value of the movable secured assets and thereafter, if considered necessary, fix in consultation with the secured creditor, the reserve price of the assets to be sold in realisation of the dues of the secured creditor.

#### **Sale of movable secured assets (Rule 6)**

(1) The authorised officer may sell the movable secured assets taken possession under sub-rule (1) of rule 4 in one or more lots by adopting any of the following methods to secure maximum sale price for the assets, to be so sold—

- (a) obtaining quotations from parties dealing in the secured assets or otherwise interested in buying such assets; or
- (b) inviting tenders from the public; or
- (c) holding public auction; or
- (d) by private treaty.

(2) The authorised officer shall serve to the borrower a notice of thirty days for sale of the movable secured assets under sub-rule (1) :

Provided that if the sale of such secured assets is being, effected by either inviting tenders from the public or by holding public auction, the secured creditor shall cause a public notice in two leading newspapers, one in vernacular language, having sufficient circulation in that locality by setting out the terms of sale, which may include,—

- (a) details about the borrower and the secured creditor;
- (b) description of movable secured assets to be sold with identification marks or numbers, if any, on them;
- (c) reserve price, if any, and the time and manner of payment;

- (d) time and place of public auction or the time after which sale by any other mode shall be completed;
- (e) depositing earnest money as may be stipulated by the secured creditor;
- (f) any other thing which the authorised officer considers it material for a purchaser to know in order to judge the nature and value of movable secured assets.

(3) Sale by any methods other than public auction or public tender, shall be on such terms as may be settled between the parties in writing.

#### **Issue of certificate of sale (Rule 7)**

(1) Where movable secured assets is sold, sale price of each lot shall be paid as per the terms of the public notice or on the terms as may be settled between the parties, as the case may be and in the event of default of payment, the movable secured assets shall be liable to be ordered for sale again.

(2) On payment of sale price, the authorised officer shall issue a certificate of sale in the prescribed form as given in Appendix III to these rules specifying the movable secured assets sold, price paid and the name of the purchaser and thereafter the sale shall become absolute. The certificate of sale so issued shall be prima facie evidence of title of the purchaser.

(3) Where the movable secured assets are those referred in sub-clauses (iii) to (v) of clause (1) of sub-section (1) of section 2 of the Act, the provisions contained in these rules and rule 7 dealing with the sale of movable secured assets shall, mutatis mutandis, apply to such assets.

#### **Sale of immovable secured assets (Rule 8)**

(1) Where the secured asset is an immovable property, the authorised officer shall take or cause to be taken possession, by delivering a possession notice prepared as nearly as possible in Appendix IV to these rules, to the borrower and by affixing the possession notice on the outer door or at such conspicuous place of the property.

(2) The possession notice as referred to in sub-rule (1) shall also be published as soon as possible but in any case not later than seven days from the date of taking possession, in two leading newspapers in two leading newspapers, one in vernacular language having sufficient circulation in that locality, by the authorised officer.

(3) In the event of possession of immovable property is actually taken by the authorised officer, such property shall be kept in his own custody or in the custody of any person authorised or appointed by him, who shall take as much care of the property in his custody as a owner of ordinary prudence would, under the similar circumstances, take of such property.

(4) The authorised officer shall take steps for preservation and protection of secured assets and insure them, if necessary, till they are sold or otherwise disposed of.

(5) Before effecting sale of the immovable property referred to in sub-rule (1) of rule 9, the authorised officer shall obtain valuation of the property from an approved valuer and in consultation with the secured creditor, fix the reserve price of the property and may sell the whole or any part of such immovable secured asset by any of the following methods:—

- (a) by obtaining quotations from the persons dealing with similar secured assets or otherwise interested in buying the such assets; or
- (b) by inviting tenders from the public;

- (c) by holding public auction; or
- (d) by private treaty.

(6) The authorised officer shall serve to the borrower a notice of thirty days for sale of the immovable secured assets, under sub-rule (5) :

Provided that if the sale of such secured asset is being effected by either inviting tenders from the public or by holding public auction, the secured creditor shall cause a public notice in two leading newspapers one in vernacular language having sufficient circulation in the locality by setting out the terms of sale, which shall include,—

- (a) the description of the immovable property to be sold, including the details of the encumbrances known to the secured creditor;
- (b) the secured debt for recovery of which the property is to be sold;
- (c) reserve price, below which the property may not be sold;
- (d) time and place of public auction or the time after which sale by any other mode shall be completed;
- (e) depositing earnest money as may be stipulated by the secured creditor;
- (f) any other thing which the authorised officer considers it material for a purchaser to know in order to judge the nature and value of the property.



In the case of *Pvt. Ltd. & Ors vs Union Of India & Ors* on 14 November, 2011 writ petition no. 1956 of 2011 decided on 14 November 2011 Dr. D.Y. Chandrachud, A.A. Sayed JJ in the High Court of judicature at Bombay held that Rule 8(6) of the Rules of 2002 provides the necessary safeguard if the action is taken in arbitrary and unreasonable manner and if the valuation of the property is not properly fixed. The

whole object of Rule 8 (6) of the Rules of 2002 appears to be that the borrower gets clear thirty days' notice before the sale takes place. During this period, the borrower can raise objections and can also point out before the appropriate forum as regards the correct and true valuation of the property. The essential purpose of sub-rule (5) of Rule 8 of the Rules of 2002 is to see that there is proper valuation by an approved valuer, who would be considered as an expert, and the view of the secured creditor on the aspect of fixation of reserved price is taken into consideration by the authorized officer. Just because the borrower is excluded from Rule 8 (5) of the Rules of 2002 or has no voice at the time when the valuation is fixed and the reserved price is also fixed, by itself will not render Rule 8 (5) unconstitutional.

(7) Every notice of sale shall be affixed on a conspicuous part of the immovable property and may, if the authorised officer deems it fit, put on the web-site of the secured creditor on the Internet.

(8) Sale by any method other than public auction or public tender, shall be on such terms as may be settled between the parties in writing.

#### **Time of sale, issue of sale certificate and delivery of possession, etc. (Rule 9)**

(1) No sale of immovable property under these rules shall take place before the expiry of thirty days from the date on which the public notice of sale is published in newspapers as referred to in the proviso to sub-rule (6) or notice of sale has been served to the borrower.

(2) The sale shall be confirmed in favour of the purchaser who has offered the highest sale price in his bid or tender or quotation or offer to the authorised officer and shall be subject to confirmation by the secured creditor:



Provided that no sale under this rule shall be confirmed, if the amount offered by sale price is less than the reserve price, specified under sub-rule (5) of rule 9 :

Provided further that if the authorised officer fails to obtain a price higher than the reserve price, he may, with the consent of the borrower and the secured creditor effect the sale at such price.

(3) On every sale of immovable property, the purchaser shall immediately pay a deposit of twenty-five per cent of the amount of the sale price, to the authorised officer conducting the sale and in default of such deposit, the property shall forthwith be sold again.

(4) The balance amount of purchase price payable shall be paid by the purchaser to the authorised officer on or before the fifteenth day of confirmation of sale of the immovable property or such extended period as may be agreed upon in writing between the parties.

(5) In default of payment within the period mentioned in sub-rule (4), the deposit shall be forfeited and the property shall be resold and the defaulting purchaser shall forfeit all claim to the property or to any part of the sum for which it may be subsequently sold.

(6) On confirmation of sale by the secured creditor and if the terms of payment have been complied with, the authorised officer exercising the power of sale shall issue a certificate of sale of the immovable property in favour of the purchaser in the form given in Appendix V to these rules.

(7) Where the immovable property sold is subject to any encumbrances, the authorised officer may, if he thinks fit, allow the purchaser to deposit with him the money required to discharge the encumbrances and any interest due thereon together with such additional amount that may be sufficient to meet the contingencies or further cost, expenses and interest as may be determined by him.

Provided that it after meeting the cost of removing encumbrances and contingencies there is any surplus available out of the money deposited by the purchaser such surplus shall be paid to the purchaser within fifteen day, from date of finalisation of the sale.

(8) On such deposit of money for discharge of the encumbrances, the authorised officer [shall issue or cause the purchaser to issue notices to the persons interested in or entitled to the money deposited with him and take steps to make the payment accordingly.

(9) The authorised officer shall deliver the property to the purchaser free from encumbrances known to the secured creditor on deposit of money as specified in sub-rule (7) above.

(10) The certificate of sale issued under sub-rule (6) shall specifically mention that whether the purchaser has purchased the immovable secured asset free from any encumbrances known to the secured creditor or not.

### **Appointment of Manager (Rule 10)**

(1) The Board of Directors or Board of Trustees, as the case may be, may appoint in consultation with the borrower any person (hereinafter referred to as the Manager) to manage the secured assets the possession of which has been taken over by the secured creditor.

Provided that the manager so appointed shall not be a person who is, or has been, adjudicated insolvent, or has suspended payment or has compounded with his creditors, or who is, or has been, convicted by a criminal court of an offence involving moral turpitude.

(2) The Manager appointed by the Board of Directors or Board of Trustees, as the case may be, shall be

deemed to be an agent of the borrower and the borrower shall be solely responsible for the commission or omission of acts of the Manager unless such commission or omission are due to improper intervention of the secured creditor or the authorised officer.

(3) The Manager shall have power by notice in writing to recover any money from any person who has acquired any of the secured assets from the borrower, which is due to may become due to the borrower.

(4) The Manager shall give such person who has made payment under sub-rule (3) a valid discharge as if he has made payments to the borrower.

(5) The Manager shall apply all the monies received by him in accordance with the provisions contained in sub-section (7) of section 13 of the [Act].

#### **Procedure for recovery of shortfall of secured debt (Rule 11)**

(1) An application for recovery of balance amount by any secured creditor pursuant to sub-section (10) of section 13 of the Act shall be presented to the Debts Recovery Tribunal in the form annexed as Appendix VI to these rules by the authorised officer or his agent or by a duly authorised legal practitioner, to the Registrar of the Bench within whose jurisdiction his case falls or shall be sent by registered post addressed to the Registrar of Debts Recovery Tribunal.

(2) The provisions of the Debts Recovery Tribunal (Procedure) Rules, 1993 made under Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (51 of 1993), shall mutatis mutandis apply to any application filed by under sub-rule (1).

(3) An application under sub-rule (1) shall be accompanied with fee as provided in rule 7 of the Debts Recovery Tribunal (Procedure) Rules, 1993.

#### **Application to the Tribunal/Appellate Tribunal (Rule 12)**

(1) Any application to the Debt Recovery Tribunal under sub-section (1) of section 17 shall be, as nearly as possible, in the form given in Appendix VII to the Rules.

(2) Any application to the Appellate Tribunal under sub-section (6) of section 17 of the Act shall be, as nearly as possible, in the form given in Appendix VIII to the said Rules. Any appeal to the Appellate Tribunal under section 18 of the Act shall be, as nearly as possible, in the form given in Appendix IX to the said Rules.

### **LESSON ROUND UP**

- The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 enacted with a view to regulate securitisation and reconstruction of financial assets and enforcement of security interest and for matters connected therewith or incidental thereto.
- Enforcement of Security Interest and Recovery of Debts Laws (Amendment) Act, 2012 amended the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act and Recovery of Debts due to Banks & Financial Institutions (RDBF) Act so as to strengthen the regulatory and institutional framework related to recovery of debts due to banks and financial institutions.
- Amendment Act, 2012 enable banks to improve their operational efficiency, deploy more funds for credit disbursement to retail investors, home loan borrowers, etc. without fearing for recovery, thus bringing about equity. Further, mandatory registration of subsisting security interest (equitable mortgages) promote innovation in credit information.
- Any security interest created in favour of any secured creditor may be enforced, without the intervention of the court or tribunal, by such creditor in accordance with the provisions of this Act.

- Any borrower or any other person aggrieved by the action of the secured creditors can file an appeal to the concerned Debt Recovery Tribunal (DRT).
- Any person aggrieved by the order of DRT, may prefer an appeal to the Appellate Tribunal within thirty days from the date of receipt of the order of Debt Recovery Tribunal.
- In exercise of the powers conferred by subsection (1) and CL (b) of sub-section (2) of Sec. 38 read with sub-sections (4), (10) and (12) of Sec. 13 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, the Central Government notified Security Interest (Enforcement) Rules, 2002.
- Rule 8(6) of the Rules of 2002 provides the necessary safeguard if the action is taken in arbitrary and unreasonable manner and if the valuation of the property is not properly fixed. The whole object of Rule 8 (6) of the Rules of 2002 appears to be that the borrower gets clear thirty days' notice before the sale takes place. During this period, the borrower can raise objections and can also point out before the appropriate forum as regards the correct and true valuation of the property.

### SELF TEST QUESTIONS

1. Write short notes on the following:
  - (a) Non-performing Assets
  - (b) Securitization Companies
  - (c) Securitization
  - (d) Bank
2. What measures are given to Asset Securitization Companies under the SARFAESI Act, 2002.
3. Comment on constitutional validity of the Rule 8 of Security Interest (Enforcement) Rules, 2002.
4. Explain the "Right to lodge a caveat" under SARFAESI Act, 2002.
5. Explain the overriding power of SARFAESI Act, 2002 over Companies Act with decided case law.

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# Lesson 19

## Debt Recovery

### LESSON OUTLINE

- Need and object of the Act
- Important Definitions
- About Establishment of Tribunals and Appellate Tribunal
- Procedure aspects involved
- Powers of Tribunal
- Recovery of debt determined by Tribunal
- Effective non-legal remedies for improving recovery management
- Act having overriding effect.

### LEARNING OBJECTIVES

The banks and financial institutions (FIs) were facing numerous problems in recovery of defaulted loans on account of delays in disposal of recovery proceedings. In order to ensure speedy adjudication of the matters relating to recovery of debts due to banks and financial institutions, the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 was passed. It provides a procedure which is different from the existing Code of Civil Procedure. To ensure expeditious adjudication and recovery of dues of banks and financial institutions, remove legal anomalies and strengthen the Recovery Tribunals, the said Act was amended in the years 1995, 2000 and 2004 respectively. The Recovery of Debts Due to Banks and Financial Institutions Act, 1993 was last amended in 2012.

This chapter contains overview of the Act, establishment of Tribunals and procedure thereof etc. The objective of the study lesson is to familiarize the students with the legal requirements stipulated under the Recovery of Debts Due to Banks and Financial Institutions Act, 1993.

*Recovery of Debts Due to Banks and Financial Institutions Act, 1993 is an Act to provide for the establishment of Tribunals for expeditious adjudication and recovery of debts due to banks and financial institutions and for matters connected therewith or incidental thereto.*

## NEED AND OBJECT

The Recovery of Debts Due to Banks and Financial Institutions Act, 1993 was passed by the Parliament of India to provide for the speedy adjudication of matters relating to recovery of debts due to banks and financial institutions. The Act provides a procedure that is distinct from the existing Code of Civil Procedure in order to ensure a speedy adjudication. The Act also provides for the setting up of a separate set of tribunals to hear such matters and these tribunals are termed as Debt Recovery Tribunals (DRTs).

With a view to help financial institutions recover their bad debts quickly and efficiently, the Government of India has constituted thirty three Debt Recovery Tribunals and five Debt Recovery Appellate Tribunals all over the country.

Each Debts Recovery Tribunal is presided over by a Presiding Officer. The Presiding Officer is generally a judge of the rank of District and Sessions Judge. A Presiding Officer of a Debts Recovery Tribunal is assisted by a number of officers of other ranks, but none of them need necessarily have a judicial background. Therefore, the Presiding Officer of a Debt Recovery Tribunal is the sole judicial authority to hear and pass any judicial order.

Each Debts Recovery Tribunal has two Recovery Officers. The work amongst the Recovery Officers is allocated by the Presiding Officer. Though a Recovery Officer need not be a judicial Officer, but the orders passed by a Recovery Officer are judicial in nature, and are appealable before the Presiding Officer of the Tribunal.

The Debts Recovery Tribunals are fully empowered to pass comprehensive orders like in Civil Courts. The Tribunals can hear cross suits, counter claims and allow set offs. However, they cannot hear claims of damages or deficiency of services or breach of contract or criminal negligence on the part of the lenders.

The Debts Recovery Tribunals can appoint Receivers, Commissioners, pass ex-parte orders, ad-interim orders, interim orders apart from powers to review its own decision and hear appeals against orders passed by the Recovery Officers of the Tribunals.

The recording of evidence by Debts Recovery Tribunals is somewhat unique. All evidences are taken by way of an affidavit. Cross examination is allowed only on request by the defense, and that too if the Tribunal feels that such a cross examination is in the interest of justice. Frivolous cross examination may be denied. There are a number of other unique features in the proceedings before the Debts Recovery Tribunals all aimed at expediting the proceedings.

Any liability (inclusive of interest) which is claimed as due from any person by a bank or a financial institution or by a consortium of banks or financial institutions during the course of any business activity undertaken by the bank or the financial institution or the consortium under any law for the time being in force, in cash or otherwise, whether secured or unsecured, or assigned, or whether payable under a decree or order of any civil court or any arbitration award or otherwise or under a mortgage and subsisting on, and legally recoverable on, the date of the application.

### Constitutional validity of the Recovery of Debts Due to Banks and Financial Institutions Act, 1993



In case of *Union of India v. Delhi High Court Bar Association*, (2002) 4 SCC 275, the petitioners have challenged the constitutional validity of the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 on the ground that the Act is unreasonable and is violative of Art. 14 of the Constitution and that it is beyond the legislative competence of the Parliament to enact such a law. This Act had been challenged for depriving a person of legal remedies in ordinary civil courts. However, the Supreme

Court held that there is no such right that the dispute should be adjudicated only by a civil court, and the replacement of the jurisdiction of civil courts by independent and specialized tribunals is completely legal and constitutional.

### ENFORCEMENT OF SECURITY INTEREST AND RECOVERY OF DEBTS LAWS (AMENDMENT) ACT, 2012

Enforcement of Security Interest and Recovery of Debts Laws (Amendment) Act, 2012 amended the Recovery of Debts due to Banks & Financial Institutions (RDBFI) Act so as to strengthen the regulatory and institutional framework related to recovery of debts due to banks and financial institutions.

To ensure expeditious adjudication and recovery of dues of banks and financial institutions, remove legal anomalies and strengthen the Recovery Tribunals, the said Act was amended in the years 1995, 2000 and 2004. The measures of recovery through the Debts Recovery Tribunal are not available to multi-State co-operative banks. In order to provide an additional and effective recovery mechanism to multi-State co-operative banks, it is considered necessary to give an option to the multi-State co-operative banks either to initiate proceedings for recovery of its debts under the Multi-State Co-operative Societies Act, 2002 or the Debts Recovery Tribunal under the Recovery of Debts Due to Banks and Financial Institutions Act, 1993, amended the Enforcement of Security Interest and Recovery of Debts Laws (Amendment) Act, 2012

### Salient features of the Enforcement of Security Interest and Recovery of Debt Laws (Amendment) Act, 2012 as under

- (a) Included the multi-State co-operative banks in the definition of 'bank' under clause (d) of section 2 of the said Act;
- (b) Permitted the multi State co-operative banks, with respect to debts due before or after the commencement of the proposed legislation, to opt either to initiate proceedings under the Multi-State Co-operative Societies Act, 2002 or to initiate the proceedings before the Debts Recovery Tribunal;
- (c) Enabled the banks and financial institutions to enter into settlement or compromise with the borrower and also to empower the Debts Recovery Tribunal to pass an order acknowledging such settlement or compromise;
- (d) Recovery proceedings pending before the commencement of the Enforcement of Security Interest and Recovery of Debts Laws (Amendment) Act, 2012 in relation to recovery of debts due to any multi-State co-operative bank shall be continued in the same manner as the proposed amendments had not come into force.

### Important Definitions

Section 2 of the Recovery of Debt due to Banks and Financial Institution Act, 1993 defines various terms used in the Act, as given under:

**“Appellate Tribunal”**

Appellate Tribunal means an Appellate Tribunal established under sub-section (1) of Section 8.

**“Bank”**

Under section 2(d) bank means—

- (i) banking company;
- (ii) a corresponding new bank;
- (iii) State Bank of India;
- (iv) a subsidiary bank; or
- (v) a Regional Rural Bank;
- (vi) a multi -State co-operative bank.

**“Banking Company”**

Under section 2 (e) banking company shall have the meaning assigned to it in clause (c) of section 5 of the Banking Regulation Act, 1949.

**‘Chairperson’**

As per Section 2(ea) of the Act Chairperson’ means a chairperson of an Appellate Tribunal appointed under Section 9.

**‘Presiding officer’**

As per Section 2(ja) of the Act Presiding officer means the presiding officer of the Debts Recovery Tribunal appointed under Sub-section (1) of Section 4.

**“Financial institution”**

Under Section 2(h) “Financial institution” means—

- (i) a public financial institution within the meaning of Section 4A of the Companies Act, 1956;
- (ia) the securitisation company or reconstruction company which has obtained a certificate of registration under sub-section (4) of section 3 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (54 of 2002)
- (ii) such other institution as the Central Government may, having regard to its business activity and the area of its operation in India, by notification, specify.

**‘Tribunal’**

As per Section 2(o) Tribunal means the Tribunal established under Sub-section (1) of Section 3.

**ESTABLISHMENT OF TRIBUNAL**

The Act provides that the Central Government shall by notification; establish one or more Tribunals, to be known as the Debts Recovery Tribunal, to exercise the jurisdiction, powers and authority conferred on such Tribunal by or under this Act. The Central Government shall also specify in the notification the areas within which the Tribunal may exercise jurisdiction for entertaining and deciding the applications filed before it. The



setting up of a Debt Recovery Tribunal is dependent upon the volume of cases. Higher the number of cases within a territorial area, more the Debt Recovery Tribunals would be set up. Some cities have more than one Debt Recovery Tribunal located therein. On the other hand, there are number of states that do not have Debt Recovery Tribunals.

The details of the Tribunals constituted as of now—

### **Debt Recovery Appellate Tribunals (DRATs)**

DRAT Allahabad, DRAT Chennai, DRAT Delhi, DRAT Kolkata, DRAT Mumbai.

### **Debt Recovery Tribunals**

DRT-I Ahmedabad, DRT-II Ahmedabad, DRT Allahabad, DRT Aurangabad, DRT Bangalore, DRT-I Chandigarh, DRT-II Chandigarh, DRT-1 Chennai, DRT-2 Chennai, DRT Coimbatore, DRT Cuttak, DRT Ernakulam, DRT Guwahati, DRT Hyderabad, DRT Jabalpur, DRT Jaipur, DRT-1 Kolkata, DRT-2 Kolkata, DRT-3 Kolkata, DRT Lucknow, DRT-1 Mumbai, DRT-2 Mumbai, DRT-3 Mumbai, DRT Nagpur, DRT-1 New Delhi, DRT-2 New Delhi, DRT-3 New Delhi, DRT Patna, DRT Pune, DRT Visakhapatnam, DRT Ranchi, DRT Madurai.

### **Composition of Tribunal**

The Act provides that a Tribunal shall consist of one person only, to be called the Presiding Officer, to be appointed, by notification, by the Central Government. The Central Government may also authorise the Presiding Officer of one Tribunal to discharge also the functions of the Presiding Officer of another Tribunal. Any person who is, or who has been, or is qualified to be, a District Judge may be appointed as the Presiding Officer, who shall, hold office for a term of five years from the date on which he enters his office or until he attains the age of sixty-two years, whichever is earlier.

The Central Government shall also appoint one or more Recovery Officers and such other officers and employees as the Government may think fit. The Recovery Officers and other officers and employees of a Tribunal shall discharge their functions under the general superintendence of the Presiding Officer.

### **ESTABLISHMENT OF APPELLATE TRIBUNAL**

The Central Government may establish one or more Appellate Tribunals, to be known as the Debts Recovery Appellate Tribunals, to exercise the jurisdiction, powers and authority conferred on such Tribunal by or under the Act.

### **Composition of Appellate Tribunal**

An Appellate Tribunal shall consist of one person to be called as the Chairperson of the Appellate Tribunal. Any person, who is, or has been, or is qualified to be, a Judge of a High Court; or has been a member of the Indian Legal Service and has held a post in Grade I of that Service for at least three years; or has held office as the Chairperson of a Tribunal for at least three years, shall be qualified for appointment as the Presiding Officer of an Appellate Tribunal.

The Presiding Officer of an Appellate Tribunal shall hold office for a term of five years from the date on which he enters his office or until he attains the age of sixty-five years, whichever is earlier.

### **APPLICATION TO THE TRIBUNAL**

Section 19 of the Act provides that where a Bank or a Financial Institution has to recover any debt from any person, it may make an application to the Tribunal within the local limits of whose jurisdiction the defendant,

or each of the defendants where there are more than one, at the time of making the application, actually and voluntarily resides, or carries on business or personally works for gain; or any of the defendants, where there are more than one, at the time of making the application, actually and voluntarily resides, or carries on business, or personally works for gain; or the cause of action, wholly or in part, arises.

Provided that the bank or financial institution may, with the permission of the Debts Recovery Tribunal, on an application made by it, withdraw the application, whether made before or after the Enforcement of Security Interest and Recovery of Debts Laws (Amendment) Ordinance, 2004 for the purpose of taking action under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 if no such action had been taken earlier under that Act:

Provided further that any application made under the first proviso for seeking permission from the Debts Recovery Tribunal to withdraw the application made under sub-section (1) shall be dealt with by it as expeditiously as possible and disposed of within thirty days from the date of such application:

Provided also that in case the Debts Recovery Tribunal refuses to grant permission for withdrawal of the application filed under this sub-section, it shall pass such orders after recording the reasons therefor.

Section 19(1A) of the Act, provides that every bank being, multi-State co-operative bank may, at its option, opt to initiate proceedings under the Multi-State Co-operative Societies Act, 2002 to recover debts, whether due before or after the date of commencement of the Enforcement of the Security Interest and Recovery of Debts Laws (Amendment) Act, 2012 from any person instead of making an application under Chapter III of the Recovery Debts Act, 1993.

Section 19(1B) states that in case, a bank being, multi-State co-operative bank has filed an application under Chapter III of the Recovery Debts Act, 1993 and subsequently opts to withdraw the application for the purpose of initiating proceeding under the Multi-State Co-operative Societies Act, 2002 to recover debts, it may do so with the permission of the Tribunal and every such application seeking permission from the Tribunal to withdraw the application made under sub-section (1A) shall be dealt with by it as expeditiously as possible and disposed of within thirty days from the date of such application:

It may be noted that in case the Tribunal refuses to grant permission for withdrawal of the application filed under Section 19 (1B), it shall pass such orders after recording the reasons therefor.

Further, when a Bank or a financial institution, which has to recover its debt from any person, has filed an application to the Tribunal and against the same person and another bank or financial institution also has a claim to recover its debt, then, the later bank or financial institution may join the applicant bank or financial institution at any stage of the proceedings, before the final order is passed by making an application to that Tribunal.

Every application has to be made in such form and be accompanied by such documents or other evidence and by such fee as may be prescribed.

Section 19(3A) provides that if any application filed before the Tribunal for recovery of any debt is settled prior to the commencement of the hearing before that Tribunal or at any stage of the proceedings before the final order is passed, the applicant may be granted refund of the fees paid by him at such prescribed rates .

On receipt of application, the Tribunal shall issue summons requiring the defendant to show cause within thirty days of the service of summons as to why the relief prayed for should not be granted.

The defendant shall, within a period of thirty days from the date of service of summons, present a written statement of this defence:

However, when the defendant fails to file the written statement within the said period of thirty days, the Presiding Officer may, in exceptional cases and in special circumstances to be recorded in writing, allow not more than two extensions to the defendant to file the written statement.

After hearing of the application has commenced, it shall be continued from day-to-day until the hearing is concluded. Tribunal may grant adjournments if sufficient cause is shown, but no such adjournment shall be granted more than three times to a party and where there are three or more parties, the total number of such adjournments shall not exceed six. The Presiding Officer may grant such adjournments on imposing such costs as may be considered necessary.

Where the defendant claims to set-off against the applicant's demand any ascertained sum of money legally recoverable by him from such applicant, the defendant may, at the first hearing of the application, but not afterwards unless permitted by the Tribunal, present a written statement containing the particulars of the debt sought to be set-off.

Section 19(7) provides that the written statement shall have the same effect as a plaint in a cross suit so as to enable the Tribunal to pass a final order in respect of both the original claim and of the set off.

The defendant in an application may, in addition to his right of pleading a set off, set up, by way of counter-claim against the claim of the applicant, any right or claim in respect of a cause of action accruing to the defendant against the applicant either before or after the filing of the application but before the defendant has delivered his defence or before the time limited for delivering his defence has expired, whether such counter-claim is in the nature of a claim for damages or not.

Tribunal may, after giving the applicant and the defendant an opportunity of being heard, pass such orders on the application as it deems fit to meet the ends of justice. A counter-claim shall have the same effect as a cross-suit so as to enable the Tribunal to pass a final order on the same application, both on the original claim and on the counter-claim.

The applicant shall be at liberty to file a written statement in answer to the counterclaim of the defendant within such period as may be fixed by the Tribunal.

Where a defendant sets up a counterclaim and the applicant contents that the claim thereby raised ought not be disposed of by way of a counter-claim but in an independent action, the applicant may, at any time before issues are settled in relation to the counter-claim, apply to the Tribunal for an order that such counterclaim may be excluded, and the Tribunal may, on hearing of such application, make such order as it thinks fit.

The Tribunal may make an interim order (whether by way of injunction or stay or attachment) against the defendant to debar him from transferring, alienating or otherwise dealing with, or disposing of, any property and assets belonging to him without the prior permission of the Tribunal.

The objective behind empowering the Tribunals for issuing such a wide variety of interim orders is to prevent unscrupulous persons from stripping the properties and/or encumbering them in such a manner so as to defeat the lenders attempt at recovering the amounts advanced by them. The Tribunals can get the property vacated, attach rents, appoint Commissioner to take inventory of the property and the stocks. The Tribunals can go ahead and attach Bank Accounts, seal lockers and much more.

However, there are a number of judgements of the Supreme Court and the High Court which have laid down conditions which must be followed by the Tribunals before passing orders which have pernicious effects on current and running business establishments. Therefore, even though the Tribunals can pass orders of wide variety, they are slow and cautious while passing such orders. Generally, they would first listen to the defendants before the orders are passed.

Where at any stage of the proceedings, the Tribunal is satisfied by affidavit or otherwise, that the defendant, with intent to obstruct or delay or frustrate the execution of any order for recovery of the debt that may be passed against him,

- (i) is about to dispose of the whole or any part of his property; or
- (ii) is about to remove the whole or any part of his property from the local limits of the jurisdiction of the Tribunal; or
- (iii) is likely to cause any damage or mischief to the property or effect its value by misuse or creating third party interest,

the Tribunal may direct the defendant, within a time fixed by the Tribunal, either to furnish security, in such sum as may be specified in the order, or to appear and show cause why he should not furnish security.

Where the defendant fails to show cause why he should not furnish security, or fails to furnish the security required, within the time fixed by the Tribunal, the Tribunal may order the attachment of the whole or such portion of the properties claimed by the applicant as the properties secured is his favour or otherwise owned by the defendant as appears sufficient to satisfy any certificate for the recovery of debt.

The applicant shall, unless the Tribunal otherwise directs, specify the property required to be attached and estimate the value thereof.

The Tribunal may also in the order direct the conditional attachment of the whole or any portion of the property. In case of disobedience of an order made by the Tribunal or breach of any of the terms on which the order was made, the Tribunal may order the properties of the person to be attached and may also order such person guilty of such disobedience or breach be detained in the civil prison for a term not exceeding three months, unless in the meantime the Tribunal directs his release.

Where it appears to the Tribunal to be just and convenient, it may, by order—

- (a) appoint a receiver of any property, whether before or after the grant of certificate for recovery of debt;
- (b) remove any person from the possession or custody of the property;
- (c) commit the same property to the possession, custody or management of the receiver;
- (d) confer upon the receiver all such powers, as to bringing and defending suits in the courts, or filing and defending applications before the Tribunal and for the realization, management, protection, preservation and improvement of the property, the collection of rents and profits thereof, the application and disposal of such rents and profits, and the execution of documents as the owner himself has, or such of those powers as the Tribunal thinks fit; and
- (e) appoint a Commissioner for preparation of an inventory of the properties of the defendant or for the sale thereof.

Where the certificate of recovery is issued against a company registered under the Companies Act, 1956, the Tribunal may order the sale proceeds of the company to be distributed among its secured creditors in accordance with the provisions of Section 529A of the Companies Act, 1956 and to pay the surplus, if any, to the company.

The Tribunal may, after giving the applicant and the defendant an opportunity of being heard, pass such interim or final order, including the order for payment of interest from date on or before which payment of the amount is found due upto the date of realization or actual payment, on the application as it thinks fit to meet the ends of justice.

Where it is proved to the satisfaction of the Tribunal that the claim of the applicant has been adjusted wholly or in part by any lawful agreement or compromise in writing and signed by the parties or where the defendant has repaid or agreed to repay the claim of the applicant, the Tribunal shall pass orders recording such agreement, compromise or satisfaction of the claim.

The Tribunal shall send a copy of every order passed by it to the applicant and the defendant. The Chairperson shall issue a certificate under his signature on the basis of the order of the Tribunal, to the Recovery Officer for recovery of the amount of debt specified in the certificate. Where the Tribunal, which has issued a certificate of recovery, is satisfied that the property is situated within the local limits of the jurisdiction of two or more Tribunals, it may send the copies of the certificate of recovery for execution to such other Tribunals where the property is situated. Provided that in case where the Tribunal to which the certificate of recovery is sent for execution finds that it has no jurisdiction to comply with the certificate of recovery, it shall return the same to the Tribunal which has issued it.

The application made to the Tribunal shall be dealt with by it as expeditiously as possible and endeavour shall be made by it to dispose of the application finally within one hundred and eighty days from the date or receipt of the application. The Tribunal may make such orders and give such directions as may be necessary or expedient to give effect to its orders or to prevent abuse of its process or to secure the ends of justice.

### **APPEAL TO THE APPELLATE TRIBUNAL**

Section 20 of the Act provides that any person aggrieved by an order made, or deemed to have been made, by a Tribunal under this Act, may prefer an appeal to an Appellate Tribunal having jurisdiction in the matter. No appeal shall lie to the Appellate Tribunal from an order made by a Tribunal with the consent of the parties. Every appeal shall be filed within a period of forty-five days from the date on which a copy of the order made, or deemed to have been made, by the Tribunal is received by him and it shall be in such form and accompanied by such fee as may be prescribed. Provided that the Appellate Tribunal may entertain an appeal after the expiry of the said period of forty-five days if it is satisfied that there was sufficient cause for not filing it within that period.

On receipt of an appeal, the Appellate Tribunal may, after giving the parties to the appeal, an opportunity of being heard, pass such orders thereon as it thinks fit, confirming, modifying or setting aside the order appealed against. The Appellate Tribunal shall send a copy of every order, made by it to the parties to the appeal and to the concerned Tribunal. The appeal filed before the Appellate Tribunal shall be dealt with by it as expeditiously as possible and endeavour shall be made by it to dispose of the appeal finally within six months from the date of receipt of the appeal.

*Deposit of amount of debt due, on filing appeal:* Where an appeal is preferred by any person from whom the amount of debt is due to a Bank or a Financial Institution or a consortium of Banks or Financial Institutions, such appeal shall not be entertained by the Appellate Tribunal unless such person has deposited with the Appellate Tribunal seventy-five percent of the amount of debt so due from him as determined by the Tribunal. Provided that the Appellate Tribunal may, for reasons to be recorded in writing, waive or reduce the amount to be deposited.

### **POWERS OF THE TRIBUNAL AND THE APPELLATE TRIBUNAL**

The Tribunal and the Appellate Tribunal shall not be bound by the procedure laid down by the Code of Civil Procedure, 1908, but shall be guided by the principles of natural justice. The proceedings before the Debt Recovery Appellate Tribunal is governed by Debt Recovery Appellate Tribunal (Procedures) Rules, 1993. In addition, Section 22 of the Act permits the Tribunal and the Appellate Tribunal to regulate their own procedure including the places at which they shall have their sittings.

The Tribunal and the Appellate Tribunal shall have, for the purposes of discharging their functions under this Act, the same powers as are vested in a civil court under the Code of Civil Procedure, 1908, while trying a suit, in respect of the following matters, namely:

- (a) summoning and enforcing the attendance of any person and examining him on oath;
- (b) requiring the discovery and production of documents;
- (c) receiving evidence on affidavits;
- (d) issuing commissions for the examination of witnesses or documents;
- (e) reviewing its decisions;
- (f) dismissing an application for default or deciding it ex parte;
- (g) setting aside any order of dismissal of any application for default or any order passed by it ex parte;
- (h) any other matter which may be prescribed.

Any proceeding before the Tribunal or the Appellate Tribunal shall be deemed to be a judicial proceeding within the meaning of Sections 193 and 228, and for the purposes of Section 196, of the Indian Penal Code, 1860 and the Tribunal or the Appellate Tribunal shall be deemed to be a civil court for all the purposes of Section 195 and Chapter XXVI of the Code of Criminal Procedure, 1973.

### **RIGHT TO LEGAL REPRESENTATION AND PRESENTING OFFICERS**

A Bank or a Financial Institution making an application to a Tribunal or an appeal to an Appellate Tribunal may authorise one or more legal practitioners or any of its officers to act as Presenting Officers and every person so authorised by it may present its case before the Tribunal or the Appellate Tribunal.

The defendant may either appear in person or authorise one or more legal practitioners or any of his or its officers to present his or its case before the Tribunal or the Appellate Tribunal.

### **Limitations**

The provisions of the Limitation Act, 1963, shall, as far as may be, apply to an application made to a Tribunal.

### **RECOVERY OF DEBT DETERMINED BY TRIBUNAL**

#### **Modes of recovery of debts**

As per the provisions of Section 25, the Recovery Officer shall, on receipt of the copy of the certificate under sub-section (7) of Section 19, proceed to recover the amount of debt specified in the certificate by one or more of the following modes, namely:

- (a) attachment and sale of the movable or immovable property of the defendant;
- (b) arrest of the defendant and his detention in prison;
- (c) appointing a receiver for the management of the movable or immovable properties of the defendant.

### **Validity of certificate and amendment thereof**

The defendant cannot dispute before the Recovery Officer the correctness of the amount specified in the certificate, and no objection to the certificate on any other ground, shall also be entertained by the Recovery Officer. However, the chair person shall have power to withdraw the certificate or correct any clerical or arithmetical mistake in the certificate by sending an intimation to the Recovery Officer. The chair person of

tribunal shall intimate to the Recovery Officer any order withdrawing or cancelling a certificate or any correction made by him.

### **Stay of proceedings under certificate and amendment or withdrawal thereof**

Section 27 provides that notwithstanding that a certificate has been issued to the Recovery Officer for the recovery of any amount, the chair person may grant time for the payment of the amount, and thereupon the Recovery Officer shall stay the proceedings until the expiry of the time so granted. Where a certificate for the recovery of amount has been issued, the chair person shall keep the Recovery Officer informed of any amount paid or time granted for payment, subsequent to the issue of such certificate to the Recovery Officer. Where the order giving rise to a demand of amount for recovery of debt has been modified in appeal, and, as a consequence thereof the demand is reduced, the chair person shall stay the recovery of such part of the amount of the certificate as pertains to the said reduction for the period for which the appeal remains pending.

Where a certificate for the recovery of debt has been received by the Recovery Officer and subsequently the amount of the outstanding demands is reduced or enhanced as a result of an appeal, the chair person shall, when the order which was the subject matter of such appeal has become final and conclusive, amend the certificate or withdraw it, as the case may be.

### **Other modes of recovery**

Section 28 deals with other modes of recovery. Section 28 (1) states that where a certificate has been issued to the Recovery Officer under sub-section (7) of Section 19, the Recovery Officer may, without prejudice to the modes of recovery specified in Section 25, recover the amount of debt by anyone or more of the modes provided under this section.

Sub-section (2) of Section 28 provides that if any amount is due from any person to the defendant, the Recovery Officer may require such person to deduct from the said amount, the amount of debt due from the defendant under this Act and such person shall comply with any such requisition and shall pay the sum so deducted to the credit of the Recovery Officer.

Provided that nothing in this sub-section shall apply to any part of the amount exempt from attachment in execution of a decree of a civil court under Section 60 of the Code of Civil Procedure, 1908.

Section 28 (3) provides that Recovery Officer may, at any time or from time to time, by notice in writing, require any person from whom money is due or may become due to the defendant or to any person who holds or may subsequently hold money for or on account of the defendant, to pay to the Recovery Officer either forthwith upon the money becoming due or being held or within the time specified in the notice (not being before the money becomes due or is held) so much of the money as is sufficient to pay the amount of debt due from the defendant or the whole of the money when it is equal to or less than that amount.

A notice under this sub-section may be issued to any person who holds or may subsequently hold any money for or on account of the defendant jointly with any other person and for the purposes of this sub-section, the shares of the joint holders in such amount shall be presumed, until the contrary is proved, to be equal.

A copy of the notice shall be forwarded to the defendant at his last address known to the Recovery Officer and in the case of a joint account to all the joint holders at their last addresses known to the Recovery Officer.

Save as otherwise provided in this sub-section, every person to whom a notice is issued under this sub-section shall be bound to comply with such notice, and, in particular, where any such notice is issued to a

post office, bank, financial institution, or an insurer, it shall not be necessary for any pass book, deposit receipt, policy or any other document to be produced for the purpose of any entry, endorsement or the like to be made before the payment is made notwithstanding any rule, practice or requirement to the contrary.

Any claim respecting any property in relation to which a notice under this sub-section has been issued arising after the date of the notice shall be void as against any demand contained in the notice. Where a person to whom a notice under this sub-section is sent, objects to it by a statement on oath that the sum demanded or the part thereof is not due to the defendant or that he does not hold any money for or on account of the defendant, then, nothing contained in this sub-section shall be deemed to require such person to pay any such sum or part thereof, as the case may be, but if it is discovered that such statement was false in any material particular, such person shall be personally liable to the Recovery Officer to the extent of his own liability to the defendant on the date of the notice, or to the extent of the defendants liability for any sum due under this Act, whichever is less.

The Recovery Officer may, at any time or from time to time, amend or revoke any notice under this sub-section or extend the time for making any payment in pursuance of such notice. This Recovery Officer shall grant a receipt for any amount paid in compliance with a notice issued under this sub-section, and the person so paying shall be fully discharged from his liability to the defendant, to the extent of the amount so paid.

Any person discharging any liability to the defendant after the receipt of a notice under this sub-section shall be personally liable to the Recovery Officer to the extent of his own liability to the defendant so discharged or to the extent of the defendants liability for any debt due under this Act, whichever is less.

If the person to whom a notice has been sent under this sub-section, fails to make payment in pursuance thereof to the Recovery Officer, he shall be deemed to be a defendant in default in respect of the amount specified in the notice and further proceedings may be taken against him for the realization of the amount as if it were a debt due from him, in the manner provided in Section 25, 26 and 27 and the notice shall have the same effect as an attachment of debt by the Recovery Officer in exercise of his powers under Section 25.

The Recovery Officer may apply to the court in whose custody there is money belonging to the defendant for payment to him of the entire amount of such money, or if it is more than the amount of debt due, an amount sufficient to discharge the amount of debt so due.

The Recovery Officer may, by order, at any stage of the execution of the certificate of recovery, require any person, and in case of a company, any of its officers against whom or which the certificate or recovery is issued, to declare on affidavit the particulars of his or its assets. The Recovery officer may recover any amount of debt due from the defendant by distraint and sale of his movable property in the manner laid down in the Third Schedule to the Income-Tax Act, 1961.

### **APPLICATION OF CERTAIN PROVISIONS OF INCOME-TAX ACT**

Section 29 of the Act provides that the provisions of the Second and Third Schedules to the Income-tax Act, 1961 and the Income-tax (Certificate Proceedings) Rules, 1962, as in force from time to time shall, as far as possible, apply with necessary modifications as if the said provisions and the rules referred to the amount of debt due under this Act instead of to the Income-tax. Provided that any reference under the said provisions and the rules to the “assessee” shall be construed as a reference to the defendant under the Act.



In the case of *Union of India and another v. Delhi High Court Bar Association and others* (2002) 4 SCC 275, the three-Judge Bench, while dealing with the constitutional validity of the RDB Act, Supreme Court observed that “By virtue of Section 29 of the Act, the provisions of the Second and Third Schedules to the Income Tax Act, 1961 and the



Income and the Income Tax (Certificate Proceedings) Rules, 1962, have become applicable for the realization of the dues by the Recovery Officer. Detailed procedure for recovery is contained in these Schedules to the Income Tax Act, including provisions relating to arrest and detention of the defaulter. It cannot, therefore, be said that the Recovery Officer would act in an arbitrary manner.

Furthermore, Section 30, after amendment by the Amendment Act, 2000, gives a right to any person aggrieved by an order of the Recovery Officer, to prefer an appeal to the Tribunal. Thus now an appellate forum has been provided against any orders of the Recovery Officer which may not be in accordance with the law. There is, therefore, sufficient safeguard which has been provided in the event of the Recovery Officer acting in an arbitrary or an unreasonable manner.”

### APPEAL AGAINST THE ORDER OF RECOVERY OFFICER

Any person aggrieved by an order of the Recovery Officer made under this Act may, within thirty days from the date on which a copy of the order is issued to him, prefer an appeal to the Tribunal. On receipt of an appeal, the Tribunal may, after giving an opportunity to the appellant to be heard, and after making such inquiry as it deems fit, confirm, modify or set aside the order made by the Recovery Officer in exercise of his powers under Sections 25 to 28 (both inclusive).



In the cases of *Pravin Gada v. Central Bank of India*[2013] 176 Comp Cas 101(SC), *Allahabad Bank v. Canara Bank*[2000] 101 Comp Cas 64(SC) and *Rajsthan Financial Corporation v. Official Liquidator*[2005] Com Cas 387(SC), Supreme Court held that anyone who is aggrieved by any act done by the Recovery Officer can prefer an appeal. The Debts Recovery Tribunal has the powers under the 1993 Act to make an enquiry as it deems fit and confirm, modify or set aside the order made by the Recovery Officer in exercise of powers under sections 25 to 28 of the 1993 Act. Thus,

the auction, sale and challenge are completely codified under the 1993 Act, regard being had to the special nature of the legislation.

The official liquidator has a role under the 1956 Act. He protects the interests of the workmen and the creditors and, hence his association at the time of auction and sale is appropriate. He has been conferred locus to put forth his stand in these matters. Since it is the Debts Recovery Tribunal which would have the exclusive jurisdiction when a matter is agitated before the Debts Recovery Tribunal, the official liquidator does not have a choice either to approach the Debts Recovery Tribunal or the company court. The language of the 1993 Act, being clear, provides that any person aggrieved can prefer an appeal. The official liquidator whose association is mandatorily required is indubitably a person aggrieved relating to the action taken by the Recovery Officer which would include the manner in which the auction is conducted or the sale is confirmed. Under these circumstances, the official liquidator cannot have recourse to the doctrine of election. He has only one remedy, i.e., to challenge the order passed by the Recovery Officer before the Debts Recovery Tribunal and further appeal under the 1993 Act and not approach the company court to set aside the auction or confirmation of sale when a sale has been confirmed by the Recovery Officer under the 1993 Act.

### ACT TO HAVE OVER-RIDING EFFECT

Section 34 provides that save as provided under subsection (2), the provisions of this Act shall have effect notwithstanding anything inconsistent herewith contained in any other law for the time being in force or in any instrument having effect by virtue of any law other than this Act.

Sub- section (2) states that the provisions of this Act or the rules made thereunder shall be in addition to, and not in derogation of, the Industrial Finance Corporation Act, 1948, the State Financial Corporations Act, 1951, the Unit Trust of India Act, 1963, the Industrial Reconstruction Bank of India Act, 1984, the Sick Industrial Companies (Special Provisions) Act, 1985 (1 of 1986) and the Small Industries Development Bank of India Act, 1989 (39 of 1989)].



In the case of *Official Liquidator, U.P and Uttarakhand v. Allahabad Bank and Others*[2013] 177 Comp Cas 426 (SC) Supreme Court observed that Section 34 of the RDB Act would have overriding effect. The RDB Act is a comprehensive Code dealing with all the facets pertaining to adjudication, appeal and realization of the dues payable to the banks and financial institutions. The Debt Recovery Tribunal has exclusive jurisdiction to sell the properties in proceeding instituted by bank or financial institution, but at the time of auction sale, it is required to associate the Official Liquidator.

### LESSON ROUND UP

- Recovery of Debts Laws Act, 1993 is an Act to provide for the establishment of Tribunals for expeditious adjudication and recovery of debts due to banks and financial institutions and for matters connected therewith or incidental thereto.
- Enforcement of Security Interest and Recovery of Debts Laws (Amendment) Act, 2012 amended the Recovery of Debts due to Banks & Financial Institutions (RDBFI) Act so as to strengthen the regulatory and institutional framework related to recovery of debts due to banks and financial institutions.
- The Act was passed to provide for the speedy adjudication of matters relating to recovery of debts due to banks and financial institutions.
- The RDB Act is a comprehensive Code dealing with all the facets pertaining to adjudication, appeal and realization of the dues payable to the banks and financial institutions.
- Section 19 of the Act deals with the procedure for making application to the Tribunal.
- Section 20 of the Act deals with provisions for an appeal to an Appellate Tribunal having jurisdiction in the matter.
- The Tribunal and the Appellate Tribunal have the same powers as are vested in a Civil Court under the Code of Civil Procedure, 1908.
- The Recovery Officer may proceed to recover the amount of debt by any of the specified modes under Section 25 of the Act.
- Any person who is aggrieved by an order of Recovery Officer may prefer an appeal to the Tribunal. The Debts Recovery Tribunal has the powers under the RDBFI Act, 1993 to make an enquiry as it deems fit and confirm, modify or set aside the order made by the Recovery Officer. The auction, sale and challenge are completely codified under the Act, regard being had to the special nature of the legislation.
- The provisions of the Limitation Act, 1963, shall, as far as may be, apply to an application made to a Tribunal.

## SELF TEST QUESTIONS

1. State the philosophy behind enactment of Recovery of Debts due to Banks and Financial Institutions Act, 1993.
2. Enumerate the salient features of Enforcement of Security Interest and Recovery of Debts Laws (Amendment) Act, 2012
3. Explain the procedure for filing application to the Tribunal under the Act.
4. Appellate Tribunal vested power of a Civil Court under the Act. Discuss.
5. State overriding effect of the DRB Act with decided case law.

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# Lesson 20

## Winding Up

### LESSON OUTLINE

- Introduction
- Meaning of winding up
- Modes of winding up
- Compulsory Winding up (Winding up by the Court)
- Voluntary winding up (Both Members' and creditor' voluntary winding up)
- Procedural aspects of Compulsory and voluntary winding up
- Provisions applicable to members' and creditors voluntary winding up
- Provisions applicable to all types of winding up (i.e. Compulsory and Voluntary winding up)
- Powers and duties of liquidators
- Winding up of unregistered companies
- Role of Secretary in Winding Up
- Outsourcing      Responsibility      of Professionals.

### LEARNING OBJECTIVES

Corporate Collapse implies business failure of the company, which may occur due to inadequate capital, fraudulent business practices, management inexperience and incompetence, failure to respond to change, recession, obsolescence, excessive gearing etc.

The Companies Act, 1956, provides various strategies to deal with such business failures such as arrangement, reconstruction, amalgamation, winding-up. Winding-up of a company is a process of putting an end to the life of a company. It is a proceeding by means of which a company is dissolved and in the course of such dissolution its assets are collected, its debts are paid off out of the assets of the company or from contributions by its members, if necessary. If any surplus is left, it is distributed among the members in accordance with their rights.

Winding up of a company is the stage, whereby the company takes its last breath. It is a process by which business of the company is wound up, and the company ceases to exist anymore. All the assets of the company are sold, and the proceedings collected are used to discharge the liabilities on a priority basis.

In the words of Prof. L.C.B. Gower, Winding-up of a company is the process whereby its life is ended and its property administered for the benefit of its creditors and members. A liquidator is appointed and he takes control of the company, collects its debts and finally distributes any surplus among the members in accordance with their rights. The main purpose of winding up of a company is to realize the assets and pay the debts of the company expeditiously and fairly in accordance with the law.

Section 270-378 of Companies Act 2013 relating to winding up are not yet notified and accordingly the provisions of Companies Act, 1956 are dealt in this lesson.

## INTRODUCTION

Winding-up of a company is a process of putting an end to the life of a company. It is a proceeding by means of which a company is dissolved and in the course of such dissolution its assets are collected, its debts are paid off out of the assets of the company or from contributions by its members, if necessary. If any surplus is left, it is distributed among the members in accordance with their rights.

Winding-up is the process by which management of a company's affairs is taken out of its directors' hands, its assets are realized by a liquidator and its debts are realized and liabilities are discharged out of proceeds of realization and any surplus of assets remaining is returned to its members or shareholders. At the end of the winding up the company will have no assets or liabilities and it will, therefore, be simply a formal step for it to be dissolved, that is, for its legal personality as a corporation to be brought to an end.

The main purpose of winding up of a company is to realize the assets and pay the debts of the company expeditiously and fairly in accordance with the law. However, the purpose must not be exploited for the benefit or advantage of any class or person entitled to submit petition for winding up of a company. It may be noted that on winding up, the company does not cease to exist as such except when it is dissolved. The administrative machinery of the company gets changed as the administration is transferred in the hands of the liquidator. Even after commencement of the winding-up, the property and assets of the company belong to the company until dissolution takes place. On dissolution the company ceases to exist as a separate entity and becomes incapable of keeping property, suing or being sued. Thus in between the winding up and dissolution, the legal status of the company continues and it can be sued in the court of law.

### Can the Company be adjudged Insolvent?

The winding up of a company is not the same thing as the insolvency of a company, for the general rule in regard to winding up is that if the members of a company desire that the company should be dissolved or if it becomes insolvent or is otherwise unable to pay its debts, or if for any reason it seems desirable that it should cease to exist, it is wound up. It is obvious that a company may be wound up even when it is perfectly solvent, e.g. for purpose of reconstruction. Furthermore, a company can never be declared bankrupt although it is unable to pay its debts. It can only be wound up, of course, some provisions of insolvency laws are made applicable to companies in liquidation (See Sections 442, 446, 477, 528 to 531 and 534 to 537 of the Companies Act). Thus, we may put the proposition that in so far as inability to pay debts is concerned, a bankruptcy of an individual under the insolvency law is the same thing as a winding up of a company under the company law but a company can also be wound up for reasons other than mere inability to pay its debts.

Following are some of the differences between the effects of insolvency of an individual or a firm and winding up of a company:

1. In the case of insolvency, the whole of the insolvent's property is taken out of his hands and rests in the Court (under the Provincial Insolvency Act, 1920) or the Official Assignee (Under the Presidency towns Insolvency Act, 1909). In winding up, on the other hand, the property remains vested in the company, subject to its being administered for the purposes of winding up as the company retains its complete existence. Its legal death comes only when it is formally dissolved.
2. In insolvency, an insolvent individual can obtain his discharge and continue living and working free from the burden of his debts. A company in liquidation cannot obtain its discharge and continue free

from the burden of its debts. The liquidator winds up its affairs and then terminates it through dissolution.

3. Although in the administration of the assets of an insolvent company the insolvency rules apply, they are, however, not identical with those of insolvency. For example, the “reputed ownership” clause of insolvency law has no application in the case of a company in liquidation.
4. In the case of an individual, the administration of his property by the Official Assignee or the Official Receiver occurs only if he is declared insolvent by the Court. But the assumption of the directors’ powers by the liquidator, occurs even if the company is fully solvent. Liquidation or winding up, even of an solvent company can be proceeded with the aid of the court, as in voluntary winding up.

### **Is Winding up and dissolution are synonymous?**

The terms “Winding up” and “Dissolution” are sometimes erroneously used to mean the same thing. But according to the Companies Act, 1956, the legal implications of these two terms are quite different and there are fundamental differences between them as regards the legal procedure involved. The main points of distinction are given below:

1. The entire procedure for bringing about a lawful end to the life of a company is divided into two stages – ‘winding up’ and ‘dissolution’. Winding up is the first stage in the process whereby assets are realised, liabilities are paid off and the surplus, if any, distributed among its members. Dissolution is the final stage whereby the existence of the company is withdrawn by the law.
2. The liquidator appointed by the company or the Court carries out the winding up proceedings but the order for dissolution can be passed by the Court only.
3. According to the Companies Act the liquidator can represent the company in the process of winding up. This can be done till the order of dissolution is passed by the Court. Once the Court passes dissolution orders the liquidator can no longer represent the company.
4. Creditors can prove their debts in the winding up but not on the dissolution of the company.
5. Winding up in all cases does not culminate in dissolution. Even after paying all the creditors there may still be a surplus; company may earn profits during the course of beneficial winding up; there may be a scheme of compromise with creditors while company is in winding up and in all such events the company will in all probability come out of winding up and hand over back to shareholders/old management. Dissolution is an act which puts an end to the life of the company.

As such winding up is only a process while the dissolution puts an end to the existence of the company. Unless and until it has been set aside under Section 559 of the Act, it prevents any proceedings being taken against promoters, directors or officers of the company to recover money or property due or belonging to the company or to prove a debt due from the company. When the company is dissolved, the statutory duty of the liquidator towards the creditors and contributories is gone, but if he has committed without complying with the requirements of the Act, he is liable to damages to the creditors.

### **Can a Company be dissolved without winding up?**

When the court sanctioning a scheme of amalgamation orders dissolution of the transferor company without winding up, such order becomes effective under Section 394(1)(iv).

## MODES OF WINDING UP

A company registered under the Companies Act, 1956 may be wound up in any of the following modes:

1. By the Court<sup>1</sup> i.e. compulsory winding up;
2. Voluntary winding up, which may be either:
  - (a) Members' voluntary winding up; or
  - (b) Creditor's voluntary winding up;

Provisions relating to winding up subject to the supervision of the court has been omitted by the Companies (Second amendment Act) 2002 and the effective date is yet to be notified.

## WINDING UP BY THE COURT<sup>1</sup>

*Important Note:* The Companies (Second Amendment) Act, 2002, has transferred to the National Company Law Tribunal the powers vested in the Court. However, the Amendment Act has not become effective as yet. Accordingly, all references to the "High Court or Court" in this study will stand replaced with "Tribunal" after the Companies (Second Amendment) Act, 2002 is enforced. Likewise, all references to the Companies Court Rules will stand replaced by the rules/regulations that will be framed by the Tribunal. However, as on date, the existing provisions are applicable.

❖ **Winding up by court is also called Compulsory Winding up.**

**Let us study the following**

1. What are the grounds of winding up by court?
2. Who can file winding up petition with the court?
3. What is the jurisdiction of the court?
4. What are the procedural aspects involved in compulsory winding up?

## Grounds on which a Company may be wound up by the Court

A company under Section 433 may be wound up by the Court if

- (a) the company has passed a special resolution of its being wound up by the Court; or
- (b) default is made in delivering the statutory report to the Registrar or in holding the statutory meeting; or
- (c) it does not commence business within a year from its incorporation or suspends business for a whole year; or
- (d) the number of its members in the case of a public company is reduced below seven and in the case of a private company, below two; or
- (e) it is unable to pay its debts; or
- (f) the Court is of the opinion that it is just and equitable that it should be wound up; or
- (g) if the company has made a default filing with the Registrar its balance sheet and profit and loss account or annual return for any five consecutive financial years; or

<sup>1</sup> Substituted by 'Tribunal' by Companies (Second Amendment) Act, 2002 w.e.f. a date yet to be notified.



- (h) if the company has acted against the interests of the sovereignty and integrity of India, the security of the state, friendly relations with foreign states, public order, decency or morality; or (It may be noted that the tribunal shall make an order for winding up of a company under clause (h) on application made by the Central Government or a State Government)
- (i) If the tribunal is of opinion that the company should be wound up under the circumstances specified in Section 424 G (i.e winding up of a sick company):

#### **(a) Special Resolution**

A company may be wound up for any cause whatever if it passes a special resolution to that effect. The Court is, however, not bound to order winding up simply because the company has so resolved. The power may not be exercised if the winding up is opposed to the public or company's interest. The power of the Court in such a case is discretionary and should be exercised only where a bona fide case is made out.

Winding up order on this ground is not a common feature because if such a large number of shareholders want the company to be wound up they would prefer the mode of voluntary winding up, which involves less time and is cheaper than winding up by order of the Court.

#### **(b) Default in filing statutory report or holding statutory meeting**

A petition for winding up of a company on this ground can only be made either by the Registrar with the previous sanction of the Central Government or by a contributory on or after the expiration of 14 days after the last day on which the statutory meeting ought to have been held. The power of the Court is discretionary. Instead of making an order for winding up, the Court may direct that the statutory report shall be filed or a meeting should be held, as the nature of the default may be. The Court may order the costs to be paid by any persons who, in its opinion, are responsible for the default [Section 443(3)].

#### **(c) Non-Commencement or Suspension of Business**

If a company does not commence its business within a year from its incorporation or has suspended business for a whole year, it may be ordered to be wound up. Here again the power of the Court is discretionary and will be exercised only when there is a fair indication that there is no intention to carry on business or where the delay has been sufficiently accounted for and there is no evidence or any probability of its commencing its business within a reasonable time. (See *The Malabar Iron and Steel Works Ltd. v. The Registrar of Companies*, AIR 1965 Ker. 35).

Similarly, when the delay appears to be due to temporary or unavoidable causes, the Court will not order a winding up. In *Re. Capital Fire Insurance Association*, (1883) 24 Ch.D. 408. Also see *Aluminium Corporation of India Ltd. v. Lakshmi Rattan Cotton Mills Co. Ltd.* AIR 1970 All 452]. Where, at the instance of the shareholders, a company's business was suspended due to recession, and a petition for winding up made by a shareholder after a year of suspension, was opposed by four-fifths in value of shareholders, the order for winding up was refused. In *Re. Middlesborough Assembly Rooms Co.*, (1880) 14 Ch.D. 104]. Where a company ceases to operate in the field of its activities but becomes a holding company in relation to other companies which are engaged in pursuit of objects for which it was incorporated, such company cannot be said to have suspended its business for a whole year so as to justify an order for its winding up. In *Re. Eastern Telegraph Co. Ltd.*, (1947) 2 All ER 104]. The suspension must be of entire business and not a part of it. Where a company having many businesses discontinues one of them, it cannot be said to have suspended its business [*Paramjit Lal Badhwar v. Prem Spg. and Weaving Mills Ltd.* (1983) Tax. L.R. 2506 (All)]. In *Registrar of Companies v. Bihar Wire* (1975) 45 Comp. Cas. 194 (P&HHC) it was held that mere fact that business has not been commenced within a year or has been suspended for a year or more is not a

ground for a Court to order winding up of a company. It has to be found out whether the non-commencement or suspension of business is for good reason. The decisive question is whether there is reasonable hope of the company commencing or resuming business and doing it at profit and whether substratum of the company has disappeared. Another consideration is taking into account the wishes of majority of shareholders about continuing the business.

Further, a company will not be wound up because it has ceased to carry on one of its several businesses unless that business is the main object of the company. In *Re. Amalgamated Syndicate* [(1897) 2 Ch. D. 600], nor can a company which has amalgamated with another company be wound up on the ground that it has ceased to carry on business as a separate company. If the company has made all possible efforts to proceed with business but due to unforeseen circumstances beyond its control, company could not proceed, company can not be ordered to be wound up under Section 433(c). [*Bikkim Gopalakrishna Rao v. Seavally Resorts* (2000) 27 SCL 242].

In *Surendra Kumar Pareek v. Shree Guru Nanak Oils (P) Ltd.* (1995) 82 Comp. Cases 642 (Raj.), the business of the company was suspended for over a year, the number of members was reduced to less than two, all directors but one were absconding and the assets were taken over by the lending institutions, the winding up was admitted despite objection from the lending institution that the winding up was being resorted to, to establish the remaining liability to the Institution.

#### **(d) Reduction of members below minimum**

If the number of members is reduced, in the case of a public company, below seven, and in case of a private company, below two, the company may be ordered to be wound up. The word “member” in clause (d) of Section 433 means actual members and does not include past members or representatives of the deceased members, or trustees or assignees of bankrupt members [See *Bowling and Welby's Contract*, (1895) 1 Ch.D. 663]. The Court usually in such a case does not order winding up, but leaves it to the company to go into voluntary liquidation. This ground for winding up is meant to enable a member to escape personal liability for the company's debts which he will incur under Section 45 of the Act.

#### **(e) Inability to pay debts**

Section 434 of the Companies Act lays down the specific circumstances when the company shall be deemed to be unable to pay its debts. These are:

- (i) If a creditor to whom the company owes more than Rs. 500/- then due, has served on the company a demand in writing for payment of the debt and the company has within three weeks thereafter, neglected to pay or secure or compound for it to the reasonable satisfaction of the Court. The debt must be really due and not under dispute. Where the object of the petition to wind up a company really is to bring pressure upon the company in order to make it pay the debt cheaply and expeditiously when the company desires to dispute the debt in the Civil Court, the petition was held to be abuse of the process of the Court and liable to be dismissed. [*P. Satya Raju v. Guntur Cotton, Jute and Paper Mills* AIR 1955 (Mad.) 199].
- (ii) If an execution or other process issued on a decree or order of any court in favour of creditor is returned unsatisfied in whole or in part. The decree or order contemplated by this clause is confined not to money decree only but is of a general nature. [*Seethal Mills Ltd. v. N. Perumalswamy*, (1980) 50 Comp. Cas. 422 Mad.].
- (iii) If it is proved to the satisfaction of the Court that the company cannot pay its debts including the contingent and prospective liabilities, it may be ordered to be wound up. In this case, it is the commercial insolvency of the company which is important rather than the difference between the

assets and liabilities. The company is liable to be wound up if it is unable to pay its current demands even though the assets, when realised, would exceed its liabilities or where its assets are locked up and it is running at a loss. The important aspect to be examined in this situation is whether in a commercial sense the company is in a position to pay its existing liabilities while it continues to carry on its business.

A debt must be a definite sum of money payable immediately or at a future date. A contingent or conditional liability is not a debt unless the contingency or condition has already happened [*Registrar of Companies v. Kavita Benefit Pvt. Ltd.* (1978) 48 Comp. Cas. 231]. If the Court is satisfied that the company cannot pay its admitted or undisputed debts, it may order the company to be wound up, however small such debts may be. It is not necessary that demand should have been made or the execution levied. In *Re. Globe Steel & Co.* (7 Eq. 337), the company accepted a bill of exchange in part payment for goods bought. No demand had been made nor execution levied. This bill was dishonoured. It was held that it was sufficient proof of the company's inability to pay its debts. The Central Government is entitled to apply and obtain an order, for the compulsory winding up of a company if the company is unable to pay a large sum lawfully due to it as income-tax [*Coimbatore Transport Co. Ltd. v. Governor General in Council* (1948) 1 M.L.J. 407].

Where a debt is bona fide disputed by the company and the Court is satisfied with the company's defence, there is no 'neglect to pay' and therefore a winding up order will not be made [*Piara Singh (S) v. S.H.R. Properties Pvt. Ltd.* (1993) 10 CLA 83]. Bona fide dispute implies the existence of a substantial ground for the dispute raised. In other words, where there is scope for honest differences of opinion and disputes in respect of the claim made, the Court will not entertain a winding up petition. [*Bhabesh Chandra Guha Roy v. Bissarwarlal Sharma*, 1973 Tax LR 2331 (Cal)]. The Court may however at its discretion direct the company to furnish security.

While hearing a winding up petition, the court decides only whether the company is liable to be wound up or not. A winding up application can not be used for obtaining decision for recovery of debts due to any banks or financial institution. The Tribunals constituted under the Recovery of Debts due to Banks and Financial Institutions Act, 1993, does not have the jurisdiction to entertain an application for winding up of a company. Such an application can be made only under the Companies Act, 1956 [*Andhra Steel Corpn. Ltd. v. Bank of Baroda* (1996) 1 Comp. LJ 313].

A notice under Section 434 is a serious matter. If the notice is validly given, its effect would be to raise a presumption as to the inability of the company to pay the debt and as to its insolvency rendering it liable to be wound up by the Court. Such a notice must comply with the requirements of the statute. All that is required by a statute is that the notice must be in respect of an existing and presently payable debt exceeding ₹ 500/-. The notice will not be invalid merely because sum demanded is more than the sum actually due. In such a case the sum due remains included in the demand (*Ofu Lynx Ltd. v. Simon Carves India Ltd.*, AIR 1970 Cal 418). The expression three weeks means three clear weeks from the date of the demand. The date on which the demand is made is excluded. [In *Re. Lympene Investments Ltd.*, (1972) 2 All. E.R. 385]. As for the second proposition it is sufficient if the company has informed a judgment-creditor that it has no assets on which to levy execution or the payment was demanded from it by the petition or without any success. [In *Re. Flag Staff Co. of Utah*, (1875) R. 20 Eq. 268]. If company persistently fails to honour its commitment made at various stages to discharge its financial obligations, it has to be held that it was unable to pay its debts and is therefore liable to be wound up. [*Bharwan Bros. v. Motorola (India) Ltd.* (2000) 25 SCL 517 (Guj HC)].

It is not the requirement of Section 434 that the creditor in his notice must mention that in the event of non-compliance, the creditor will apply for winding up. No form has been prescribed for the notice. [*Color Coats v. Venkataramanas Hotels Ltd.* AIR 1999 AP 16]. Notice is valid even in absence of stipulation of period of

three weeks notice and expression 'winding up proceedings', if the notice specifically states that in the event of default in payment of debt due, appropriate legal proceedings will be taken. [*J.G. Finance v. Hansaflon Plastochem* (2001) 30 SCL 430].

### **(f) Just and Equitable**

If the Court is of opinion that it is just and equitable that the company should be wound up, it may be ordered to be wound up. In this case, the Court has wide powers and has a complete discretion to decide when it is just and equitable that the company should be wound up.

The word "just and equitable" are not confined to matters ejusdem generis (of the same kind) as the preceding clauses of the section, nor to proved cases of mala fides. They are general words which must not be reduced to the sum of particular instances, nor confined to circumstances affecting the petitioner in his capacity as shareholder. They enable the Court to subject the exercise of legal rights to equitable considerations through the words themselves, and not because the company's structure is in any way analogous to a partnership. [*Ebrahimi v. Westbourne Galleries Ltd. & Others* (1972) 2 W.L.R. 1289].

Lord Wilberforce observed in *Ebrahimi v. B. Westbourne Galleries Ltd.*: "the tendency to create categories or headings is wrong: the general words of the sub-section should remain general and not be reduced to the sum of particular instances." The discretion of the Court under this clause is very wide and the courts have exercised this discretion on a variety of grounds. Some of the cases by way of illustration are given here in which, the Court ordered winding up of the company under 'just and equitable' clause to indicate the general categories:

- (i) Where the whole object of the company was fraudulent [In *Re. German Date Coffee Co.*, (1882) 20 Ch.D. 169].
- (ii) Where the substratum of the company is gone. The substratum of a company is deemed to have gone where (a) the subject matter of the company is gone, or (b) the object for which it was formed has substantially failed, or (c) it is impossible to carry on the business of the company except at a loss, or (d) the existing and possible assets are insufficient to meet the existing liabilities of the company (*Seth Mohan Lal v. Grain Chambers Ltd.*, AIR 1968 S.C. 772).
- (iii) Where the main object of the company for which it was incorporated has been completely achieved.
- (iv) Where there is a complete deadlock in the management of the company e.g., where two shareholders, who were also directors of private company, were not on speaking term [In *Re. Yenidje Tobacco* (1916) 2 Ch. 426]. Fractions among shareholders is, however, not a sufficient ground.
- (v) Where the company is a "bubble" and has no business to carry on e.g. where the main business of the company has been taken over by the Government and there is no prospect of the company doing any other business mentioned in the objects clause of the Memorandum of Association.
- (vi) Where the company is insolvent and its business is being carried on for the benefit of the debenture holders.
- (vii) Where there has been mismanagement and misapplication of funds by the directors of private company [*Lock v. John Blackwood Ltd.*, (1924) A.C. 73].
- (viii) Where the petitioner was excluded from all participation in the business of a private company.
- (ix) If the company has committed default in making payment to various investors, allegations that

directors have cheated several thousand investors, banks and FIs, company has not filed balance sheet for two years and no reply from company to advertisement under Rule 24, the company is liable to be wound up [*ROC v. Country Informtech Services P. Ltd.* (2002) 39 SCL 504 (All HC)].

**The following are some of the cases in which winding up was not ordered under just and equitable clause:**

- (i) Where the company was under a loss but there was a chance of its making profit and the majority of shareholders were against winding up.
- (ii) Where the directors in the exercise of their powers to do so, refused to register the executors of the deceased shareholder even when this caused hardship to the shareholders.
- (iii) Where there is honest difference between the petitioner, a director and the other directors and he has been outvoted.
- (iv) Where the business of the company was temporarily suspended owing to trade depression and was intended to be continued when conditions improved.
- (v) Where there was a deadlock in management of a public company.
- (vi) If the 'just and equitable' ground does not exist at the time of hearing the petition though it might have existed at the time of presenting the petition.

Winding up by the Court<sup>1</sup> or compulsory winding up is initiated by an application by way of petition to the appropriate Court<sup>1</sup> for a winding up order. A winding up petition has to be resorted to only when other means of healing an ailing company are of absolutely no avail. Remedies are provided by the statute on matters concerning the management and running of company. The extreme and irretrievable step of winding up must be resorted to only in very compelling circumstances. [*Daulat Makanmal Luthrid v. Solatire Hotels* (1993) 76 Comp. Cas. 215 (Bom. HCD)]. It is primarily the High Court which has the jurisdiction to wind up companies under Section 10 of the Companies Act, 1956 in relation to the place at which registered office of the company concerned is situated except to the extent to which jurisdiction has been conferred on any District or District Courts subordinate to the High Court. The Central Government may empower any District Court to exercise that jurisdiction, presumably to reduce the burden of the High Court, only in respect of small companies with the paid-up capital of not more than one lakh of rupees and having their registered office within the District, with a view to achieving expeditious and efficient disposal of winding up proceedings. The Act, therefore, under Sections 435 to 438,<sup>1</sup> confers wide powers upon the High Court to regulate the conduct of such proceedings. Accordingly the High Court which is the winding up Court may direct a District Court to retain and continue winding up proceedings which should not really have been commenced in that Court (Section 437). It may also withdraw any winding up which is in progress in a District Court from that Court and proceed with the winding up itself, or transfer it to another District Court (Section 436), and with respect to all proceedings subsequent to its own order of winding up, direct them to be had in a District Court or with the consent of any other High Court, in such High Court or in a District Court subordinate to that High Court, whereupon the Court in respect of which such direction is given shall be deemed to be the Court with all powers and jurisdiction of the High Court under the Act (Section 435). Lastly, the High Court can pass orders under any of the foregoing sections at any time and at any stage, whether or not an application in that behalf is made by any of the parties to the proceedings (Section 438). There must be strong reasons to order winding up as it is a last resort to be adopted. Temporary difficulty cannot be ground for liquidating company when company is on path of revival. *D. Ashokan v. S.T. Reddiar & Sons* (2002) 40 SCL (Ker. HC DB).

<sup>1</sup> Sections 435 to 438 have been omitted by Companies (Second Amendment) Act, 2002 w.e.f. a date yet to be notified.

In the case of *Tower Vision India Pvt. Ltd. vs. Procall Private Limited* CO.PET. 302/2009 CO.PET. 458/2010 & CA No.2179/2010 decided on 24th August, 2012[2012]115SCL 840/26 TAXMANN.COM 201(Delhi) the issue involved is whether in a contract for rendering of services/use of site, a stipulation to pay an amount for 'lock-in-period, as an admitted debt within the meaning of section 433(e) or whether the same is in the nature of damages. The Delhi High Court held that due to the following factors the amount of unexpired lock-in period can not be treated as debt or liquidated damages:

(i) Whether a particular clause about pre-determined liquidated damages represents genuine covenanted pre-estimate of damages or it is in the nature of penalty has to be judged in the facts of each case and in the background of relevant factors which are case specific. In that case, no facts and circumstances were pleaded to show that clause relating to lock-in period was a genuine pre-estimate of damages which the petitioner would have suffered in case the respondent company vacated the premises before the expiry of lock-in period.

(ii) In order to prove that amount mentioned as payable for the lock-in period is genuine pre-estimate of damages, proper evidence is required of specific nature, namely, the landlord had altered its position by making the premises available to the tenant keeping in view the tenants' requirements and spending thereupon. Certain expenditure was incurred on infrastructure specifically provided to the tenant as per tenant's requirements; certain other expenditure incurred on whitewashing, fixtures and fittings and the landlord was forced to incur such expenditure again before giving the premises to new tenant and, therefore, lock-in period was treated as reasonable period to avoid duplication of such expenditure, etc.

(iii) The doctrine of mitigation of damages may also apply in such cases and even if the tenant had committed breach by leaving the premises before the expiry of lock-in period, it was for the landlord to prove that he had taken reasonable steps to minimize the loss, but could not award the loss to the extent mentioned in the clause and, therefore, the same is to be treated as genuine pre-estimation of the loss.

On this reasoning, in that case, winding up petition was dismissed.

#### ***Who may file Petition for the Winding up?***

An application for the winding up of a company has to be made by way of petition to the Court. A petition may be presented under Section 439 by any of the following persons:

- (a) the company; or
- (b) any creditor or creditors, including any contingent or prospective creditor or creditors; or
- (c) any contributory or contributories; or
- (d) all or any of the parties specified above in clauses (a), (b), (c) whether together or separately; or
- (e) the Registrar; or
- (f) any person authorised by the Central Government in the case falling under Section 243, i.e., following upon a report of inspectors; or
- <sup>1</sup>(g) in case falling under clause (h) of Section 433, by the Central Government or State Government i.e. Company acting against the interest of the sovereignty and integrity of India.

<sup>1</sup> Inserted by Companies (Second Amendment) Act, 2002 w.e.f. a date yet to be notified.

### (i) Petition by the Company

The company may make a petition through its directors with the authority of a special resolution passed at a general meeting. It may also, apply to liquidator if it is being wound up voluntarily. The directors may, on their authority present a petition on behalf of the company. However, when the ground for winding up is that the company has passed special resolution, the petition must be presented by the company itself.

It may be mentioned here that without the authority of the general meeting the directors are not entitled to present a winding up petition in the name of the company. But where the directors have presented such a petition, it is open to general meeting of shareholders to ratify their action.

### (ii) Petition by Creditor

A creditor or creditors (including any contingent or prospective creditor) may make petition, and the Court would make a winding up order on such petition if the creditor proves that the claims are undisputed debt and any of the contingencies stated in Section 433 (grounds of winding up) had arisen to justify the order. The expression “creditors” includes the assignee of debt, a decreeholder, a secured creditor, a debenture holder or the trustee for debenture holders. But a creditor whose debt is unliquidated cannot apply for winding up order. A contingent or prospective creditor can present petition on giving security for costs and showing that a prima facie case has arisen. A petition by a secured creditor for winding up may not be allowed by the Court where the security is ample and the petition is not supported by the other creditors.

A Guarantor of a Company's loan is a contingent creditor within the meaning of Section 439. *Dollar Land Holdings Plc Re 1994, 1 BCLC 404(Ch D)*. Under Section 439(8) a contingent or prospective creditor must obtain leave from the court before his petition is admitted. It is a condition precedent to the passing of any further orders in the petition. (*Kermeen Foods P Ltd., In re(1985)58 Com Cases156(Guj)(DB)*).

In the case of *Kotak Mahindra Bank Ltd. v. Eastern Spinning Mills and Industries Ltd.* [2013]177 Comp Case 15(Cal) Decided on Feb. 13, 2013, the right of a creditor of a company, secured or unsecured, to maintain a winding up petition against the company would lie both under section 434(1)(a) as well as section 433(e) and (f) of the Companies Act, 1956.

Once the creditor establishes his right to claim an amount more than Rs.500 the onus would shift on to the company to rebut the claim by raising a bona fide dispute is raised it would weaken the petitioning creditor's chance to have the winding up petition admitted, otherwise admission is an obvious consequence.

The debts of the respondent company were assigned to the appellant-bank. The bank initiated proceedings under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002. However, it did not take possession of the assets. A petition filed by the appellant seeking winding up the respondent company on the ground of its inability to pay its debts was dismissed by the single judge on the ground that the appellant had failed to establish that the security enjoyed by it was ineffectual or inadequate to meet its claim against the company. On appeals:

Calcutta High Court allowing the appeals, Held that that no bona fide dispute had been raised by the company. The single judge's view that to claim deemed insolvency the creditor would have to show that the securities were insufficient was not correct. The petition could not be held to be not maintainable on mere failure by the creditor to show that the securities were insufficient to claim deemed insolvency of the company. The single judge erred in holding that the appellant had maintained the petition exclusively under section 434(1)(a) of the 1956 Act. There were enough material to hold that the company was commercially insolvent. The entire fixed assets were mortgaged. The company did not have sufficient funds to pay off the dues. The balance sheet clearly demonstrated such insolvency. Even if its fixed assets were sufficient to

pay off the dues, that could only be possible upon sale of those assets and the company would hardly have anything left to carry on its day-to-day business. The petition was maintainable in terms of section 433(e) and (f) read with section 439(1)(b) and (2) of the 1956 Act.

That non-receipt of the acknowledgment card for the statutory notice sent by the creditor by itself could not be a ground to deny admission of the petition and that this irregularity could not be presumed mala fide. The order of the single judge was set aside and the petition remanded to the single judge for necessary direction with regard to admission and advertisement.

### **Debentureholder can file an application for winding up**

In *Gramercy Emerging Market Fund v. Essar Steels* (2002) 39 SCL 435 (Guj. HC). It was held that debentureholder can file application for winding up. However trustee is a necessary party if there is no direct covenant between the company and debentureholder, but the covenant is between company and trustee. This principle is not applicable where there is a direct covenant between company and debentureholder. Moreover trustee can sue the company in its own right as a covenanting party.

Although an unpaid creditor, as between himself and the company, is prima facie entitled to a winding up order, *ex debito justitiae* (i.e., as a matter of right), he is not so entitled as between himself and others creditors of the same class, for the Court may have regard to the wishes of creditors in all matters relating to the winding up, and may refuse to make a winding up order if a majority in value of the creditors oppose the petition. For instance, if a creditor to whom the company owes Rs. 10,000, petitions for winding up of the company and other creditors to whom the company owes ₹ 10 lakhs oppose the petition, the Court would obviously refuse to order winding up of the company (*Ram Kumar v. Busar Oil and Rice Mills*, AIR 1960 Cal. 764).

The term creditor includes the Central Government or any State Government or municipal or local authority to whom any tax or other public charge is due. A foreign creditor and a guarantor who is a prospective creditor has a right to apply for winding up.

In *Padam Team Tea Co. Ltd. v. Darjeeling Commercial Co. Ltd.*, (1977) 47 Comp. Cas. 15, it was held that on the basis of an admission by the company of its indebtedness to a creditor, the creditor is entitled to petition for the winding up of the company, even if he has given full details of his petition as required under Section 434.

### **Petition by Workers not maintainable**

Section 439 of the Companies Act, 1956 confers right upon certain persons to file a petition for winding up. The said section does not authorize the workers to make a winding up petition. Accordingly, the workers can not make a winding up petition. [*National Textile Workers' Union v. P.R. Ramakrishnan* (1983) 53 Comp. Cas. 184].

*Vans Gopal Singh V Jaipur Udyog*, (2008) 88 SCL 194(Raj) the petition filed on the ground that the company was not able to pay dues of its employees was held to be not a proper remedy, as there are adequate provisions in the Industrial Disputes Act, 1947, Payment of Wages Act, 1936 for recovery of wages by sale of Company's property. The petition had to be dismissed even otherwise because the requirement as to notice under Section 434 was not complied with.

In *Mumbai Labour Union v. Indo French Time Industries* (2002) 38 SCL 924, it was held that a trade union can not file winding up petition for unpaid wages of workmen/employees. They are disentitled as other legitimate and efficacious remedy under labour laws is available. In such case, filing winding up petition is abuse of law.



### Appeal by workers against winding up order maintainable

There is nothing in the Act which prohibits workers from being heard in a winding up petition. Accordingly, the workers would be entitled to be heard though as interveners and not as parties. Further after the winding up order is made, the workers may appeal against it. But once the order becomes final, the workers shall not participate in any further proceedings [*National Textile Workers' Union v. P.R. Ramakrishnan* (1983) 53 Comp. Cas. 184].

### A time barred debt cannot be the basis for winding up petition.

A time barred debt cannot be the basis of a winding up petition. The fact that the petitioner filed a civil suit before filing the winding up petition was immaterial because such suit does not have the effect of extending the period of limitation. (*Hariom Firestocks Ltd., v Sunjal Engineering P Ltd.*, (1994) 4 Comp LJ 469 (Kant).

### Pre-incorporation debt unsustainable –

A pre-incorporation debt taken over by the company was held to be unsustainable for a winding up petition, *Jan Bazar Manna Estate Ltd., In re* AIR 1931 Cal. 92.

### (iii) Petition by Contributory

#### Who is a Contributory?

Section 428 of the Companies Act defines a 'contributory' as "every person liable to contribute to the assets of a company in the event of its being wound up, and includes holders of any shares which are fully paid-up and for the purposes of all proceedings for determining, and all proceedings prior to the final determination of, the persons who are deemed to be contributories, includes any person alleged to be a 'contributory'.

In terms of the provisions of this section, the holder of fully paid-up share is also a contributory though he has no further liability to contribute to the assets of the company in winding up. The holder of a fully paid-up shares is included in the list of contributories for distribution of the residuary assets of the company after satisfying the claims of the creditors. He is also entitled to file a winding up petition.

While every member of a company becomes a contributory on the company going into liquidation, every contributory need not be a member. Besides, the members presently borne on the register, the past members of a company, who ceased to be members within one year of the commencement of the winding up, are also liable as contributories by virtue of Section 426.

By virtue of Section 439(1)(c), a contributory has a statutory right to present a petition for the winding up of the company, which right cannot be excluded or limited by the articles, but is subject to certain conditions as laid down in the section [Sub- section (4)].

### When a contributory can file a winding up petition?

A contributory is entitled to present a winding up petition in case where:

- (a) the number of members of the company is reduced below the statutory minimum of 7, in the case of a public company and below 2 in the case of private company; or
- (b) the shares in respect of which he is a contributory or some of them:
  - (i) were originally allotted to him; or
  - (ii) have been held by him and registered in his name for at least six months during the 18 months before the commencement of the winding up; or
  - (iii) have devolved upon him through the death of a former holder.

The object of making these provisions is to prevent a person buying a share or two in order to qualify himself as a contributory to wreck the company.

In *Re. Gattapardo Ltd.* (1969) 2 All. ER 344, a transfer of shares had been executed, stamped and dated in June, 1967. The company did not register it until October, 1968. The shareholder presented a petition for the winding up of the company in December, 1968. It was held that the petition did not lie, as the petitioner shareholder did not hold her shares for six months as required by the Act. However, where the company has been ordered by the Court to allot shares and had failed to do so, the person in whose favour the order had been made was qualified to apply [*In Re. Petent Steam Engines Co. (1878) 8 Ch.D. 464*].

A petition for the winding up of a company can be presented by a contributory notwithstanding the fact that he may be holder of fully paid-up shares or the company may have no assets at all or may have no surplus assets at all or may have no surplus assets left for distribution amongst the shareholders after satisfaction of its liabilities towards creditors. A contributory is, thus, entitled to present a winding up petition even when the company is insolvent and is not in a position to satisfy even the creditors and the contributory have no tangible interest is as much as nothing is left back for distribution amongst the shareholders.

It may be noted that an insolvent shareholder whose name still appears on the register of members as holder of the shares may present petition as a contributory at the instance of the Official Assignee or Receiver, but the Official Assignee or Receiver himself cannot petition as he is not a contributory. Again, a legal representative of a deceased shareholder can present petition for a winding up order.

#### **(iv) Petition by Registrar**

The Registrar may, with the previous sanction of the Central Government present a petition for winding up of a company but only on the following grounds, namely:

- default is made in delivering the statutory report to the Registrar or in holding the statutory meeting; or
- it does not commence business within a year from its incorporation or suspends business for a whole year; or
- the number of its members in the case of a public company is reduced below seven and in the case of a private company, below two; or
- it is unable to pay its debts; or
- the Court is of the opinion that it is just and equitable that it should be wound up; or
- if the company has made a default filing with the Registrar its balance sheet and profit and loss account or annual return for any five consecutive financial years;
- If authorized by the Central Government under Section 243

In all these cases the Registrar has to obtain previous sanction of the Central Government to the presentation of a petition. However the registrar shall not present a petition unless it appears to him either from the financial condition of the company as disclosed in its balance sheet or from the report of special auditor appointed under 233A or an inspector appointed under Section 235/237 that the Company is unable to pay its debts.

#### **(v) Petition by persons authorised by Central Government<sup>1</sup>**

By virtue of Section 243, if any report of an inspector appointed under Section 235 or 237 to investigate

<sup>1</sup> Powers are now delegated to Regional Directors.

affairs of a company discloses:

- (i) that the business of the company is being conducted to defraud its creditors or members or any other person otherwise for a fraudulent or unlawful purpose or in a manner oppressive of any of its members or that the company was formed for any fraudulent or unlawful purposes or
- (ii) that the persons concerned in the formation of the company or management have been guilty of fraud, misfeasance or misconduct towards the company or towards any of its members;

and it appears to the Central Government from such report that it is expedient so to do, then the Central Government may, unless the company or body corporate is already being wound up by the court, authorise any person (including the Registrar) to petition for the winding up of the company on the ground that it is just and equitable that the company should be wound up.

#### **(vi) Jurisdiction of Court for entertaining Winding up Petition**

In terms of the provisions of Section 10 of the Companies Act, 1956, the jurisdiction for entertaining winding up petition vests either in the High Court having jurisdiction in relation to the place where the registered office of the company is situate or the District Court of the area subordinate to the High Court, in which the jurisdiction has been vested either by the Act or by the Central Government by notification in the Official Gazette. In *GTC Industries Ltd. v. Parasrampur Trading* (1999) 34 CLA 380 (All HC), it was held that only High Court where the registered office is situated has jurisdiction in winding up, even if there was agreement between parties that dispute between parties will be resolved before High Court where registered office is not situated. Regardless of where agreement is executed, Company Court having jurisdiction over the place where the registered office is situated, will have the jurisdiction to entertain a petition for winding up. *LKP Merchant Financing v. Arwin Liquid Gases* (2001) 103 Comp. Cas. 211 (Guj.).

For the purposes of jurisdiction to wind up companies, the expression 'Registered Office' means the place which has longest been the registered office of the company during the six months immediately preceeding the presentation of the petition for winding up. In *Kalpna Trading v. N.C.L. Industries Ltd.* [(1996) 1 Comp. LJ 152], the Orissa High Court refused to entertain the petition for winding up as the Company had its place of Registered Office at Hyderabad.

#### **Compulsory Winding up by the Court**

(i) A winding up of a company by the Court shall be deemed to commence at the time of the presentation of the petition for winding up [Section 441(2)].

(ii) As per rules of the High Court, every petition shall be advertised 14 days before the hearing, stating the date on which the petition was presented and names and addresses of petitioners. The petition has to be verified by an affidavit. The petition must contain the allegations and true facts together with the date of incorporation of the company, the situation of its registered office, the amounts of its paid-up capital a prayer that the company be wound up in the end. A copy of such petition must be served at the registered office of the company. (Rule 24 of Companies(Court) Rules, 1959.

(iii) An order for winding up a company shall operate in favour of all the creditors and of all the contributories of the company as if it had been made on the joint petition of a creditor and of a contributory (Section 447).

(iv) At any time after the presentation of a winding up petition and before a winding up order had been made, the company or any creditor or contributory may apply to the High Court or supreme Court, in which the suit or proceeding is pending against the company in any other Court, such an application may be made to the Court having jurisdiction to wind up the company, to stay or restrain further proceeding in the suit or

proceeding. The Court to which application is so made may stay or restrain the proceedings accordingly on such terms as it thinks fit (Section 442): [See also *Governor General-in Council v. Shiromani Sugar Mills*, AIR (1946) FC 16].(This provision has been omitted by Companies(Second Amendment) Act, 2002. How ever effective date is yet to be notified)

(v) Two companies cannot be wound up by the same order.

(vi) In case several petitions are presented; they rank according to the date of presentation.

(vii) On hearing the petition, the Court may either

- (a) dismiss it, with or without costs, or
- (b) adjourn the hearing conditionally or unconditionally, or
- (c) make any interim order that it thinks fit, or
- (d) make a compulsory order for winding up the company with or without costs, or any other order that it may deem fit [Section 443(1)].

[(xi) <sup>1</sup>[As soon as the Court makes an order for the winding up of a company, the court shall forthwith cause intimation thereof to be sent to the Official Liquidator and the Registrar. This is necessary so that Official Liquidator can take up the administration of the Company in winding up immediately (Section 444).]

In the case of *Laguna Holdings P. Ltd. And Others v. Edin Park Hotels P. Ltd. And others* [2013] 176 Comp Cas 118 & 119 (Delhi), maintainability of winding up petition, to be taken as a preliminary issue. The admission of a petition for winding up itself and the public advertisement which has to be effected being a necessary corollary of its admission would cause irreparable harm to the company if the petition ultimately fails. This is especially so if it is a solvent company. Relied on the case of *Mridula Bhaskar(Smt) v. Iswar Industries Ltd.*, Delhi high Court held that Section 433(f) of the Companies Act, 1956, has necessarily to be read along with Section 443(2) of the Act which stipulates that the court may refuse to make an order for winding up where the “just and equitable” ground is being pressed if there is an alternative remedy available to the petitioner and the court prima facie holds that the petition seeking winding up of the company on this “just and equitable” clause is an unreasonable demand made by the petitioner.

The settled legal position is that the partnership principle for winding up a company would be applicable only in cases where the deadlock is complete and irresoluble under its constitution.

Those who take advantage of a corporate body must be held bound by the provisions of the Act and the averments that a limited company should be treated as a quasi partnership should not be easily accepted.

Once the partnership principle is rejected, the petitioner has to prove almost the same grounds for succeeding in the petition and sections 397 and 398 must be treated as another alternative and effective remedy. Thus, wherever an alternative remedy is available to a party, the just and equitable clause cannot be resorted to casually. It is not the interest of the petitioner alone which has to be considered but the general interest of the company; fairness demands that even of the “just and equitable” ground for winding up is satisfied, the alternate remedy being available under section 397 of the 1956 Act, an order for winding up should not be made and this is particularly so in a solvent and healthy company.

Under section 344 of the said Act the court at the time of hearing of winding up petition, may either dismiss it

<sup>1</sup> Substituted by Companies (Second Amendment) Act, 2002 w.e.f. a date yet to be notified as:

Where the tribunal makes an order for the winding up of the company, the tribunal shall within a period not exceeding ‘two weeks from the date of passing the order, cause intimation thereof to be sent to the official liquidator and the Registrar.

with or without costs or in the second alternate, it may adjourn the hearing conditionally or unconditionally. The third alternative gives powers to the Court to make any interim order as it thinks fit. Lastly it may make an order for winding up of the company or any other order as it thinks fit. The words “any other order as it thinks fit” have necessarily to be read *ejusdem generis* and in the context of the words preceding in the sub-clause meaning thereby that in the fourth alternate, the company judge may either wind up the company or pass any other order in the course of its winding up of in its relation thereto.

(xii) On the making of a winding up order, it is the duty of the petitioner in the winding up proceedings and of the company to file with the Registrar a certified copy of the order in e-form 21, within 30 days from the date of making of the order. The Registrar shall thereupon make a minute thereof in his books relating to the company and shall notify in the Official Gazette that such an order has been made. Such order shall be deemed to be the notice of discharge to the officers and employees of the company, except when the business of the company is continued. In computing the period of 30 days from the date of the making of a winding up order under this section, the time requisite for obtaining certified copy of the order shall be excluded [Section 445].

(xiii) When a winding up order has been made or the Official Liquidator has been appointed as Provisional Liquidator, no suit or other legal proceedings shall be commenced, or if pending at the date of the winding order, shall be proceeded with, against the company, except by leave of the Court and subject to such terms as the Court may impose [Section 446].

(xiv) As per Section 449 of the Companies Act, 1956, on the issue of the winding up order, the Official Liquidator becomes the liquidator of the company by virtue of his office.

In *Mafatbhai v. Shah v. Secretary* (2000) 27 SCL 361, it was held that if Official Liquidator does not have adequate staff and is not in a position to look after properties of the company which are wound up under orders of the Court, he can get Receiver appointed with the leave of the Court. The Court can pass appropriate orders.

(xv) The Court shall also settle the list of contributories, make calls and determine any other question arising in winding up on the application of the liquidator (Section 467).

(xvi) Where the Court has made the order or appointed the Official Liquidator, the directors, secretary, manager or chief officer of the company shall make out and submit to the Official Liquidator, a statement as to the affairs of the company in the prescribed form, verified by an affidavit, containing the following particulars:

- (a) the assets of the company stating separately the balance in hand and at the bank and the negotiable securities, if any, held by the company;
- (b) its debts and liabilities;
- (c) the names, residences and occupations of its creditors, stating separately the amount of secured and unsecured debts; and in the case of secured debts particulars of securities, their values and their dates;
- (d) the debts due to the company and the names and addresses of the debtors and the amount likely to be realised thereupon [Section 454(1)];
- (e) such further or other information as may be prescribed, or as the official liquidator may require.

This statement has to be submitted within 21 days from the date of the appointment of provisional liquidator or if no such appointment is made, the date of winding up order. The Official Liquidator or the Court, for

special reasons, may extend this time up to three months. The persons making the statement and affidavit are to be paid by the Official Liquidator or Provisional Liquidator out of the assets of the company, such costs and expenses incurred as the Official Liquidator may consider reasonable subject to an appeal to the Court. If any person without reasonable excuse makes a default in complying with any requirements of this section, he is liable to be punished with imprisonment for a term which may extend to two years or to a fine not exceeding ₹1,000 for every day during which the default continues. This is a criminal liability triable by the winding up Court, which is a High Court itself. For speedy administration of liquidation proceedings it is necessary that Official Liquidator should know all the assets and liabilities with necessary details at an early date. If directors and officers commit default, without reasonable excuse then they are criminally liable to severe punishment.

In *Official Liquidator v. P.R. Mehta* (2000) 36 CLA 210, it was held that the prosecution has to prove that the person has failed to submit the statement without reasonable cause. If a person was not director on relevant date or if there was reasonable cause for non-filing for statement, liability under this provision would not be there. In *Indla Satya Raju v. Sramika Agro Farm* (2002) 39 SCL 940, it was held that a person cannot be prosecuted and convicted under Section 454 merely for reason that he committed default in complying with any requirements of Section 454. In addition to establishing default, prosecution is also required to establish that the said person, without reasonable excuse, committed such fault.

(xvii) After the receipt of the above statement the Official Liquidator prepares and submits a preliminary report to the winding up Court within six months or such extended period as may be allowed by the Court stating the amount of capital issued, subscribed and paid-up and the estimated amount of assets and liabilities of the company in liquidation giving separately, under the heading of assets, particulars of:

1. Cash and negotiable securities;
2. Debts due from contributories;
3. Debts due to the company and security, if any, available in respect thereof;
4. Moveable and immovable properties belonging to the company; and
5. Unpaid calls (Section 455).

If the liquidator is of the opinion that a fraud has been played in relation to the company and if he thinks fit he may submit a further report to the Court in this regard [Section 455(2)]. This report of the Official Liquidator is absolutely privileged. The preliminary report of the Official Liquidator shall be heard by the judge in Chambers. The Judge can give such directions as he may consider necessary. On further report there can be a direction about the public examination of the directors (Section 478).

(xviii) The Official Liquidator shall take into his custody or control all the property, effects and actionable claims to which the company is or appears to be entitled. For this purpose, he can take help of the Chief Presidency Magistrate or District Magistrate (Section 456). The Official Liquidator then acts as a custodian. His position is that of a receiver and an officer of the Court. The liquidator has to realise all the assets. For that he may institute various legal proceedings, sell the immovable and movable property and actionable claims of the company and distribute these assets (Section 457). For this purpose he has to invite claims from creditors, settle them and make payments to creditors as per their respective rights (Sections 528 to 530).

A Liquidator is an agent employed for the purpose of winding up of the company. In some respects he is a trustee, but he is not a trustee for each individual creditor. His principal duties are to take possession of assets, to make out the requisite list of contributories and of creditors, to have disputed cases adjudicated upon, to realize the assets subject to the control of the Court in certain matters and to apply the proceeds in

payment of the company's debts and liabilities in due course of administration and having done that, to divide the surplus amongst the contributories and to adjust their rights [*Discount Bank of India Ltd. (in liquidation) v. Trilok Nath* (1952) 54 Punj LR 335].

In *Remu Pipes v. IFCI* (2002) 35 SCL 358, it was held that ownership of assets of company in liquidation remains with the company but by a legal fiction the properties are taken to be vested in the Court. The Official Liquidator takes properties under his control and custody with the permission of Court and under its superintendence. The Official Liquidator is custodian of property and statutory trustee. Assets of company in liquidation vest in Court and not in Official Liquidator. Official Liquidator can not sell property without sanction of Court. He has no absolute say in the matter of disposal of the company's property. While granting sanction, the Court can issue suitable directions as it may think fit and proper.

On commencement of winding up, the limitation ceases to run in favour of the company. The period from the date of commencement of winding up to date of the making of the winding up order (both inclusive) and a period of one year from the date of winding up order is excluded for computing the period of limitation for any suit or application in the name and on behalf of the company, notwithstanding the provisions of the Limitation Act, 1963 or any other law for the time being in force. The suit or application must satisfy both the conditions, i.e., it must be in the name and on behalf of the company [Section 458(A)].

This relaxation and extension is only in favour of the company i.e. it is only in respect of suit or application in the name and on behalf of the company. It is not applicable to suits filed against the company. However, if the debt was time barred on date of winding up (i.e. when application for winding up was made) and was not enforceable, it does not get revived on filing of winding up application and passing of winding up order. [*Karnataka Steel v. Kohinoor Rolling Shutters* (2002) AIR SCW 4613].

(xix) By virtue of Section 482, any order made by a Court for, or in the course of, winding up a company is enforceable at any place in India other than that over which such Court has jurisdiction, by the Court which would have jurisdiction if the registered office of the company had been situated at such place, and in the same manner in all respects as if the order had been made by that Court. The section may be illustrated by a decision of the Andhra Pradesh High Court in *Tulasamma v. Subhadaya Publications Ltd.*, AIR 1969 AP 207 that the District Court in Andhra Pradesh has jurisdiction to execute the order of the Madras High Court calling upon a judgment-debtor to pay call money which was sent to the Andhra Pradesh High Court for enforcement.

The expression 'in the course of winding up' as used in the section is not limited to what happens after a winding up order is made. As was pointed out by Sir George Jessel, M.R. in [ *In Re. International Pulp and Paper Co.* (1876) 3 Ch.D. 594], "it would defeat the object of enabling the Court, once a winding up petition is presented, to see that the creditors of the company share rateably in the assets and that one particular creditor is not enabled 'to jump the gun' by taking an enforcement proceeding to any part of the country". The words have accordingly been widely interpreted to mean that once a winding up petition has been presented, everything thereafter is 'in the course of winding up a company', although it does not necessarily follow that a winding up order will eventually be made [In *Re. Dynamics Corporation of America*, (1976) 2 All ER 669].

### **Appeals from Orders or Decisions in the Matter of Winding Up**

Section 483 of the Act provides that appeals from any order made, or decision given, in the matter of the winding up of a company by the Court shall lie to the same Court to which, in the same manner in which, and subject to the same conditions, under which, appeals lie from any order or decision of the Court in cases within its ordinary jurisdiction. Such order or decision, however, must be a judicial and not an administrative or a procedural one. An administrative order would be an order which is directed to the regulation or

supervision of matters as distinguished from an order which decides the rights of parties or confers or refuses to confer rights to property which are the subject of adjudication before the Court. Thus, where the Court confirms the winding up sale after hearing the two contending parties and the order vitally affects the rights of such parties, the Court in making the order acts in a judicial way, and the order is a judicial way, and not a procedural or administrative one so as to be inherently incapable of being brought up in appeal [*Shankarlal v. Shankarlal*, AIR 1965 SC 507]. On the same principle, an order refusing stay of the winding up proceedings is a judicial order in the matter of winding up and is appealable (*Jagannath Gupta & Co. v. Mulchand Gupta*, AIR 1969 Cal 363). The stay order made in this case was set aside by the Supreme Court. On the other hand, no appeal would lie against an order removing a liquidator since such order cannot be said to be an order determining or affecting any rights of the parties in the winding up (*Gordhan Das v. Shilwate Deve*, AIR 1963 All. 606).

Similarly, an order dropping the misfeasance proceedings under Section 543 against some of the directors at an initial stage on the ground that there is no prima facie case against them directing them to continue against the other is not appealable since it cannot be said to decide finally the rights and liabilities even in respect of the former and the Court can reopen the inquiry in respect of them on the basis of fresh materials or otherwise according to law (*D.C. Mehta v. Lakshmipat*, AIR 1968 Pat. 280).

The expression 'in the matter of the winding up of a company' as used in the Section would include the case of an application made under Section 446 of the Act for leave to file a suit against the company, and the order made on such application would be appealable under the Section (*Balkrishna Mahadeo Vertak v. Indian Associate Chemical Industries Ltd.*, 60 Bom. LR 30). The expression also includes an order directing advertisement of the winding up petition and an appeal would lie against such order (*Western India Theatres Ltd. v. Ishwarbhai Somabhai Patel*, AIR 1959 Bom. 386); [*Golcha Investment (P) Ltd., v. S.C.Bafna*, AIR 1970 SC 1850]. In the latter case, the Supreme Court further held that, by virtue of Rule 966-A in Chapter XII of the Bombay High Court Rules, such an appeal was entitled to be admitted as a matter of course and could not be summarily dismissed as was done by the High Court treating the order appealed against as interlocutory order.

The second part of the section which refers to 'the manner' in which and 'the conditions' subject to which appeals may lie must be construed as merely regulating the procedure to be followed in the presentation of the appeal and of hearing them, the period of limitation within which the appeal is to be presented and the forum to which the appeal would lie, and not as restricting or impairing the substantial right of appeal which has been conferred by the opening words of the section. It must be noted, however, that though the rights of appeal under the section is a substantive right, since the procedure applicable to regular appeals under the Civil Procedure Code is applicable to the appeals under the section, the right to file a cross-appeal or a cross-objection to any such appeal is a matter of procedure as comprised in Order 41, Rule 22 of that Code. Consequently, the respondent to any such appeal is entitled to file a cross objection under that provision of the Code [*The Central Provinces Syndicate (Private) Ltd. v. Sita Devi*, AIR 1973 MP 134].

### **Dissolution of Company in Compulsory Liquidation**

The Court may make an order for dissolution of a company in the following conditions:

- (a) when the affairs of the company have been completely wound up; or
- (b) when the Court is of the opinion that the liquidator cannot proceed with the winding up of a company for want of funds and assets or for any other reason and it is just and equitable in the circumstances of the case that an order of dissolution of the company should be made.



Where an order in the above circumstances is made by the Court, the company will be dissolved from the date of the order of the Court. Within 30 days from the date of the order, the liquidator must send a copy of the order to the Registrar. On the dissolution, the corporate existence of the company comes to an end.

After order of dissolution, the company has no legal existence. Thus no suit can lie by or against the company after order of dissolution. In *Narendra Bahadur Tandon v. Shanker Lal* AIR (1980) SC 575, it was held that after company is dissolved, liquidator can not represent company and execute a deed of sale. Once company is dissolved, it ceases to exist and official liquidator can not represent a non-existent company.

The property of dissolved company vest in Government and not in the trustee. Hence shareholders or creditors of dissolved company cannot be regarded as heirs and successors. They cannot maintain any action for recovery of assets.

The Court may at any time declare the dissolution void within two years from the date of dissolution on application by the liquidator of the company or by any other person who appears to the Court to be interested. Thereupon such proceedings may be taken as might have been taken if the company had not been dissolved (Section 559).

In *Rishabh Agro Industries Ltd. v. PNB Capital Services Ltd.* (2000) AIR SCW, it was observed that winding up order passed under the Companies Act is not the culmination of proceedings pending before company Judge but is in effect the commencement of the process. The ultimate order to be passed in such a petition is the dissolution under Section 481.

### **Court's Power to declare Dissolution Void**

The Court has also got the power to declare the dissolution of a company void in appropriate cases under Section 559 of the Act. Where a company has been dissolved as a result of the Court's order as aforesaid, or under Section 394 or otherwise, the Court, by that section, may at any time within two years of the date of dissolution, make an order, on the application of the liquidator or of any other person interested and upon such terms as it thinks fit, declaring the dissolution to have been void.

The effect of an order under Section 559 is that it makes the dissolution void *ab initio* and all consequences resulting from the dissolution are avoided, including proceedings taken during the interval between the date of dissolution and the date of declaration of dissolution as void. [*Morris v. Harris*, 1927 AC 252].

The person who obtains the order avoiding the dissolution must file a certified copy thereof with the Registrar within thirty days or such further time as the Court may allow. In case of default, he will be punishable with fine to the extent of ₹ 500 for every day during which the default continues.

### **Duties of the Secretary in respect of Compulsory Winding Up**

The duties of the Secretary in respect of compulsory winding up of the company may be enumerated as follows:

- (i) If the company itself makes the petition for compulsory winding up, the Secretary should help the directors in drawing up the petition.
- (ii) He should see that a copy of winding up order, when passed by the Court is filed with the Registrar within 30 days of the making of the order.

- (iii) He should help in preparation of the statement of affairs of the company in the prescribed form for submission to the Official Liquidator. He should see that it is properly verified by an affidavit.
- (iv) He should give all necessary information to the Court, when called upon by it during the course of the winding up.
- (v) He should see that all documents, correspondence etc., issued by the company during the period of winding up contain a statement that the company is being wound up.

## **VOLUNTARY WINDING UP**

The companies are usually wound up voluntarily as it is an easier process of winding up. It is altogether different from a compulsory winding up. In voluntary winding up the company and its creditors are left to settle their affairs without going to a Court, although they may apply to the Court for directions or orders, as and when necessary. One or more liquidators are to be appointed by the company in general meeting for the purpose of winding up the affairs and distributing the assets of the company. The remuneration of the liquidators is also required to be fixed by the company in general meeting. Unless the remuneration as aforesaid is fixed the liquidators shall not take charge of his/their offices (Section 490). The circumstances in which a company may be wound up voluntarily are:

- (a) when the period fixed for the duration of the company as mentioned in its articles has expired; or
- (b) the event, on the happening of which the articles provide that the company is to be dissolved has occurred; and
- (c) the company passes a special resolution that the company be wound up voluntarily [Section 484 (1)].

Thus, a company may be wound up voluntarily on the expiry of the term fixed for duration of the company or on the occurrence of the event as provided in its articles. In these two cases only an ordinary resolution may be passed in the general meeting of the company. Apart from these two cases, a company may be voluntarily wound up for any other reason as well for which a company has to pass a special resolution. A proper notice required for the respective meetings must be given to all the members and in the latter case the text of the special resolution to be passed together with the reason to wind up voluntarily must be mentioned therein.

The resolution (whether ordinary or special), when passed, must be advertised within 14 days of the passing of the resolution in the Official Gazette and also in some newspaper circulating in the district where the registered office of the company is situated. A default in complying with the above requirements renders the company and every officer of the company, who is in default, liable to a penalty which may extend to five hundred rupees for every day during which the default continues. A liquidator of the company is deemed to an officer of the company for the purposes of the above requirements (Section 485).

A voluntary winding up commences from the date of the passing of the resolution for voluntary winding up. This is so even when after passing a resolution for voluntary winding up, a petition is presented for winding up by the Court.

The effect of the voluntary winding up is that the company ceases to carry on its business except so far as may be required for the beneficial winding up thereof. The corporate status and the powers of the company, however, continue until it is dissolved [Section 487].

## Kinds of Voluntary Winding Up

Section 488(5) divides voluntary winding up into two kinds:

- (i) Members' voluntary winding up; and
- (ii) Creditors' voluntary winding up.

## Members' Voluntary Winding Up

When the company is solvent and is able to pay its liabilities in full, it need not consult the creditors or call their meeting. Its directors, or where they are more than two, the majority of its directors may, at a meeting of the Board, make a declaration of solvency verified by an affidavit stating that they have made full enquiry into the affairs of the company and that having done so they have formed an opinion that the company has no debts or that it will be able to pay its debts in full within such period not exceeding three years from the commencement of the winding up as may be specified in the declaration.

In *Shri Raja Mohan Manucha v. Lakshminath Saigal* (1963) 33 Comp. Cas. 719, it was held that where the declaration of solvency is not made in accordance with the law, the resolution for winding up and all subsequent proceedings will be null and void. Such a declaration must be made within five weeks immediately preceding the date of the passing of the resolution for winding up the company and be delivered to the Registrar for registration before that date. The declaration must embody a statement of the company's assets and liabilities as at the latest practicable date before the making of the declaration. Any director making a declaration without having reasonable grounds for the aforesaid opinion, shall be punishable with imprisonment extending up to six months or with fine extending up to ₹ 50,000 or with both [Section 488].

A winding up in the case of which such a declaration has been made and delivered in accordance with Section 488 is referred to as "a member's voluntary winding up". A winding up in the case of which such a declaration has not been so made and delivered is referred to as a "creditors' voluntary winding up" [Section 488(5)].

## Members' Voluntary Winding Up (Section 489 – 498)

- (i) When declaration of solvency is made and filed with the Registrar in e-form 62, the directors arrange to convene a meeting of the members of the company and pass the necessary resolution of winding up (Section 484).
- (ii) The company shall appoint in general meeting one or more liquidators for the purpose of winding up the affairs and distributing the assets of the company and fix the remuneration to be paid. Any remuneration so fixed shall not be increased in any circumstances. The liquidators shall not take charge of his office unless the remuneration is fixed (Section 490).
- (iii) On the appointment of liquidation, all the powers of the Board of directors, managing directors, or wholetime directors, and managers (if any) of the company cease except for the purpose of giving notice of the appointment of liquidator to the Registrar or so far as the company in general meeting or the liquidator may sanction their continuance (Section 491).
- (iv) If any vacancy occurs by death, resignation or otherwise in the office of any liquidator appointed by the company, the company in general meeting, subject to any arrangement with its creditors, can fill the vacancy. The general meeting for this purpose may be convened by the continuing liquidator or by any contributory and must be held in the manner provided by the article or in any manner prescribed by the Court (Section 492).
- (v) The company has to give notice to the Registrar relating to the appointment of liquidator or liquidators

made by it under Section 490, of every vacancy occurring in the office of the liquidator, and of the name of the liquidator or liquidators appointed to fill every such vacancy under Section 492. The notice aforesaid shall be given by the company in within 10 days of the event to which it relates. In case of default, the company and every officer of the company (including every liquidator or continuing liquidator) who is in default, shall be punishable with fine extending up to ₹ 1,000 for every day till the default continues [Section 493]. The liquidator must also inform the Registrar of his appointment within thirty days thereof and publish the notice in the Official Gazette (Section 516). He is also required to file Form No. 152 of the Companies (Court) Rules, 1959 with Registrar. He is also required to notify his appointment to the Income-tax Officer who is entitled to assess the income of the company. He must also comply with the other provisions of the Section 178 of the Income Tax Act.

(vi) The liquidator (under members' voluntary winding up) may transfer the whole or any part of the company's business or property to another company (called the transferee company) and receive, with the sanction of the special resolution of the transferor company by way of compensation for the transfer or sale, shares, policies or other like interests in the transferee company, for distribution among the members of the transferor company or may enter into any other arrangement whereby the members of the transferor company may in lieu of receiving cash, shares, policies, or other like interests participate in the profits or receive any benefit from the transferee company. Any sale or arrangement made by the liquidator shall be binding on the members of the transferor company [Section 494(1) and (2)].

If any member of the transferor company, who did not vote in favour of the special resolution, objects to the arrangement entered into by the liquidator, he may express his dissent in writing addressed to the liquidator and leave it at the registered office of the company within seven days after the passing of the resolution and he may also require the liquidator either to abstain from carrying the resolution into effect or to purchase his interest at a price to be determined by arrangement or by arbitration. If the liquidator decides to purchase the dissenting member's interest, the purchase money shall be paid before the company is dissolved [Section 494(3) and (4)].

(vii) In the event of the winding up continuing for more than one year, the liquidator is required to call general meeting of the company at the end of the first year from the commencement of the winding up, and at the end of the each succeeding year, or as soon thereafter as may be convenient within three months from the end of the year or such longer period as the Central Government<sup>1</sup> may allow, and must lay before the meeting an account of his acts and dealings and of the conduct of the winding up during the preceding year, together with a statement in the prescribed form containing the prescribed particulars with respect to the proceedings and position of liquidation. In case of default, the liquidator is liable to a fine not exceeding ₹1,000 (Section 496).

(viii) As soon as the affairs of the company are fully wound up, the liquidator has to make an account of the winding up showing how the winding up has been conducted and the property of the company has been disposed of and is required to summon a general meeting of the company for the purpose of laying the account before it and giving any explanation thereof. The meeting must be called by giving a month's notice specifying the time, place and object of the meeting and the notice must appear in the Official Gazette and also in some newspaper circulating in the district where the registered office of the company is situate. Within one week after the meeting, the liquidator must send to the Registrar and the Official Liquidator a copy of the account and shall make a return to each of them of the date and holding of the meeting. If a quorum is not present at this meeting, the liquidator shall make a return that the meeting was duly called but the quorum was not present [Section 497(1) to (4)].

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<sup>1</sup> Powers are delegated to Regional Director.

(ix) The Registrar, on receiving account and the return shall forthwith register them. The Official Liquidator, on receiving the account and the return shall, as soon as may be, make and the liquidator and all officers, past or present, of the company shall give the official liquidator all reasonable facilities to make a scrutiny of books and papers of the company and if on such scrutiny the official liquidator makes a report to the Court that the affairs of the company have not been conducted in a manner prejudicial to the interest of its members or to public interest then from the date of submission of such report the company shall be deemed to be dissolved. The Official Liquidator scrutinise the accounts of pre-liquidation as well as of post-liquidation period and for discharging this duty the Voluntary Liquidator and all past and present Officers of the company shall give to the Official Liquidator all reasonable facilities.

If on such scrutiny the Official Liquidator makes a report to the Court that the affairs of the company have been conducted in a manner prejudicial to the interest of its members or to public interest, the Court shall by order direct the Official Liquidator to make a further investigation of the affairs of the company and for that purpose shall invest him with all such powers as the Court may deem fit.

On the receipt of the report of the Official Liquidator on such further investigation, the Court may either make an order that the company shall stand dissolved with effect from the date to be specified by the Court therein or make such other order as the circumstances of the case brought out in the report permit. If the liquidator fails to call a general meeting of the company, he is also liable to fine extending up to ₹5,000 [Section 497(5) to (7)].

### **Creditors' Voluntary Winding Up (Sections 500 to 509)**

The following provisions as contained in Sections 500 to 509 of the Companies Act, 1956 apply to a creditors' voluntary winding up:

(i) In this case the company must call a meeting of its creditors for the day or the day next following the day on which there is to be held the general meeting of the company at which the resolution for voluntary winding up is to be proposed and notices of the meeting of creditors be sent by post to the creditors simultaneously with the notices of the general meeting of the company. The notice of the meeting must also be advertised once at least in the Official Gazette and once at least in two newspapers circulating in the district where the registered office or principal place of business of the company is situate [Section 500(1) and (2)].

(ii) The directors of the company shall prepare a full statement of the position of the company's affairs together with a list of the creditors of the company and an estimated amount of their claims to be laid before the meeting of the creditors to be held as aforesaid. They must also appoint one of their number to preside at the said meeting. It shall be the duty of the director appointed to preside at the meeting of the creditors to attend the meeting and preside thereat [Section 500(3) and (4)].

(iii) If the meeting of the company at which the resolution for voluntary winding up is to be proposed is adjourned owing to some reason and the resolution is passed at an adjourned meeting, any resolution passed at the meeting of the creditors held in pursuance of Sub-section (1) of Section 500 shall have effect as if it had been passed immediately after the passing of the resolution for winding up the company [Section 500(5)].

Default in complying with Section 500 will render the company, the directors and officers liable to a fine up to ₹10,000.

(iv) Notice of any resolution passed at a creditors meeting must be given by the company to the Registrar within ten days of the passing thereof. In case of default, the company and every officer of the company who

is in default is liable to a fine which may extend to ₹500 for every day till the default continues. For this purpose, a liquidator of the company shall be deemed to be an officer of the company [Section 501].

(v) The creditors and the company at their respective meetings mentioned in Section 500 may nominate a person to be liquidator, but the person nominated by the creditors shall become the liquidator subject to an application to the Court. If no person is nominated by the creditors, the person nominated by the company shall be liquidator. Further if no person is nominated by the company, the person nominated by the creditors shall be liquidator. (Section 502).

(vi) The creditors may at the same or subsequent meeting appoint a Committee of Inspection consisting of not more than five members. If such a committee is appointed, the company may also at the same or any subsequent general meeting appoint such number of persons not exceeding five as they think fit to act as members of the committee. In any case, the creditors may resolve that all or any of the persons so appointed by the company ought not to be members of the committee of Inspection, whereupon the persons mentioned in the company's resolution shall not be qualified to act as members of the committee unless the Court otherwise directs. The Act provides that the powers and proceedings of such Committee of Inspection are the same as those of a Committee of Inspection appointed in a winding up by Court (compulsory winding up) and as provided in Section 465 (Section 503).

(vii) The remuneration to be paid to the liquidator in creditors voluntary winding up is to be fixed either by the Committee of Inspection or by creditors. Where the remuneration is not so fixed, it shall be determined by the Court. Any remuneration fixed by the Committee or creditors cannot be increased in any circumstances whatsoever whether with or without the sanction of the Court (Section 504).

(viii) On the appointment of a liquidator, all the powers of the Board of directors shall cease, except in so far as the Committee of Inspection, or if there is no such committee, the creditors in general meeting may sanction the continuance thereof (Section 505).

(ix) If a vacancy in the office of Liquidator occurs by death, resignation or otherwise (other than a liquidator appointed by or by the direction of the Court) the creditors in general meeting may fill the vacancy. (Section 506)

Section 508 of the Act requires the liquidator, in creditors winding up, to call a general meeting of the company and a meeting of the creditors at the end of the first year from the commencement of the winding up and at the end of each succeeding year or as soon thereafter as may be convenient, within three months from the end of the year or such longer period as the Central Government may allow. At this meeting he must lay accounts of his acts and dealings and of the conduct of winding up during the preceding year together with a statement in Form No. 153 of the Companies (Court) Rules, 1959, containing the prescribed particulars with respect to the proceedings in, and position of, the winding up.

Section 509 provides that as soon as the affairs of the company in creditors' winding up are fully wound up the liquidator shall make up an account of the winding up showing how the winding up has been conducted and the property of company has been disposed of. Thereafter he will call general meeting of the company and of the creditors for the purposes of laying the accounts before the meeting and giving explanations thereof as may be required. The procedure for calling the meeting, filing of the return with the Registrar and the Official Liquidator, making of the report to the Court by the Official Liquidator for dissolution of the Company etc., is the same as prescribed in the case of final meeting of a company in members' voluntary liquidation.

### **Distinction between Members' and Creditors' Voluntary Winding Up**

The main differences between the two are as follows:

1. A member's voluntary winding up results where, before convening the general meeting of the company at which the resolution of winding up is to be passed, the majority of the directors file with the Registrar a statutory declaration of solvency. A creditors' voluntary winding up is one where no such declaration is filed.
2. In a member's voluntary winding up, the creditors do not participate directly in the control of the liquidation, as the company is deemed to be solvent; but in a creditors' voluntary winding up, the company is deemed to be insolvent and, therefore, the control of liquidation remains in the hands of the creditors.
3. There is no meeting of creditors in a members' voluntary winding up and the liquidator appointed by the company acts in the liquidation of its affairs; whereas in a creditors' voluntary winding up, meetings of creditors have to be called at the beginning and subsequently the liquidator is appointed by the creditors.
4. In a members' voluntary winding up the liquidator can exercise some of his powers with the sanction of a special resolution of the company; but in a creditors' voluntary winding up he can do so with the sanction of the Court or the Committee of Inspection or of a meeting of creditors.
5. In a winding up where the creditors are interested and the directors are not able to guarantee the company's solvency, the creditors are entitled to secure control of the winding up, so that their interests may be safeguarded. (Section 495)

### **Provisions applicable to every type of voluntary winding up (ie both Members/Creditors Voluntary Winding up)**

The provisions applicable to every type of voluntary winding up are comprehensively stated in Sections 511 to 521 of the Act and these apply to every type of voluntary winding up whether it be a members' or a creditors' winding up:

#### **(i) Distribution of Property of Company**

Subject to the provisions of the Act as to preferential payments, the assets of the company shall, on its winding up, be applied in satisfaction of its liabilities *pari passu* and subject to such application, shall unless the articles otherwise provide, be distributed among the members according to their rights and interests in the company (Section 511).

#### **(ii) Powers and Duties of Liquidators in Voluntary Winding Up**

(a) The liquidator of a company in a voluntary winding up may exercise the same powers as are exercised by an Official Liquidator in a compulsory winding up - some with the sanction of a special resolution of the company or with sanction of the Court or the Committee of Inspection, and some without any such sanction.

In the case of a member's voluntary winding up, with the sanction of a special resolution of the company, and in the case of a creditor's voluntary winding up, with the sanction of the Court or, the Committee of Inspection or, if there is no such committee, of a meeting of the creditors, exercise any of the following powers as specified in Sections 457(1)(a) to (d)—

- (i) To institute or defend any suit, prosecution or other proceeding, civil or criminal, in the name and on behalf of the company.
- (ii) To carry on the business of the company so far as may be necessary for the beneficial winding up of the company.

- (iii) To sell the immovable and movable property and actionable claims of the company by public auction or private contract, with power to transfer the whole thereof to any person or body corporate, or to sell the same in parcels.
- (iv) To raise on the security of the asset of the company any money requisite.
- (b) The liquidator may, without sanction referred to in (a) above, exercise any of other powers.
- (c) He may exercise the power of the Court, under this Act, of settling a list of contributories and of making calls.
- (d) He may call general meeting of the company for the purpose of obtaining the sanction of the company by ordinary or special resolution, as the case may require or for any other purpose he may think fit.
- (e) The liquidator shall pay the debts of the company and shall adjust the rights of the contributories among themselves.
- (f) When several liquidators are appointed, one or more of them may exercise such powers as may be determined at the time of their appointment (Section 512).

### **(iii) Body Corporate not to be appointed**

A body corporate is not qualified for appointment as liquidator of a company in a voluntary winding up. Any appointment made in contravention to the body corporate is void and every director, or manager of that body corporate shall be punishable with fine which may extend to ₹10,000 [Section 513].

➤ ***A body corporate cannot be appointed as liquidator***

### **(iv) Corrupt Inducement Affecting appointment as Liquidator**

Any person who gives, or agrees or offers to give, to any member or creditor of a company any gratification whatever with a view to securing his own appointment or nomination as the company's liquidator; or securing or preventing the appointment or nomination of some person other than himself, as the company's liquidator shall be punishable with fine which may extend to ₹10,000 (Section 514). The inducement must be by way of giving any gratification. 'Gratification' means satisfaction of appetite or desire. It is not always money given by way of bribe. It is anything which gives satisfaction to the recipient. *State v. Pundlik Bhikaji Ahire*, AIR 1959 Bom 543.

### **(v) Power of Court to appoint and remove liquidator in voluntary winding up**

If from any cause whatever, there is no liquidator acting, the Court may appoint the official liquidator or any other person as a liquidator.

The Court may, on cause shown, remove a liquidator and appoint the Official Liquidator or any other person as a liquidator in place of the removed liquidator.

The Court may also appoint or remove a liquidator on the application made by the Registrar in this behalf. If the Official Liquidator is appointed as Liquidator under Section 502(2) or under Section 515, the remuneration to be paid to him shall be fixed by the Court and shall be credited to the Central Government [Section 515(4)].

### **(vi) Notice by Liquidator of his Appointment**

The liquidator shall, within 30 days after his appointment, publish in the Official Gazette, and deliver to the



Registrar in e-form 62 for registration, a notice of his appointment in the form prescribed. He cannot escape the statutory liability by disputing the legality of his own appointment. *Emperor v. Satish Ch. Ghose*, ILR 39 ALL 412. In case of default, the liquidator is liable to punishment with fine up to ₹ 500 per day till the default continues (Section 516).

#### **(vii) Arrangement when Binding on Company and Creditors**

Any arrangement entered into between a company about to be or in the course of being, wound up and its creditors shall, subject to the right of appeal under Section 517, be binding on the company and on the creditors if it is sanctioned by a special resolution of the company and acceded to by three-fourth in number and value of creditors. Any creditor or contributory may within three weeks from the completion of the arrangement; appeal to the Court against it and the Court may thereupon, as it thinks just, amend, vary, confirm or set aside the arrangement (Section 517).

#### **(viii) Public Examination of Directors etc.**

The Court may on application by a liquidator, contributory or creditor determine any question arising in the winding up of a company and order public examination of promoters, directors, etc. on a complaint of liquidator that in his opinion a fraud has been committed by any person in the promotion or formation of the company or by an officer of the Company in relation to Company since its formation. (Sections 518-519).

#### **(ix) Cost of Voluntary Winding Up**

All costs, charges and expenses properly incurred in the winding up including the remuneration of the liquidator is, subject to the rights of secured creditors, payable out of the assets of the company in priority to all other claims (Section 520).

It is only where the assets of a Company in voluntary liquidation are insufficient to discharge its liabilities, the question of priority of payment of costs, charges and expenses will arise. Costs and expenses of an investigation brought about by the liquidator which was not at all necessary were held to be not allowable. *Tony Rowse NMC Ltd., Re*, (1996) 2 BCLC 225 (CH D). Even if the Court has a discretion under the inherent jurisdiction to permit the liquidator to recover the costs of the proposed litigation from the assets of the company, the Court would not exercise that discretion since there was insufficient information before the Court to reach a proper decision. *Floor Fourteen Ltd. Re*, (2001) 2 BCLC 392 (CA); *Levis v. IRC*, (2001) 2 CCLC 392 (CA).

#### **Duties of the Secretary in case of Voluntary Winding Up**

Some of the important duties of the secretary are given below:

- (i) He should arrange for the calling of a Board meeting to fix the date, time, place and agenda of the general meeting of members where the resolution for winding up the company is to be passed and the creditors' meeting to be held immediately thereafter.
- (ii) He should see that the Board meeting approves the draft resolution to be placed at the general meeting, as well as nominates a director to preside over the creditors' meeting.
- (iii) He should help in preparing the statement of affairs of the company and the list of creditors to be placed at the creditors' meeting.
- (iv) Notices of the general meeting of members' and the creditors' meeting should be issued by post simultaneously. He should also send these notices to be published in the Official Gazette as well as in two newspapers circulating in the district in which the registered office of the company is situated [Section 500].

- (v) To see that the general meeting of members is duly held and a special resolution, for winding up the company and appointing a liquidator, is duly passed thereat [Section 502].
- (vi) According to Sections 500, 502 and 504 of the Companies Act, he should see that the creditors' meeting is duly held, the statement of affairs and creditors' list is duly placed before the meeting and a resolution, approving the winding up appointing a liquidator and fixing his remuneration, is duly passed thereat.
- (vii) He should see that a statement of affairs of the company in Form No. 57 is duly verified by affidavit and submitted in duplicate to the liquidator within 21 days of the commencement of the winding up [Section 454].
- (viii) He should intimate to the Income-tax Officer about the winding up of the company within 15 days.
- (ix) He should file the notice of the resolution passed at the creditors' meeting with the Registrar within 10 days of passing of the resolution (Section 501).
- (x) He should file a copy of special resolution for winding up in e-Form No. 23 with the Registrar within 30 days of the passing of it (Section 192).
- (xi) He should get a copy of the resolution published in the Official Gazette and newspapers within 14 days of its passing (Section 485).
- (xii) All correspondence and documents issued by the company during the period of the winding up contain a statement that the company is being wound up.
- (xiii) He should assist the liquidator in every possible way and see that all books, papers and documents, as well as movable and immovable properties of the company are delivered to liquidator as and when directed, and to appear before the Court, if directed, and give evidence regarding the affairs of the company (Sections 519 and 538).

### **IMPORTANT PROVISIONS APPLICABLE IN CASE OF EVERY MODE OF WINDING UP (I.E. COMPULSORY AND VOLUNTARY WINDING UP)**

#### **(i) Overriding Preferential Payments (Section 529A)**

According to Section 529A, notwithstanding anything contained in any other provision of this Act or any other law for the time being in force in the winding up of the company—(a) workmen's dues; (b) debts due to secured creditors to the extent such debts rank under clause (c) of the proviso to Sub-section (1) of Section 529 *pari passu* with such dues shall be paid in priority to all other debts.

In the case of *Allahabad Bank v. Canara Bank* [2000 (101) Comp. Cas. 64 (SC)] the Supreme Court held that when the secured creditors stand outside the winding up and realise their security on the assets of the company sold in pursuance of the order of Debt Recovery Tribunal, dues of workers, if any, are to be satisfied first before the sale proceeds are appropriated by the secured creditors. The impact is that Section 529A of the Companies Act has overriding effect on the provisions of Recovery debts due to Banks and Financial Institutions Act, 1993.

Section 529(2) provides that the debts payable under clause (a) and clause (b) of Sub-section (1) shall be paid in full, unless the assets are insufficient to meet them, in which case they shall abate in equal proportions.

The statutory charge under Section 529 acquires the status of *pari passu* charge for labour dues alongwith secured creditor.

## (ii) Preferential Payments

Section 530 provides that in winding up subject to the provisions of Section 529A, the following debts shall be paid in priority to all other debts:

- (a) all revenues, taxes, cesses and rates due from the company to the Central or State Government or to a local authority. The amount should have become due and payable within twelve months before the date of commencement of winding up. The amount imposed and demanded as advance-tax under Section 207 of the Income-tax Act, 1961, is a tax within the meaning of this clause but any amount due to the Government in relation to commercial transactions does not enjoy preferential right, as it is not tax or cess.
- (b) all wages or salary of any employee in respect of services rendered to the company and due for a period not exceeding four months within twelve months before the relevant date. The amount to be paid as preferential payment must not exceed ₹ 20,000 in the case of each employee or workmen.
- (c) all accrued holiday remuneration becoming payable to any employee or in the case of his death to any other person in his right on termination of his employment before or by the effect of the winding up order or resolution.
- (d) unless the company is being wound up voluntarily only for the purpose of reconstruction or of amalgamation with another company in respect of all contributions payable during 12 months next before the relevant date, by the company as the employer of any persons, under the Employees State Insurance Act, 1948, or any other law for the time being in force.
- (e) unless as in (d) above or unless workmen's compensation insurance policy is taken, all sums due as compensation under the Workmen's Compensation Act, 1923.
- (f) all sums due to any employee from a provident fund, a pension fund, a gratuity fund or any other fund for the welfare of the employees, maintained by the company.
- (g) the expenses of any investigation held under Section 235 or Section 237 in so far as they are payable by the company.

Where any payment has been made to an employee of a company (i) on account of wages and salary, or (ii) to him or in case of his death, to any other person in his right, on account of accrued holiday remuneration, out of money advanced by some person for that purpose, the person by whom the money was advanced, shall in a winding up, have a right of priority in respect of the money so advanced and paid-up to the amount by which the employee would have been entitled to priority.

All the preferential debts rank equally among themselves and are to be paid in full unless the assets are insufficient, in which case they will abate in equal proportion. After retaining sufficient sum for costs charges and expenses of winding up, preferential debts must be paid forthwith so far as assets are sufficient to meet them.

Persons who claim to be creditors must prove their debts within the time fixed by the Court, or in voluntary winding up, by the liquidator. If a creditor does not prove within the time fixed, he may still prove. In a winding up by the Court, if a creditor fails to file his proof of debt within time then he should apply to the Court for relief, i.e., condonation of delay under rule 177 of the Companies (Court) Rules, 1959. The creditor may then be paid out of any assets remaining in the hands of the liquidator but he cannot upset any dividend which has already been paid. Even where no claim is made by a creditor, the liquidator must pay him after all the other creditors have been paid and assets available, provided he is satisfied that the debt is due to the creditor. But the liquidator must not pay a statute barred debt if the shareholders object.

*In the case of Employees Provident Fund Commissioner ... v. O.L. of Esskay Pharmaceuticals Limited With C IVIL APPEAL NO. 9633 O F 2011 D/-8.11.2011 AIR 2012 SUPREME COURT 11(PARA 42&43) Supreme Court held that Section 529A inserted in the Companies Act by Act No.35 of 1985 Parliament, in its wisdom, did not declare the workmen's dues (this expression includes various dues including provident fund) as first charge. The effect of the amendment made in the Companies Act in 1985 is only to expand the scope of the dues of workmen and place them at par with the debts due to secured creditors and there is no reason to interpret this amendment as giving priority to the debts due to secured creditor over the dues of provident fund payable by an employer.*

It is also important to bear in mind that even before the insertion of proviso to Sections 529(1), 529(3) and Section 529A and amendment of Section 530(1), all sums due to any employee from a provident fund, a pension fund, a gratuity fund or any other fund established for welfare of the employees were payable in priority to all other debts in a winding up proceedings [Section 530(1)(f)]. Even the wages, salary and other dues payable to the workers and employees were payable in priority to all other debts. What Parliament has done by these amendments is to define the term "workmen's dues" and to place them at par with debts due to secured creditors to the extent such debts rank under clause (c) of the proviso to Section 529(1). However, these amendments, though subsequent in point of time, cannot be interpreted in a manner which would result in diluting the mandate of Section 11 of the EPF Act, sub-section (2) whereof declares that the amount due from an employer shall be the first charge on the assets of the establishment and shall be paid in priority to all other debts. The words "all other debts" used in Section 11(2) would necessarily include the debts due to secured creditors like banks, financial institutions etc. The mere ranking of the dues of workers at par with debts due to secured creditors cannot lead to an inference that Parliament intended to create first charge in favour of the secured creditors and give priority to the debts due to secured creditors over the amount due from the employer under the EPF Act. 43. At the cost of repetition, we would emphasize that in terms of Section 530(1), all revenues, taxes, cesses and rates due from the company to the Central or State Government or to a local authority, all wages or salary or any employee, in respect of the services rendered to the company and due for a period not exceeding 4 months all accrued holiday remuneration etc. and all sums due to any employee from provident fund, a pension fund, a gratuity fund or any other fund for the welfare of the employees maintained by the company are payable in priority to all other debts. This provision existed when Section 11(2) was inserted in the EPF Act by Act No. 40 of 1973 and any amount due from an employer in respect of the employees' contribution was declared first charge on the assets of the establishment and became payable in priority to all other debts. Of course, after the amount due from an employer under the EPF Act is paid, the other dues of the workers will be treated at par with the debts due to secured creditors and payment thereof will be regulated by the provisions contained in Section 529(1) read with Section 529(3), 529A and 530 of the Companies Act.

### **(iii) Fraudulent Preference**

The insolvency rules as to fraudulent preference apply to companies. The object of the Act being a pari passu distribution, Section 531 provides that every transfer of property, movable or immovable, delivery of goods, payment, execution or other act relating to property made, taken or done by or against the company within six months before the commencement of its winding up shall be deemed, in the event of its being wound up, a fraudulent preference of its creditors and, therefore, invalid. It will amount to a fraudulent preference if it is shown that-

- (i) the company was at the date of transfer unable to pay its debts as they became due;
- (ii) the transaction took place within six months of the presentation of the petition to the Court and in case of voluntary winding up, within six months from the date of the resolution for winding up;

- (iii) the dominant motive of the company, acting by its directors was to prefer one creditor to another;
- (iv) the transaction was made in favour of a creditor.

There is no fraudulent preference when a debtor's dominant intention is to benefit himself rather than to confer an advantage on his creditor. Thus where a company created a legal mortgage in favour of a bank in the hope that by keeping good faith with the bank it could get further advance from the bank which could be utilized to revive the company, the mortgage was held not to be a fraudulent preference even though the mortgage was ceased after it was fairly clear that the company had become insolvent. [*Re. F.L.E. Holdings Ltd. (1967) 3 ALL ER 353.*]

The essence of fraudulent preference is the giving of an improper benefit to a few creditors leading to inequality between them and the generality of the creditors. In order to establish fraudulent preference it is not enough only to show that the preference was to a particular creditor, it must also be proved that it was done with a view to giving him a "favoured treatment". The dominant motive attending transfer has to be ascertained and if it is tainted with an element of dishonesty, the question of fraud arises. The probe into the debtors' mind and an assessment of the various motives that animate his conduct is thus involved. There must be solid grounds for drawing an inference of dishonesty. Mere suspicion, however strong, is not sufficient. There is no fraudulent preference if the transfer is not voluntary. [*Official Liquidator, Kerala High Court v. Victory Hire Purchasing Co. (P) Ltd., (1982) 52 Comp. Cas. 88 (Ker).*]

#### **(iv) Avoidance of Voluntary Transfer**

Any voluntary transfer of property of any kind by a company, otherwise than in the ordinary course of business for valuable consideration, made within a period of one year before the commencement of winding up, shall be void against liquidator [Section 531A].

The purpose of the provision is to be preserve the assets of the Company and to enable the company to carry out transactions that might be for the benefit of those interested in the assets of the company. *Sugar Properties (Derisley Wood) Ltd., 1988 BCLC 146 (Ch. D)*

- (v) Any transfer or assignment by a company of all its property to trustees for the benefit of all its creditors shall be void (Section 532). The words 'any transfer of all its property' includes the transfer of an interest in all its property. Accordingly, a floating charge or a debenture upon the whole of a company's property for the benefit of all its creditors comes within this section. *London Joint City and Midland Bank v. Dickinson (H.) 1922 WN 13.*
- (vi) On the commencement of winding up any floating charge created within the preceding 12 months becomes invalid except as to any cash advanced at the time of or subsequent to the creation of the charge, together with interest on that amount at the rate of 5 per cent per annum or at such other rate as from time to time be notified by the Central Government in the Official gazette (Section 534).
- (vii) Section 535 states that the liquidator may disclaim onerous properties belonging to the company. Following types of properties are regarded as onerous for purposes of this section:
  - (a) land of any tenure, burdened with onerous covenants; or
  - (b) shares or stock in companies; or
  - (c) any other property which is unsaleable or is not readily saleable by reason of the fact that it requires the possessor to perform certain acts or pay a sum of money.
  - (d) unprofitable contracts; or

The liquidator may, with the leave of the Court, disclaim any such property. The Court will assist the liquidator to get rid of “onerous and burdensome contracts” whenever it is necessary to safeguard in full the interests of the body of creditors and the shareholders of the company. The right of disclaimer can be exercised in relation only to property which in effect has ceased to be an asset and has become a liability. The disclaimer should be made in writing signed by the liquidator within 12 months after the commencement of the winding up or such extended period as the Court may allow. If the liquidator does not come to know of the existence of an onerous property within one month of the commencement of the winding up, the period of 12 months begins from the date of his knowledge.

The disclaimer shall operate to determine, as from the date of disclaimer, the rights, interests and liabilities of the company. It release the company and the property from liability. However, it does not affect the rights and liabilities of any other person in respect of the property. Any person injured by the operation of a disclaimer is deemed to be a creditor of the company to the amount of the compensation or damages payable in respect of the injury, and may accordingly prove the amount as a debt in the winding up. The Court may, require notices to be given to persons interested in the property before granting the disclaimer.

Where a person interested in the property has required the liquidator to decide whether he will or will not disclaim the property, the liquidator should, within 28 days, give notice to the applicant that he intends to apply to the Court for leave to disclaim. If he fails to do so, he shall not be entitled to disclaim the property and where the property is a contract which he has not disclaimed within the aforesaid time, he shall be deemed to have adopted it.

#### **(viii) Disposition of Property after the commencement of winding up shall be void.**

According to Section 536, any disposition of the property (including actionable claims) of the company, any transfer of shares in the company or alteration in the status of its members, made after the commencement of the winding up shall be void, unless the court otherwise orders. Thus, the court can direct that any such disposition of property or actionable claims or transfer of shares or alteration of status of members will be valid. But unless the Court so directs, such disposition, transfer or alteration will be void.

#### **(ix) Any attachment and sale of the estate properties or effects of the company, after the commencement of the winding up will be void**

Section 537 declares that any attachment and sale of the estate properties or effects of the company, after the commencement of the winding up will be void. In the case of winding up by the Court any attachment, distress or execution put in force, without leave of the Court against the estate or effects of the company after the commencement of the winding up will be void. Similarly any sale held, without leave of the Court, of any of the properties or effects of the company after the commencement of the winding up will be void. But with leave of the Court, attachment and sale of the properties of the company will be valid even if such attachment and sale are made after the commencement of the winding up of the company. Besides, this section does not apply to any proceedings for the recovery of any tax or impost or any dues payable to the Government. In *Titan Industries v. Punwire Mobile Communications* (2002) 40 SCL 117, it was held that Section 537 being a central legislation prevails over state law in case of conflict/overlapping and Registrar of Cooperative Societies cannot attach property of company under liquidation.

#### **(x) Avoidance of Transfer of Shares in Voluntary Winding Up**

Section 536 provides that any transfer of shares in the company not being a transfer made to or with the sanction of the liquidator and any alteration in the status of the members of the company made after the commencement of the winding up shall be void. In the case of winding up by, or subject to the supervision of the Court, any disposal of property (including actionable claims) of the company and any transfer of shares in

the company or alteration in the status of its members made after the commencement of the winding up is void unless Court otherwise orders.

## CONSEQUENCES OF WINDING UP

The process of winding up has important consequences for different parties - contributories, creditors, officers of the company and so on. Firstly, we shall deal with the consequences of winding up as to different parties and other aspects of the administration of company law subsequently.

### Consequences as to Shareholders described as Contributories

A shareholder in a company limited by shares is liable to pay full amount on the shares held by him but nothing more. This liability of his continues after winding up, but then a shareholder or member is described by the Companies Act, 1956 as a “Contributory”, and the nature of his liability changes.

### Nature of Contributory's Liability

According to Section 428, a “Contributory” means every person liable to contribute to the assets of a company in the event of its being wound up, and includes the holder of fully paid-up shares. In the case of a deceased member, his legal representatives will be liable in due course of administration to contribute to the assets of the company in discharge of his liability and will be contributories accordingly [Section 430]. Thus, in the case of a deceased member his legal representatives will be liable for the debts of the deceased contributory but their liabilities will be limited to the extent of the assets of the deceased coming in their hands [see *Bayswater Trading Co. Ltd., (1970) 1 all ER 608*]. If the legal representatives make default in paying the money demanded to be paid by them, proceedings may be taken for administering the estate left by the deceased contributory and compelling payment there out of the money due (Section 430). In the case of an insolvent member his assignees in insolvency represent him for all the purposes of the winding up as contributories and will be liable to the debts of the insolvent contributory out of the assets that have come into their hands (Section 431).

If a contributory happens to be a body corporate which has been ordered to be wound up, the liquidator of the body corporate will be treated as contributory and may be called on to admit to proof against the assets of the body corporate or otherwise to allow to be paid out of its assets any money due from the body corporate in respect of its liability to contribute to the assets of the company (Section 432).

But the term “Contributory” does not include ordinary debtor of the company. It, however, comprises present and past members of the company who are liable to the company in their capacity as members. A present member is one whose name appears on the register of members at the commencement of the winding up, and his name is put on the list of contributories, known as “A List”. A past member is one who ceased to be a member of the company within a year before the commencement of winding up, and his name is put by the Liquidator on the list of contributories known as “B List”.

With regard to liability, before winding up, the liability of a member is contractual obligation arising out of membership. But winding up creates a new liability and the liquidator can call upon him to pay the unpaid calls even if they had become time barred before liquidation. [In *Re East Bengal Sugar Mills Ltd.* I.L.R. (1940) 2 Cal. 175 (AIR 1941 Cal 143). The liability arises from the fact that his name appears on the register of members [*Goenka v. Majumdar*, (1958) 28 Comp. Cas. 536].

The members of a company in liquidation are liable in respect of unpaid calls even though the calls were made by the company before it went into liquidation and suit of the company for its realisation had become time barred. Thus, on the commencement of winding up, a new liability is cast on the members in respect of unpaid calls. The liquidator gets a fresh right to enforce the payment of unpaid calls. His rights are

independence of the rights which the company had before winding up. [*Pokhar Mal v. Flour and Oil Mills Co. Ltd.* AIR (1934) Lah. 1015].

Section 429 expressly defines the liability of contributory, and states that the liability of a contributory shall create a debt accruing due from him at the time when his liability commenced, but payable at the time specified in the calls made on him for enforcing the liability (by the liquidator). This means that the liability of a member arises as soon as he makes a contract with the company under which he becomes a member and during winding up it is only contingent until a call is made by the liquidator.

It has been held in numerous cases that after winding up the liability of a contributory is *ex lege* (legal) and not *ex contract* (contractual) and is the direct result of his being a member of the company with his name appearing on the register of members [*Lakshmi Narasa Reddy v. O.L. Shree films Ltd.*, AIR (1951) Mad. 890]. As the liability of a contributory is legal and statutory because his name appears on the register of members, he will not be allowed to say that, although his name is on the register of members, he is not liable because the allotment of shares to him was void. The Court has power to rectify the register of members, if required (Section 467). Unless the Court orders the rectification of register of members, the liability of a contributory is absolute. [*Mohd. Akbar v. Official Liquidator*, AIR 1950 Bom. 386]. In *Re. Whitehouse & Co.*, (1878) 9 ch. D. 595, Jessel M.R. said: "After winding up the liability is a 'new liability': the contributory is to contribute, it is a new contribution; it is a liability to be enforced by the liquidator". Thus, the time will not run as against the liquidator as soon as the company goes into liquidation, for the liability to contribute does not arise unless and until a call is made by the liquidator (*L. Gupta v. Vishnu Sarvate*, AIR 1956 Nag. 204).

In the absence of a proceeding for rectification of the register of members before winding up, the contributory has been held out of the public as a member of the company. Whatever may have been the rights and liabilities of the shareholders before the winding up, the position is altered by the happening of that event. His name appears on the register of members at the commencement of the winding up with his full knowledge and assent. On the winding up, his liability under Section 426 in respect of shares held by him is statutory and absolute and flows from the fact of his being on the register of members in respect of those shares. Hence, his liability in respect of unpaid calls is absolute even though the calls were made by the company for their realisation had become barred by time under Article 112 of the Schedule to the Limitation Act, 1963.

The estate of the deceased contributory is liable to the same extent as it would have been if he had been alive. The legal representatives of a deceased contributory are liable to contribute to the assets of the company in discharge of the liability. If a contributory becomes insolvent after the commencement of winding up, he becomes a stranger to the company, and his assignee in insolvency (Official Assignee or Official Receiver) represents him for all purposes and is deemed to be a contributory.

### List of Contributories

On winding up a list called the list of contributories is prepared by the liquidator and settled by the Court in a compulsory winding up. In a voluntary winding up the list is both prepared as well as settled by the liquidator. The list consists of two parts, namely:

- (a) the list of present members, i.e. those whose names appear on the register of members at the commencement of winding up, called the "A" List, and
- (b) the list of past members, i.e. those who ceased to be members of the company within one year before the commencement of winding up, called the "B" List. Past members, therefore, include persons whose shares have been forfeited, surrendered or transferred within twelve months before the commencement of winding up, but not a person who has died.



## Extent of Liability

By virtue of Section 426, in the event of the company being wound up every present and past member is liable to contribute to the assets of the company to an amount sufficient for payment of its debts and liabilities and the costs, charges and expenses of winding up, and for the adjustment to the rights of the contributories among themselves. Subject to the provisions of Section 427 and subject also to the following qualifications, namely:

- (a) a past member shall not be liable to contribute if he has ceased to be a member for one year or more before the commencement of the winding up;
- (b) a past member shall not be liable to contribute in respect of any debt or liability contracted by the company after he ceased to be a member;
- (c) a past member shall not be liable to contribute unless it appears to the court that the present members are unable to satisfy the contribution required to be made by them in pursuance of the Act;
- (d) In the case of a company limited by shares, the present and past members shall not be liable to contribute more than the unpaid amount, if any, in respect of his shares.
- (e) In the case of a company limited by guarantee, the present and the past members shall not be liable to contribute more than the amount, undertaken to be contributed by them in the event of the company being wound up;
- (f) Any sum due to the present or past member by way of dividend, profits or otherwise shall not be deemed to be a debt payable by the company in case of competition between himself and the creditors but any such amount shall be taken into consideration for the purpose of final adjustment of the rights of the contributories among themselves.

The relation of present and past members is one of primary and secondary liability, and they do not in any way, stand to each other in the relation of principal and surety. The liquidator cannot call upon the past members to contribute before the present ones. The measure of liability of "A" List contributory is the full amount unpaid on his shares. He is primarily liable and must be tried first. The liability of "B" List contributory is equated by the Act and arises only:

- (i) if it appears to the Court that the present members are unable to satisfy the contribution required to be made by them, within a reasonable time;
- (ii) the debt or liability was incurred while he was a member; and
- (iii) he had not ceased to be a member for one year or upward before the commencement of the winding up, i.e., to be liable he must have ceased to be a member within 12 months immediately before the commencement of the winding up.

It is to be noted that "B" List can be resorted to only when the "A" List has been exhausted and part of the debts have been paid. Even when he resorts to "B" List, he can only claim from a "B" List member when the corresponding "A" List member has been unable to pay.

Let us suppose that there is a debt of Rs. 50,000 contracted before six "B" List contributories had transferred their shares. There are many debts amounting to Rs. 50,000 in all contracted after all the "B" List members had transferred their shares. The total liability on shares of the six "B" List members is Rs. 10,000. In such case the liquidator can demand from them only ₹5,000, and he must apply this ₹5,000 *pari passu* towards all the debts. It is clear that if he has ₹5,000 to apply towards debts of ₹50,000 + ₹ 5,000 = ₹55,000, each

creditor will receive one-eleventh (₹55,000 : ₹ 5,000) of the amount which he is owed. The single "B" List creditor will, therefore, receive one-eleventh of ₹5,000, yet there is still a liability on the "B" List shares of ₹5,000.

As per Section 427, in the winding up of a limited company, any director, or manager whether past or present, whose liability is unlimited (under the provisions of the Act) shall be liable to contribute to the assets of the company to an unlimited extent, over and above his ordinary liability to contribute as an ordinary member.

There are three exceptions to the rule contained in Section 427 of the Companies Act, 1956 Firstly, past director or manager shall not be liable to make such further contribution if he has ceased to hold office for a year or more before the commencement of winding up. Secondly, past director or manager shall not be liable to make such further contribution in respect of any debt or liability of the company contracted after he ceased to hold office. Subject to the articles of the company, a director or manager shall not be liable to make such further contribution, unless the Court deems it necessary to require the contribution in order to satisfy the debts and liabilities of the company and the costs, charges and expenses of the winding up.

### **Enforcement of Liability of Contributory**

The liability of the contributories is enforced by means of calls. In the case of winding up by the Court the call is made by the liquidator with the sanction or order of the Court. In the case of a voluntary winding up, the call may be made by the liquidator without the sanction of the Court.

### **Set Off**

A person, as observed earlier, who is both a contributory and a creditor of the company (in respect of dividends, profits or otherwise) cannot set off his debts against his liability for calls even if there is an express agreement to do so whether the call was made before or after winding up [*Rameshwar Prasad v. Simla Banking & Industrial Co. etc. Ltd.*, (1955) 25 Comp. Cas. 475]. The principle underlying denial of right of set off is that where a person entitled to participate in a fund is also bound to make a contribution in aid of that fund, he cannot be allowed to participate until he has discharged his obligation [Re. Peruvian Railway Constructions Co. (1915) 2 Ch. 442]. When all the creditors have been paid in full, the debts due from the company to the contributory in respect of independent dealing or contracts may be set off against debts due to the company in the case of an unlimited company. Such an allowance may be made, in the case of a limited company, to any director or manager whose liability is unlimited.

A creditor to whom money is due from the company, other than in his capacity as a member of the company, may claim set off against the money owed by him to the company. In *Official Liquidator, High Court of Karnataka v. Smt. V. Lakshmi Kutty*, (1981) - 51 Comp. Cas. 566 (SC), it has been held by the Supreme Court that Sections 529 and 530 of the Companies Act should be read together whenever any creditor seeks to prove his debt against the company in liquidation, the rule enacted in Section 46 of the Provincial Insolvency Act, 1920, should apply and only that amount which is found due from him at the foot of the account in respect of the mutual dealings should be recoverable from him and not that the amount due from the company in liquidation should rank in payment after the preferential claims prescribed under Section 530 have been paid. The set off is allowed where the dealings are mutual. In the case of chit fund transactions the subscribers can set off the debts owing to them by chit fund company against the debts due by them to the chit fund company. The cut off date for the purpose of set off is the date of commencement of the winding up. Therefore, any claim arising after the commencement of the winding up cannot be set off.

### **Consequences as a Creditor**

A company, as observed earlier, cannot be adjudged an insolvent, although it may become insolvent in the

sense that it is unable to pay its debts. As to the rights of the creditors in winding up, a distinction between solvent and insolvent companies has to be made.

Where a solvent company is being wound up, all debts payable on a contingency, and all claims against the company, present or future, certain or contingent, are admissible to proof against the company, a just estimate being made as far as possible, of the value of such debts or claims as may be subject to any contingency or for some other reason do not bear a certain value. No difficulty arises in the case of an insolvent company, as when the claims are proved they are paid off according to the availability of the assets.

In the winding up of an insolvent company, the same rules shall prevail as in the case of insolvency law, in respect of:

- (i) debts provable,
- (ii) the valuation of annuities and future and contingent liabilities, and
- (iii) the respective rights of secured and unsecured creditors [Section 529].

### Secured Creditors

A secured creditor is defined in the Insolvency Act to mean “a person who holds a mortgage, charge or lien on the company’s property or any part of it as security for any debt due to him from the company.”

The effect of the provisions of Section 529 is that the secured creditor may either:

- (i) rely on the security and ignore the liquidation altogether;
- (ii) value his security and prove for the balance of his debt; or
- (iii) give up his security and prove for the whole amount as an unsecured creditor.

The secured creditor can, on his option, stand wholly outside the winding up proceedings. He need not prove his debts out of that security with the leave of the winding up Court. If the security is insufficient to pay his debt fully, he may exhaust the security and prove for the deficiency in the winding up. Alternatively, he can assess the value of his security and prove for the balance. The liquidator can redeem the security from the secured creditors at the value assessed by him. With the amendment of Section 529 by the Companies (Amendment) Act, 1985 the law about realisation of dues by the secured creditors has now been amended w.e.f. 1st May, 1985. Now Section 529 has been amended by making wide amendments and also by inserting a new Section 529A. Henceforth the security of other secured creditors shall be deemed to be subject to a *pari passu* charge in favour of the workmen to the extent of their dues. The Official Liquidator has been given the duty of representing the workmen to enforce their charge over the property. The dues of the workmen are to be paid in full but if the assets are insufficient to meet them, then, in such a case the dues of the workmen shall abate in equal proportions alongwith the secured creditors. A secured creditor who realises his security is liable to reimburse the liquidator for all expenses incurred by the latter for the preservation of the security before the realisation. The secured creditor is liable to pay the whole of the expenses but if workmen are participating in the security, then such expenses should be apportioned between the secured creditors and workers in the proportion of the amount to be distributed to them.

### Secured creditors can apply for Winding Up

A Secured Creditor can apply for winding up if the adequacy of security is open to grave doubt. *Banaras Beads v. Shrishti Carriers* (2000) 38 CLA 352. The secured creditor can file winding up petition. He is not required to relinquish his security at the time of filing a company petition for winding up. He can realize his

security and prove for balance due to him. However, if the secured creditor seeks to prove whole of his debt in winding up proceedings, he must relinquish his security for benefit of general body of creditors, before proving his debt. [*Canfin Homes v. Lloyds Steel Industries Ltd.* (2001) 32 SCL 283 (Bom. HC).]

### **Position of State Financial Corporation**

Section 29 of State Financial Corporation Act empowers State Financial Corporation to take over management and/or possession of property of industrial concern. However once winding up order is issued, these powers can be exercised only with permission of Court. In *A.P. State Financial Corporation v. Official Liquidator* 2000 (5) Scale 486, it was held that the provisions of Section 529A of the Act prevails over provisions of Section 29 of SFC Act.

### **Unsecured Creditors**

Unsecured creditors of an insolvent company are paid in the following order:

- (i) Over-riding preferential payments under Section 529A.
- (ii) Preferential payments under Section 530;
- (iii) Other debts *pari passu*.

### **Order of Priority of Debts**

- (a) Secured creditors subject to a *pari passu* charge in favour of the workmen to the extent of workmen's portion therein;
- (b) Workmen's dues; and debts due to secured creditors to the extent such debts rank under clause (c) of the proviso to Sub-section (1) of Section 529 *pari passu* with such dues;
- (c) Costs and charges of winding up. In a voluntary winding up this item is a priority automatically but in compulsory winding up, the court has, to give priority by order under Section 476;
- (d) Preferential debts – Section 530;
- (e) Floating charges – Section 530(5)(b); and
- (f) Unsecured creditors.

If there is any surplus (as it may happen in the case of a solvent company), capital is returned to preference shareholders, and then equity shareholders are returned their capital, if assets are still available. If there is still some more surplus, it depends on the articles as to whether preference shares are participating or not. In the case of a solvent company, interest can be claimed subsequent to winding up order, if there is agreement to pay interest.

## **POWERS AND DUTIES OF LIQUIDATORS**

### **Powers and duties of the Liquidators in Compulsory winding up of a Company**

Section 456 of the Act requires the liquidator to take into the custody or under the control, all the property, effects and actionable claims to which the company is or appears to be entitled. After this, all the property and effects of the company shall be deemed to be in the custody of the court as from the date of the order for the winding up of the company.

### **Liquidator is not employer**

When Official Liquidator is merely directed to wind up the affairs of company in liquidation, he is not

'employer' liable to make contribution of provident fund of ESIC contribution [*Rohtas Industries Ltd. (In liquidation) - In re. (2000) 99 Comp. Cas. 503 (Pat HC)*].

Section 457 confers on the liquidator in a winding up by the Court, certain specific powers necessary for the performance of his duties in relation to winding up. Under Sub-section (1) of Section 457, the liquidator has following powers with the sanction of the Court:

- (a) to institute or defend any suit, prosecution or other legal proceeding, civil or criminal, in the name and on behalf of the company;
- (b) to carry on the business of the company so far as may be necessary for the beneficial winding up of the company;
- (c) to sell the immovable and movable property and actionable claims of the company by public auction or private contract, with power, to transfer the whole thereof to any person or body corporate or the sell the same in parcels;
- (d) to raise on the security of the assets of the company any money requisite;
- (e) to do all such other things as may be necessary for winding up the affairs of the company and distributing its assets;

As per Section 459, the liquidator may, with the sanction of Court, appoint an advocate, attorney or pleader entitled to appear before the Court to assist him in the performance of his duties.

Under Section 546, the liquidator may exercise the following powers with the sanction of the Court in winding up by or under the supervision of the Court, and with the sanction of the special resolution of the company in voluntary winding up:

- (i) to pay any classes of creditors in full;
- (ii) to make any compromise or arrangement with creditors or persons claiming to be creditors or having or alleging themselves to have any claim, present or future, certain or contingent, ascertained or sounding only in damages, against the company or whereby the company may be rendered liable; or
- (iii) to compromise any call or liability to call, debt and liability capable of resulting in a debt, and any claim, present or future, certain or contingent, ascertained or sounding only in damages, subsisting or alleged to subsist between the company and a contributory or alleged contributory or other debtor or person apprehending liability to the company, and all questions in any way relating to or affecting the assets or liabilities or the winding up of the company, on such terms as may be agreed, and take any security for the discharge of any such call, debt, liability or claim, and give a complete discharge in respect thereof.

The exercise of aforesaid powers by the liquidator in the case of voluntary winding up is subject to the control of the Court.

Under Sub-section (2) of Section 457, the liquidator has following powers without obtaining any sanction of the Court:

- (a) to do all acts and to execute in the name and on behalf of the company and to execute all deeds, receipts and other documents and for that purpose to use, when necessary the company's seal;
- (b) to inspect the records and returns of the company on the files of the Registrar without payment of any fee;

- (c) to prove, rank and claim in the insolvency of any contributory for any balance against his estate and to receive dividends in the insolvency in respect of that balance as a separate debt due from the insolvent, and rateably with other separate creditors;
- (d) to draw, accept, make and endorse any negotiable instruments in the name and on behalf of the company in the course of its business;
- (e) to take out, in his official name, letters of administration to any deceased contributory and to do in his official name any other act necessary for obtaining payment of any money due from a contributory or his estate;
- (f) to appoint an agent to do any business which the liquidator is unable to do himself.

“(2A)<sup>1</sup> The liquidator shall —

- (a) appoint security guards to protect the property of the company taken into his custody and to make out an inventory of the assets in consultation with secured creditors after giving them notice;
- (b) appoint, as the case may be, valuer, chartered surveyors or chartered accountant to assess the value of the company's assets within fifteen days after taking into custody of property, assets referred to in sub-clause (a) and effects or actionable claims subject to such terms and conditions as may be specified by the Tribunal;
- (c) give an advertisement, inviting bids for sale of the assets of the company, within fifteen days from the date of receiving valuation report from the valuer, chartered surveyors or chartered accountants referred to in clause (b), as the case may be.

(2B) The liquidator shall, immediately after the order for winding up or appointing the liquidator as provisional liquidator is made, issue a notice requiring any of the persons mentioned in Sub-section (2) of Section 454, to submit and verify a statement of the affairs of the company and such notice shall be served by the liquidator.

(2C) The liquidator may apply to the Tribunal for an order directing any person who, in his opinion, is competent to furnish a statement of the affairs under Sections 439A and 454 and such person shall for the said purpose be served a notice by the liquidator in the manner as may be prescribed.

(2D) The liquidator may, from time to time, call any person for recording any statement for the purpose of investigating the affairs of the company which is being wound up and it shall be the duty of every such person to attend to the liquidator at such time and place as the liquidator may appoint and give the liquidator all information which he may require and answer all such questions relating to winding up of company as may be put to him by the liquidator.

(2E) Every bidder shall, in response to the advertisement referred to in clause (c) of Sub-section (2A), deposit, his offer in the manner as may be prescribed, with liquidator or provisional liquidator, as the case may be, within forty-five days from the date of the advertisement and the liquidator or provisional liquidator shall permit inspection of property and assets in respect of which bids were invited:

Provided that such bid may be withdrawn within three days before the last day of closing of the bid.

Provided further that the inspection of property shall be open for not more than five days before closing of the bid.

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<sup>1</sup> Inserted by the Companies (Second Amendment) Act, 2002 w.e.f. a date yet to be notified.

(2F) The advertisement inviting bids shall contain the following details, namely:—

- (a) name, address of registered office of the company and its branch offices factories and plants and the place where assets of the company are kept and available for sale;
- (b) last date for submitting bids which shall not exceed ninety days from the date of advertisement;
- (c) time during which the premises of the company shall remain open for inspection;
- (d) the last date for withdrawing the bid;
- (e) financial guarantee which shall not be less than one-half of the value of the bid;
- (f) validity period of the bids;
- (g) place and date of opening of the bids in public;
- (h) reserve price and earnest money to be deposited along with the bid;
- (i) any other terms and conditions of sale which may be prescribed.

(2G) The liquidator appointed shall—

- (a) maintain a separate bank account for each company under his charge for depositing the sale proceeds of the assets and recovery of debts of each company;
- (b) maintain proper books of account in respect of all receipts and payments made by him in respect of each company and submit half yearly return of receipts and payments to the Tribunal.”

Although the liquidator is not required to obtain sanction of the Court before exercising any of the foregoing powers yet he is subject to the control of the Court, and any contributory or creditor may apply to the Court with respect to any exercise of any such powers. He should have regard to any directions which may be given by resolutions of creditors or contributories in their respective meetings, called by the liquidator. The liquidator may summon general meetings of creditors and contributories, whenever he thinks fit, to ascertain their wishes. He is bound to call such meetings at such times as the creditors or contributories may by resolutions direct or whenever requested in writing to do so by not less than 1/10th in value of creditors or contributories (Sections 458 and 460).

The liquidator is required to present to the Court twice a year an account of his receipts and payments as liquidator. The Court gets the accounts audited; and the liquidator has to send a copy of the printed accounts to every creditor and contributory. A copy is also filed with the Registrar.

The Central Government is conferred with the power to take cognizance of the conduct of liquidators of companies which are being wound up by the Court. If it appears that a liquidator is not faithfully performing his duties or is not observing the requirements of the Act or if any complaint is made by a creditor or a contributory, the Central Government shall inquire into the matter and take necessary action (Section 463).

### **Power of the Liquidator in Voluntary Winding Up of a Company**

The powers of the liquidator in voluntary winding up are just the same as those of an Official Liquidator in a winding up by the Court. However, in cases where the Official Liquidator has to obtain the sanction of the Court before acting, the voluntary liquidator shall have to obtain the sanction of the company, and in case of creditors' voluntary winding up, he shall have to obtain the sanction of the Court, or of the Committee of Inspection or, in its absence, of the creditors. However, for the convenience of the students, the powers of a voluntary liquidator are detailed below. Thus, the voluntary liquidator may exercise the following powers, in the case of a members' voluntary winding up with the sanction of a special resolution of the company, and in

the case of a creditors' voluntary winding up, with the sanction of the Court or the Committee of Inspection or, if there is no Committee of Inspection, with the sanction of the creditors:

- (a) to institute or defend any suit, prosecution or other legal proceedings, civil or criminal, in the name and on behalf of the company;
- (b) to carry on the business of the company so far as may be necessary for the beneficial winding up of the company;
- (c) to sell immovable or movable property and actionable claims of the company; and
- (d) to raise on the security of the assets of the company any money requisite.

The following powers can be exercised by voluntary liquidator without any sanction:

- (i) to do all acts and to execute, in the name and on behalf of the company all deeds, receipts and other documents, and for that purpose to use, when necessary, the company's seal.
- (ii) to inspect the records and returns of the company on the files of the Registrar without payment of any fee.
- (iii) to prove, rank and claim in the insolvency of any contributory.
- (iv) to draw, accept, make and endorse any bill of exchange, hundi or promissory note in the name and on behalf of the company.
- (v) to take out, in his official name, letters of administration to any deceased contributory, and to do in his official name any other act necessary for obtaining payment of any money due from a contributory or his estate.
- (vi) to appoint an agent to do any business which the liquidator is unable to do himself.
- (vii) to exercise the power of the Court of setting the list of contributories (which shall be prima facie evidence of the liability) of the persons named therein to be contributories.
- (viii) to exercise the power of the court of making calls.
- (ix) to call general meetings of the company for the purpose of obtaining the sanction of the company by ordinary resolution or special resolution, as the case may require, or for any other purpose he may think fit.
- (x) to pay the debts of the company and adjust the rights of the contributories among themselves.

Although the foregoing powers can be exercised by the voluntary liquidator without any sanction, they are, nevertheless, subject to the control of the Court inasmuch as any creditor or contributory may apply to the Court with respect to any exercise or proposed exercise of any of these powers. For example, a contributory, whose name has been settled on the list of contributories by the voluntary liquidator, may apply to the Court with the prayer that his name ought not to have been so settled on the list as he is not a member or had ceased to be a member more than 12 months before the commencement of winding up. Or a creditor may apply to the Court against the decision of the voluntary liquidator to admit his claim.

When more than one liquidators are appointed, the manner and extent of their powers are determined at the time of their appointment by the authority appointing them. If the powers of the liquidators are not so determined on their appointment, then any of the aforesaid powers is exercisable only jointly by all or by not less than 2 of them.



## Duties and Functions of Voluntary Liquidator

The function and duties of a voluntary liquidator may be summarized as follows:

1. To satisfy himself that the resolution for voluntary winding up was validly passed and that a copy of the resolution was duly filed with the Registrar.
2. To file with the Registrar a notice of his appointment.
3. To advertise in the Official Gazette and in a local newspaper asking the creditors to meet at a certain specified place and time within 21 days of his appointment, and also to send notice to each creditor.
4. To take possession of the companies assets and see that they are intact.
5. To call by advertisement for the claims of creditors by a certain specified date, and to admit the claims.
6. To prepare a list of debts and claims and send notices to contributories for the settlement of list of contributories.
7. To settle the list of contributories on the date fixed for the purpose.
8. To look into payment made during six months immediately preceding the winding up and satisfy himself that there has been no fraudulent preference.
9. To avoid voluntary transfers.
10. To disclaim onerous property.
11. To dispose of the assets of the company to the best advantage and collect so far as practicable all outstanding debts due to the company.
12. To apply the proceeds of realisation in the prescribed manner.
13. To make calls on unpaid shares, if necessary.
14. To file returns at the end of the first year and then every six months during the continuation of the winding up.
15. To convene annual general meetings of the company and of creditors during liquidation and present the annual accounts thereat.
16. At the end of winding up, to call a general meeting and lay before it the account of the winding up. For this to make publication in the Official Gazette and in newspapers.
17. To file within one week of this meeting a return with the Registrar and the Official Liquidator.
18. To give information, papers, books and documents to the Official Liquidator for his scrutiny and submission of report to the Court.

## Status of Liquidator

The liquidator in a winding up by the Court or under the supervision of the Court, is an officer of the Court, and as such is required to exercise a high degree of honesty and fairness towards the creditors and the members of the company. he is also the agent of the company and incurs no personal liability when he enters into any contracts as a liquidator.

In a voluntary winding up, the liquidator is more rightly described as the agent of the company. He is not an officer of the Court. As a paid agent of the company he has statutory duties towards the creditors and contributories including the administration of the assets of the company.

Both in a compulsory winding up and voluntary winding up, a liquidator as an agent of the company, must exercise a high degree of care and diligence in discharging his statutory duties. He may be liable in damage to a creditor or contributory for injury caused to him as a result of his breach of statutory duties.

A liquidator is not a trustee. The property of the company is not vested in him. But he is in a fiduciary position in relation to any property of the company and is in the position of a trustee, or what is sometimes stated, he is a "statutory trustee". Accordingly, if he pays an invalid claim, even without willful default, he is liable to misfeasance proceedings. He is not a trustee for individual creditors or contributories.

### **Persons entitled to be Heard**

The persons entitled to be heard by the Court in a winding up petition are the company, the creditors, the contributories, the Registrar and the Central Government. The Court may, however, in its discretion hear any other person who may be interested in the winding up. Rule 34 of the Companies (Court) Rules, 1959, provides that any person who intends to appear at the hearing of the petition must give notice in Form No. 9 to the petitioner indicating the grounds of opposition, if he wishes to oppose the petition.

### **Procedure after the Winding Up Order**

(1) For the purpose of winding up of companies by the Court, an Official Liquidator may be appointed either from a panel of professional firms of chartered accountants, advocates, company secretaries, costs and works accountants or firms having a combination of these professionals, which the Central Government shall constitute for the Tribunal, or may be a body corporate consisting of such professionals as may be approved by the Central Government from time to time, or may be a whole-time or a part-time officers appointed by the Central Government. Before appointing the Official Liquidator, the Tribunal may give due regard to the views or opinion of the secured creditors and workmen.

Provided that before appointing the Official Liquidator, the Tribunal may give due regard to the views or Opinion of the secured creditors and workmen.

(2) The terms and conditions for the appointment of Official Liquidators appointed by Tribunal shall be approved by the Tribunal and remuneration shall be subject to a maximum remuneration of five per cent of the value of debt record and realization of sale of assets.

The terms and conditions of the Official Liquidator appointed from the Officers appointed by the Central Government shall be approved by the Central Government in accordance with the rules made by it in this behalf.

(3) Where the Official Liquidator is an officer appointed by the Central Government under clause (c) of Sub-section (1), the Central Government may also appoint, if considered necessary, one or more Deputy Official Liquidators or Assistant Official Liquidators to assist the Official Liquidator in the discharge of his functions, and the terms and conditions for the appointment of such Official Liquidators and the remuneration payable to them shall also be in accordance with the rules made by the Central Government.

(4) All references to the "Official Liquidator" in this Act shall be construed as reference to the Official Liquidator specified in Sub-section (1), or to the Deputy Official Liquidator or Assistant Official Liquidator referred to in Sub-section (3), as the case may be.

(5) The amount of the remuneration payable shall—

- (a) form part of the winding up order made by the Tribunal;
- (b) be treated as first charge on the realisation of the assets and be paid to the Official Liquidator or to the Central Government, as the case may be.

(6) The Official Liquidator shall conduct proceedings in the winding up of a company and perform such duties in reference thereto as the Tribunal may specify in this behalf:

Provided that the Tribunal may—

- (a) transfer the work assigned from one Official Liquidator to another Official Liquidator for the reasons to be recorded in writing;
- (b) remove the Official Liquidator on sufficient cause being shown;
- (c) proceed against the Official Liquidator for professional misconduct.

The Official Liquidator is required to conduct the proceedings in winding up of the company and perform such duties as the Court may impose.

### **Statement of Affairs by Directors**

Section 454 provides that within twenty-one days of the date of winding up order a statement as to the affairs of the company has to be submitted to the Official Liquidator. This time may be extended up to three months either by the Official Liquidator or by the Court. The statement has to be submitted and verified by a director, manager, secretary or other chief officer of the company or such other persons as the Official Liquidator may, subject to the direction of the Court, require. The statement should be verified by an affidavit by any of the aforementioned officers of the company and should contain the following particulars:

- (a) assets of the company, showing separately cash in hand and at the bank and negotiable securities if any held by the company;
- (b) its liabilities and debts;
- (c) names, residences and occupation of the company's creditors indicating the amount of secured or unsecured debts and in the case of secured debts, the particulars of the securities given, whether by the company or an officer thereof, their value and dates on which they were given;
- (d) the debts due to the company and the names, residences and occupation of the persons from whom they are due, and the amount likely to be realised on account thereof; and
- (e) such other information as may be required.

As per Sub-section (5) of said section, if any person, without reasonable excuse, makes default in complying with any of the requirements of this Section, he shall be punishable with imprisonment for a term which may extend to two years or with fine which may extend to one thousand rupees for every day during which the default continues or with both.

In *Official Liquidator v. P.R. Mehta* (2000) 36 CLA 210, it was held that the prosecution has to prove that the person has failed to submit the statement without reasonable cause. If a person was not director on relevant date or if there was reasonable cause for non-filing for statement, liability under this provision would not be there. In *Indla Satya Raju v. Sramika Agro Farm* (2002) 39 SCL 940, it was held that a person cannot be prosecuted and convicted under Section 454(5) merely for reason that he committed default in complying with any requirements of Section 454. In addition to establishing default, prosecution is also required to establish that the said person, without reasonable excuse, committed such fault.

In the case of *P. V. R.S. Manikumar vs. Official Liquidator*, High Court of Madras [2013] 176 Comp Cas 547(Mad) Section 454 of the Companies Act, 1956 was inserted with a definite purpose of helping the Official Liquidator to verify the factual position of the company including financial background. It is only for that purpose, the legislature has incorporated a specific provision casting a duty on the official of the Company including the ex-directors to submit the statement of the affairs of the company, before the official liquidator. Since the absence of reasonable excuse is an essential ingredient of an offence punishable under sub-section (5) of section 454 of the Act. The initial burden is on the official Liquidator to prove the said fact.

Madras High Court held that the failure on the part of the appellant to submit the statement of affairs of the company was not willful and the official liquidator failed to prove that the default was without reasonable excuse. Since the single judge had found merit in the contention raised by the appellant that he had no access to the records and entertained a doubt with regard to the discharge of obligation by the official liquidator, necessarily the benefit of doubt should have been given to the appellant. Section 633 gave wide powers to the court to grant relief in appropriate cases, provided the court was convinced that the accused acted honestly and reasonably. The observation of the single judge with regard to failure on the part of the official liquidator to prove the case itself was sufficient to acquit the accused.

### **Report by the Official Liquidator**

Section 455 provides that, in case where a winding up order is made, the Official Liquidator shall, as soon as practicable after receipt of the above mentioned statement of affairs submitted to him under Section 454 but not later than 6 months of the date of winding up order or such time as extended by the Court submit a preliminary report to the Court showing:

- (a) the amount of issued, subscribed and paid-up share capital and the estimated amount of assets and liabilities;
- (b) if the company has failed, the causes of the failure; and
- (c) whether, in his opinion, further inquiry is desirable as to any matter relating to the promotion, formation or failure of the company or the conduct of its business.

If the Official Liquidator is of the view that there has been a fraud about formation of the company then he may submit a further report or reports. This can be the basis of public examination of the directors of the company under Section 478.

### **Committee of Inspection (Sections 464 and 465)**

The Court may, at the time of making an order for the winding up or at any time thereafter, direct that there shall be appointed a Committee of Inspection to act with the liquidator. Where such a direction is given by the Court, the liquidator is required to convene, within two months from the date of direction, a meeting of the creditors for the purpose of determining who are to be members of the committee, the liquidator must call a meeting of the contributories within fourteen days from the date of creditor's meeting, to consider the creditors meetings' decision with respect to the membership of the Committee. Contributories may accept the decision of the creditors with or without modification or reject it. If the contributories at their meeting do not accept the creditors' decision in its entirety, the liquidator shall apply to the Court for directions as to what the composition of the committee shall be and who shall be its members (Section 464). The committee of inspection shall consist of not more than twelve members, being creditors and contributories of the company or persons holding general or special power of attorney from creditors or contributories, in such proportion as may be agreed upon by the meetings of the creditors and contributories and in case of difference of opinion between the meetings, as may be determined by the Court [Section 465(1)].

The committee of inspection may inspect the accounts of the liquidator at all reasonable times [Section 465(2)].

The committee of inspection will meet at such times as it may from time to time appoint and the liquidator or any member of the committee may also call a meeting of the committee as and when he thinks necessary. The quorum for a meeting of the committee shall be one-third of the total number of the members or two whichever is higher. The committee may act by a majority of its members present at a meeting but shall not act unless a quorum is present. A member of the committee may resign by notice in writing signed by him and delivered to the liquidator. If a member is adjudged an insolvent or compounds or arranges with his creditors or is absent from five consecutive meetings of the committee without leave of those members who, together with himself, represent the creditors or contributories, his office shall become vacant.

A member of the Committee of Inspection may be removed at a meeting of the creditors, if he represents creditors, or at a meeting of contributories if he represents contributories, by an ordinary resolution of which seven days notice has been given stating the object of the meeting. When any vacancy has occurred in the committee the liquidator shall call a meeting of the creditors or contributories, as the case may be, and the meeting may re-appoint the same person or appoint some other person to fill the vacancy. However, the liquidator may apply to the Court that in the circumstances of the case the vacancy need not be filled. The Court may make an order accordingly.

### **General Powers of the Court**

The Court has the power to cause the assets of the company to be collected and applied in discharge of its liabilities. For this purpose, the Court will settle a list of contributories. The Court may, after ascertaining the adequacy of the company's assets, proceed to make calls on all or any of the contributories requiring them, within the extent of their liability, to pay any money which the Court considers necessary to satisfy the debts and liabilities of the company, and the expenses of winding up and for the adjustment of the rights of the contributories.

Where the contributory owes money on calls on his shares and the company owes him some money, he cannot set off one against the other except:

- (1) in the case of unlimited company;
- (2) in the case of limited company with directors having un-limited liability in respect of such directors;
- (3) in the case of any company after the creditors are paid in full;

He must first pay what is due by him on the shares and then claim payment of his debt along with other creditors.

Where any contributory, trustee, receiver, banker, agent, officer or other employee of the company is in possession of any money, property, books or papers of the company, the Court may require him to deliver the same to the liquidator.

The Court can also summon before it any officer of the company or person known or suspected to have in his possession any such property of the company, or any person whom the Court deems capable of giving information concerning the promotion, formation, trade, property or other affairs of the company. Such person may be examined on oath which is called "private examination". The examination may be ordered by the Court ex-parte or on an application by the liquidator or any other person including a creditor or contributory. A person failing to respond to the order to appear before the Court may be caused to be apprehended and brought before the Court. The Court may require him to produce any books and papers in

his custody relating to the company. It may be remembered that the auditor is also an officer of the company for this purpose.

### **Offences antecedent to or in course of winding up**

#### **(i) Offences of Officers**

Section 538 stipulates the offences for which officers of a company in winding up are made liable to be punished with imprisonment or with fine or with both. For this purpose, officers include any person in accordance with whose directions or instructions the directors of the company have been accustomed to act.

A past or present officer of the Company is liable to be punished with imprisonment up to five years or with fine or with both if within twelve months next before the winding up or any time thereafter, he:

- (i) obtains fraudulently or on false representation any property on credit for or on behalf of the company which the company does not subsequently pay for; or
- (ii) obtains on credit under false pretence that the company is carrying on its business, any property which the company does not subsequently pay for; or
- (iii) pawns, pledges or disposes of any property of the company which has been obtained on credit and has not been paid for unless such pawning, pledging or disposing is in the ordinary course of business of the company.

The pawnee or pledgee or receiver of property who knows that the property pawned, pledged or disposed of was obtained on credit and has not been paid for is also punishable as per Section 538(2), with imprisonment up to three years or with fine or with both.

Similarly, a past or present officer of the company is punishable with imprisonment up to two years or with fine or with both, if he—

- (i) does not to the best of his knowledge and belief, fully or truly discover to the liquidator all property movable or immovable of the company and how and to whom and for what consideration and when the company disposed of any part thereof, except such part as has been disposed of in the ordinary course of business of the company;
- (ii) does not deliver up to liquidator or in the manner he directs, all movable or immovable property, books and papers of the company that are in his custody or control;
- (iii) within twelve months next before the commencement of the winding up or any time thereafter:
  - (a) conceals or fraudulently removes any part of the company's property to the value of ₹100 or more;
  - (b) conceals any debt to or from the company;
  - (c) conceals, destroys, mutilates or falsifies any books or papers affecting or relating to the property of the company;
  - (d) makes or is privy to the making of any false entry in books or papers affecting or relating to the property or affairs of the company;
  - (e) fraudulently parts with, alters or makes any omission or is privy to the fraudulent parting with or altering or making of any omission in any books or papers affecting or relating to the property or affairs of the company;
- (iv) makes any material omission in any statement relating to the affairs of the company;

- (v) fails for a period of one month to inform the liquidator about any false debts having been proved within his knowledge;
- (vi) attempts to account for any part of the property of the company by fictitious losses or expenses within 12 months next before the commencement of the winding of the creditors of the company or any of them to an agreement with reference to the affairs of the company or to the winding up.

No Court shall take cognizance of any offence against the Act, (other than an offence with respect to which proceedings are instituted under Section 545), which is alleged to have been committed by any officer of the company, except on the complaint in writing of the Registrar, or of a shareholder of the company, or of a person authorised by the Central Government or of a person authorised by SEBI.

The burden of proof to establish the offence and bring the case within any one of the aforesaid clauses is on the prosecution. It is good defence to the accused to show that he had no intent to defraud or that he had no intent to conceal the true state of affairs of the company.

### **(ii) Penalty for Falsification of Books**

According to Section 539, if with intent to defraud or deceive any person, any officer or contributory of a company in liquidation destroys, mutilates, alters, falsifies or secrets or is privy to any of these acts any books, papers or securities, or makes any fraudulent entry in any register, books of account or document belonging to the company, he shall be punished with imprisonment up to seven years and fine.

### **(iii) Penalty for Frauds by Officers**

Section 540 states that if any person, being at the time of the commission of the alleged offence, an officer of a company which is subsequently ordered to be wound up by the Court or which passes a resolution for voluntary winding up has:

- (a) by false pretences or by means of any fraud induced any person to give credit to the company, or
- (b) with intent to defraud creditors of the company, made or caused to be made any gift or transfer of or charge on, or has caused or connived at the levying any execution against, the property of the company, or
- (c) with intent to defraud creditors of the company concealed or removed any part of the property of the company, since the date of any unsatisfied judgment or order of payment of money obtained against the company or within two months before that date,

he shall be punishable with imprisonment up to two years and also with fine.

### **(iv) Liability where proper accounts are not kept**

According to Section 541 where proper books of account were not kept by the company for a period of two years immediately preceding the commencement of the winding up or the period between the incorporation of the company and the commencement of winding up, whichever is shorter, every officer of the company, who is in default, is liable to punishment with imprisonment for a term which may extend to one year, unless he shows that he acted honestly and that in the circumstances in which the business of the company was carried on, the default was excusable.

In the following cases it shall be deemed that proper books of account have not been kept, if there have not been kept:

- (a) such books or account as are necessary to exhibit and explain the transactions and financial position of the business of the company, including books containing entries made from day-to-day in sufficient detail of cash received and cash paid; and

- (b) where the business of the company has involved dealing in goods, statements of the annual stock takings and (except in the case of goods sold by way of ordinary retail trade) of all goods sold and purchased, showing the goods and the buyers and sellers thereof in sufficient details to enable those goods and those buyers and sellers to be identified.

#### **(v) Fraudulent conduct of business**

Section 542 lays down that, if in the course of winding up of a company, it appears that any business of the company has been carried on, with intent to defraud creditors of the company, or any other person, or for any fraudulent purpose, the Court on the application of the liquidator or any creditor or contributory of the company may, if it thinks proper, declare that any persons who were knowingly parties to the carrying on the business in the manner aforesaid shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the Court may direct. Moreover, every person who is knowingly a party to be carrying on of the business in such a manner is liable to imprisonment up to two years, or fine up to ₹ 50,000 or both. The above penalties are in addition to any criminal liabilities in respect of any of the above matters.

The Court is also empowered to give such further directions as it thinks proper for the purpose of giving effect to that declaration. In particular, the Court may make provision for making the liability of any such person under the declaration a charge of any debt or obligation due from the company to him, or of any mortgage or charge on any interest in any mortgage or charge on any assets of the company held by or vested in him, or any person on his behalf or any person claiming as assignee from or through the person liable or any person acting on his behalf. The Court is also empowered to make such further orders, from time to time, as may be necessary for the purpose of enforcing any charge.

The expression, “assignee”, for the above purposes, includes any person to whom or in whose favour, by the directions of the person liable, the debt, obligation, mortgage or charge was created, issued or transferred or the interest was created, but does not include an assignee for valuable consideration (nor including consideration by way of marriage) given in good faith and without notice of any of the matters on the grounds on which the declaration is made.

In the case of *ASA Agencies (P) Ltd v. Shri G. Sagar Suri & Ors* CCP No. 7/2010 in CP No. 169/2006 decided on August 6, 2012[2012]115scl665/26 taxmann.com 33(Delhi) , Liability for fraudulent conduct of business. Petitioner has filed winding up petition against respondent for its failure to pay loan amount with interest. In said petition, court passed an injunction order restraining respondent from disposing of immovable property except with the permission of the court. However, respondent large chunk of its land. Petitioner filed contempt proceeding against respondent for disobedience of the order of court.

Delhi High Court held that the contempt proceedings are quasi criminal in nature and any willful and intentional disobedience of an order of the court will certainly make a person liable for contempt. It is a trite law that the contempt jurisdiction has to be exercised with great care, caution and circumspection and it will not be invoked where the order passed by the court is not complied with by mistake, inadvertence or by misunderstanding or where the disobedience is merely accidental. However, where the court is satisfied after holding a summary enquiry that not only the party has disobeyed the order of the court but such disobedience on the part of the party is willful and deliberate, then the power of contempt has to be exercised by the court to ensure that the dignity of the court and the majesty of law is maintained.

The respondents have committed contempt of this court by willfully disobeying the order.



### (vi) Recovery of Damages from Delinquent Persons

Section 543 of the Act confers powers on the Court to examine the conduct of any person who has taken part in the promotion or formation of the company or any past or present director, manager, liquidator or officer of the company, if in the course of winding up proceedings, it appears that such a person:-

- (i) has misapplied or retained or become liable or accountable for any money or property of the company; or
- (ii) has been guilty of any misfeasance or breach of trust in relation to a company.

The enquiry into the aforesaid matters can be conducted by the Court on an application made by the Official Liquidator, liquidator or any contributory or creditor within a period of five years from the date of the order of the winding up or of the first appointment of liquidator or of the mis-application, retention, misfeasance or breach of trust, whichever is longer. If as a result of the enquiry mentioned above, the person concerned is found guilty, the Court may compel him to repay or restore the money or the property or any part thereof or to contribute such sums to be assets of the company by way of compensation in respect of the mis-application, retention, misfeasance or breach of trust as the Court thinks fit.

The aforesaid powers of the Court are available in all kinds of winding up including voluntary winding up. These powers can be exercised by the Court notwithstanding the fact that the matter is one for which the person concerned is criminally liable.

Where the person proceeded against under Section 543 dies, the misfeasance proceedings can be continued against his heirs and legal representatives for the purpose of determining and declaring the loss of damage caused to the company. [*Official Liquidator v. Parthasarathi Sinha*, (1983) 53 Comp. Cas. 163 (SC)].

Where a declaration or an order under Section 542 or Section 543, as the case may be, is made in respect of any firm or body corporate, the Court has also the power to make a declaration or an order in respect of any person who was at the relevant time a partner in that firm or a director of that body corporate.

In the matter of *Ajay G Podar v. Official Liquidator of JS & WM & Ors.* (2008) 85 CLA 398 (SC), Hon'ble SC has held that section 543(2) of the Companies Act, 1956 deals with the limitation of applications/claims including misfeasance proceedings and prescribes five (5) years period of limitation from the date of the winding up order for filing an application under section 543 (1). However, section 458A of the Companies Act, 1956 provides for the concept of computation of the limitation period. Section 458A being a non obstante clause exclude the period starting from commencement of winding up proceedings till the date on which winding up order is passed and a period of one (1) year thereafter. In view of the above, misfeasance proceedings filed by the OL are well within limitation period.

In *L.K. Prabhu v. S.M. Ameerul Millath* (2002) 40 SCL 385 (Ker HC), it was held that application under Section 543 (for damages for misapplication or misfeasance) is maintainable against Official Liquidator also, as 'liquidator' includes 'Official Liquidator'. Moreover he is 'Officer' of the company as defined in Section 2(30), even if not specifically mentioned in the definition. However there should be prima facie case against him and there is substance in the allegations. If Official Liquidator has acted in good faith, he is entitled to protection under Section 635A.

It has been held in *Official Liquidator v. Ashok Kumar*, (1976) 46 Comp. Cas. 575 (Pat), that a director who has not been duly elected and has taken his qualification shares shall be liable if he has acted as such. In other words, where a director continued to act de facto without being validly elected, he shall be liable for misfeasance.

Examples of misfeasance are:

- (i) improper payment of dividends, e.g. out of capital;
- (ii) ultra vires investment;
- (iii) director selling his own property to the company without disclosure;
- (iv) allotting shares in breach of Section 69;
- (v) knowingly allotting shares to a minor.

#### **(vii) Prosecution of delinquent officers and members**

According to Section 545, if it appears to the Court in the course of a winding up or winding up subject to supervision of the Court, that any past or present officer or member of the company has been guilty of any offence in relation to the company, it may either on the application of any person interested in the winding up or of its own motion, direct the liquidator either himself to prosecute the offender or to refer the matter to the Registrar. In the course of voluntary winding up, if it appears to the liquidator that any officer, past or present, or any member of the company has been guilty of any offence in relation to the company, he shall forthwith report the matter to the Registrar. Where any such report is made to the Registrar, he may, if he thinks fit, refer the matter to the Central Government for further investigation. Where the Registrar finds that the case is not one in which the proceedings ought to be taken by him he shall inform the liquidator who may with the sanction of the Court, himself take proceedings against the offender. Where the liquidator does not make any report to the Registrar but an offence appears to the Court to have been committed, the Court may on the application of any person interested in the winding up or on its own motion direct the liquidator to make such report.

In the case of companies under voluntary winding up, if the liquidator finds that any past or present member or officer is guilty of an offence, he should make a reference to the Registrar and to furnish him such information as he may require. The Registrar has to be allowed access to all the books and papers in the custody and control of the liquidator which might be relevant to the matter in question. If the liquidator does not report, any person interested in the winding up may apply to the Court for an order or the Court may of its own motion direct the liquidator to make such a reference to the Registrar.

On receipt of the report, if the Registrar is of the view that the case does not merit prosecution of the offender he will inform the liquidator accordingly. The liquidator may, however, himself prosecute the offender with the sanction of the Court.

In cases where the Registrar considers that prosecution ought to be launched he shall refer the matter to the Central Government. Before making the reference he is required to give to the accused person an opportunity of being heard. The Central Government may after taking such legal advice, as it thinks fit, direct the Registrar to institute proceedings.

#### **(viii) Disposal of Books and Papers of the Company**

Section 550 provides for the manner in which the books and papers of the company and those of the liquidator are to be disposed of when the affairs of the company have been wound up and is about to be dissolved. It is provided that the books and papers of the company should be disposed of in the following manner.

- (a) in the case of winding up by or subject to the supervision of the Court, in such manner as may be directed by the Court;

- (b) in the case of members' voluntary winding up in the manner as the company may, by special resolution, direct;
- (c) in the case of creditors' voluntary winding up, in such manner as the Committee of Inspection or, if there is no such Committee, as the creditors of the company may direct.

The company or liquidator or the person to whom custody of books and papers is entrusted is not responsible for producing the books and papers after the expiry of a period of five years from the date of dissolution.

The Central Government may frame rules to prevent the destruction of the books and papers of the company which has been wound up and of its liquidator for such period as it may think proper but not exceeding five years.

Rule 15 of the Companies (Central Government's) General Rules and Forms, 1956 provides that these books and papers shall not be destroyed for a period of five years. Any contributory or creditor or liquidator of the company, may make a representation of destroying these books and papers at a period earlier than five years. After considering as may be concerned with the matter, the Central Government may decide to reduce the period as may be considered proper or keep the period unaltered. An appeal against the directions of the Central Government can be made to the Court.

#### **Annual Statement, if winding up is not concluded within one year**

Section 551 provides that if the winding up of the company is not concluded within one year of the commencement, the liquidator shall file a statement in the prescribed form containing the prescribed particulars duly audited by the person qualified to act as auditor of the company with respect to proceedings and position of the liquidation. The statement is required to be filed in the Court where the company is being wound up by or subject to the supervision of the Court. A copy of the statement is required to be filed simultaneously with the Registrar. A copy is also required to be kept in the records of the company. Where the company is being wound up voluntarily, the statement is required to be filed with the Registrar.

In case of Government company in liquidation, the liquidator shall forward a copy of the statement to the Central Government or State Government or to both as the case may be depending upon which Government is a member of the company.

The filing of the statement is to be done within two months of the expiry of the period of one year and thereafter until the winding up is concluded at intervals of not more than one year or at such shorter intervals as may be prescribed. The statement to be filed with the Official Liquidator should be in Form No. 153 of the Companies (Court) Rules, 1959.

#### **Court to ascertain the wishes of Creditors and Shareholders**

Section 557 provides that in all matters relating to the winding up of the company, the Court may ascertain the wishes of the creditors or the contributories of the company. For this purpose, the Court may:

- (a) direct for calling, holding and conducting of the meeting of the creditors or contributories in such manner as it may think proper;
- (b) appoint a person to act as a Chairman of such meeting and to report the result thereof to the Court.

While ascertaining the wishes of the creditors the Court shall have regard to the value of each creditor's debt. In the case of contributories, the Court shall have regard to the number of votes which may be cast by each contributory.

## WINDING UP OF UNREGISTERED COMPANIES

Section 582 of the Act specifies “unregistered companies”, which may be wound up by the order of the Court under the provisions of Part X of the Act. By virtue of that section, an “unregistered company” does not include the following:

- (a) a railway company incorporated by any Act of Parliament or other Indian Law or any Act of Parliament of the United Kingdom;
- (b) a company registered under the Companies Act, 1956; or
- (c) a company registered under any previous companies law and not being a company the registered office whereof was in Burma, Aden or Pakistan immediately before the separation of that country from India.

Except as aforesaid, any partnership, association or company consisting of more than seven members at the time when the petition for winding up the partnership, association or company, as the case may be, is presented before the Court, will be deemed to be an unregistered company and may be wound up by the order of the Court. It should be noted that if the number of members is not more than seven, the Court has no jurisdiction to wind up such a company.

In *Polaroid Industries v. Nav Nirman Co.* (2001) 105 Comp. Cas. 188, it was held that an unregistered partnership is an unregistered company and winding up of such partnership is permissible under Section 583, if number of partners are more than seven.

An unregistered company, which includes any partnership or association, is liable to be wound up like any company if it is hit by conditions prescribed in Section 433, but the prerequisite for such winding up is that it should be established that the partnership or association has more than seven members. Otherwise, petition for winding up is not maintainable. [*Makhan Singh v. Raja Oil Mills* (2000) 38 CLA 74].

In *Smt. M.V. Parsvarthavardhana v. M.V. Ganesh Prasad* (1999) 35 CLA 318 it was held that a partnership firm can be wound up even if there is arbitration clause. It was also held that even if partnership firm is dissolved, the partnership subsists for the purpose of winding up its business and adjusting the rights of partners inter-se.

An illegal association “formed in contravention of Section 11 of the Companies Act, 1956, is not an unregistered company as defined by Section 582 above, and cannot be wound up under Section 583” as was held in *Raghubar Dayal v. The Sarafa Chamber*, AIR 1954 All. 555 that the Court cannot entertain a petition for winding up of a company formed in contravention of the provisions of Section 4 (now Section 11) of the Act.

An “unregistered company” not being “company” as defined in the Act cannot be wound up under Part VII of the Act which deals with winding up of companies. The legislature has, therefore, enacted special provisions in Part X to provide for the winding up of unregistered companies legitimately or lawfully formed. The circumstances in which an unregistered company may be wound up by the Court are following:

- (a) if the company is dissolved, or has ceased to carry on business, or is carrying on business only for the purpose of winding up its affairs;
- (b) if the company is unable to pay its debts;
- (c) if the Court is of the opinion that it is just and equitable that the company should be wound up.

### When unregistered company unable to pay its debts

An unregistered company shall be deemed to be unable to pay its debts:

- (i) if a creditor, to whom the company owes more than ₹500 has served on the company a demand under his hand requiring the company to pay the sum so due, and the company has for three weeks after the service of demand, neglected to pay the sum or to secure or to compound for it to the satisfaction of the creditor; or
- (ii) if any other suit or other legal proceeding has been instituted against any member for any debt or demand due, or claimed to be due, from the company, or from him in his character as member, and notice in writing of the institution of the suit or other legal proceeding having been served on the company, the company has not, within ten days after service of the notice, paid, secured or compounded for the debt or demand or procured the suit or other legal proceeding to be stayed, or indemnified the defendant to his satisfaction against the suit or other legal proceeding; or
- (iii) if execution or other process issued on a decree of Court is returned unsatisfied; or
- (iv) if it is otherwise proved that the company is unable to pay its debts (Section 583).

An unregistered company cannot be wound up either voluntarily or subject to the supervision of the Court. It can only be wound up by the Court. For the purpose of determining the jurisdiction of the Court in the matter of winding up, the State where the company has its principal place of business is deemed to be the State in which the registered office of the company is situated. If the principal place of business is situated in more than one State then the State in which the winding up proceedings are instituted is deemed to be the State in which the registered office of the company is situated.

### Winding up of Foreign Company as Unregistered Company

Section 584 provides that where a company incorporated outside India (i.e. a foreign company) has been carrying on business in India, ceases to carry on business in India, it may be ordered to be wound up as an unregistered company, even though the company has been dissolved or ceases to exist by virtue of the laws of the country under which it was incorporated.

### Contributories in winding up of an unregistered company

Where an unregistered company is being wound up, every person shall be deemed to be a contributory, who is liable to pay, or contribute to the payment of:

- (a) any debt or liability of the company; or
- (b) any sum for the adjustment of the rights of the members among themselves; or
- (c) the cost, charges and expenses of the winding up of the company.

Every contributory shall be liable to contribute to the assets of the company, all sums due from him in respect of any liability to pay or contribute as aforesaid, and in the event of death or insolvency of any contributory the provisions of the Act with respect to legal representatives of deceased contributories or with respect to assignees of insolvent contributories shall apply (Section 585).

As regards legal proceedings and stay of proceedings the same provisions as are applicable to a “company” will apply in the case of an unregistered company.

If an unregistered company has no power to sue and be sued in a common name, or if the Court for any other reason considers it expedient, the Court may by winding up order or by any subsequent order, direct

that all or any part of the property of all description shall vest in the Official liquidator by his official name. The liquidator may bring or defend in his official name, any suit or other legal proceedings relating to the property or necessary to be brought or defended for the purpose of effectually winding up the company and recovering its property (Section 588). All these provisions relating to the winding up of an unregistered company are in addition to other provisions/relating to winding up of companies by the Court.

### **Role of the Secretary in Winding Up**

When an order for winding up of a company has been made or a provisional liquidator has been appointed or where a resolution for voluntary winding up has been passed, the secretary is required to make out and submit to the Official Liquidator or to provisional liquidator, or the liquidator, as the case may be, within 21 days from the date of appointment of the provisional liquidator or from the commencement of the winding up, a statement, verified by an affidavit, as to the affairs of the company. The statement is required to contain the following particulars, namely:

- (a) the assets of the company, stating separately:
  - (i) the cash balance in hand and at the bank, if any, and
  - (ii) the negotiable securities, if any, held by the company.
- (b) its debts and liabilities;
- (c) the names, residences and occupations of its creditors stating separately:
  - (i) the amount of secured and unsecured debts, and
  - (ii) in the case of secured debts, particulars of the securities given and whether they were given by the company or an officer thereof;
- (d) the debts due to the company, and
  - (i) the names, residences and occupations of the persons from whom they are due, and
  - (ii) the amount likely to be realised on account thereof;
- (e) such further statement as the Official Liquidator or liquidator may require [Section 454 read with Section 511A].

The secretary may make an application for dispensing with the requirements of law regarding the making of statement of affairs, showing the special circumstances which, in his opinion, render such a course desirable. The Court may, on such application, dispense with the requirement of making of statement of affairs.

The Official Liquidator shall, as soon as possible after his appointment as the provisional liquidator, or after the winding up order, or in the case of a voluntary winding up, after the commencement of the winding up, shall serve a notice on the secretary or other persons who are officers or chief executive officers of the company calling upon them to submit and verify a statement of affairs within 21 days or within such extended time not exceeding three months [Sections 454(2) and 511(A)].

The Official Liquidator or the liquidator in a voluntary winding up may also require persons who had been secretaries of the company within one year before the commencement of the winding up order or before the date of appointment of the provisional liquidator to submit and verify a statement of affairs. The time limit of 21 days may be extended to three months by the Court, Official Liquidator or a liquidator, as the case may be. The statement of affairs is to be made in the prescribed form and the liquidator is required to give adequate facilities to the secretary to make the statement of affairs. The statement of affairs is to be verified

by the secretary and the verified statement shall be submitted to the Official Liquidator or liquidator within twenty-one days of the extended time limit, as the case may be.

The secretary may submit a bill for his actual expenses for the preparation and making of the statement of affairs. Such costs and expenses shall not be paid until the statement of affairs, verified by an affidavit, has been submitted to the Official Liquidator or liquidator, as the case may be.

The secretary is required to attend on the Official Liquidator or the liquidator if required so to do at such time and place as may be appointed by him. He is further required to answer all such questions as may be put to him by the Official Liquidator or the liquidator. The Official Liquidator or liquidator is required to maintain minutes of such interviews or the memorandum containing the substances of such interviews.

Any default, without any reasonable excuse, in complying with the requirements of law of making a statement of affairs is a punishable offence and may be punished with imprisonment for a term which may extend to two years or a daily fine of rupees one hundred for every day during which the default continues, or with both. The offence is triable only by the winding up Court.

After the statement of affairs has been made, the Official Liquidator is required to make a preliminary report to the Court not later than six months from the date of the winding up order or within such extended period as the Court may allow. Where the making of statement of affairs is dispensed with, such preliminary report shall be submitted as soon as practicable after the commencement of the winding up.

A creditor or contributory has a right to inspect the statement of affairs and the preliminary report submitted by the Official Liquidator at all reasonable times and to obtain copies there of or extracts therefrom on payment of the prescribed charges.

The Official Liquidator may also submit further report or reports:

- (a) stating the manner in which the company was promoted or formed and whether, in his opinion, any fraud has been committed by any person in its promotion or formation or by any officer of the company in relation to the company since the formation thereof; and
- (b) any other matter which in his opinion, it is desirable to bring to the notice of the Court.

Such report shall set out the names of the persons by whom the fraud, in the opinion of the Official Liquidator or liquidator was committed and the facts on which such opinion is based.

On a consideration of the report made by the Official Liquidator, or liquidator, the Court may direct the public examination of the promoters, directors or officers of the company (which will include secretaries) with a view to discovering the facts. The object of the public examination is to get information to enable the Court to determine what course is to be followed with reference to the winding up. After the public examination, the Court may, if it is of opinion that a fraud has been committed.

- (a) by any person in the promotion or formation of the company; or
- (b) by any officer of the company in relation to the company since its formation,

direct the public examination of such person or officer.

Where an order has been made for public examination of any person, the examination shall be held before the judge. The liquidator is to take part in the public examination and employ such legal assistance as may be sanctioned by the Court. Any creditor or contributory may also take part in the public examination and may appear personally or through an advocate. The person who is examined publicly is to be examined on oath and is required to answer all such questions as the Court may allow to be put to him. A person who is

ordered to be publicly examined is required to be furnished, at his own cost, with a copy of the liquidator's report. He may, at his own cost, with a copy of the liquidator's report. He may, at his own cost, engage a lawyer to defend his case. The notes of the public examination are to be taken down in writing and are required to be read over and signed by the person examined.

After the public examination, the Court may start misfeasance proceedings against any officer of the company who is found to have misappropriated or misapplied or retained any money or property of the company or who has become liable or accountable for any money or property of the company or has been guilty of wrongful exercise of lawful authority or breach of trust in relation to the company. The misfeasance proceedings may be started within 5 years from the commencement of the winding up, mis-application, retainer, misfeasance or breach of trust, whichever is longer.

As a result of the misfeasance proceedings any amount belonging to the company which is found to have been misappropriated, misapplied or retained or in respect of which any wrongful exercise of any lawful authority has been made or breach of trust has been committed, may be recovered from the concerned officer of the company.

Every officer of the company who is found guilty is also liable to be prosecuted for negligence, default, breach of duty, misfeasance or breach of the trust. But every such offence is non-cognizable and no prosecution can be launched except when a complaint in writing has been made by the Registrar of Companies or a shareholder of the company or any person authorised by the Central Government.

## **OUTSOURCING RESPONSIBILITIES TO PROFESSIONALS**

The absence of involvement and participation of professionals possessing appropriate knowledge and skills can impact the quality and efficiency of the entire process. The National Company law tribunal has also been empowered to pass an order for winding up of a company by the Companies (Second Amendment) Act, 2002. Therefore, Practising Company Secretaries may represent the winding up case in the tribunal. Hitherto, only government officers could act as Official Liquidators. Now professionals like Practising Company Secretary can act as Liquidator in case of winding up by the tribunal as well as voluntary winding up.

### **Legal Position**

At present Private Liquidator may be appointed only in case of Voluntary Winding Up either by Members or Creditors.

After the commencement of the Companies (Second Amendment) Act, 2002 Private Liquidator may be appointed by Tribunal in cases of Winding up other than Voluntary Winding Up and National Company Law Tribunal authorized to appoint liquidator who may also be called as deputy or assistant liquidator from the panel of professionals in the cases of winding up.

## **Responsibilities**

### *General Duties*

- (a) To act in good faith and for proper purpose.
- (b) Not allow a conflict of interest and duty.
- (c) Be impartial.
- (d) To exercise a degree of care and skill.



**Specific Duties**

- To call meetings of the Members/Creditors as per provisions of the Act.

Meetings are required to be held at specific intervals and happenings of certain events as provided in the Act.

- To give notices of appointment to all concerned authorities

Notice of appointment shall be given to Income Tax, Sales Tax, Excise, Property Tax and other concerned authorities. It is expected that they shall expedite the assessment and crystallize the liability.

- To keep proper books of accounts & other books

Maintenance of proper records is very important part of liquidator's duty. He is required to submit half yearly report to the ROC in Form 153 and give report on liquidation proceedings. Maintenance of other books does help him in preparing the same. This report covers areas such as receipt and payment statement for the period, statement of status of assets, status of creditors, estimation of outstanding to be realized, causes for delay, if any, probable date of completion of winding up, statement of pending legal cases etc.

- To maintain all records of proceedings of liquidation

It is expected to maintain various books as provided in the court rules.

- To secure control of the assets and papers

Control of assets includes insurance of property and providing security to protect the assets.

- To realize assets and debts

It seems to be very simple duty to realize assets and debts but practically most difficult part, buyers do talk about only defects in the assets. They try to buy the same at scrap value. Also debtors do not respond at all or claim that they had paid the dues. Even after getting ex-parte decree difficulties are faced in tracing the debtors and execution of decree by attachment.

- To ascertain liabilities and discharge them

Here also liabilities of creditors can be fixed faster but liability of Tax authorities and workmen are most difficult to be fixed in time. One has to face trade union and their abnormal demands.

- To distribute surplus to the contributories

Problem can be there in finalizing list of contributories even though list is provided. As the company is in existence all types of transactions do continue like Demat facility, transfer and transmission cases etc.

- To comply with all applicable laws and Court Rules for dissolution

To name few - Company Law, Labour Laws, Income Tax, Sales Tax, Pollution Control, National Statistics, Provident Fund, ESI, Banking, Municipal Law, Depository Act, Securities Contract Act, SEBI, Listing Agreement, Specific law applicable to that industry.

**Authority**

Private liquidator has authority:

- (a) To institute or defend any suit or prosecution.

- (b) To carry on business necessary for beneficial winding up.
- (c) To sell immovable and movable assets.
- (d) To raise security on assets.
- (e) To do all necessary things for winding up the affairs.

In case of voluntary winding up liquidator is entering the shoes of Board of Directors. Enjoying full authority to decide the matter but he has to discharge his responsibilities and comply with applicable provisions of various laws. Company remains live till the order of dissolution by the Tribunal and hence liquidator is required to submit all necessary returns in time. Consider the provisions of TDS, Capital Gain and finally sales tax set off. After the amendment Act in other cases of winding up liquidator will be under the supervision and control of Company Law Tribunal as at presently Official Liquidator is under the supervision and control of the court.

### Remuneration

Most important aspect for any practitioner is reward for his efforts. One must be very cautious while fixing the remuneration because no one is having the authority to increase the same subsequently.

As the Company remains live till dissolution liquidator is expected to follow the procedure as given in tax laws i.e. preparation of balance sheet and filing the same with Income Tax. Accounts of liquidator can be of different period but the Balance sheet must be as of 31st March. TDS deduction and filing of return is must. Sales Tax returns are required to be filed till the cancellation of sales tax number even though they are nil returns. Demat facility continues. Listing continues with the exchange though they do not allow trading of scrip. Nothing is automatic in Voluntary winding up including retrenchment of workers.

Keeping in view the large role for professionals and experts in the insolvency process, the Irani Committee has recommended the recognition of the concept of insolvency Practitioners in its report. If the recommendations of the Irani Committee including those extracted above meet the favour of policy makers, the Indian insolvency system will undergo a revolutionary change bringing it at par with the international benchmark. The professionals will get the opportunity to participate and perform various roles in the insolvency process. The professionals would be able to get appointed as liquidators, administrators, valuers, turnaround advisors, and supervisors besides performing the services such as representing and advising creditor committees, individual creditors and other stakeholders, investigator, inspector, auctioneer, trustees, security advisors, etc.

### LESSON ROUND UP

- Corporate Collapse implies business failure of the company, which may occur due to inadequate capital, fraudulent business practices, management inexperience and incompetence, failure to respond to change, recession, obsolescence, excessive gearing etc.
- Winding-up of a company is a process of putting an end to the life of a company. It is a proceeding by means of which a company is dissolved and in the course of such dissolution its assets are collected, its debts are paid off out of the assets of the company or from contributions by its members, if necessary.
- There are fundamental differences between winding up and dissolution as regards the legal procedures are involved.
- A company may be wound up by the Court i.e. compulsory winding up; by voluntary winding up (members' voluntary winding up or creditors' voluntary winding up).
- Contributory means every person liable to contribute to the assets of a company in the event of its being

wound up, and includes holders of any shares which are fully paid-up and for the purposes of all proceedings for determining, and all proceedings prior to the final determination of, the persons who are deemed to be contributories, includes any person alleged to be a 'contributory'.

- If in the course of winding up of a company, it appears that any business of the company has been carried on, with intent to defraud creditors of the company, or any other person, or for any fraudulent purpose, the Court on the application of the liquidator or any creditor or contributory of the company may, if it thinks proper, declare that any persons who were knowingly parties to the carrying on the business in the manner aforesaid shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the Court may direct.
- Unregistered companies may be wound up by the order of the Court under the provisions of Part X of the Act.
- A company incorporated outside India (i.e. a foreign company) has been carrying on business in India, ceases to carry on business in India, it may be ordered to be wound up as an unregistered company, even though the company has been dissolved or ceases to exist by virtue of the laws of the country under which it was incorporated.
- When an order for winding up of a company has been made or a provisional liquidator has been appointed or where a resolution for voluntary winding up has been passed, the secretary is required to make out and submit to the Official Liquidator or to provisional liquidator, or the liquidator, as the case may be, within 21 days from the date of appointment of the provisional liquidator or from the commencement of the winding up, a statement, verified by an affidavit, as to the affairs of the company.

### SELF TEST QUESTIONS

1. What do you mean by winding up? Enumerate various modes of winding up.
2. What is voluntary winding up? Who are entitled to make a petition to the Court?
3. Describe the duties and powers of liquidator appointed by the Court.
4. Discuss about fraudulent preference in the course of winding -up.
5. Write brief note on the liquidators' right of disclaimer.
6. Define an unregistered company and point out how and when such a company can be wound up?
7. Write short notes on the following:
  - (a) Committee of Inspection.
  - (b) Contributory.
  - (c) Dissolution of Company.
  - (d) Winding up of Company.
8. 'A voluntary liquidator is more rightly described as an agent of the company'. Discuss.
9. How is a 'Committee of Inspection' in a compulsory winding up appointed? What are its functions? How is any vacancy in the Committee filled up?
10. What is a 'Statement of Affairs'? State the contents that must be included therein. By whom and within what time limit should it be made?
11. Discuss in brief the outsourcing responsibility of a Professional.

[illegible]

# Lesson 21

## Cross Border Insolvency

### LESSON OUTLINE

- Corporate Insolvency Vs. Individual insolvency
- Development of UNCITRAL Model law
- Salient features of Model law
- UNCITRAL Legislative guide to insolvency law
- Summary of World Bank Principles
- Chapter 11 of US Bankruptcy code
- Reforms in Insolvency laws
- Legislative response to the reform process

### LEARNING OBJECTIVES

Although the number of cross-border insolvency cases has increased significantly since the 1990s, the adoption of national or international legal regimes equipped to address the issues raised by those cases has not kept pace. The lack of such regimes has often resulted in inadequate and uncoordinated approaches to cross-border insolvency that are not only unpredictable and time-consuming in their application, but lack both transparency and the tools necessary to address the disparities and, in some cases, conflicts that may occur between national laws and insolvency regimes. These factors have impeded the protection of the value of the assets of financially troubled businesses and hampered their rescue.

United Nation Commission on International Trade Law (UNCITRAL), with the general mandate to further the progressive harmonization and unification of the law of international trade, has developed a Model Law which is designed to assist States to equip their insolvency laws with a modern legal framework to more effectively address cross-border insolvency proceedings concerning debtors experiencing severe financial distress or insolvency. Further, the World Bank and Asian Development Bank have also contributed to legislative developments in dealing with cross border insolvency. Chapter 11 of US Bankruptcy code is considered as one of the effective ways of rehabilitation of bankrupt corporates.

After reading this lesson you will be able to understand the overall view of UNCITRAL model law, world bank principles, Chapter 11 of US Bankruptcy Code and other emerging aspects of insolvency laws.

## INTRODUCTION

The law of Insolvency in India owes its origin to English law. Before the British came to India there was no indigenous law of Insolvency in the country.

The earliest rudiments of insolvency legislation can be traced to sections 23 and 24 of the Government of India Act, 1800, which conferred insolvency jurisdiction on the Supreme Court.

The passing of Statute 9 in 1828 (Geo. IV. c. 73) can be said to be the beginning of the special insolvency legislation in India. Under this Act, the first insolvency courts for relief of insolvent debtors were established in the Presidency-towns. A further step in the development of Insolvency Law was taken when the law in 1848 (11 and 12 Viet. c. 21) was passed. The Provisions of the Indian Insolvency Act, 1848, were, however, found to be inadequate to meet the changing conditions. However, the Act of 1848 was in force in the Presidency-towns until the enactment in 1909 of the present Presidency-towns Insolvency Act, 1909.

### Individual Insolvency

In case of individuals there are two insolvency Act, one for the presidency towns and the other for the rest of the country. The Presidency –Towns Insolvency Act, 1909 and The Provincial Insolvency Act, 1920 respectively.

### Corporate Insolvency

Indian insolvency law is contained in the Companies Act, 1956 (1956 Act) under which winding up of companies is carried out and Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) which deals with revival and rehabilitation of sick companies.

### Companies Act, 1956

In India the Companies Act, 1956 provides for the law relating to corporate insolvency and *inter alia* contains the provisions for winding up of companies.

A company can be wound up in one of the following ways:

- Compulsory winding up by order of court
- Voluntary winding up
  - ▶ Members' voluntary winding up
  - ▶ Creditors' voluntary winding up
- Winding up subject to supervision of the court (Omitted by Companies (Amendment) Act, 2002 and yet to be notified).

In addition, the Registrars of Companies are empowered under section 560 to strike off the name of a defunct company from the register. An unregistered company or a foreign company can also be wound up under the provisions of the Companies Act.

### Sick Industrial Companies (Special Provisions) Act, 1985

The process for rehabilitation, regulated by the Sick Industrial Companies (Special Provisions) Act 1985 is done through the institutional structure of Board of Industrial and Financial Restructuring (BIFR).

## DEVELOPMENT OF UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW (UNCITRAL) MODEL LAW

### Let us know about UNCITRAL

The United Nations Commission on International Trade Law (UNCITRAL) was established in 1966 as a subsidiary body of the General Assembly of the United Nations with the general mandate to further the progressive harmonization and unification of the law of international trade.

The UN General Assembly is the main deliberative, policymaking and representative organ of the United Nations. Comprising all 193 Members of the United Nations, it provides a unique forum for multilateral discussion of the full spectrum of international issues covered by its Charter.

India is a member of UN General Assembly and UNCITRAL.

### Is UNCITRAL part of WTO?

**No, UNCITRAL is the subsidiary body of UN General assembly and WTO is an intergovernmental organization independent from United Nations.**

### Harmonization of legislations on cross-border insolvency

The following circumstances necessitated the harmonization of legislations across nations with reference to cross border insolvency

- Continuing global expansion of trade and investment.
- Increasing incidences of cross-border insolvency due to integration of trade across countries.
- National insolvency laws of different countries have by and large not kept pace with the trend.
- Inadequate and inharmonious legal approaches due to differences in regulatory platform across countries that hampers the rescue of financially troubled businesses and impede the protection of the assets of the insolvent debtor against dissipation.

### The UNCITRAL Model Law aims at harmonization of legislations across countries.

The United Nations Commission on International Trade Law (UNCITRAL) has a mandate from the General Assembly of the United Nations to harmonize and unify the law of international trade. As part of this programme of harmonization, the Commission has developed a Model Law on Cross-Border Insolvency ("the Model-Law") in order to create and maintain harmony in regulatory aspects of insolvency mechanism across countries. The Commission approved the text of the UNCITRAL Model Law on Cross-Border Insolvency (the Model Law) in May 1997. The Model Law respects the differences among national procedural laws and does not attempt a substantive unification of insolvency law. It offers solutions that help in several significant ways to have harmony among regulatory frameworks..

### The objectives

The purpose of the Model Law is to provide effective mechanisms for dealing with cases of cross-border insolvency so as to promote the objectives of:

- (a) Cooperation between the courts and other competent authorities of different countries dealing with cases of cross-border insolvency;
- (b) Greater legal certainty for trade and investment;

- (c) Fair and efficient administration of cross-border insolvencies that protects the interests of all creditors and other interested persons, including the debtor;
- (d) Protection and maximization of the value of the debtor's assets; and
- (e) Facilitation of the rescue of financially troubled businesses, thereby protecting investment and preserving employment.

### **Key provisions of Model Law**

The model law focuses on four identified elements viz

- (a) access,
- (b) recognition,
- (c) relief (assistance) and
- (d) cooperation.

#### *(a) Access*

The provisions relating

- (i) to access give representatives of foreign insolvency proceedings and creditors a right of access to the courts of an enacting (domestic) country to seek assistance, and
- (ii) to authorize representatives of local proceedings being conducted in the enacting country (domestic) to seek assistance elsewhere.

For Example, in a cross border insolvency involving Indian and Australian companies, the access is with respect to representatives of Australian proceedings to Indian court and vice versa.

#### *(b) Recognition*

These core provisions accord recognition to orders issued by foreign courts commencing qualifying foreign proceedings and appointing the foreign representative of those proceedings. Provided it satisfies specified requirements, a qualifying foreign proceeding should be recognized as either a main proceeding, taking place where the debtor had its centre of main interests at the date of commencement of the foreign proceeding or a non-main proceeding, taking place where the debtor has an establishment. Recognition of foreign proceedings under the Model Law has several effects - principal amongst them is the relief accorded to assist the foreign proceeding.

#### *(c) Relief*

A basic principle of the Model Law is that the relief considered necessary for the orderly and fair conduct of cross-border insolvencies should be available to assist foreign proceedings. By specifying the relief that is available, the Model Law neither imports the consequences of foreign law into the insolvency system of the enacting State nor applies to the foreign proceedings the relief that would be available under the law of the enacting State.

Key elements of the relief include interim relief at the discretion of the court between the making of an application for recognition and the decision on that application, an automatic stay upon recognition of main proceedings and relief at the discretion of the court for both main and non-main proceedings following recognition.



*(d) Cooperation and coordination*

These provisions address cooperation among the courts of different countries where the debtor's assets are located and coordination of concurrent proceedings concerning that debtor. The Model Law expressly empowers courts to cooperate in the areas governed by the Model Law and to communicate directly with foreign counterparts.

Cooperation between courts and foreign representatives and between representatives, both foreign and local, is also authorized. The provisions addressing coordination of concurrent proceedings aim to foster decisions that would best achieve the objectives of both proceedings, whether local and foreign proceedings or multiple foreign proceedings.

**Situations under which model law can be applied for cross border insolvencies- Examples**

- Access to local representatives for foreign records and access to foreign representatives to local records
- Request for assistance by foreign court/foreign representatives in a foreign proceedings
- Co-ordination of concurrent proceedings etc.,

**Let us understand certain basic terms.**

- (a) "Foreign proceeding" means a collective judicial or administrative proceeding in a foreign State, including an interim proceeding, pursuant to a law relating to insolvency in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation;
- (b) "Foreign main proceeding" means a foreign proceeding taking place in the State where the debtor has the centre of its main interests;
- (c) "Foreign non-main proceeding" means a foreign proceeding, other than a foreign main proceeding, taking place in a State where the debtor has an establishment within the meaning of subparagraph (f) of this Article;
- (d) "Foreign representative" means a person or body, including one appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor's assets or affairs or to act as a representative of the foreign proceeding;
- (e) "Foreign court" means a judicial or other authority competent to control or supervise a foreign proceeding;
- (f) "Establishment" means any place of operations where the debtor carries out a non-transitory economic activity with human means and goods or services.
- (g) The word "State", as used in the preamble and throughout the Model Law, refers to the country that enacts the Law (the "enacting State"). The term should not be understood as referring, for example, to a state in a country with a federal system.

**GENERAL PROVISIONS**
**Scope of application (Article 1)**

According to Article 1 of the Model Law, it applies where:

- (a) Assistance is sought in the enacting State by a foreign court or a foreign representative in connection with a foreign proceeding; or

- (b) Assistance is sought in a foreign State in connection with a proceeding under the laws of the enacting State relating to insolvency; or
- (c) A foreign proceeding and a proceeding under the laws of the enacting State relating to insolvency in respect of the same debtor are taking place concurrently; or
- (d) Creditors or other interested persons in a foreign State have an interest in requesting the commencement of, or participating in, a proceeding under the laws of the enacting State relating to insolvency.

It further says that the Model Law does not apply to a proceeding concerning any types of entities, such as banks or insurance companies, that are subject to a special insolvency regime in a State and that State wishes to exclude from the Law (the type of entity to be excluded may be designated).

Banks or insurance companies are mentioned as examples of entities that the enacting State might decide to exclude from the scope of the Model Law. The reason for the exclusion would be that the insolvency of such entities gives rise to the particular need to protect vital interests of a large number of individuals, or that the insolvency of those entities usually requires particularly prompt and circumspect action (for instance to avoid massive withdrawals of deposits). For those reasons, the insolvency of such types of entities is in many States administered under a special regulatory regime. The enacting State might decide to exclude the insolvency of entities other than banks and insurance companies.

### **Types of foreign proceedings covered**

To fall within the scope of the Model Law, a foreign insolvency proceeding needs to possess certain attributes. These include the basis in insolvency-related law of the originating State; involvement of creditors collectively; control or supervision of the assets and affairs of the debtor by a court or another official body; and reorganization or liquidation of the debtor as the purpose of the proceeding. Within those parameters, a variety of collective proceedings would be eligible for recognition, be they compulsory or voluntary, corporate or individual, winding-up or reorganization. It also includes those in which the debtor retains some measure of control over its assets, albeit under court supervision (e.g. suspension of payments, "debtor in possession"). An inclusive approach is used also as regards the possible types of debtors covered by the Model Law.

### **Principle of supremacy of international obligations (Article 3)**

Article 3 provides that to the extent that the Model Law conflicts with an obligation of the state enacting the Model Law arising out of any treaty or other form of agreement to which it is a party with one or more other States, the requirements of the treaty or agreement prevail.

### **Competent court or authority (Article 4)**

The functions under the Model Law relating to recognition of foreign proceedings and cooperation with foreign courts shall be performed by the court, courts, authority or authorities as specified in the Model Law who are competent to perform those functions in the enacting State.

## **ACCESS OF FOREIGN REPRESENTATIVES AND CREDITORS TO COURTS IN STATE ENACTING MODEL LAW**

### **Right of direct access (Article 9)**

A foreign representative is entitled to apply directly to a court in the State enacting law. Article 9 is limited to expressing the principle of direct access by the foreign representative to courts of the enacting State, thus freeing the representative from having to meet formal requirements such as licences or consular action.

### Application by a foreign representative to commence a proceeding (Article 11)

According to Article 11, a foreign representative is entitled to apply to commence a proceeding under the laws of the enacting State relating to insolvency, if the conditions for commencing such a proceeding are otherwise met.

A foreign representative has this right without prior recognition of the foreign proceeding because the commencement of an insolvency proceeding might be crucial in cases of urgent need for preserving the assets of the debtor.

The Model Law avoids the need to rely on cumbersome and time-consuming letters rogatory<sup>1</sup> or other forms of diplomatic or consular communications that might otherwise have to be used. This facilitates a coordinated, cooperative approach to cross-border insolvency and makes fast action possible.

In addition to establishing the principle of direct court access for the foreign representative, the Model Law:

- (a) Establishes simplified proof requirements for seeking recognition and relief for foreign proceedings, which avoid time-consuming "legalization" requirements involving notarial or consular procedures (Article 15);
- (b) Provides that the foreign representative has procedural standing for commencing an insolvency proceeding in the enacting State (under the conditions applicable in the enacting State) and that the foreign representative may participate in an insolvency proceeding in the enacting State (Articles 11 and 12);
- (c) Confirms, subject to other requirements of the enacting State, access of foreign creditors to the courts of the enacting State for the purpose of commencing in the enacting State an insolvency proceeding or participating in such a proceeding (Article 13);
- (d) Gives the foreign representative the right to intervene in proceedings concerning individual actions in the enacting State affecting the debtor or its assets (Article 24);
- (e) Provides that the mere fact of a petition for recognition in the enacting State does not mean that the courts in that State have jurisdiction over all the assets and affairs of the debtor (Article 10).

Upon recognition of a foreign proceeding, the foreign representative is entitled to participate in a proceeding regarding the debtor under the laws of the enacting State relating to insolvency (Article 12).

Article 12 is limited to giving the foreign representative procedural standing (or "procedural legitimation") to make petitions, requests or submissions concerning issues such as protection, realization or distribution of assets of the debtor or cooperation with the foreign proceeding and does not vest the foreign representative with any specific powers or rights.

### Protection of creditors and other interested persons

Foreign creditors have the same rights regarding the commencement of and participation in a proceeding under the laws of the enacting state relating to insolvency as creditors in the state.

The Model Law contains following provisions to protect the interests of the creditors (in particular local creditors), the debtor and other affected persons:

- availability of temporary relief upon application for recognition of a foreign proceeding or upon recognition is subject to the discretion of the court; it is expressly stated that in granting such relief

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<sup>1</sup> Seeking information by one Court from another, especially foreign Court.

the court must be satisfied that the interests of the creditors and other interested persons, including the debtor, are adequately protected (Article 22, paragraph 1);

- the court may subject the relief it grants to conditions it considers appropriate; and
- the court may modify or terminate the relief granted, if so requested by a person affected thereby (Article 22, paragraphs 2 and 3).

In addition to those specific provisions, the Model Law in a general way provides that the court may refuse to take an action governed by the Model Law if the action would be manifestly contrary to the public policy of the enacting State (Article 6).

#### **Notification to foreign creditors of a proceeding (Article 14)**

Article 14 of the Model Law provides that whenever under laws of the enacting State relating to insolvency, a notification is to be given to creditors, such notification shall also be given to the known creditors that do not have addresses in the State. The court may order that appropriate steps be taken with a view to notifying any creditor whose address is not yet known. The main purpose of notifying foreign creditors is to inform them of the commencement of the insolvency proceeding and of the time-limit to file their claims.

Such notification shall be made to the foreign creditors individually, unless the court considers that, under the circumstances, some other form of notification would be more appropriate. No letters rogatory or other, similar formality is required. When a notification of commencement of a proceeding is to be given to foreign creditors, the notification shall:

- (a) Indicate a reasonable time period for filing claims and specify the place for their filing;
- (b) Indicate whether secured creditors need to file their secured claims; and
- (c) Contain any other information required to be included in such a notification to creditors pursuant to the law of this State and the orders of the court.

### **RECOGNITION OF A FOREIGN PROCEEDING AND RELIEF**

#### **Application for recognition of a foreign proceeding (Article 15)**

Article 15 defines the core procedural requirements for an application by a foreign representative for recognition. In incorporating the provision into national law, it is desirable not to encumber the process with additional requirements beyond these requirements. A foreign representative may apply to the court for recognition of the foreign proceeding in which the foreign representative has been appointed. An application for recognition shall be accompanied by:

- (a) A certified copy of the decision commencing the foreign proceeding and appointing the foreign representative; or
- (b) A certificate from the foreign court affirming the existence of the foreign proceeding and of the appointment of the foreign representative; or
- (c) In the absence of evidence referred to in subparagraphs (a) and (b), any other evidence acceptable to the court of the existence of the foreign proceeding and of the appointment of the foreign representative.

An application for recognition shall also be accompanied by a statement identifying all foreign proceedings in respect of the debtor that are known to the foreign representative. The court may require a translation of documents supplied in support of the application for recognition into an official language of State.

The Model Law presumes that documents submitted in support of the application for recognition need not be authenticated in any special way, in particular by legalization. According to Article 16, the court is entitled to presume that those documents are authentic whether or not they have been legalized. "Legalization" is a term often used for the formality by which a diplomatic or consular agent of the State in which the document is to be produced certifies the authenticity of the signature, the capacity in which the person signing the document has acted and, where appropriate, the identity of the seal or stamp on the document.

In respect of the provision relaxing any requirement of legalization, the question may arise whether that is in conflict with the international obligations of the enacting State. Several States are parties to bilateral or multilateral treaties on mutual recognition and legalization of documents. According to Article 3 of the Model Law, if there is still a conflict between the Model Law and a treaty, the treaty will prevail. In order not to prevent recognition because of non-compliance with a mere technicality, the law allows evidence other than that specified; that provision, however, does not compromise the court's power to insist on the presentation of evidence acceptable to it.

It further requires that an application for recognition must be accompanied by a statement identifying all foreign proceedings in respect of the debtor that are known to the foreign representative. That information is needed by the court not so much for the decision on recognition itself but for any decision granting relief in favour of the foreign proceeding. In order to tailor such relief appropriately and make sure that the relief is consistent with any other insolvency proceeding concerning the same debtor, the court needs to be aware of all foreign proceedings concerning the debtor that may be under way in third States.

### **Decision to recognize a foreign proceeding (Article 17)**

Subject to Article 6, a foreign proceeding shall be recognized if:

- (a) The foreign proceeding is a proceeding within the meaning as defined under Article 2;
- (b) The foreign representative applying for recognition is a person or body within the meaning as defined under Article 2;
- (c) The application meets the requirements of Article 15; and
- (d) The application has been submitted to the court referred to in Article 4.

The foreign proceeding shall be recognized as a foreign main proceeding if it is taking place in the State where the debtor has the centre of its main interests; or as a foreign non-main proceeding if the debtor has an establishment within the meaning of subparagraph (f) of Article 2 in the foreign State.

The purpose of Article 17 is to indicate that, if recognition is not contrary to the public policy of the enacting State and if the application meets the above said requirements, recognition will be granted as a matter of course. A decision to recognize a foreign proceeding would normally be subject to review or rescission, as any other court decision.

### **Subsequent information (Article 18)**

The foreign representative shall inform the court immediately, if from the time of filing the application for recognition of the foreign proceeding, there is:

- (a) Any substantial change in the status of the recognized foreign proceeding or the status of the foreign representative's appointment; and
- (b) Any other foreign proceeding regarding the same debtor that becomes known to the foreign representative.

It is possible that, after the application for recognition or after recognition, changes may occur in the foreign proceeding that would have affected the decision on recognition or the relief granted on the basis of recognition. For example, the foreign proceeding may be terminated or transformed from a liquidation proceeding into a reorganization proceeding, or the terms of the appointment of the foreign representative may be modified or the appointment itself terminated. The technical modifications in the status of the proceedings or the terms of the appointment are frequent, but that only some of those modifications are such that they would affect the decision granting relief or the decision recognizing the proceeding; therefore, the provision only calls for information of "substantial" changes.

### **Relief that may be granted upon application for recognition of a foreign proceeding (Article 19)**

According to Article 19, from the time of filing an application for recognition until the application is decided upon, the court may, at the request of the foreign representative, where relief is urgently needed to protect the assets of the debtor or the interests of the creditors, grant relief of a provisional nature, including:

- (a) Staying execution against the debtor's assets;
- (b) Entrusting the administration or realization of all or part of the debtor's assets located in a State to the foreign representative or another person designated by the court, in order to protect and preserve the value of assets that, by their nature or because of other circumstances, are perishable, susceptible to devaluation or otherwise in jeopardy;
- (c) Any relief mentioned in Article 21.

Relief available under Article 19 is provisional in the sense that, the relief terminates when the application for recognition is decided upon; however, the court is given the opportunity to extend the measure, as provided in Article 21. The court may refuse to grant relief under this Article if such relief would interfere with the administration of a foreign main proceeding.

### **Effects of recognition of a foreign main proceeding (Article 20)**

Once foreign proceeding is recognized which is a foreign main proceeding, the following are the effects:

- (a) Commencement or continuation of individual actions or individual proceedings concerning the debtor's assets, rights, obligations or liabilities is stayed;
- (b) Execution against the debtor's assets is stayed; and
- (c) The right to transfer, encumber or otherwise dispose of any assets of the debtor is suspended.

The effects provided by Article 20 are not discretionary in nature. These flow automatically from recognition of the foreign main proceeding. The automatic effects under Article 21 apply only to main proceedings.

### **Relief that may be granted upon recognition of a foreign proceeding (Article 21)**

Upon recognition of a foreign proceeding, whether main or non-main, where necessary to protect the assets of the debtor or the interests of the creditors, the court may, at the request of the foreign representative, grant any appropriate relief, including:

- (a) Staying the commencement or continuation of individual actions or individual proceedings concerning the debtor's assets, rights, obligations or liabilities, to the extent they have not been stayed under Article 20;
- (b) Staying execution against the debtor's assets to the extent it has not been stayed under Article 20;
- (c) Suspending the right to transfer, encumber or otherwise dispose of any assets of the debtor to the extent this right has not been suspended under Article 20;

- (d) Providing for the examination of witnesses, the taking of evidence or the delivery of information concerning the debtor's assets, affairs, rights, obligations or liabilities;
- (e) Entrusting the administration or realization of all or part of the debtor's assets located in this State to the foreign representative or another person designated by the court;
- (f) Extending relief granted under Article 19;
- (g) Granting any additional relief that may be available to a person or body administering a reorganization or liquidation under the law of the enacting State under the laws of that State.

Upon recognition of a foreign proceeding, whether main or non-main, the court may, at the request of the foreign representative, entrust the distribution of all or part of the debtor's assets located in the State enacting the Model Law to the foreign representative or another person designated by the court, provided that the court is satisfied that the interests of creditors are adequately protected.

In granting relief under this Article to a representative of a foreign non-main proceeding, the court must be satisfied that the relief relates to assets that, under the law of the enacting State, should be administered in the foreign non-main proceeding or concerns information required in that proceeding.

### **Protection of creditors and other interested persons (Article 22)**

The court may under Article 22, at the request of the foreign representative or a person affected by relief granted, or at its own motion, modify or terminate such relief. In granting or denying relief under Article 19 or 21, or in modifying or terminating relief, the court must be satisfied that the interests of the creditors and other interested persons, including the debtor, are adequately protected.

The idea underlying Article 22 is that there should be a balance between relief that may be granted to the foreign representative and the interests of the persons that may be affected by such relief.

### **Actions to avoid acts detrimental to creditors (Article 23)**

Under many national laws both individual creditors and insolvency administrators have a right to bring actions to avoid or otherwise render ineffective acts detrimental to creditors. Such a right, insofar as it pertains to individual creditors, is often not governed by insolvency law but by general provisions of law (such as the civil code); the right is not necessarily tied to the existence of an insolvency proceeding against the debtor so that the action may be instituted prior to the commencement of such a proceeding. The person having such a right is typically only an affected creditor and not another person such as the insolvency administrator. Furthermore, the conditions for these individual-creditor actions are different from the conditions applicable to similar actions that might be initiated by an insolvency administrator.

The procedural standing conferred by Article 23 extends only to actions that are available to the local insolvency administrator in the context of an insolvency proceeding, and the Article does not equate the foreign representative with individual creditors who may have similar rights under a different set of conditions. Such actions of individual creditors fall outside the scope of Article 23.

The Model Law expressly provides that a foreign representative has "standing" to initiate actions to avoid or otherwise render ineffective legal acts detrimental to creditors. The provision is drafted narrowly in that it does not create any substantive right regarding such actions and also does not provide any solution involving conflict of laws. The effect of the provision is that a foreign representative is not prevented from initiating such actions by the sole fact that the foreign representative is not the insolvency administrator appointed in the enacting State.

### **Intervention by a foreign representative in proceedings (Article 24)**

Upon recognition of a foreign proceeding, the foreign representative may, provided the requirements of the law of the State are met, intervene in any proceedings in which the debtor is a party. The purpose of Article 24 is to avoid the denial of standing to the foreign representative to intervene in proceedings merely because the procedural legislation may not have contemplated the foreign representative among those having such standing. The Article applies to foreign representatives of both main and non-main proceedings.

### **Cooperation with Foreign Courts and Foreign Representatives**

Chapter IV (Articles 25-27), on cross-border cooperation, is a core element of the Model Law. Its objective is to enable courts and insolvency administrators from two or more countries to be efficient and achieve optimal results. Cooperation as described in the chapter is often the only realistic way, for example, to prevent dissipation of assets, to maximize the value of assets.

Articles 25 and 26 not only authorize cross-border cooperation, they also mandate it by providing that the court and the insolvency administrator "shall cooperate to the maximum extent possible". The Articles are designed to overcome the widespread problem of national laws lacking rules providing a legal basis for cooperation by local courts with foreign courts in dealing with cross-border insolvencies.

Enactment of such a legal basis would be particularly helpful in legal systems in which the discretion given to judges to operate outside areas of express statutory authorization is limited. However, even in jurisdictions in which there is a tradition of wider judicial latitude, enactment of a legislative framework for cooperation has proved to be useful. To the extent that cross-border judicial cooperation in the enacting State is based on the principle of comity among nations, the enactment of Articles 25-27 offers an opportunity for making that principle more concrete and adapted to the particular circumstances of cross-border insolvencies.

The Articles in chapter IV leave certain decisions, in particular when and how to cooperate, to the courts and, subject to the supervision of the courts, to the insolvency administrators. For a court to cooperate with a foreign court or a foreign representative regarding a foreign proceeding, the Model Law does not require a previous formal decision to recognize that foreign proceeding.

### **Cooperation and direct communication between courts or foreign representatives (Article 25)**

The court is entitled to communicate directly with, or to request information or assistance directly from, foreign courts or foreign representatives. The ability of courts, with appropriate involvement of the parties, to communicate "directly" and to request information and assistance "directly" from foreign courts or foreign representatives is intended to avoid the use of time-consuming procedures traditionally in use, such as letters rogatory.

### **Cooperation and direct communication between a person or body administering a reorganization or liquidation under the law of the enacting State and foreign courts or foreign representatives (Article 26)**

Article 26 on international cooperation between persons who are appointed to administer assets of insolvent debtors reflects the important role that such persons can play in devising and implementing cooperative arrangements, within the parameters of their authority. The provision makes it clear that an insolvency administrator acts under the overall supervision of the competent court. The Model Law does not modify the rules already existing in the insolvency law of the enacting State on the supervisory functions of the court over the activities of the insolvency administrator.

According to Article 27, Cooperation may be implemented by any appropriate means, including:

- (a) Appointment of a person or body to act at the direction of the court;



- (b) Communication of information by any means considered appropriate by the court;
- (c) Coordination of the administration and supervision of the debtor's assets and affairs;
- (d) Approval or implementation by courts of agreements concerning the coordination of proceedings;
- (e) Coordination of concurrent proceedings regarding the same debtor;
- (f) The enacting State may wish to list additional forms or examples of cooperation.

## CONCURRENT PROCEEDINGS

### Commencement of a proceeding after recognition of a foreign main proceeding (Article 28)

After recognition of a foreign main proceeding, a proceeding under the laws of the enacting State relating to insolvency may be commenced only if the debtor has assets in the state enacting the Model Law. The effects of that proceeding shall be restricted to the assets of the debtor that are located in such State and to the extent necessary to implement cooperation and coordination under Articles 25, 26 and 27 to other assets of the debtor that, under the law of such State, should be administered in that proceeding.

Article 28, in conjunction with Article 29, provides that recognition of a foreign main proceeding will not prevent the commencement of a local insolvency proceeding concerning the same debtor as long as the debtor has assets in the State.

### Coordination of a proceeding (Article 29)

Article 29 gives guidance to the court that deals with cases where the debtor is subject to a foreign proceeding and a local proceeding at the same time. Where a foreign proceeding and a proceeding under the laws of the enacting State relating to insolvency are taking place concurrently regarding the same debtor, the court shall seek cooperation and coordination under Articles 25, 26 and 27, and the following shall apply:

- (a) When the proceeding in the State (which has enacted model law) is taking place at the time the application for recognition of the foreign proceeding is filed,
  - (i) Any relief granted under Article 19 or 21 must be consistent with the proceeding in such State; and
  - (ii) If the foreign proceeding is recognized in such State as a foreign main proceeding, Article 20 does not apply;
- (b) When the proceeding in such State commences after recognition, or after the filing of the application for recognition, of the foreign proceeding,
  - (i) Any relief in effect under Article 19 or 21 shall be reviewed by the court and shall be modified or terminated if inconsistent with the proceeding in this State; and
  - (ii) If the foreign proceeding is a foreign main proceeding, the stay and suspension referred to in Article 20 shall be modified or terminated, if inconsistent with the proceeding in such State;
- (c) In granting, extending or modifying relief granted to a representative of a foreign non-main proceeding, the court must be satisfied that the relief relates to assets which, according to the law of the enacting State, should be administered in the foreign non-main proceeding or concerns information required in that proceeding.

The salient principle embodied in Article 29 is that the commencement of a local proceeding does not prevent or terminate the recognition of a foreign proceeding. This principle is essential for achieving the objectives of the Model Law in that it allows the court in the enacting State in all circumstances to provide relief in favour of the foreign proceeding.

### **Coordination of more than one foreign proceeding (Article 30)**

Article 30 deals with cases where the debtor is subject to insolvency proceedings in more than one foreign State and foreign representatives of more than one foreign proceeding seek recognition or relief in the enacting State. The provision applies whether or not an insolvency proceeding is pending in the enacting State. If, in addition to two or more foreign proceedings, there is a proceeding in the enacting State, the court will have to act pursuant to both Article 29 and Article 30.

In respect of more than one foreign proceeding regarding the same debtor, the court shall seek cooperation and coordination under Articles 25, 26 and 27, and the following shall apply:

- (a) Any relief granted under Article 19 or 21 to a representative of a foreign non-main proceeding after recognition of a foreign main proceeding must be consistent with the foreign main proceeding;
- (b) If a foreign main proceeding is recognized after recognition, or after the filing of an application for recognition, of a foreign non-main proceeding, any relief in effect under Article 19 or 21 shall be reviewed by the court and shall be modified or terminated if inconsistent with the foreign main proceeding;
- (c) If, after recognition of a foreign non-main proceeding, another foreign non-main proceeding is recognized, the court shall grant, modify or terminate relief for the purpose of facilitating coordination of the proceedings.

The objective of Article 30 is similar to that of Article 29 in that the key issue in the case of concurrent proceedings is to promote cooperation, coordination and consistency of relief granted to different proceedings. Such consistency will be achieved by appropriate tailoring of relief to be granted or by modifying or terminating relief already granted. Unlike Article 29, which, as a matter of principle, gives primacy to the local proceeding, Article 30 gives preference to the foreign main proceeding if there is one.

### **Rule of payment in concurrent proceedings (Article 32)**

Without prejudice to secured claims or rights in rem, a creditor who has received part payment in respect of its claim in a proceeding, pursuant to a law relating to insolvency, in a foreign State, may not receive a payment for the same claim in a proceeding under the laws of the enacting State relating to insolvency regarding the same debtor, so long as the payment to the other creditors of the same class is proportionately less than the payment the creditor has already received.

The rule set forth in Article 32, also referred to as the hotchpotch rule, is a useful safeguard in a legal regime for coordination and cooperation in the administration of cross-border insolvency proceedings. It is intended to avoid situations in which a creditor might obtain more favourable treatment than the other creditors of the same class by obtaining payment of the same claim in insolvency proceedings in different jurisdictions.

## **UNCITRAL LEGISLATIVE GUIDE ON INSOLVENCY LAWS<sup>1</sup>**

### **Purpose**

The Legislative Guide provides a comprehensive statement of the key objectives and principles that should be reflected in the insolvency laws of respective countries. It is intended to inform and assist insolvency law reform around the world, providing a reference tool for national authorities and legislative bodies when preparing new laws and regulations or reviewing the adequacy of existing laws and regulations. The advice provided aims at achieving a balance between the need to address a debtor's financial difficulty as quickly and efficiently as possible; the interests of the various parties directly concerned with that financial difficulty,

<sup>1</sup> [http://www.uncitral.org/uncitral/en/uncitral\\_texts/insolvency/2004Guide.html](http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/2004Guide.html)

principally creditors and other stakeholders in the debtor's business; and public policy concerns, such as employment and taxation. The Legislative Guide assists the reader to evaluate the different approaches and solutions available and to choose the one most suitable to the local context.

The purpose of the Legislative Guide on Insolvency Law is

- (i) to assist the establishment of an efficient and effective legal framework to address the financial difficulty of debtors.
- (ii) intended to be used as a reference by national authorities and legislative bodies when preparing new laws and regulations or reviewing the adequacy of existing laws and regulations.

### Key provisions

The Legislative Guide is divided into three parts.

*Part one* discusses the key objectives of an insolvency law, structural issues such as the relationship between insolvency law and other law, the types of mechanisms available for resolving a debtor's financial difficulties and the institutional framework required to support an effective insolvency regime.

*Part two* deals with core features of an effective insolvency law, following as closely as possible the various stages of an insolvency proceeding from their commencement to discharge of the debtor and closure of the proceedings. Key elements are identified as including: standardized commencement criteria; a stay to protect the assets of the insolvency estate that includes actions by secured creditors; post-commencement finance; participation of creditors; provision for expedited reorganization proceedings; simplified requirements for submission and verification of claims; conversion of reorganization to liquidation when reorganization fails; and clear rules for discharge of the debtor and closure of insolvency proceedings.

*Part three* addresses the treatment of enterprise groups in insolvency, both nationally and internationally. While many of the issues addressed in *parts one* and *two* are equally applicable to enterprise groups, there are that only apply in the enterprise group context. *Part three* thus builds upon and supplements *parts one* and *two*. At the domestic level, the commentary and recommendations of *part three* cover various mechanisms that can be used to streamline insolvency proceedings involving two or more members of the same enterprise group. These include: procedural coordination of multiple proceedings concerning different debtors; issues concerning post-commencement and post-application finance in a group context; avoidance provisions; substantive consolidation of insolvency proceedings affecting two or more group members; appointment of a single or the same insolvency representative to all group members subject to insolvency; and coordinated reorganization plans. In terms of the international treatment of groups, *part three* focuses on cooperation and coordination, extending provisions based upon the Model Law on Cross-Border Insolvency to the group context and, as appropriate, considering the applicability to the international context of the mechanisms proposed to address enterprise group insolvencies in the national context.

### EFFECTIVE INSOLVENCY AND CREDITOR RIGHTS SYSTEMS - WORLD BANK PRINCIPLES

The World Bank Principles were originally developed in 2001 in response to a request from the international community in the wake of the financial crises in emerging markets in the late 90s. At the time, there were no internationally recognized benchmarks or standards to evaluate the effectiveness of domestic creditor rights and insolvency systems. The World Bank's initiative began in 1999, with the constitution of an ad hoc committee of partner organizations, and with the assistance of leading international experts who participated in the World Bank's Task Force and Working Groups. The Principles were vetted in a series of five regional conferences, involving officials and experts from some 75 countries, and drafts were placed on the World Bank's website for public comment. The Bank's Board of Directors approved the Principles in 2001 for use in

connection with the joint IMF-World Bank program to develop Reports on the Observance of Standards and Codes (ROSC), subject to reviewing the experience and updating the Principles as needed.

From 2001 to 2004, the Principles were used to assess country systems under the ROSC and Financial Sector Assessment Program (FSAP) in some 24 countries in all regions of the world. Assessments using the Principles have been instrumental to the Bank's developmental and operational work, and in providing assistance to member countries. This has yielded a wealth of experience and enabled the Bank to test the sufficiency of the Principles as a flexible benchmark in a wide range of diverse country systems. In taking stock of that experience, the Bank has consulted a wide range of interested parties at the national and international level, including officials, civil society, business and financial sectors, investors, professional groups, and others.

In 2003, the World Bank convened the Global Forum on Insolvency Risk Management (FIRM) to discuss the experience and lessons from the application of the Principles in the assessment program. The forum consisted of over 200 experts from 31 countries to discuss the lessons from the principles and to discuss further refinements to them. During 2003 and 2004, the Bank also convened three working group sessions of the Global Judges Forum, involving judges from approximately 70 countries, who have assisted the Bank in its review of the institutional framework principles and in developing more detailed recommendations for strengthening court practices for commercial enforcement and insolvency proceedings. Other regional fora have also provided a means for sharing experience and obtaining feedback in areas of the Principles, including the Forum on Asian Insolvency Reform (FAIR) from 2002-2004 (organized by OECD and co-sponsored with the Bank and the Asian Development Bank), and Forum on Insolvency in Latin America (FILA) in 2004 organised by the Bank.

In the area of the insolvency law framework and creditor rights systems, staffs of the Bank maintained participation in the UNCITRAL working groups on insolvency law and security interests and liaised with UNCITRAL staff and experts to ensure consistency between the Bank's Principles and the UNCITRAL Legislative Guide on Insolvency Law. The Bank has also benefited from an ongoing collaboration with the International Association of Insolvency Regulators (IAIR) to survey regulatory practices of IAIR member countries and develop recommendations for strengthening regulatory capacity and frameworks for insolvency systems. A similar collaboration with INSOL International has provided feedback and input in the area of director and officer liability and informal workout systems.

Based on the experience gained from the use of the Principles, and following extensive consultations, the Principles have been thoroughly reviewed and updated. The revised Principles have benefited from wide consultation and, more importantly, from the practical experience of using them in the context of the Bank's assessment and operational work.

The World Bank Principles have been designed as a broad-spectrum assessment tool to assist countries in their efforts to evaluate and improve core aspects of their commercial law systems that are fundamental to a sound investment climate, and to promote commerce and economic growth. Efficient, reliable and transparent creditor rights and insolvency systems are of key importance for reallocation of productive resources in the corporate sector, for investor confidence and forward looking corporate restructuring. These systems also play a pivotal role in times of crisis to enable a country and stakeholders to promptly respond to and resolve matters of corporate financial distress on systemic scales.

The Principles emphasize contextual, integrated solutions and the policy choices involved in developing those solutions. The Principles highlight the relationship between the cost and flow of credit (including secured credit) and the laws and institutions that recognize and enforce credit agreements (Part A). The Principles also outline key features and policy choices relating to the legal framework for risk management

and informal corporate workout systems (Part B), formal commercial insolvency law frameworks (Part C) and the implementation of these systems through sound institutional and regulatory frameworks (Part D).

The principles have broader application beyond corporate insolvency regimes and creditor rights. The Principles are designed to be flexible in their application, and do not offer detailed prescriptions for national systems. The Principles embrace practices that have been widely recognized and accepted as good practices internationally. As legal systems and business and commerce are evolutionary in nature, so too are the Principles, and it is anticipated that these will continue to be reviewed going forward to take account of significant changes and developments.

## THE WORLD BANK PRINCIPLES – A SUMMARY

A brief summary of the key elements of the World Bank Principles for effective insolvency and creditor rights systems is given below:

### 1. Credit Environment

**Compatible credit and enforcement systems.** A regularized system of credit should be supported by mechanisms that provide efficient, transparent and reliable methods for recovering debt, including seizure and sale of immovable and movable assets and sale or collection of intangible assets, such as debt owed to the debtor by third parties. An efficient system for enforcing debt claims is crucial to a functioning credit system, especially for unsecured credit. A creditor's ability to take possession of a debtor's property and to sell it to satisfy the debt is the simplest, most effective means of ensuring prompt payment. It is far more effective than the threat of an insolvency proceeding, which often requires a level of proof and a prospect of procedural delay that in all but extreme cases make it not credible to debtors as leverage for payment.

**Collateral systems.** One of the pillars of a modern credit economy is the ability to own and freely transfer ownership interests in property, and to grant a security interest to credit providers with respect to such interests and rights as a means of gaining access to credit at more affordable prices. Secured transactions play an enormously important role in a well functioning market economy. Laws on secured credit mitigate lenders' risks of default and thereby increase the flow of capital and facilitate low cost financing. Discrepancies and uncertainties in the legal framework governing security interests are the main reasons for high costs and unavailability of credit, especially in developing countries.

The legal framework for secured lending addresses the fundamental features and elements for the creation, recognition and enforcement of security interests in all types of assets, movable and immovable, tangible and intangible, including inventories, receivables, proceeds and future property, and on a global basis, including both possessory and non-possessory interests. The law should encompass any or all of a debtor's obligations to a creditor, present or future and between all types of persons. In addition, it should provide for effective notice and registration rules to be adapted to all types of property, and clear rules of priority on competing claims or interests in the same assets. For security rights and notice to third parties to be effective, they must be capable of being publicized at reasonable costs and easily accessible to stakeholders. A reliable, affordable, public registry system is therefore essential to promote optimal conditions for asset based lending. Where several registries exist, the registration system should be integrated to the maximum extent possible so that all notices recorded under the secured transactions legislation can be easily retrieved.

**Enforcement systems.** A modern, credit-based economy requires predictable, transparent and affordable enforcement of both unsecured and secured credit claims by efficient mechanisms outside of insolvency, as well as a sound insolvency system. These systems must be designed to work in harmony. Commerce is a system of commercial relationships predicated on express or implied contractual agreements between an

enterprise and a wide range of creditors and constituencies. Although commercial transactions have become increasingly complex as more sophisticated techniques are developed for pricing and managing risks, the basic rights governing these relationships and the procedures for enforcing these rights have not changed much. These rights enable parties to rely on contractual agreements, fostering confidence that fuels investment, lending and commerce. Conversely, uncertainty about the enforceability of contractual rights increases the cost of credit to compensate for the increased risk of nonperformance or, in severe cases, leads to credit tightening.

**Credit information systems.** A modern credit-based economy requires access to complete, accurate and reliable information concerning borrowers' payment histories. This process should take place in a legal environment that provides the framework for the creation and operation of effective credit information systems. Permissible uses of information from credit information systems should be clearly circumscribed, especially regarding information about individuals. Legal controls on the type of information collected and distributed by credit information systems may often be used to advance public policies, including anti-discrimination laws.

Privacy concerns should be addressed through notice of the existence of such systems, notice of when information from such systems is used to make adverse decisions, and access by data subjects to stored credit information with the ability to dispute and have corrected inaccurate or incomplete information. An effective enforcement and supervision mechanism should be in place that provides efficient, inexpensive, transparent and predictable methods for resolving disputes concerning the operation of credit information systems along with proportionate sanctions which encourage compliance but that are not so stringent as to discourage operations of such systems.

**Informal corporate workouts.** Corporate workouts should be supported by an environment that encourages participants to restore an enterprise to financial viability. Informal workouts are negotiated in the "shadow of the law." Accordingly, the enabling environment must include clear laws and procedures that require disclosure of or access to timely and accurate financial information on the distressed enterprise; encourage lending to, investment in or recapitalization of viable distressed enterprises; support a broad range of restructuring activities, such as debt write-offs, reschedulings, restructurings and debt-equity conversions; and provide favorable or neutral tax treatment for restructurings. A country's financial sector should promote an informal out-of-court process for dealing with cases of corporate financial difficulty in which banks and other financial institutions have a significant exposure— especially in markets where enterprise insolvency is systemic.

## 2. Insolvency Law Systems

**Commercial insolvency.** Though approaches vary, effective insolvency systems have a number of aims and objectives. Systems should aspire to:

- (i) integrate with a country's broader legal and commercial systems;
- (ii) maximize the value of a firm's assets and recoveries by creditors;
- (iii) provide for both efficient liquidation of nonviable businesses and those where liquidation is likely to produce a greater return to creditors and reorganization of viable businesses;
- (iv) strike a careful balance between liquidation and reorganization, allowing for easy conversion of proceedings from one proceeding to another;
- (v) provide for equitable treatment of similarly situated creditors, including similarly situated foreign and domestic creditors;

- (vi) provide for timely, efficient and impartial resolution of insolvencies;
- (vii) prevent the improper use of the insolvency system;
- (viii) prevent the premature dismemberment of a debtor's assets by individual creditors seeking quick judgments;
- (ix) provide a transparent procedure that contains, and consistently applies, clear risk allocation rules and incentives for gathering and dispensing information;
- (x) recognize existing creditor rights and respect the priority of claims with a predictable and established process; and
- (xi) establish a framework for cross-border insolvencies, with recognition of foreign proceedings.

Where an enterprise is not viable, the main thrust of the law should be swift and efficient liquidation to maximize recoveries for the benefit of creditors. Liquidations can include the preservation and sale of the business, as distinct from the legal entity. On the other hand, where an enterprise is viable, meaning it can be rehabilitated, its assets are often more valuable if retained in a rehabilitated business than if sold in a liquidation. The rescue of a business preserves jobs, provides creditors with a greater return based on higher going concern values of the enterprise, potentially produces a return for owners and obtains for the country the fruits of the rehabilitated enterprise.

The rescue of a business should be promoted through formal and informal procedures. Rehabilitation should permit quick and easy access to the process, protect all those involved, permit the negotiation of a commercial plan, enable a majority of creditors in favor of a plan or other course of action to bind all other creditors (subject to appropriate protections) and provide for supervision to ensure that the process is not subject to abuse.

### 3. Implementation: Institutional and Regulatory Frameworks

Strong institutions and regulations are crucial to an effective insolvency system. The institutional framework has three main elements: the institutions responsible for insolvency proceedings, the operational system through which cases and decisions are processed and the requirements needed to preserve the integrity of those institutions—recognizing that the integrity of the insolvency system is the linchpin for its success.

### 4. Overarching considerations of sound investment climates

**Transparency, accountability and corporate governance.** Minimum standards of transparency and corporate governance should be established to foster communication and cooperation. Disclosure of basic information—including financial statements, operating statistics and detailed cash flows—is recommended for sound risk assessment. Accounting and auditing standards should be compatible with international best practices so that creditors can assess credit risk and monitor a debtor's financial viability. A predictable, reliable legal framework and judicial process are needed to implement reforms, ensure fair treatment of all parties and deter unacceptable practices.

Corporate law and regulation should guide the conduct of the borrower's shareholders. A corporation's board of directors should be responsible, accountable and independent of management, subject to best practices on corporate governance. The law should be imposed impartially and consistently. Creditor rights and insolvency systems interact with and are affected by these additional systems, and are most effective when good practices are adopted in other relevant parts of the legal system, especially the commercial law.

**Transparency and Corporate Governance.** Transparency and good corporate governance are the cornerstones of a strong lending system and corporate sector. Transparency exists when information is

assembled and made readily available to other parties and, when combined with the good behavior of “corporate citizens,” creates an informed and communicative environment conducive to greater cooperation among all parties. Transparency and corporate governance are especially important in emerging markets, which are more sensitive to volatility from external factors. Without transparency, there is a greater likelihood that loan pricing will not reflect underlying risks, leading to higher interest rates and other charges. Transparency and strong corporate governance are needed in both domestic and cross-border transactions and at all phases of investment—at the inception when making a loan, when managing exposure while the loan is outstanding, and especially once a borrower’s financial difficulties become apparent and the lender is seeking to exit the loan.

Transparency increases confidence in decision making and so encourages the use of out of- court restructuring options. Such options are preferable because they often provide higher returns to lenders than straight liquidation through the legal process—and because they avoid the costs, complexities and uncertainties of the legal process.

**Predictability.** Investment in emerging markets is discouraged by the lack of well defined and predictable risk allocation rules and by the inconsistent application of written laws. Moreover, during systemic crises investors often demand uncertainty risk premiums too onerous to permit markets to clear. Some investors may avoid emerging markets entirely despite expected returns that far outweigh known risks. Rational lenders will demand risk premiums to compensate for systemic uncertainty in making, managing and collecting investments in emerging markets. The likelihood that creditors will have to rely on risk allocation rules increases as fundamental factors supporting investment deteriorate. That is because risk allocation rules set minimum standards that have considerable application in limiting downside uncertainty, but that usually do not enhance returns in non-distressed markets. During actual or perceived systemic crises, lenders tend to concentrate on reducing risk, and risk premiums soar. At these times the inability to predict downside risk can cripple markets. The effect can impinge on other risks in the country, causing lender reluctance even toward untroubled borrowers.

## US BANKRUPTCY CODE

Six basic types of bankruptcy situations are dealt with under the US Bankruptcy Code.

*Chapter 7* bankruptcy leading to liquidation. In this type of bankruptcy, a court-appointed trustee or administrator takes possession of any nonexempt assets, liquidates these assets (for example, by selling at an auction), and then uses the proceeds to pay creditors.

*Chapter 9*, entitled Adjustment of Debts of a Municipality, provides essentially for reorganization. Only a “municipality” may file under chapter 9, which includes cities and towns, as well as villages, counties, taxing districts, municipal utilities, and school districts.

*Chapter 11*, entitled Reorganization, ordinarily is used by commercial enterprises that desire to continue operating a business and repay creditors concurrently through a court-approved plan of reorganization..

*Chapter 12* allows a family farmer or fisherman to continue to operate the business while the plan is being carried out.

*Chapter 13*, enables individuals with regular income to develop a plan to repay all or part of their debts. Under this chapter, debtors propose a repayment plan to make installments to creditors over three to five years.

*Chapter 15* provides effective mechanisms for dealing with insolvency cases involving debtors, assets, claimants, and other parties of interest involving more than one country.



## US BANKRUPTCY CODE – CHAPTER 11

American bankruptcy procedures enable sick Companies to restructure its debt obligations even while remaining operational. In this context, one must recognise that in the US the well known Chapter 11 bankruptcy proceedings are considered as re-organization/ resurrection process for corporates. Many companies are known to have revived under Chapter 11. Further, Chapter 11 ensures the emergence of companies with sustainable debt levels and profitable working.

One of the most remarkable events in recent business history has been the decision of General Motors Corporation USA to file bankruptcy proceedings — a decision forced on the company after it lost market share in the ongoing recession. Its assets were significantly lower than its liabilities. It has emerged from 40 days bankruptcy protection after creating a "new GM" made up of the best assets with fewer brand, fewer employees etc. For that matter, Chapter 11 could even recover WorldCom which *emerged from bankruptcy as MCI during 2004*.

Section 363 under Chapter 11 of US Bankruptcy law is an established procedure which enables companies to sell assets free of debts and encumbrances to preserve the value of the enterprise. A company under Chapter 11 can choose to sell off particular assets. A bankrupt company, the "debtor," might use this Code to "reorganize" its business and become profitable again.

The key to a successful Chapter 11 case is the continued operation of the debtor's business. In addition to running the business, the debtor or the trustee must fulfill additional duties required by the Bankruptcy Code and work with creditors, the court, and other parties to obtain financing for ongoing business operations.

### Salient Features of Chapter 11

- Chapter 11 is not a declaration of insolvency.
- Companies don't file Chapter 11 to liquidate; they do so in order to continue operating and to take the necessary steps to emerge as a financially stronger business, reorganizing their operations or balance sheet or in some cases by selling substantially all its assets.
- Management remains in control of the business during the chapter 11 rehabilitative process. Trustees, administrators and monitors typically are not appointed.
- Chapter 11 normally does not cause interruption to business operations.
- The company is given breathing room during the process - an "automatic stay" generally prevents parties from taking legal action against the company or taking the company's assets.
- Most publicly-held companies prefer to file under Chapter 11 rather than Chapter 7 because they can still run their business and control the bankruptcy process. Chapter 11 provides a process for rehabilitating the business of the company.

Sometimes the company successfully works out a plan to return to profitability; sometimes, in the end, it liquidates. Under Chapter 11 reorganization, a company usually keeps doing business and its stock and bonds may continue to trade in securities markets.

The U.S. Trustee, the bankruptcy arm of the Department of Justice, appoints one or more committees to represent the interests of creditors and stockholders in working with the company to develop a plan of reorganization to enable it to get out of debt. The plan must be accepted by the creditors, bondholders, and stockholders, and confirmed by the court. However, even if creditors or stockholders vote against the plan, the court can disregard the vote and still confirm the plan if it finds that the plan treats creditors and stockholders fairly.

Committees of creditors and stockholders negotiate a plan with the company to relieve the company from repaying part of its debt so that the company is able to get back to its normal condition.

After the committees work with the company to develop a plan, the bankruptcy court must find that it legally complies with the Bankruptcy Code before the plan can be implemented.

Thus, Chapter 11 bankruptcy involves a reorganization plan that accommodates debt reorganization through a payment plan and the major advantage is that the debtors generally remain in possession of their property and operate their business under the supervision of Court. Chapter 11 debtors also often keep a substantial portion of their assets. The provisions of Chapter 11 allow the debtor relief from pending obligations and the opportunity to reorganize its business and restructure debts while continuing to operate the business. Under this chapter a company can choose to sell off particular assets. Accordingly, subsidiaries outside US need not be included in the Chapter 11 filings.

There is therefore no change in the legal status of its subsidiaries that are kept out of Chapter 11 filings. Further, Debtors Audit, Debtors Counselling, Mandatory debtor education etc are provided under US Bankruptcy laws which help in minimizing the fraudulent bankruptcies. In the light of the above, a need is felt to have similar legal framework in India which allows continuity of business during bankruptcy proceedings, control over the management of company filing bankruptcy application, keeping subsidiaries / certain assets outside the purview of bankruptcy application etc in line with Chapter 11 of US Bankruptcy Code.

## **6. REFORMS IN INSOLVENCY LAWS – Indian Position**

World over, insolvency procedures help entrepreneurs close down unviable businesses and start up new ones. This ensures that the human and economic resources of a country are continuously rechannelised to efficient use thereby increasing the overall productivity of the economy. It is in this context, free entry and exit are sine qua non for attaining efficiency.

Indian insolvency law is contained in the Companies Act, 1956 (1956 Act) under which winding up of companies is carried out and Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) which deals with revival and rehabilitation of sick companies. The two laws were enacted to cater to meet the expectations of industries thriving in a protectionist environment unexposed to competition in a closed economy. As India swiftly moves to the centre stage of world economy there has been a consistent effort by the policy makers to undertake comprehensive reforms in the laws and systems to bring them at par with international standards and incentivise the foreign investors to invest in the Indian economy.

### **Justice Eradi Committee**

In the year 1999, the Government of India set up a High Level Committee headed by Justice V.B.Eradi, to examine and make recommendations with regard to the desirability of changes in existing law relating to winding up of companies so as to achieve more transparency and avoid delays in the final liquidation of the companies; the mechanism through which the management of companies will be conducted after the winding up order is issued and the authority which will supervise timely completion of proceedings; the rules of winding up and adjudication of insolvency of companies; the manner in which the assets of the companies are brought to sale and the proceeds are distributed efficiently; and a self-contained law on winding up of companies having regard to SICA, and the Securities Contracts (Regulation) Act, 1956, with a view to creating confidence in the minds of investors, creditors, labour and shareholders. The committee submitted its report to the Central Government in the year 2000.

The Committee addressed and recommended the following key points:

- The Committee recognized after considering international practices that the law of insolvency

should not only provide for quick disposal of assets but in Indian economic scene, it should first look at the possibilities of rehabilitation and revival of companies.

- The Committee noted that there are three different agencies namely,
  - (i) the High Courts, which have powers to order winding up of companies under the provisions of the Companies Act, 1956;
  - (ii) the Company Law Board to exercise powers conferred on it by the Act or the powers of the Central Government delegated to it and
  - (iii) Board for Industrial and Financial Reconstruction (BIFR) which deals with the references relating to rehabilitation and revival of companies.
- The committee revealed data of time taken to wind up a company – it may run on an average upto 25 years; Eastern region being the worst.
- Position as on 31.3.1999 as indicated by Eradi Committee was as under:

	<i>0-5 years</i>	<i>5-10 Years</i>	<i>10-15 Years</i>	<i>15-20 Years</i>	<i>20-25 Years</i>	<i>25 Years and Above</i>	<i>Total</i>
Northern Region	259	130	86	56	47	66	644
Eastern Region	126	77	83	73	71	293	723
Southern region	325	212	89	68	51	78	823
Western Region	355	184	224	124	82	36	1005
Total	1065	603	482	321	251	473	3195

- Committee further noted that the High Courts are not able to devote exclusive attention to winding up cases which is essential to conclude the winding up of companies quickly. The experiment with BIFR for speedy revival of companies has also not been encouraging. Committee recognized that there is a need for establishing a National Tribunal as a specialized agency to deal with matters relating to rehabilitation, revival and winding up of companies. With a view to avoiding multiplicity of fora, the National Tribunal should be conferred with jurisdiction and powers to deal with matters under Companies Act, 1956 presently exercised by the Company Law Board; jurisdiction, power and authority relating to winding up of companies vested with High Courts and power to consider rehabilitation and revival of companies presently vested in the BIFR.

The Committee also recommended that the jurisdiction, power and authority relating to winding up of companies should be vested in a National Company Law Tribunal instead of the High Court as at present. The National Company Law Tribunal—

- (a) should have the jurisdiction and power presently exercised by Company Law Board under the Companies Act, 1956;
- (b) should have the power to consider rehabilitation and revival of companies – a mandate presently entrusted to BIFR/AAFIR under SICA;
- (c) should have the jurisdiction and power relating to winding up of companies presently vested in

the High Courts. In view of above recommendations Article 323B of the Constitution should be amended to set up National Tribunal. SICA should be repealed and the Companies Act, 1956 be amended accordingly.

- (d) should be headed by a sitting judge or a former judge of a High Court and each of its Benches should consist of a judicial member and a technical member.
  - (e) shall have such number of member as may be prescribed by the Central Government. The principal Bench of the Tribunal should be located at New Delhi and its Benches should be located at the principal seats of each High Court. The Central Government may set up more such Benches if so required. While passing the order for winding up of a company, the Tribunal shall have power to prescribe time limit for each step to be taken by the Liquidator in the course of winding up process. The Tribunal shall also have power to prescribe the time limits for compliance of each step by parties while considering the reference for revival of sick companies.
  - (f) should be vested with the power to transfer all proceedings from one Private Liquidator to another "Private liquidator" or to the "Official Liquidator", as the circumstances of case may require. The Tribunal shall have the power to direct the sale of business of the company as a going concern or at its discretion to sell its asset in a piece-meal manner.
- Tribunal may continue to have jurisdiction for winding up the companies on grounds stated in section 433 but following further grounds may be added therein, namely:
    - a company has failed to file balance sheet and profit and loss accounts and/or annual returns for last three years on due dates; or
    - any action of the company has or is likely to threaten the security or integrity of India. Share holder or the Central Government will be entitled to file the petition under on aforesaid grounds.
  - There should be two distinct aspects of the liquidation:
    - (i) sale of assets (ii) distribution of sale proceeds

An all-out effort should be made by the Liquidator for sale of assets of the company promptly as in absence of the receipt of sale proceeds, timely distribution among the creditors. The pending references before BIFR/ AAIFR under SICA should abate in view of repeal of SICA recommendations by the Committee. However, the winding up proceedings pending in High Courts under Companies Act, 1956 shall stand transferred to National Tribunal for expeditious disposal of those cases.
  - There is a need to encourage voluntary winding up of companies. To achieve this object, a provision may be made in the Companies Act, 1956 to provide a company having paid-up capital of ₹10 lac or more may submit a petition for its winding up in the process Tribunal and companies with paid-up capital below that amount must resort to voluntary winding up. Creditors may approach the Tribunal for winding up only if a company defaults in payment of undisputed debts exceeding ₹ 1,00,000 and in other cases of default, creditors voluntary Winding up should be resorted. The provisions regarding winding up subject for supervision of court may be deleted as such cases will be taken care of by procedure of compulsory winding up by Court.
  - It should be obligatory for a company filing a winding up petition to submit the Statement of Affairs along with the petition for winding up. In cases where the company opposes winding up petition, it should file Statement of Affairs along with its counter affidavit/reply statement. The Statement of Affairs should be accompanied by latest addresses of directors/company secretary of company, a

details of location of assets and their value and debtors and creditors list with complete addresses. This will ensure speedy winding up of the company.

- "A Fund for Revival and Rehabilitation" preservation and protection of companies may be created under the supervision and control of the Government. The Fund shall be maintained and operated by an officer authorised in that behalf of such Government.
- The winding up order passed by the Tribunal should be made available to the liquidator within a period not exceeding two weeks from the date of passing of the order.
- The directors and officers of the company should be responsible for ensuring that books of account are completed and got audited up to the date of winding up order and submitted to the Tribunal at the cost of company failing which such directors and officers should be subjected to monetary penalty as well as imprisonment.
- The present system of liquidator required to seek the court's directions, even for small matters relating to routine administrative decisions not only causes delay in winding up but also takes valuable time of the court. Therefore, the liquidator should not seek the sanction of the court except for important matters such as confirmation of sale of assets and distribution of proceeds realised.
- Appropriate legislative action must be taken to ensure that the claims of all employees of a company and its secured creditors are ranked "pari-passu".
- Specific provisions may be made in the Companies Act, 1956 that the liquidator may distribute interim dividend.
- There should be a two point criteria for determining the maintainability of the reference for revival and rehabilitation to the of a company to the Tribunal, namely, that the company has suffered 50% of erosion of its net worth or there is a debt default involving a sum of not less than ₹1 lakh in respect of undisputed debts.
- The reference to the Tribunal for revival by a company should be voluntary. As already stated the jurisdiction of hearing references of revival and rehabilitation of companies will vest in the Tribunal and not BIFR as at present.
- An explicit provision need be made in the Companies Act giving a right to the secured creditors to file proof of debt with the liquidator without surrendering his status as a secured creditor and get the dividend in accordance with the priority to which he is entitled.
- The committee further favoured the appointment of professionals as the Liquidators from a panel to be prepared by the Government.
- The repeal of SICA and the ameliorative, revival and reconstructionist procedures obtaining under it to be reintegrated in a suitably amended form in the structure of the Companies Act 1956.
- The committee considered the adoption of the UNCITRAL Model Law in the Companies Act itself to deal with all cases of "Cross-Border Insolvency".
- The Committee also considered that the principles enunciated under legal frame work of "Orderly and Effective Procedure" recommended by IMF be incorporated in the Companies Act.
- The Committee strongly recommended appointing Insolvency Professionals who are members of Institute of Chartered Accountant of India (ICAI), Institute of Company Secretaries of India (ICSI), Institute of Cost and Work Accountants of India (ICWAI), Bar Councils or corporate managers who are well versed in Corporate management on lines of U.K. Insolvency Act. For this purpose Central

Government may maintain a panel of persons who may act as professional Insolvency practitioners subject to their fulfilling of the qualification and experience as may be specified by rules.

#### **DR. J.J. IRANI EXPERT COMMITTEE ON COMPANY LAW**

Dr. J.J. Irani Expert Committee on Company Law was set up by the Government to recommend a new company law as a part of the on-going legal and financial sector reform process in the country. Committee submitted its report to the Government of India on 31 May, 2005.

The Committee proposed significant changes in the law to make the restructuring and liquidation process speedy, efficient and effective. Recommendations are directed at restoring the eroded confidence of key stakeholders in the insolvency system while balancing their interest.

The Committee noted that a beginning towards reform was made with the enactment of Companies (Second Amendment) Act, 2002, which in addition to significant changes in the restructuring and liquidation provisions provided for the setting up of a new institutional structure in the form of the National Company Law Tribunal (NCLT)/Tribunal and its Appellate Body, the National Company Law Appellate Tribunal (NCLAT). The highlights of the report of the Committee regarding Restructuring and Liquidation are given below:

- Corporate insolvency to be addressed in company law. No need for a separate insolvency law.
- Law to strike a balance between rehabilitation and liquidation process.
- Rehabilitation and liquidation processes to be time bound.
- Setting up of institutional structure in the form of NCLT/NCALT for overseeing such processes.
- Winding up to be resorted to only when revival is not feasible.
- Reasonable opportunity for rehabilitation of business before it is decided to be liquidated.
- Period of one year to be adequate for rehabilitation from commencement of process to sanction of plan.
- Time bound procedures which limit the possibility of appeals and thereby delays.
- Two years to be feasible for completion of liquidation.
- Insolvency process to apply to all corporate entities except banks, financial institutions and insurance companies.
- Insolvent company to replace the concept of sick industrial company
- Debtors and creditors to have fair access to insolvency system.
- Rather than net worth erosion principle, test for insolvency should be default in payment of matured debt on demand within a prescribed time [liquidity test].
- Debtors seeking rehabilitation to approach the Tribunal only with a draft scheme. Creditors being at least 3/4th in value may also file rehabilitation scheme.
- If tribunal deems fit, liquidation proceedings may be converted into restructuring proceedings.
- Law to impose certain duties and prohibitions to apply to debtors and creditors on admission of rehabilitation application. Automatic prohibition on Debtors' rights to transfer, sale or dispose off assets or parts of the business except to the extent necessary to operate the business, with the approval of the Tribunal.
- There should be a duty cast on companies to convene creditors and shareholders meeting in case

of default in payments to creditors to consider suitable steps to protect interest of stakeholders, preserve assets and adopt necessary steps to contain insolvency.

- Tribunal be vested with the power to summarily dismiss the proceedings for not meeting commencement standards with cost/ sanction.
- Law to impose a prohibition on the unauthorized disposition of the Debtors' assets and suspension of actions by creditors.
- Law to provide for treatment of unperformed contracts.
- Provisions to interfere with the contractual obligations, which are not fulfilled completely.
- Meeting of the secured creditors be convened by the debtors to consider a rehabilitation plan when the Company has failed to repay its due debt without waiting for creditors to act on default or filing of application for rehabilitation.
- Companies to convene a General Meeting without delay where losses in financial year are equal to 25% or more of its average net worth during last two financial years and there is a default in making payments to the creditors.
- Role of operating agency envisaged under the existing law should be performed by independent Administrator or other qualified professionals.
- Qualified Administrator appointed by the Tribunal in consultation with the secured creditors with board authority to administer the estate in the interest of all stakeholders should replace management of the going concern.
- Creditors to actively participate and monitor the insolvency process.
- Appointment of professional experts and specialists by Creditor Committee to advise them on technical and legal issues.
- Separate Committee to represent other categories of creditors and unsecured creditors and stakeholders be formed with separate rules thereof.
- Provisions to Coordinate meetings of unsecured and secured creditors to be made.
- Mechanism to recognize and record claims of unsecured creditors in preparation of the rehabilitation plan.
- Panel of Administrators and Liquidators to be prepared and maintained by an independent body of professionals with appropriate experience and knowledge of insolvency practice.
- Tribunal to appoint Administrator and Liquidators out of the panel maintained by the independent body and Official Liquidators from panel of officials made available by the Government.
- Identification of the assets that constitute the insolvency estate including assets of debtor and third party owned assets wherever located and collection of assets forming part of insolvency estate by Administrator/ Liquidator be facilitated.
- Avoidance or cancellation of pre-bankruptcy fraudulent and preferential transactions. A flexible but transparent system for disposal of assets efficiently to be provided for.
- Sales free and clear of security interests, charges or other encumbrances be allowed subject to priority of interests in the proceeds from assets disposal.

- Provision for monitoring and effective implementation of the scheme/ plan to be made.
- Provision should also be made to
  - amend the plan in the interest of rehabilitation
  - terminate the plan and to liquidate the company.
- Discharge or for alternation of debts and claims that have been discharged or otherwise altered under the plan.
- National Company Law Tribunal (NCLT) envisaged as the forum to address Insolvency issues to be constituted speedily.
- Provisions to be made for ready access to court records, court hearings, debtors, financial data and other public information.
- Tribunal should have clear authority and effective methods of enforcing its judgments.
- Encourage and recognize the concept of Insolvency Practitioners (Administrators, Liquidators, Turnaround Specialists, Valuers etc). CA, CS and Cost Accountancy disciplines can offer high quality professional for this purpose.
- Insolvency Fund may be set up to meet the costs of the insolvency process.
- Company under restructuring and liquidation to draw out of the Fund only in proportion of the contribution made by it to the Fund in the pre-restructuring and pre-liquidation period. Application of the Fund to the insolvency/ rehabilitation process be subject to the orders of the Tribunal.
- International considerations
- Insolvency law to provide for rules of jurisdiction, recognition of foreign judgments and co-operation amongst courts in different countries.
- Provisions to deal with issues concerning treaties and arrangements entered into with different countries be framed.

## LEGISLATIVE RESPONSE TO THE REFORM PROCESS

### Companies (Second Amendment) Act, 2002

Companies (Second Amendment) Act, 2002, the objective of which provides to expedite the winding-up process of the companies, facilitating rehabilitation of sick companies and protection of workers interest, is a sound attempt towards creating a balance between reorganization and liquidation. The Second Amendment has introduced some significant improvements in the law. Some of major provisions made under the Companies (Second Amendment) Act, 2002 are briefly discussed below:

### National Company Law Tribunal

The Companies (Second Amendment) Act, 2002 provides for setting up of a National Company Law Tribunal (NCLT) and its Appellate Tribunal. The purpose of creation of the Tribunal is to avoid multiplicity of litigation before various courts or quasi-judicial bodies or forums regarding revival or rehabilitation or merger and amalgamation, and winding up of companies. NCLT will have-

- The power to consider revival and rehabilitation of companies<sup>2</sup> – a mandate presently entrusted to BIFR under SICA.

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**2.** A new Part VIA (Section 424A to 424L) has been incorporated by the Companies (Second Amendment) Act, 2002.



- The jurisdiction and power relating to winding up of companies presently vested in the High Court. The winding up proceeding pending in High Courts shall stand transferred to the Tribunal.
- The jurisdiction and power exercised by the Company Law Board under the 1956 Act. The Company Law Board will stand abolished.

### **Revival and rehabilitation of sick industrial companies**

The Amendment Act has inserted a new Part VI-A in the Principal Act to provide for the revival and rehabilitation of sick industrial companies.

### **Management of insolvency proceedings**

The Second Amendment provides for appointment of court appointed professionals as Liquidators who will be capable and competent of handling insolvency proceedings much more efficiently.

### **Sick Industrial Companies (Special Provisions) Repeal Act, 2003**

Sick Industrial Companies (Special Provisions) Repeal Act, 2003 proposed to repeal the said Act, SICA, 1985 and dissolution of BIFR. The establishment of National Company Law Tribunal under the Companies (Second Amendment) Act, 2002 and providing it with powers for expediting the winding up procedure is in a way transfer of power and functions of BIFR to the Tribunal.

## **LESSON ROUND UP**

- A company is said to be insolvent when its liabilities exceed its assets which results in its liability to pay off the debts. Cross border insolvency issues arise when a non-resident is either a debtor or contributory or creditor.
- Since National insolvency laws have by and large not kept pace with the trend, they are often ill equipped to deal with cases of cross border nature. It hampers the rescue of financially troubled business. It hampers the administration of cross border insolvencies. This gave the path for evolution of UNCITRAL Model law on Cross-Border Insolvency in 1997.
- UNICITRAL had also came out with the legislative guide on Insolvency Law in 2004.
- The study deals with each article of the UNCITRAL Model law covering its purpose, scope, the process, reliefs foreign courts, foreign proceedings etc. in a summarized and easy language.
- The study further discusses about World Bank Principles which have been designed as a broad-spectrum assessment tool to assist countries in their efforts to evaluate and improve core aspects of their commercial law systems that are fundamental to a sound investment climate and to promote commerce and economic growth.
- These principles emphasize contextual, integrated solutions and the policy choices involved in developing the solutions. The principles inter alia outline key features and policy choices relating to legal framework for risk management and informal corporate work out systems, formal commercial insolvency law frame works etc.
- The study discusses various suggestions by various committees on reforms in Insolvency law in India.
- Engagement and participation of experts possessing appropriate knowledge and skills in insolvency process becomes necessary for the quality and efficiency of the insolvency system. The suggestions as highlighted under J.J. Irani Committee report on role of professionals in Insolvency process is discussed in the study.

## SELF TEST QUESTIONS

(These are meant for recapitulation only. Answers to these questions are not required to be submitted for evaluation).

1. Distinguish between Corporate Insolvency and Individual Insolvency.
2. Write short note on:
  - (i) UNCITRAL Model Law
  - (ii) Foreign proceedings
  - (iii) State
3. Under UNCITRAL Model Law, what are the reliefs that may be granted upon recognition of a foreign proceeding under Article 21.
4. What are the world Bank Principles? Why and how these are designed?
5. Chapter 11 of US bankruptcy code is preferred by many corporates based in the US. Discuss.

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PROFESSIONAL PROGRAMME  
CORPORATE RESTRUCTURING, VALUATION AND INSOLVENCY

# PP-CRVI

## TEST PAPERS

### A Guide to CS Students

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"27. Suspension and cancellation of examination results or registration

In the event of any misconduct by a registered student or a candidate enrolled for any examination conducted by the Institute, the Council or the Committee concerned may suo motu or on receipt of a complaint, if it is satisfied that, the misconduct is proved after such investigation as it may deem necessary and after giving such student or candidate an opportunity to state his case, suspend or debar the person from appearing in any one or more examinations, cancel his examination result, or studentship registration, or debar him from future registration as a student, as the case may be.

Explanation - Misconduct for the purpose of this regulation shall mean and include behaviour in a disorderly manner in relation to the Institute or in or near an Examination premises/centre, breach of any regulation, condition, guideline or direction laid down by the Institute, malpractices with regard to postal or oral tuition or resorting to or attempting to resort to unfair means in connection with the writing of any examination conducted by the Institute".

PROFESSIONAL PROGRAMME  
CORPORATE RESTRUCTURING, VALUATION AND INSOLVENCY

TEST PAPER 1

***(This Test Paper is for recapitulate and practice for the students. Students need not to submit responses/answers to this test paper to the Institute.)***

*Time Allowed: 3 hours*

*Maximum Marks: 100*

**PART A (50 Marks)**  
**(Corporate Restructuring)**

1. (a) Comment on the following statements.
  - (i) Cross border mergers are possible in India.
  - (ii) Reduction of capital is external restructuring leading to inorganic growth
  - (iii) Creation of synergies is a challenge in corporate mergers
  - (iv) Raising objections to the scheme of amalgamation is possible, even if the scheme is just and equitable
  - (v) Joint applications to the court by transferor and transferee companies are possible.

*(3 marks each)*
- (b) Competition Act 2002 prescribes thresholds as to combinations. Discuss. *(5 marks)*
2. (a) Promoters did not participate in the buy-back scheme of ABC Limited, a listed company. However, Promoter group shareholding increased from 60% to 76 % post buyback. Do you think this situation attracts Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011? Examine and comment on the situation.
- (b) Discuss the taxation aspects of demerger and slump sale.
- (c) Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 stipulates about interse transfers. Give five examples of interse transfers. *(5 marks each)*

OR

- 2A. (a) In case of taking over of a listed company, draft a suitable Board Resolution with regard to the following .
  - (i) Appointment of a merchant banker
  - (ii) opening of escrow account.

*(5 marks each)*
- (b) Discuss the economic benefits of mergers. *(5 marks)*
3. (a) Discuss broadly, the process involved in Mergers.
- (b) Discuss the stamp duty aspects of amalgamations.
- (c) Discuss the funding options of mergers. *(5 marks each)*

**PART B (30 Marks)**  
**(Valuation)**

4. (a) Discuss briefly how valuation strategies differ under different restructuring plans.
- (b) Explain the regulatory aspects of valuation under SEBI (ICDR) Regulations, 2009.
- (c) What should be the scope of a valuation report? *(5 marks each)*

5. (a) Intangibles can be valued. Discuss.
- (b) Asset Based Valuation and Earning Based Valuation are most popular methods of valuation. Examine.
- (c) Discuss the circumstances requiring valuation of companies. (5 marks each)

**PART C (20 Marks)**  
**(Insolvency)**

6. (a) A company under liquidation owed to the State Excise Department a sum of Rs.1,00,00,000/- towards sales tax, central tax and entry tax dues payable for its production Unit in the State . The Official Liquidator ranked the State Excise Department as preferential creditor. Against this ranking, the State Excise Department in its' appeal contended that in terms of the provisions of the State General Sales Tax Act and Commercial Tax Act, any amount of tax/penalty/interest payable by a dealer or other person under this Act shall be first charge on the property of the dealer or such person and as such he be treated *pari passu* with the secured creditors. Check whether State Excise Department is entitled to be ranked as preferential creditor instead of secured creditor. Give your answer with reference to Sections 529-A, 530, 530 (1)(a) of the Companies Act, 1956.
- (b) Wizard Limited has taken a premises on rent from CRP foreign exchange consultancy limited the land lord of the premises. The lease deed was not registered. Wizard Limited paid a monthly rent of Rs 50,000 for seven months and there after did not pay. The premises was occupied on 1st January 2011. During the period of August 2011 to September 2012, Wizard Limited paid Rs.3,00,000 to CRP Foreign Exchange Consultancy Limited. Wizard limited did not pay to CRP Foreign Exchange Consultancy Limited, the remaining dues, inspite of several reminders. Wizard Limited claims that the facilities provided by CRP Foreign Exchange Consultancy Limited in the leased premises is unsatisfactory. Whether petition by CRP Foreign Exchange Consultancy Limited seeking the winding up of Wizard Limited under Section 433 read with 434 of the Companies Act is tenable? Give reason for your answer.

(10 marks each)

OR

- 6A. (a) Discuss in general, the process involved in Securitisation. (5 marks).
- (b) Discuss the duties of company secretary in case of voluntary winding up of a company. (5 marks)
- (c) Write short notes on the following:
- (i) World Bank Principle for effective Insolvency
- (ii) "Just and Equitable" ground of Winding Up (5 marks each)

**TEST PAPER 2**

***(This Test Paper is for recapitulate and practice for the students. Students need not to submit responses/answers to this test paper to the Institute.)***

*Time Allowed: 3 hours*

*Maximum Marks: 100*

**PART A (50 Marks)**

1. (a) Examine whether the following statements are correct, briefly citing the relevant regulatory provisions.
  - (i) Court cannot refuse to sanction a scheme of arrangement which has been approved by majority of shareholders/creditors of the companies concerned.
  - (ii) The order of court sanctioning the scheme of arrangement is final and effective. Companies need not do anything thereafter in respect of court's sanction.
  - (ii) Amalgamation cannot be sanctioned by the court when the transferee company's objects do not cover business of the transferor company which the former proposes to carry on after the amalgamation.
  - (iv) Amalgamation between two banking companies is governed solely by the Companies Act, 1956.
  - (v) Scheme of amalgamation which is not approved at a meeting by the requisite majority, but is subsequently approved by individual affidavits is deemed to be validly approved. *(2 marks each)*
- (b) State the object and reasons for buy-back of shares. Explain the provisions relating to buy-back of shares through book-building route. *(10 marks each)*
2. (a) Reduction of capital is one of the modes of re-organisation of capital structure of the company. Explain the procedural aspects involved in reduction of capital.
- (b) Discuss various types of approvals required in a scheme of compromise or arrangement.
- (c) Explain 'open offer thresholds' under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 2011. *(5 marks each)*

OR

- 2A. (a) What do you mean by combination? Discuss thresholds for combinations under the Competition Act, 2002. *(8 marks each)*
- (b) Explain the provisions relating to 'escrow' account under SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 2011. *(7 marks)*
3. (a) Minority interest is to be considered in the course of mergers. Do you agree? Explain the same with regulatory provisions. *(5 marks)*
- (b) Leveraged buyout is one of the effective ways of funding mergers. Explain the same with a case study. *(10 marks)*

**PART B (30 Marks)**  
**(Valuation)**

4. (a) Elucidate the principles involved in valuation of business.
- (b) What are the preliminary steps involved in business valuation?

- (c) Explain the provisions relating to valuation of shares, under SEBI (Delisting of Equity Shares) Regulations 2009. *(5 marks each)*
5. (a) How do you value securities issued under Employee Stock Option Scheme?
- (b) SEBI (ICDR) Regulations, 2009 prescribes valuation methods for initial public offer of securities. Discuss.
- (c) How do you value the shares issued to a person residing outside India? *(5 marks each)*

**PART C (20 Marks)**  
**(Insolvency)**

6. (a) Discuss the types of bankruptcy cases provided under US Bankruptcy code. Explain the provisions of Chapter 11 of US Bankruptcy code.
- (b) The "Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002" was challenged in various courts. Discuss the constitutional validity of the Act? *(10 marks each)*

OR

- 6A (a) Who do you think is a contributory? When a contributory can file a winding up petition?
- (b) Explain with case laws, the immunities provided to a sick industrial company under the Sick Industrial Companies (Special Provisions) Act, 1985. *(10 marks each)*

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