Mergers & Acquisitions under the Companies Act, 2013: A Critical Analysis

On 7th December 2016 the Ministry of Corporate Affairs notified 90 sections of the Companies Act, 2013 and these were made effective from 15th December, 2016. These sections also include provisions on Compromises, Arrangements and Amalgamations provided under Chapter XV (Sections 230- 240). In this article, the author attempts to analyse the impact of those provisions of the Companies Act, 2013 that relate to mergers and acquisitions. In doing so, firstly an analysis has been made on the concepts that have been modified under the new Act and then, a comparison has been made with similar provisions under the old Act, and secondly, certain new concepts relating to mergers and acquisitions have been analysed that were introduced under the new Act. Read on…

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Background

Introduction of Companies Act, 2013 was a landmark event in the history of corporate laws of India. Companies Act, 2013 as introduced, contained 29 chapters, 479 clauses and 7 schedules. Since then, the Ministry of Corporate Affairs has made a phased transition from the Companies Act, 1956 to the new Act. On 7th December 2016, the Ministry of Corporate Affairs notified 90 Sections of the Companies Act, 2013, which were made effective from 15th December 2016. These Sections

also include the provisions on *Compromises, Arrangements and Amalgamations* provided under the Chapter XV (Sections 230- 240). Further, Companies (Compromises, Arrangements and Amalgamations) Rules, 2016 were also notified, which got effective from 15th December 2016. Also, Section 434(1)(c) was also notified, which provides for the transfer of proceedings under the 1956 Act, pending before any District or High Court to the relevant bench of the National Company Law Tribunal.

Companies Act, 2013 defines 'merger' as a combination of two or more entities into one; the desired effect being not just the accumulation of assets and liabilities of the distinct entities, but organization of such entity into one business.

Let us analyse the impact of new provisions of the Companies Act, 2013 relating to the mergers and acquisitions. We will first analyse the concepts that have been modified under the new Act and compare those with similar provisions under the old Act. Then, we will also analyse certain new concepts related to mergers and acquisitions introduced under the new Act.

Companies Act, 1956 vis-à-vis Companies Act, 2013: A Comparison

1. Reverse Mergers and Companies Act, 2013, Section 232(3)(h)

Reverse Mergers have been largely used by private companies as a method to become public instead of opting for the traditional Initial Public Offering (IPO) method. The term 'Reverse Mergers' has not been statutorily defined either under the old Act or the 2013 Act. In simple terms, when an active private company merges with a dormant public company, it is called a reverse merger wherein the private entity buys majority of the shares of the publicly listed company after which both merge.[1] Here, the private company is a healthy company which merges with a financially weak public company. The public company is usually a shell company which does not have real assets or net worth.

In India, the case of *Bihari Mills Ltd., In Re Maneklal Harilal Spinning and Manufacturing Company Ltd. (1985) 58 Comp Cas 6 (Guj).*, was the first precedent where the Gujarat High Court laid down certain parameters to be satisfied before an arrangement could be termed as a Reverse Merger:

1) If the value of the assets of the healthy company exceeds the value of the loss making or less profit-making company.
2) If the net profits (after deducting all charges except taxation and excluding extraordinary items) attributable to the assets of healthy company exceed those of loss making or less profit making company.
3) If the aggregate value of the consideration being issued by loss making or less profit making company exceeds the value of the net assets of healthy company.
4) If the equity capital to be issued by loss making or less profit making company as consideration for the acquisition exceeds the amount of the equity share capital of loss making or less profit making company prior to the acquisition or
5) If the issue of shares in loss making or less profit making company would result in a change in control of loss making or less profit making company through the introduction of a minority holder or group of holders.

Under the Companies Act, 1956, there were no specific provisions for reverse mergers.[2] It was dealt with under Section 394 read with Section 391, which also governed other mergers and like any other merger, it was carried out through the process of obtaining approval from a High Court. Under the Companies Act, 2013, Section 232(3)(h) deals with the same although it does not use the term 'reverse merger'. *Section 232(3)(h) of Companies Act, 2013:* The Tribunal, after satisfying itself that the procedure

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[1] *What Is Reverse Merger And How Do Companies Gain From It, July 18, 2016, available at: www.moneycontrol.com*
[2] *PWC, Notification of Various Sections under the Companies Act, 2013, 15th December, 2016.*

specified in sub-sections (1) and (2) has been complied with, may, by order, sanction the compromise or arrangement or by a subsequent order, make provision for the following matters, namely:

where the transferor company is a listed company and the transferee company is an unlisted company,—

(A) the transferee company shall remain an unlisted company until it becomes a listed company;

(B) if shareholders of the transferor company decide to opt out of the transferee company, provision shall be made for payment of the value of shares held by them and other benefits in accordance with a pre-determined price formula or after a valuation is made, and the arrangements under this provision may be made by the Tribunal:

Provided that the amount of payment or valuation under this clause for any share shall not be less than what has been specified by the Securities and Exchange Board under any regulations framed by it;

Thus, the changes introduced under the 2013 Act are:

- Exit option to shareholders of listed company in case of merger where transferor is listed company and transferee is unlisted company.
- Shareholders deciding to opt out of the transferee company to be paid the value of their shares and other benefits on the basis of a pre-determined formula or after a valuation process.
- No automatic listing of the resulting entity, unless it goes through the process of listing.
- Compliance with the valuation requirements as laid down by the Securities and Exchange Board of India

The issues that may arise under the new provisions related to Reverse Mergers are:

- Absence of specific rules for determining consideration to be paid to shareholders of a company exiting in case of a reverse merger.

In the case of *In Re: M/s Indrama Investment Pvt. Ltd., M/s Select Holiday Resorts Ltd., CAPT. Swadesh Kumar and CAPT. RAM Kohl,* as decided on 12th June 2012, while deciding the value of shares in a reverse merger, it has been held that further events that had taken place after amalgamation and circumstances under which profitability of company had increased could not be relevant consideration for valuation of shares or to judge profitability of company at time when decision for amalgamation was taken for stake holders.

- The term "other benefits" to be paid to the shareholders along with the value of their shares in case of exit during reverse merger, is ambiguous. What constitutes other benefits is not defined. Here, the company may misuse this provision by giving disproportionate benefits as the term is very wide in scope and similarly the provision may be used to the shareholders to demand certain extra benefits which otherwise they would not be entitled to.
- Now, as the reverse merger will not lead to automatic listing of the resulting entity unless it goes through the process of a listing through a public offering, this may be misused to cause a delisting and needs clarification from MCA. Guidelines in this regard are required as to whether such a provision can be used as an alternative or an addition to the Delisting Regulations.

2. Minimum Threshold to Object to Compromise/ Arrangement

Under the Companies Act, 1956 there were no specific threshold limits to object to a scheme of compromise or arrangement. Companies Act, 2013 specifies certain threshold requirements to object to a scheme.[3] *Proviso* to Section 230(4) of the 2013 Act stipulates the minimum criteria to raise any objections.

Proviso to Section 230(4) of Companies Act, 2013: Provided that any objection to the compromise or arrangement shall be made only by persons holding not less than ten per cent. of the shareholding or having outstanding debt amounting to not less than five per cent of the total outstanding debt as per the latest audited financial statement.

Thus, the changes introduced under the 2013 Act are:

- In the case of members, objections can be raised only be persons holding not less than ten percent of the shareholding.

[3] *Grant Thornton India, LLP, "Implications of Companies Act, 2013, Mergers and Amalgamations".*

- In case of creditors, objections can be raised by creditors holding not less than five percent of the total outstanding debt as per the latest audited financial statements.
- The objection is to be conveyed to the chairperson of the meeting within 30 days of receipt of the notice of the meeting.
- However, under the 2013 Act, the National Company Law Tribunal ("NCLT") may dispense with the requirement for calling a meeting of the creditors if the creditors representing at least 90% in value of the total outstanding debt consent to the same by way of an affidavit.

Under the 1956 Act, the tribunal in sanctioning a compromise or arrangement could take cognizance of and make provision for any persons dissenting from the compromise or arrangement, which raised the possibility of frivolous objections.[4] In the case of *Astorn Research v. Respondents*[5], the High Court of Gujarat held that where the status of the objector as a creditor was not only doubtful but was also disputed and even if it was presumed, it was less than even minimal for which the objector has other remedy under law and, therefore, on such ground the scheme cannot be halted.

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In the case of In *Re: Larsen and Toubro Limited*[6] it has been held that a few shareholders cannot oppose such scheme of arrangement, which has been passed by majority of shareholders and unanimously by the creditors or unsecured creditors. The burden is heavy on such objectors, to prove otherwise, with material and evidence on record. Mere vague and bald averments are not sufficient. In this background, the court cannot unveil the companies' corporate veil and their commercial wisdom and make the scheme of arrangement, unworkable or delay its implementation, specially when the scheme has been widely advertised and approved by an overwhelming majority and in the absence of even another possible view of the matter.

In the case of In *Re: Reliance Communications Limited*[7] where the objections were made by the Regional Director and a shareholder holding 10 equity shares in RCom, the Court overruled such objections terming them as utterly frivolous.

These problems have been done away with by providing for the above mentioned thresholds which are applicable to creditors (5%) and shareholders (10%). Shareholders/ creditors having miniscule shareholding or a minimum lending cannot delay or abuse the process of approving a scheme. However, a problem may arise where the meeting has been dispensed with consent of 90% creditors by the NCLT and there may not be a forum for the objecting 5% creditors to raise objections.

3. Cross-Border Mergers under Companies Act, 2013

On 13th April 2017, the MCA notified Section 234 of the Companies Act, 2013 which permits cross border mergers. Also, Rule 25A of the Companies (Compromises, Arrangements and Amalgamations) Amendment Rules, 2017 deals with the Merger or amalgamation of a foreign company with a Company and *vice versa*. Under the Companies Act, 1956, the merging a foreign company with an Indian company was allowed while the merging of an Indian Company with a foreign company was not possible since the definition of the transferee company under Section 394(4)(b) of the 1956 Act was defined to mean only 'company incorporated under the Act.'[8]

Section 234 of Companies Act, 2013: (1) The provisions of this Chapter unless otherwise provided under any other law for the time being in force, shall apply mutatis mutandis to schemes of mergers and amalgamations between companies registered under this Act and companies incorporated in the jurisdictions of such countries as may be notified from time to time by the Central Government.

[4] *CS NPS Chawla, Case Studies and Practical Aspects of Mergers and Demergers, available at: https://www.icsi.edu/portals/70/EDSG29062013.pdf.*
[5] *Astorn Research v. Respondents,on 31st July, 2012, Gujarat HC.*
[6] *In Re: Larsen and Toubro Limited (2004) 3 CompLJ 304 Bom.*
[7] *In Re: Reliance Communications Limited, decided on 7th October, 2016.*
[8] *Kamal Preet Kaur, Merger Regime under the Companies Act, 2013, PSA Legal, January 2014.*

Thus, changes introduced under the 2013 Act are:

- Outbound mergers are now permitted (i.e. an Indian company can merge into a body corporate incorporated in notified countries outside India) under the 2013 Act with the prior approval of RBI.
- The 2013 Act restricts cross border mergers to certain specified territories.
- The Section further provides authority to the Central Government to make rules in consultation with the Reserve Bank of India for such mergers and amalgamations.
- Such cross-border mergers are also subject to any other law for the time being in force.
- The Foreign Company in both cases would require the prior approval of the Reserve Bank of India.

Issues that may arise under this Section are:

- To ensure full benefit of this provision it is important to ensure that the list of countries covers all jurisdictions relevant for Indian business and is notified along with the notification of this section.
- Corresponding amendments are required in related laws including the Income Tax Act, Exchange Control Regulations security related laws (change in rules regarding dual listings), etc.

4. Abolition of Treasury Stock

Another key change introduced under the 2013 Act is the abolition of treasury stock. Section 77 of the Companies Act, 1956 specifically restricted a company from issuing shares to itself or through its own holding company. However, the proviso to the Section allowed a company to purchase, or subscribe to fully paid shares in itself or its holding company where the subscription is by trustees or to be held by or for the benefit of employees of the company, including any director holding a salaries office or employment in the company.[9] The advantage of transferring shares to a trust is that these shares can be sold in open market or by private arrangement. Several big companies have used this method in intra-group mergers.[10] Treasury stocks were utilized by companies to control voting rights and manage cash flows.

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Section 233(10) of Companies Act, 2013: "A transferee company shall not on merger or amalgamation, hold any shares in its own name or in the name of any trust, either on its behalf or on behalf of any of its subsidiary or associate company, and all such shares shall be cancelled or extinguished on the merger or amalgamation,"

Thus, Companies are now prohibited from holding shares in their own name or in the name of any trust. The new provision negates the advantage utilized by companies to indirectly hold shares to provide it access to voting power and/or liquidity. This is in line with the object of the new legislation to enable increased transparency and accountability in the corporate sector.

Issues that may arise under the new provision are:

- Treatment of treasury stock holdings already created under the 1956 Act in the future -whether they can continue in the same manner or they need to be abolished.
- Complete abolition of treasury stock may not be absolutely advantageous. Instead such shares could have been subjected to certain strict terms and conditions. This is because treasury shares have certain advantages also like incentive to employees, protection against hostile takeovers.

New Concepts Introduced under Companies Act, 2013

1. Regulatory Approvals for Scheme of Compromise/ Arrangement [Section 230(5)]

[9] *Mahafrin Sidhwa, Treasury Stock – A Dying Enigma, June 19, 2013, available at: http://www.jsalaw.com/wp-content/uploads/2015/09/Treasury-Stock-A-Dying-Enigma-_2_.pdf.*

[10] *ICSI, Corporate Restructuring, Valuations & Insolvency, available at https://www.icsi.edu/WebModules/PP_CRVI_FULL_BOOK_AGUST_26_2016.pdf*

The 2013 Act provides that the notice of scheme and documents to be circulated to regulators (Income Tax, Reserve Bank of India, SEBI, Competition Commission of India (if necessary)) and the regulators shall respond within 30 days from the date of receipt of notice, failing which, it shall be presumed that they have no representations to make on the proposals.[11]

Issues that may arise under the new provisions are:

- Is the notice required to be given to offshore regulators and self regulatory bodies.
- Whether the period of 30 days for regulators to make objections will continue to apply or extend if regulators request for additional information.
- If the scheme is not objected to by those affected, can regulatory bodies still object to such scheme?

In the case of *In Re: Novopan India Limited; In Re: G.V.K. Hotels Ltd.*[12] where the scheme of Reverse Merger had been approved in the general meeting unanimously and the creditors had given their consent, whether the objections raised by Registrar of Companies (ROC) and Central Government contending that scheme of amalgamation contains reduction of capital by way of arrangement between company and members is sustainable, it was held that the objections raised by the Registrar of Companies on behalf of the Central Government, therefore, do not come in the way, in sanctioning the scheme. Thus, this provision may prove to be both a boon and a bane, as it contemplates the involvement of all Central and State authorities.

2. Fast Track Mergers under Companies Act, 2013 (Section 233)

Under the 1956 Act, all mergers and amalgamations required court approval. The 2013 Act provides that mergers and amalgamations between two or more small companies or between holding companies and its wholly-owned subsidiary (or between such companies as may be prescribed) does not require court approval. However, notice has to be issued to ROC and official liquidator and objections / suggestions has to be placed before the members. The 2013 Act enables mergers or amalgamations between two or more small companies and between a holding company and its wholly owned subsidiary without being referred to NCLT for approval subject to the approvals obtained from (i) Members or class of members holding 90% of the total number of shares and (ii) Majority representing 9/10th in value of creditors or class of creditors.

This is a beneficial provision for speedy mergers or amalgamations of small companies inter se, and between a holding company and its wholly owned subsidiary. This will reduce the time consumed in court proceedings, result in faster disposal of the matter and help in removal of bureaucratic barriers involved in court proceedings.

Issues that may arise in this process are:

- Provisions relating to valuation by Registered Valuer are not specified.
- It is not clear as to which person is to be considered as affected by the scheme for giving the notice.
- Lack of clarity as to the impact of objections if any.
- It is not clear if a merger between a small company in India and a small company in foreign jurisdiction may avail the exemption, given the definition of company.

3. Squeeze Out Provisions (Section 236)

Under the 2013 Act, an acquirer or person(s) acting in concert (as defined in the 1997 Takeover Code (now repealed) with such acquirer and holding 90% or more of issued equity share capital of a company shall have an option to offer to buy the remaining equity shares of the company.[13] Similarly, minority shareholders have an option to offer their shares to such majority shareholders. The purchase price of such sale/ purchase has to be determined by a registered valuer in accordance with prescribed valuation rules.

Previously, implementing "minority squeeze out" was a difficult task given the stringent rules that applied to voluntary squeeze out under the Companies Act, 1956. While the new law retains the provision for voluntary squeeze-out, it also provides for mandatory minority squeeze out, subject to appropriate shareholders resolutions.

[11] *Deepak Verma, A study of Mergers & Acquisitions with Provisions under the Companies Act, 2013, UNI Journal of Research, Vol. 2(3), March (2015).*
[12] *In Re: Novopan India Limited; In Re: G.V.K. Hotels Ltd. [1997] 14 SCL 233 (AP).*
[13] *Supra note 12.*

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shareholders. Unlike Section 235 of the 2013 Act which will apply only when there is dissenting minority shareholder, Section 236 is available to the minority as a whole.

Persons acting in concert: It is a well settled legal principle that the question of whether or not two persons are persons acting in concert is a question of fact, to be answered after evaluating the facts and circumstances of each case [*Hitachi Home and Life Solutions Inc v. SEBI* (SAT Order dated July 6, 2005)]. The test under Regulation 2(1)(q)(1) of the SEBI (Substantial Acquisition of Shares and Takeover) Regulations, 2005 has to be applied to each case to find out if the alleged persons are PACs in fact.

The issues that may arise under the new provisions are:

- The option to acquire shares or exit under this Section is available only in respect of equity shares, and not in case of preference shares and other securities.
- Minority shareholders have no statutory right to participate in the price discovery process and the company squeeze them out without their consent.

Conclusion

The new notified sections are going to bring a paradigm shift in the way corporate restructuring is done in India. The new provisions seek to streamline the process and make it more transparent. Further, the jurisdiction of NCLT over these matters will speed up the entire process and also provide uniformity. The 2013 Act has provided statutory force to many of the corporate restructuring practices that were in practice earlier through judicial approval. ■

I destroy my enemies when I make them my friends. - Abraham Lincoln