January, 2006

Approval of a Scheme for Mergers Is it a Legal Barrier?

Narsimha Rao A.V
Approval of a Scheme for Mergers
Is it a Legal Barrier?

A V Narsimha Rao*

Mergers and acquisitions of companies should comply with the provisions of the Companies Act, 1956. According to the Act, the approval of the scheme of mergers by the court has been made mandatory.

The pace of mergers and acquisitions has augmented after the liberalization of economy and the globalization of the business. On par with the global corporate scenario, the Indian corporate environment has become vibrant with increased proposals for corporate integrations. The forces which triggers the pace of the corporate integration by way of mergers and acquisitions are accelerated changes in the technical know-how, availability of cost-effective communication systems, globalization of market places, emergence of new specific sectors in the industries and services front, easing of regulatory systems, adopting of international standards of accounting practices, and valuation of assets, as well as international bilateral and multilateral agreements and treaties.

The Scheme of Mergers and Acquisitions

A merger is the fusion of two or more companies resulting in the formation of a single company which acquires the assets and liabilities of the target companies. Mergers may be horizontal or vertical. The horizontal merger involves companies in the same class of business and the vertical merger takes place among the companies in different classes and stages of the businesses. Whatever be the type of the merger, the basic ingredient is the consensus of the people concerned to the companies involved therein. Free consent of the parties under the framework of the law of the land is the essential requirement of the merger. The formalities of negotiations for consent are initiated among the parties involved. The protection of members' interests is the ultimate objective of the negotiations and the consent for mergers is only possible when the integration of the interests of the members of all companies involved in the process, is arrived at without leaving any ground for abuse of compulsions. Integration of the companies at every stage and every aspect, whether it may be horizontal or vertical merger, is essential. The consensus and understandings in the negotiations are transformed into well-defined terms of references, generally known as "the scheme of mergers and acquisitions".

Mergers of companies involve the strategic integration of businesses within the ambit of existing legal regime of the land. The integration of the companies throws up issues like understanding the need for the merger and acquisitions, structure of the companies along with their strategic visions and policies, and other important issues relating to acquisition of stocks, assets, human resources of the companies involved in the mergers, and also formulating new policies for the newly formulated company. The process concentrates on the transfer of technical

* Faculty Member, Academic Wing (Law), ICFAI, Hyderabad. He can be reached at avnrao@icfai.org

© 2006 The ICFAI University Press. All Rights Reserved.
know-how, human competencies, financial assets, and organizational systems. The entire gamut of these issues should be looked into in the context of existing law of the land. The cross-boundary mergers further throw the challenges of international legal regime. Thus, the scheme of merger contains terms and conditions duly agreed to integrate the companies.

The process of mergers poses critical challenges before the people involved in the process of arriving at the consensus. Because of failures in arriving at the consensus of integration of some of the aspects of the companies, many processes of mergers have ended up in midway. Some of the important causes for failure of transformation of mergers are the failure to apply due diligence process in integrating the policies and visions of companies, business environments, and the cultures of companies and of the people involved—the employers, employees, suppliers, consumers, etc. Another significant contribution for failure is the slow and complex nature of the process. In India, the entire activities of mergers are being undertaken with the approval of the courts and Registrar of Companies, and approval of scheme by the courts is the trigger of a merger. Delays caused by the processes adopted by the court while approving the scheme of mergers are also cited as a reason for failure of the mergers. In the US, the mergers and acquisitions are processed under the supervision of the Department of Justice and the Federal Trade Commission.

Mergers and Acquisitions: Legal Dimensions

Mergers and acquisitions are nothing but contracts between the companies to integrate them to formulate either a new company or to integrate one into another existing firm. During the mergers, the parties negotiate how relative values and ownership of the company in terms of stocks, assets, and human competencies, are to be translated into the newly formed company. Negotiations result in mutual consent, and the facts and figures that arise from the negotiations are translated into a letter of intent in the first stage, and later, it takes a shape of contract. The scheme of the merger contains a contract about the consensus on various issues such as the integration of vision and mission of the companies, valuation of stocks and assets, disclosures by the parties, transfer of employees and their benefits, integration of intellectual properties of the companies and their transfer of ownership, environmental issues, warranties and covenants, payment of compensations to suppliers and creditors, indemnification provisions, etc. The contract should have all the above-stated information, along with the clauses for future performances.

The contract should also have provisions to deal with the possible issues cropping up at the time of closing down the companies and address the post-closure issues. The provisions of Indian Contract Act, 1872, are applied to find out whether there is legal and binding contract between the parties or not. The contract binds the parties, creates rights and obligations among the parties. In addition to the law of contracts, other statutes such as the Companies Act, 1956, Securities and Exchange Board of India Act, 1992, SEBI (Substantial Acquisitions of Shares and Takeovers) Regulations Act, 1997 (amended up-to-date), and the Income Tax Act, 1961, regulates the mergers and acquisitions. The provisions of the Companies Act, 1956, play an important role in effecting the mergers and acquisitions of the companies.

The Companies Act, 1956 and Mergers

Sections 391 to 396 of the Companies Act, 1956, contain the provisions which regulate the process of mergers and acquisitions. According to the provisions of the Companies Act, the approval of the scheme of mergers by the court is mandatory. Without the approval of the court, the scheme cannot be implemented. The scheme of mergers and acquisition is nothing but a blueprint of

1 Section 391 of the Companies Act 1956.
approved terms, conditions, and understandings amongst the target companies to join the companies either to form a new company or integrate into one of the existing target companies. Once the consensus among the companies proposed to merge is arrived at, it has to be drafted and placed before the Board of Directors of the respective companies for approval. In addition to it, approval has to be obtained from the financial institutions including the banks, trustees of debenture holders, stock exchanges, and the members of the companies.

Once the approval has been obtained, an application has to be made to the High Court having the jurisdiction for grant of permission. The Court issues directions to conduct the meeting of the members and other interested parties either by giving individual notices to the members or by a publication in the newspaper. The meeting should pass a resolution with 3/4th majority, and the chairman of the meeting should sign the resolution and submit to the court stating the facts of the approval of the scheme. The companies involved in the scheme have to submit an application to the Court. After hearing the petition, if satisfied, the Court passes an order approving the merger of the companies. The order has to be registered with the Registrar of Companies (RoC). Failure to register the order with the RoC, will vitiating the process of mergers. Mergers cannot be effected without the registration. But once the registration is made, the scheme of mergers is effective from the date stated in the Court’s order and if the court does not mention the date, it will be a date stated in the scheme. “Once a scheme is sanctioned by a court by passing an order under sections 391 and 394 of the Companies Act, 1956, the sanction relates back to the date on which the scheme was to come into operation as provided in the scheme.”

The objective of the approval of scheme of mergers by the court is to protect the interests of the people and stakeholders. The court examines the scheme presented before it by the companies, to understand as to what extent the scheme is advantageous to the members of the company and others. Once the court is satisfied, it grants approval to the scheme, otherwise the proposal of merging companies is stayed. Without the approval of Court, no merger takes place even though all the parties to the proposal accepts and are interested. There should not be any procedural lapses in conducting the meetings of the members, creditors, suppliers, and other parties having an interest in the companies. Once the court is of the opinion that the scheme proposed is in the interest of the shareholders, creditors, workmen, and public, it grants the scheme of mergers.

Approval of the Scheme: Some Issues

The approval of scheme of mergers is mandatory for effecting the fusion of the companies. But, in the prelude to the approval, companies face a number of challenges like arriving at the consensus among the companies participating in the process. Unless the members of each company are satisfied with the benefits they derive from the mergers, they will not be interested in passing a resolution approving the merger in a meeting conducted for the purpose. The other important challenge is to convince the employees of the companies. The working cultures of the companies as well as the compensation packages and benefits enjoyed by the employees, differ from one company to another. It is very difficult to integrate the interests of all the employees of all companies involved in the merger action at one point. Unless it is a compulsion for the employees and no other alternative is available, they will not agree to the new terms and failure to get their consensus is a hurdle for the court sanction of the scheme. The third challenge before the companies is to consolidate and convince the creditors. The creditors may be the debenture holders or the financial institutions including banks. Under no circumstances would they prefer...
to loose their investment. As such, it is difficult to convene a meeting of creditors and conclude it on a positive note. Only a ray of hope in such a scenario would be the better prospects of the proposed company that arise out of the mergers.

Designing the scheme of mergers has another basic problem: The valuation of the assets and stocks of the companies involved. The valuation of the assets varies from place to place, time to time, based upon the demand-and-supply theory. Different companies adopt different accounting methods and valuation methods. Unification of systems, methods, models of accounts, and valuation, poses a challenge because the court will not accept the scheme without a proper valuation of the assets. The best example of this problem could be found in the proposed merger of Global Trust Bank with the UTI Bank. Valuation of intellectual property is another area of dispute. Capitalization of the expenditure in the research development is another challenge as it is a present expenditure for future benefits.

In addition to these challenges, the time taken for arriving at the consensus is very long. It may run into years. Even after filing a petition with the court, the time taken for other activities like conducting the meetings, is also very lengthy. As a result, the keenness in arriving at the consensus will become stale and parties may not be interested thereafter. The delays in the process of mergers certainly discourage the mergers because the target companies lose time, money, output, and benefits during the process. The employees may not be interested under the changed circumstances and unrest may prevail. Though the companies may succeed in getting the approval from the court, by the time the approval comes, there may be a new business environment and that may cause concern in the minds of the people involved whether to continue the process of the mergers or not.

**Irani Panel on Mergers and Acquisitions**

In order to promote the mergers and acquisitions, which are felt to be drivers of the economy, the Government of India has appointed an Expert Committee on Company Law under the Chairmanship of JJ Irani on December 2, 2004. The panel was asked to examine the causes for delay in effecting mergers, to explore solutions to minimize the court sanctions, and to inculcate the international best practices to encourage cross-border mergers. The Committee submitted its report on May 31, 2005.

The panel has recognized the significance of the time factor in mergers and acquisitions and understood the delays that are taking place in the Indian corporate scenario in relation to the provisions of Section 391 of the Companies Act, 1956, i.e., the approval of the scheme of merger by the courts. The panel suggested that the mergers should be completed fast with the help of digital technology. It recommended that the contractual mergers should also be recognized, in addition to the statutory mergers as provided under sections 391 to 394 of the Companies Act. A contractual merger, which is a result of the consensus among the parties to the process, whether it is a short form or long form, should be recognized to avoid delays caused by the compliance of legal compulsions without the interventions of the courts. It will help remove the avoidable delays in the mergers.

The Panel also recommended the filing of the consents of members, creditors, and financial institutions, instead of conducting the class meetings for passing resolutions to express their consents. It proposed the introduction of electronic registers to file schemes of mergers under sections 391 to 394 to avoid the delays in communication, and the amendment of relevant legislations to facilitate the same. It will help avoid the complexities relating to the stamp duties, and establishes uniformity and cost-effectiveness. The panel also recommended the removal of the problems relating the merger of listed companies with that of unlisted companies. It further proposed to simplify the requirement of approval of the scheme by a special majority.
Conclusion

It is an unequivocal feeling in the minds of the people that the legal procedures in India are more time consuming, complex, and cumbersome. But, these proved to be the best tools in testing times to protect the interests of the people involved therein. In the sphere of company mergers, the ultimate objective of the courts is to protect the members, stakeholders, and other persons involved, from intentional and unintentional frauds committed by the majority of the members driving the companies. The innocent and helpless minority members should be protected from the magical displays of prowess by the corporate stalwarts. Paying too much attention to this process of protecting the minority members may, sometimes, place hurdles and delays in taking decisions. It does not mean that the law is playing with the interests of the people moving for the mergers with good faith. The inconveniences that are faced by the parties and delays can be reduced by opting for good governance. The recommendations made by the Irani Panel will certainly help bringing in good governance in the corporate world, particularly in the process of mergers and acquisition. In addition to the existing system of approving the scheme by the courts before the companies merge, the law should also permit the contractual mergers without the interference of the courts. The courts may come into picture only when a contractual merger is questioned in the court on the terms of fraud, misrepresentation or protection of the interests of minority shareholder rights. With the help of fast-track courts and simplified provisions of company law, law appears to be the savior of the common people who invest their hard earned money in the companies.

Reference # 02M - 2006-01-06-01

Press Note 18 replaced by Press Note 1

The government on Wednesday scrapped Press Note 18, through which Indian businessmen have for years held foreign companies to ransom. Instead, Press Note 1, under which Indian firms must deal with their joint ventures (JVs) with foreign firms on their own steam, comes into force with immediate effect.

Press Note 18 was a provision by which foreign companies entering into a JV with an Indian company needed to get a “no objection” from their Indian partner before they set up another JV with a new partner or even a 100% owned company in the country. The provision was misused by Indian promoters who arm-twisted their foreign partners, even if their own JVs were languishing or defunct. The provision was seen as a severe disincentive by foreign companies to align with Indian partners with a majority stake in the JV and was an impediment to FDI inflow.

“A perception has grown that Press Note 18 is standing in the way of FDI. I do not entirely agree with this view. However, since the government wishes to make crystal clear its intention of facilitating FDI. Therefore, it has been decided to substantially modify the applicability of Press Note 18,” Commerce and Industry Minister Kamal Nath said. His statement also reveals the difference within the government on the issue, with the finance ministry pressing for its abolition while the commerce ministry was seeking its continuance.

Despite the scrapping of Press Note 18, the government has stopped short of going all the way. Several provisions of Press Note 18 will apply to the existing Indian-foreign JVs, though with substantial changes. For one, under Press Note 1, foreign firms will not need permission from Indian partners before setting up a business in a related field. They will, however, need permission if they are setting up a business in the same field as their Indian JV.
