Conceptual Framework: Mergers and Acquisitions

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INTRODUCTION

Business is subject to number of competitions forced by various factors like the bargaining power of suppliers and buyers, the threat of new entrants, the threat of substitute products and services and rivalry among the existing competitors. In all these situations the main objective of any company is profitable growth of enterprise to maximize the wealth of its shareholders. Further, to achieve profitable growth of business it is necessary for any company to limit competition, solve the problem of slow growth, to gain economies of large scale and increase in income with proportionally less investment, to establish a trans-national bridgehead without excessive start-up cost to gain access to foreign market, to achieve diversification and utilize underutilized market opportunities. Due to numerous and fast economical developments, and rapid regulatory changes, it become indispensable for even small companies to grow up rapidly without using large resources like new technology, upgraded plant and machinery, least knowledge updating to achieve effective reduction in cost and saving in time. In order to achieve goals, business needs to remain competitive and work towards its long term sustainability. Fuehrer, the liberalization and consequent globalization has resulted into tough competition not only in Indian business market but globally as well.

In response to these pressures, an increasing number of companies around the world are dramatically restructuring their assets, operations and contractual relationships with shareholders, creditors, and other financial stakeholders. Corporate restructuring has facilitated thousand
of companies to re-establish their competitive advantage and respond more quickly and effectively to new opportunities and unexpected challenges. Corporate restructuring has had an equally profound impact on the many more thousands of suppliers, customers and competitors that do business with restricted companies. In a rapidly changing world, companies are facing unprecedented turmoil in global markets. Several competition, rapid technological change, and rising stock market volatility have increased the burden on companies to deliver superior performance and value for their shareholders.

Generally most of the corporate growth occurs by internal expansion, when a company’s existing divisions grow through normal capital budgeting activities. Nevertheless, if the goals are easily achieved within the company, it may mean that the goals are too small. Growth opportunities come in a variety of other forms and a great deal of energy and resources may be wasted if an entrepreneur does not wait long enough to identify the various dynamic which are already in place.

Under different dynamic situations as laid above, a profitable growth of business can achieved successfully if as a strategic tool merger is adopted. The most remarkable examples of growth and often the largest increases in stock prices are a result of mergers and acquisitions. M&A’s provide tremendous opportunities for companies to grow and add value to stake holder’s wealth. M&A’s increase value and efficiency and thereby increase holders value. M&A’s is a generic term used to represent many different types of corporate restructuring exercises.
However, as every coin has second side potential gainful merger activity do fail for varied reasons such as failing to anticipate and define problem, failing to attempt or success in solving problem. Merger activity is also subject to certain challenges like due diligence, cultural factors, implementation and integration.

In order to avoid difficulties it is necessary to carry out initial investigation in various areas like growth potential, profitability, strength in terms of skills and capabilities, financial projections of the impact and value of merger, etc., need to be systematically thought out and planned.

The profitable growth of the business can be achieved “internally” by developing and introducing new products or by expansion of capacity of existing product(s). However, under different dynamic situations like fast economical changes, technological developments, rapid regulatory changes and emergence of new competitive factors merger as external strategic tool for profitable growth of business is gaining popularity, resulted into merger activity rose to unprecedented levels since last few decades.

The main objective of any merger activity is profitable growth of business to maximize wealth of its stakeholders. The trend towards globalization of all national and regional economies has increased the intensity of mergers, in a bid to create more focused, competitive, viable larger players, in each industry. If an industrial want to survive, it has to excel and compete successfully both with multinational competitors in internal as well as international markets. Merger of companies are implicit in free enterprise system because of their obvious advantages
infusion of better management and healthy growth of capital market. Thus, the concept of merger has assumed greater significance as offering number of opportunities, especially in the context of the ongoing program of liberalization and globalization.

The present chapter purports to discuss the conceptual framework of mergers and acquisitions (Mass) within the board parameters of corporate restructuring taking place in India and Abroad with a view to enhance shareholder value. In common parlance, the terms mergers, acquisitions, amalgamations and takeovers are often used interchangeably. However, in different circumstances, some of these terms carry different meanings. So, for the sake of clarity, it is necessary to discuss the meaning of these terms in details.

CORPORATE RESTRUCTURING ACTIVITIES IN INDIA

Restructuring of business is an integral part of the new economic paradigm. As controls and restrictions give way to competition and free trade, restructuring and reorganization become essential. Restructuring usually involves major organizational change such as shift in corporate strategies to meet increased competition or changed market conditions. This activity can take place internally in the form of new investments in plant and machinery (green field investments), research and development at product and process levels, hiving off of non core activities, divestitures, sell offs, demergers act. It can also take place externally through mergers and acquisitions (Mass) by which a may acquire another firm or by forming joint ventures with other firms.
The process of economic liberalization and globalization that swept the Indian economy in 1990’s created a highly competitive business environment forcing Indian companies to restructure their operations. This restructuring process has result in rise in strategies like mergers, acquisitions, takeovers, collaborations, consolidation, diversification etc. Domestic firms have taken steps to consolidate their position to face increasing competitive pressures and MNCs have taken this opportunity to enter Indian Corporate Sector. The different forms of corporate restructuring are summarized in Table 2.1 and explained in brief thereafter.

Table 2.1
Different Forms of Corporate Restructuring

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EXPANSION

Expansion is a form of restructuring, which results in an increase in the size of the company. It may be in the form of merger, amalgamation, absorption, joint venture offer, asset acquisition, tender offer.

Merger

When two or more companies decide to combine their business by forming a single company it is called merger. A merger can take place either as an amalgamation or absorption.

Amalgamation

This involves fusion of two or more companies where the companies lose their individual identity and a new company comes into existence to takeover the business of companies being liquidated.

The merger of Brooke Bond India Limited and Lipton India Limited resulted in formation of a new company Brooke Bond Lipton India Limited. This form of restructuring is mostly applied to combine companies of same size.

Absorption

In absorption, one company purchases the business of another company. This involves fusion of a small company with a large company where the smaller company cases to exist after the merger. In case of merger of HDFC Bank and Times Bank, after the merger Times Bank ceased to exist while HDFC Bank continued in expanded form.
Joint Venture

This involves two or more companies enter into an agreement to provide certain resources for the achievement of particular common business goal. It involves intersection of only a small fraction of the activities of the companies involved and normally for a limited time period. The co-ventures distribute profit earned from joint venture according to pre-arranged ratio companies coming together and forming a new company whose ownership is changed. Generally this strategy is adopted by MNCS to enter into a foreign market. DCM group and DAEWOO MOTORS entered into a joint venture to form DCMDAWEOO LTD to manufacture automobiles in India.

Asset Acquisition

This involves purchasing of assets of another company. The assets may be tangible assets like factory building, plant machinery or intangible like patent and brands.

The acquisition of the cement division of Tata Steel by Lafarge of France. Lafarge acquired only the 1.7 million tone cement plant and its related assets from Tata Steel. The assets being purchased may also be intangible in nature. For example, Coca-Cola purchased soft drinks brands like Thumps Up, Limca, Gold Spot etc. from Parle by paying Rs. 170 crore to Parle. HLL bought the brands of Lakme.

Tender Offer

This involves making a public offer for acquire management control in that company. Takeover by Tata Tea of Consolidated Coffee
Ltd (CCL) is an example of tender offer where more than 50% of shareholders of CCL sold their holding to Tata Tea at the offered price which was more than the investment price.

CONTRACTION

This is a form of restructuring which results in a reduction in the size of the company. It can be in the form of demergers, spin-off, split-ups, equity carve-out, and divestiture or asset sale.

Demergers

Demergers mean split or division of a company. Such divisions may take place for various reasons internal or external. An internal factor generally consists of split in the family rather than lack of competence on the part of management. For example, DCM Ltd. was divided into four separate companies which are being managed by different family members of Late Shriram.

There are generally the following types of demergers:

Spin-offs: This type of demergers involves division of company in which a company distributes all of the shares it own in a subsidiary on a pro-rata basis to its own shareholders. Hence, the shareholders proportional ownership of shares is the same in the new legal subsidiary as well as the parent company. The new company run business independently from the parent company and has its own management. By this way, both the companies’ i.e. holding as well as subsidiary company exist and carry on business. For example, Kotak Mahindra
Capital Finance Ltd formed a subsidiary called Kotak Mahindra Capital Corporation by spinning off its invest division.

Split-Ups: This type of demerger involves the division of the parent company into two or more separate companies where parent company ceases to exit after the demerger and only the new offsprings survive. A split-up involves the creation of new class of stock for each partner operating subsidiaries, paying current shareholders a dividend of each new class of stock and than dissolving the parent company. Stockholders in the new companies may be different as shareholders in the parent company may exchange their stock for stock in one or more of the spin-offs.

The Andhra Pradesh State Electricity Board (APSEB) was split-up in 1999 as part of the Power Sector reforms. The power generation business and the transmission and distribution were transferred to two separate companies called APGENCO and APTRANSO respectively. APSEB ceased to exist as a result of the split-up.

Split-offs: Under this type of demerger a new subsidiary company is to be formed to takeover the operations of an existing division. A part of the shareholders of the parent company receives shares in new company in exchange of shares in parent company. A split-offs does not lead to any cash inflow to the parent company. This results into decrease in the equity size of parent company.

Equity Carve Outs: This is similar to Spin Offs, except that some part of shareholding of this subsidiary is offered to public through a public issue and the parent company continues to enjoy control over the subsidiary company by holding controlling interest in it.
Divestiture: This is a sale of undervalued segment of a company which is non-strategic or unrelated to the core business for cash. The company uses this sale proceeds for investment in potentially higher return opportunities.

Asset Sale: This involves sale of tangible or intangible assets of a company to generate cash. The company may than distribute the cash to its shareholders and go out of its existence or use it to purchase other assets.

CORPORATE CONTROL

A company can also go for restructuring without purchasing new company or selling existing company or part of it. It is by obtaining corporate control over the management of other company. Control is the process by which managers influence other members of company to implement the organizational strategies. Following are various techniques of obtaining corporate control.

Going Private: It refers to transformation of public company into a privately held company. It involves purchase of entire equity interest in a previously public corporation by a small group of investors. Thus, it involves buying back the all outstanding shares from the markets and converting a listed company into a private company by buying back the entire outstanding share from the markets.

Equity Buyback: This involves the company buying its own shares back from the market. This leads to reduction in the equity capital of the company. This, in turn, strengthens the promoter’s controlling position.
by increasing his stake in the equity of the company. It is use as a takeover defense to reduce the number of shares that could be purchased by the potential acquirer. Sterlite industries had proposed a buyback of its shares through the open market to acquire a maximum of 25 percent of the equity.

Anti takeover defenses: With a high level of hostile takeover activity in recent years, takeover defenses, both premature and reactive, have been resorted to by the companies. Premature defenses, also called preventive defenses are employed to prevent a sudden, unexpected hostile bid for gaining control of the company. When preventive takeover defenses are not successful in fending off an unwanted bid, the targets implements post-bid or reactive defenses. These takeover defenses intend to charge the corporate control position of the promoters.

Leveraged buyouts (LBO): This involves rising of capital from the management to acquire a company on the strength of its assets. This is a financing technique where debt is used in a acquisition of a company. The term is often applied to a firm borrowing fund to buy back its stock to convert from a publicly-owned to privately-owned company. A management buyout is a LBO in which managers of the firm to be taken private are also equity investors.

Exchange Offers: It provides one or more classes of securities, the right or option to exchange part or all of their holdings for a different class of securities of the firm.
The terms of exchange offered necessarily involve new securities of greater market value than the pre-exchange offer announcement market value. Exchange offer involves exchanging debt for common stock, which increase leverage, or conversely, exchanging common stock for debt, which decrease leverage. This helps a company to change its capital structure while holding the invest policy unchanged.

Proxy contests: A proxy contents is an attempt by a single shareholder or a group of shareholders to take control or bring about other changes in a company through the use of the proxy mechanism of corporate voting. In a proxy fight, a bidder may attempt to use his or her voting rights and garner the support from the other shareholders to expel the incumbent board or management.

Changes in Ownership Structure: This represent the fourth group of restructuring activities which results in the restructuring the ownership of a company. A company’s ownership structure affects, and is affected by other variables and these variables also influence the market value. These variables include the levels of principal-agents conflicts and information asymmetry and their effects on other variables such as the firm’s operating strategy, dividend policy and capital structure. The various techniques of changing the ownership structure are explained below.

Employee Stock Option Plan (ESOP): An employee stock option plan (ESOP) is a mechanism whereby a company can make tax deductible contribution of cash or stock in to a trust. The assets are allocated the employees and are not taxed until withdrawn by them.
ESOPs are involved in mergers and LBOs in two ways as a financing vehicle for the acquisition of companies, including through LBOs, and as an Anti take over defense.

Master Limited Partnership (MLPs) : A master limited partnership is a type of limited partnership whose shares are publicly trade. The limited partnership interests are divided in to units which trade as shares of common stock. In addition to tradability, it has the advantage of limited liability for the limited partners.

This kind of structure is however not prevalent in our country through there was a move some time back to design necessary regulatory framework for floating such organizations, particularly in the context of divergent needs of IT sector.

MERGER

Background

Indian corporate world has witnessed major changes in the last decade. Thanks to the government’s policy of liberalization and globalization of the Indian economy.

Starting with the opening of the economy the much-needed impetus was rightly described of restructuring. Throughout 1998, most of the firms went ahead- with mergers, acquisitions, sell-offs and spin-offs.

Corporate restructuring activity is so far in the post-liberalization period. Entry of the MNCs in to the country which are eyeing India as a sourcing base particularly in the labor-intensive industries fueled the
domestic industry to focus on their core competencies. This clearly gives the MNCs an edge over the local players. In India, given the upsurge in the restructuring activities the opening up of the economy big business houses in India started formulating strategies so as meet competition from domestic as well as the international players.

As the current wave of mergers in India is the first of its kind, international experience are relied upon to understand the issues relating to mergers in a historical perspective. We don’t really understand why merger activity is so volatile. If mergers are prompted by economic motives at least one of these one of these motives must be “here today and gone tomorrow.”

Indian corporate sector are undergoing structural changes in the post liberalization period. Competitive pressures are high not only due to deregulation but also due to globalization. As a part of the restructuring programmed. Merger has been defined as an arrangement whereby the assets of two or more companies become vested in, or under the control of one company (which mayor may not be one of the original two companies), which has as its shareholders, all or substantially all the shareholders of the two companies. It may also include fusion of two or more companies into another. In a merger, one of the two existing companies merge its identify into another existing company, or one or more of existing companies may form a new company and merge their identities into the new company by transferring their businesses and undertakings including all other assets and liabilities to the new company (i.e. merged company). The shareholders of companies whose
identities have been merged (referred here as merging companies) get substantial shareholding in the merged company based on the share exchange ratio incorporated in the scheme of merger as approved by majority of shareholders of both merged and merging companies.

The situation may be illustrated as under:

There are two companies X and Y which decide to merge:

Option 1: Where X Company mergers into Y Company.
Combined merged company emerges as Y Ltd.

Option 2: Where Y Company mergers into X Company.
Combined merged company emerges as X Ltd.

Option 3: X Company and Y Company both merge to form a new company Z.
Combined merged company emerges as Z Ltd.

Thus, merger is a marriage between two companies of all most of same size. It is thus a combination of two or more companies in which one company remains in existence in its own name and the other ceases to exist as a legal entity. The survivor company acquires assets and liabilities of merged companies. Generally, the company which survives is the buyer which retains its identity and Seller Company is extinguished.

Indian Scenario

During the licensing era, several corporate sectors had indulged in unrelated diversification depending on the availability of the licenses.
The corporate sector thrived in spite of their inefficiencies because the total capacity in the industry was restricted due to licensing. The corporate sectors, over a period to time, become unwieldy conglomerate with a sub optimal portfolio of assorted businesses. The policy of decontrol and liberalization coupled with globalization in the economy has exposed the corporate sector to severe domestic and global competition. This has been further accentuated by the recessionary trend which resulted in falling demand, which in turn resulted in over capacity in several sectors of the economy. The industry is currently engaged in efforts to consolidate themselves in areas of their core competence and divest those businesses where they do not have any competitive advantage.

The actual wave in the Indian context, however, started after code was felt by the regulatory authorities. Prior to 1994, the Murugappa group, the Chabbria group and the RPG group, had sought to build industrial empires through merger. They followed the prevailing industries practice of building a conglomerate of diverse businesses into one group. In recent times, mergers have attempted to restructure firms and achieve economies of scale to deal with an increasingly competitive environment.

The Underlying Logic of Merger

The efficiency theories under mergers suggest that mergers provide a mechanism by which capital can be used with more efficiency and the productivity of the company can be increased through “economies of scale”. The theory of differential efficiency states that if the management
of the company “A” is more efficient than that of company “B” and if “A” acquires “B”, the efficiency of the company “B” is likely to be brought up to the level of company “A”. According to this theory, the increased efficiency of company “B” is considered to be the outcome of merger.

Another important theory of mergers is the “synergy theory” which states that when two companies combine, they should be able to produce a greater effect together than what the two operating independently could. It refers to the phenomenon of two plus becoming five. This synergy could be “financial synergy” or “operating synergy”.

\[ V(A + B) > V(A) + V(B) \]

Where; \( V(A + B) \) : Value of the combined companies, \( V(A) \) : Value of the company “A” and \( V(B) \) : Value of the company “B”.

A merger of two companies should be invariably result in a “positive” i.e. it should result in increased volume of revenue from the combined sales or decreased operating cost or decreased investment requirements. If the effects are neutral i.e. no change is effected over the standalone position, the whole labor of merger excessive would go waste. On the other hand, if the combined effect is “negative” the merger may even prove fatal later.

The increased outflows from the merged entity over that of the total output of the units when they were operating individually is more due to operation of either “economies of scale” or “economies of scope”. The nature of “economies of scale” may be different. Some merger look for
cost-based economies of scale: some may look for revenue-based economies of scale, defense-based economies of scale etc. Similarly, “economies of scale” is varied in nature: Cost-based economies of scope, revenue-based scope and diversification based economies of scope.

**TYPES OF MERGERS**

From an economic stand point, different types of mergers can be grouped on the basis of their stage of economic activity and the degree of relatedness of the firm.

**Horizontal Merger**

It is a merger of two competing firms which are at the same stage of industrial process. Both the firms belong to the same industry i.e. merger is between business competitors, such as manufactures of the same type of products or distributors selling competition products in the same market area. The main purpose of such merger is to obtain economies of scale in production by eliminating duplication of facilities and operation, broadening the product line, reducing investment in working capital elimination of competition reduction in advertising costs, increase in market segments and exercise of better control in the market. A company manufacturing washing machines and taking over a company manufacturing audio system will be horizontal merger as both are companies in the consumer durable market. For example, merger of TOMCO by HLL is horizontal merger.

Horizontal mergers generally account for majority of merger cases. These are defended on the wounds that they permit efficiency gains by
exploiting economics of scale, avoiding duplicate expenditures etc. Also, they raise seller concentration thus enhancing opportunities for exercise of market power. The number of films in an industry is decreased by horizontal mergers and this may make it easy for the industry members to collide for monopoly profits. Hence, the major concern in such mergers is from an anti-monopoly point of view. So these types of mergers are regulated by the government.

Weinberg and Blank define horizontal merger as follows:

A takeover or merger is horizontal if it involves the joining together of two companies which are producing essentially the same products or services or products or services which compete directly with each other (for example, sugar and artificial sweeteners). In recent years, the great majority of takeovers and mergers have been horizontal. As horizontal takeovers and mergers involve a reduction in the number of competing firms in an industry, they tend to create the greatest concern from anti-monopoly point of view on the other hand horizontal mergers and takeovers are likely to give the greatest scope for economies of scale and elimination of duplicate facilities.

Vertical Merger

It involves the integration of companies having supplementary relationships either in production or distribution of products or services. In such cases, both the companies have different level of production processes either of same line of business. In vertical mergers, the acquiring and target companies are in the same industry with strong
buyer supplier relationship. The target company is either a supplier or buyer/customer of the acquiring company. Vertical merger is generally undertaken when market of intermediate product is imperfect. It called backward integration when company expands backward towards the source of raw material and forward integration when it moves forward in the direction of customer. For example, RPG groups’ merger with Harrison Malayalam Ltd. Gave it control over rubber, a major tire input for the other group company- Ceat Ltd. This was vertical backward integration. The effect of such mergers is generally to improve efficiency through improving the flow of production and reduction of stockholding and handling costs.

Thus, vertical mergers help to ensure a smooth source of supply or an outlet for product or services. Merger of Reliance Petrochemicals Ltd, By Reliance Industries is also vertical merger with backward linkage. Also, global mergers between AT & T and TCL and Time Warner and Turner are good instances of vertical integration. Shunned by local distributors AT&T acquired cable operators TCL to link its long distance carrier lines to industrial homes and business establishments without the aid of local distributors. Similarly, combing the production unit, Time Warner with the distribution network of Turner, broadcasting could create vertical integration.

Weinberg and Blank define vertical merger in the following manner:
“A takeover or merger is vertical where one of the two companies is an actual or potential supplier of goods or services to the other so that the two companies are both engaged in the manufacture or provision of the same goods or services but at different stages in the supply route (for example, where a motor car manufacture takes over a manufacturer of sheet metal, or a car distributing firm). Here, the object is usually to ensure a source of supply or an outlet for products or services, but the effect of the merger may be to improve efficiency through improving the flow of production and reducing stockholding and handling costs. Where, however there is a degree of concentration in the markets of either of the companies, anti-monopoly problems may arise”

Co-generic Merger

In these mergers, the acquirer and target companies are related through basic technologies, production processes or markets. The acquired company represents an extension of product line, market participants or technologies of the acquiring companies. These mergers represent an outward movement by the acquiring company form its current set of business to adjoining business. The acquiring company derives benefits by exploitation of strategic resources and form these mergers is high because these transaction offer opportunities to diversify around a common core of strategic resources Western and Mansinghka classified congeneric mergers into product extension and market extension types. When a new product line allied to or complimentary to an existing product line is added to existing product line through merger, it is defined as product extension merger. Similarly market extension
merger helps to add a new market either through same line of business or adding a field both these types bear some common elements of horizontal, vertical or conglomerate merger. For example, merger between Hindustan Sanitary ware Industries Ltd and Associated Glass Ltd is a product extension merger and merger between Cimmco Ltd and Xpro Ltd contains elements of both product extension and market extension merger.

Conglomerate Merger

These mergers involve firms engaged in unrelated type of business activities i.e. the business of two companies are not related to each other horizontally (in the sense of producing the same or competing products), nor vertically (in the sense of standing towards each other in the relationship of buyer and supplier) in a pure conglomerate, there are no important and technology. In practice, however there are no important common factors between the companies in production marketing, research and development and technology. In practice however, there is some degree of overlap in one or more of these common factors. Conglomerate merger are unification of different kinds of business under one flagship company. The purpose of merger remains utilization of financial resources, enlarged debt capacity and also synergy of managerial functions. However, these transactions are not explicitly aimed at sharing these resources, technologies, synergies or product market strategies. Rather, the focus of such conglomerate mergers is on how the acquiring firm can improve its overall stability and use resources in better way to generate addition revenue. It does not have
direct impact on acquisition of monopoly power and is thus favored throughout the world as a means of diversion.

Reverse Merger

In the conventional method, the sick company is absorbed by the profitable one (called normal merger). On the other hand, if reverse situation takes place i.e. if sick company extends its embracing arm to the profitable company and in turn absorbs it in its fold this action is called reverse merger. Reverse merger is thus a merger of healthy company to a loss making company as compared to a normal merger where weaker units merge to stronger ones. The deal is generally followed by a change of name and brings major tax benefits for the profit making unit along with retention of its goodwill. It gives the profit making company an automatic tax entitlement benefit of carry forward and set off of losses without complying with provision of Section 72A of Income Tax Act. It is also resorted to for other reasons such as to save tax on stamp duty, to save on public issues expenses. To obtain quotation on stock exchange etc. The financial institutions which act as operating agency for the sick company suggests this remedy between two companies in the promoter group thus attempting to control the growing sickness in a process of quick and enduring solution. The financial institutions have spearheaded this concept and their support ensures the smooth passage of the scheme before various authorities. In essence, it can be said that reverse mergers are rehabilitation oriented scheme adapted to achieve quick corporate turnaround.
Moreover, with amendment in Sick Industrial Company Act, 1985 effective from 1st February, 1994, reverse mergers are being allowed by BIFR. The first case of reverse merger formulated by BIFR envisaged the merger of healthy company Sagar Real Estate Developers Ltd. With sick textile company SLM Maneklal Industries Ltd as rehabilitation cum revival package for the sick company. This was followed by merger of healthy Kirlosker Oil Engines Ltd with ailing Prashant Khosla Pneumatics Ltd. Then, there were many other reverse mergers which include merger of Eicher Tractors Limited with loss making Royal Enfield Motors Ltd, merged entity being called Eicher Limited (1996) etc.

Many times, reverse mergers are also accompanied by reduction in the unwieldy capital of the sick company. This capital reduction helps in writing off of the accumulated losses and other asses which are not represented by the share capital of the company. Thus, a capital reduction cum rehabilitation scheme (byway of reverse merger) is an ideal antidote for the sick company. For example, Godrej Soaps Ltd. (GSL) (with pre-merger turnover of 436.77 crores) entered in to scheme of reverse merger with loss making Gujarat Godrej Innovative Chemicals Ltd (GGLCL) (with pre-merger turnover of 60. crores) in 1994. The scheme involved reduction of share capital of GGICL from Rs. 10 per share to Re.1 per share and later GSL would be merged with 1 share of GGICL to be allotted to every shareholder of GSL. The post-merger company, Godrej Soaps Ltd (with post-merger turnover of Rs. 611.12 crores) restructured its gross profits of 49.08 crores which led
to an effective tax burden of Rs. 105 crores and net profits of Rs. 48.03 crores, higher than GSL’s pre-merger profits of Rs. 25.30 crores. The amalgamated company, GGICL reverted back to the old name of amalgamating company, Godrej Soaps Ltd.

Thus, this innovative merger which was by way of forward integration in the name of GGICL was competed with the help of financial institution like IDBI, IFCI, ICICI, UTI etc. All financial institution agreed to waive penal interest. Liquidate damages besides funding of interest, reschedule outside loans and also lower interest rate on term loans. However, there is a danger of violation of sprits of provision of Income Tax Act, 1961 which might invoke McDowell principle if such exercise if reverse merger is carried out solely for the purpose of tax saving of amalgamated/merged company. Reverse mergers in such cases are looked down upon as opportunist mergers.

Demerger

It has been defined as split or division. As the name suggests, it denotes a situation opposite to that of merger. Demerger or spin off, as called in US involves splitting up of conglomerate (multi-divisions) of company into separate companies. This occurs in cases where dissimilar businesses are carried on within the same company, thus becoming unwieldy and cyclical almost resulting in a loss situation. Corporate restructuring in such situations in the form of demerger becomes inevitable. Merger of SG Chemicals and dyes Ltd with Ambalal Sarabai Enterprises Ltd (ASE) had made ASE big conglomerate which had become unwieldy and cyclic, so demerger of ASE was done.
Apart from core competencies being main reason for demerging companies according to their nature of business, in some cases, restructuring in the form of demerger was undertaken for splitting up the family owned large business empires into smaller companies. The historical demerger of DCM group, where it split into four companies (DCM LTD, DCM Shriram Industries Ltd., Shriram Industrial Enterprise Ltd and DCM Shriram Consolidated Ltd) is one example of family units splitting through demergers. Such demergers are accordingly, more in the nature of family settlements and are affected through the courts order.

Thus, demergers also occur due to reason almost the same as mergers i.e. the desire to perform better and strengthen efficiency, business interest and longevity and to curb losses, wastage and competition. Undertakings demerge to delineate business and fix responsibility, liability and management so as to ensure improved results from each of the demerged unit. Demergers are skin to the survival of the fittest ideology i.e. if one unit is making profit and other unit is making loss thus eroding its profits, alienate the loss making unit.

As per Section 2(19AA) of Income Tax Act, 1961, demerger, in relation to companies means transfer pursuant to Scheme of Arrangement as per section 391-394 of Companies Act by a demerged company of one or more undertakings to any resulting company in such a manner that:
(1) All property of undertaking being transferred by demerger company immediately before demerger become property of resulting company by virtue of demerger.

(2) All the liabilities of the undertaking being transferred by demerged company immediately before demerger become liabilities of resulting company by virtue of demerger.

(3) The property and liabilities of the undertaking(s) being transferred by the demerged company are transferred at values appearing in its books of accounts immediately before the demerger.

(4) Shareholders holding not less than three fourths in the value of shares of Demerger Company become shareholders of resulting company by virtue of demerger.

(5) Transfer of undertaking is ongoing concern basis.

(6) The demerger is in accordance with the condition, if any, notified u/s Sec 72A by the Central Government.

Demerged company, according to Section 2(19AA) of Income Tax Act, 1961 means the company whose undertaking is transferred, pursuant to a demerger to a resulting company.

Resulting company, according to Section 2(41A) of Income Tax Act, 1961 means one or more company (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 transferred of undertaking, issues shares to the shareholder of the
demerger company and includes any authority or body local authority or public sector company or a company established, constituted or formed as a result of demerger.

Merger through BIFR

The Companies (Amendment) Act, 2001 has repealed the Sick Industrial Companies (Special Provisions) Act (SICA), 1985 in the order to bring sick industrial companies within the preview of Companies Act, 1956 from the jurisdiction of SICA, 1985. The Act has introduced new provision for the constitution of a tribunal known as the National Company Law Tribunal with regional benches which are empowered with the powers earlier vested with the Board for Industrial and Financial Reconstruction (BIFR).

Before the evolution of SICA, the power to sanction the scheme of amalgamation was vested only with the High Court. However, Sec 18 of the SICA, 1985 empowers the BIFR to sanction a scheme of amalgamation between sick industrial company and another company over and above the powers of High Court as per section 391-394 of the companies Act 1956. The amalgamations that take place under SICA have a special place in law and are not bound by the rigors of Companies Act, 1956 and Income Tax Act, 1961.

There is no need to comply with the provision of Sec 391-394 of Companies Act, 1956 for amalgamations sanctioned by BIFR. The scheme of amalgamation however must be approved by shareholders of healthy company after getting approval from BIFR. Sec 72A of the
Income Tax Act has been enacted with a view to providing incentives to healthy companies to take over and amalgamate with companies which would otherwise become burden on the economy. The accumulated losses and unabsorbed depreciation of the amalgamating company is deemed to be loss or allowance for depreciation of the amalgamated company. So, amalgamated company gets the advantage of unabsorbed depreciation and accumulated loss on the precondition of satisfactory revival of sick unit. A certificate from specified authority to the effect that adequate steps have been taken for rehabilitation or revival of sick industrial undertaking has to be obtained to get these benefits. Thus, the main attraction for the healthy company to takeover a sick company through a scheme of amalgamation is the tax benefits that may be available to it consequent to amalgamation. The approach usually followed is to quantify the possible tax benefits first and then get an order as part of rehabilitation package from BIFR. Once BIFR is convinced about the rehabilitation benefits, it passes an appropriate order see that benefits of tax concession properly ensue to the transferee company.

Section 18 of SICA provides for various measures to be recommended by the operating agency in the scheme to be prepared by it for submission to the BIFR concerning the sick industrial unit. Before the amendment in 1994, under SICA only normal amalgamation (of sick company with healthy one) was possible and the SICA Act did not provide for reverse merger of a profitable company with sick company. Now the amended Sec 18 of the Act contains provisions for effecting
both normal and reverse merger. It provides for the amalgamation of sick industrial company with any other company any other company with the sick industrial company.

LEGAL PROCEDURE FOR MERGER

A step by step procedure for merger (amalgamation) is detailed below.

Thorough study of the firm being merged: This not only includes financial analysis but also recent and likely future government policies, product profile, location of the factory, and economy of scale.

Examination of object clauses: The memorandum of association of both the firms should be examined to check if the power to amalgamate is available. Further, the object clause of the merged firm should permit it to carry on the business of the merging firm. If such clauses do not exist, necessary approvals of the shareholders, boards of directors and CLB are required.

Intimation to stock exchanges: The stock exchanges where the merged and merging firms are listed should be informed about the amalgamation proposal. These proposals should be mailed to the concerned stock exchanges.

Approval of the draft amalgamation proposal by the Respective Boards: The Respective Boards of directors should approve the draft amalgamation proposal. The board of each company should pass
resolution authorizing its directors/ executives to pursue the matter further.

Application to the High Court: The Respective Boards of each company should make an application to the High Court so it can convene the meetings of shareholders and creditors for passing the amalgamation proposal approval once the draft of amalgamation proposal.

Dispatch of notice to shareholders and creditors: In order to convene the meeting of shareholders and creditors a notice and an explanatory statement of the meeting, as approved by the High Court, should be dispatched by each company to its shareholders and creditors so that they get 21 days advance intimation. The notice of the meeting should also be published in two newspapers (One English and One Vernacular). An affidavit confirming that the notice has been dispatched to the shareholders/creditors and that the same has been published in newspapers should be filed in the court.

Holding of meeting of shareholders and creditors: A meeting of shareholders should be held by each company for passing the scheme of amalgamation. At least 75 per cent (in value) of shareholders, in each class, who vote either in person or by proxy, must approve the scheme of amalgamation. Likewise in a separate meeting, the creditors of the company must approve of the amalgamation scheme. Here, too at least 75 percent (in values) of the creditors who vote, either in person or by proxy must approve of the amalgamation scheme.
Petition to the courts of confirmation and passing of court orders:
Once the amalgamation scheme is passed by the shareholders and creditors, the companies involved in the amalgamation should present a petition to the court for confirming the scheme of amalgamation. The court will fix a date of hearing. A notice about the same has to be published in two newspapers. It has also to be served to the Regional Director, CLB. After hearing the parties concerned and ascertaining that the amalgamation scheme is fair and reasonable, the court will pass an order sanctioning the same. However, the court is empowered to modify the scheme and pass orders accordingly.

Filing the order with the Registrar:
Certified true copies of the court order must be filed with the Registrar of companies within the limit specified by the court.

Transfer of assets and liabilities:
After the final orders have been passed by both the High Courts, all the assets and liabilities of the merging firm will, with effect from the appointed date, have to be transferred to the merged firm.

Issue of share and debentures:
The merged firm, after fulfilling the provisions of the law, should issue share and debentures of the merging firm. (Cash payment may have to be arranged in same cases.) The new shares and debentures so issued will then be listed on the stock exchange. Scheme of Merger /Amalgamation.

Scheme of Merger /Amalgamation:
Whenever two or more firms agree to merger with each other they have to prepare a scheme of
amalgamation. The merged firm should prepare the scheme in consultation with its merchant banker(s) / financial consultants. The main contents of a model scheme are as listed below:

Determination of Transfer Date (Appointed Date) : This involves fixing of the out-off date from which all properties, movable as well as immovable and rights attached thereto are sought to be transferred from the merging firm to the merged firm. This date is known as transfer date or the appointed date and normally the first day of the financial year of the preceding, the financial year for which the audited accounts are available with the company.

Determination of Effective Date : The date is determined by the time all the required approvals under various statutes, viz., the Companies Act, 1956; the Companies (court) Rules 1959; Income Tax Act, 1961; Sick Industrial Companies (special provisions) Act, 1985; are obtained and the transfer vesting of the undertaking of merging firm with the merged firm take’s effect. This date is called effective date. A scheme of amalgamation normally should also contain conditions to be satisfied for the scheme to become effective.

The effective date is important for income tax purposes. The Companies Act does not provide for such a date but it is a practical necessity so that a court passing an order under Section 394(2) dealing with vesting of properties in the merged firm has before it a meaningful date contained in the scheme serving the purpose and in the contemplation of the applicant companies who are free to choose any date which will be a binding one. While sanctioning the scheme the
court also approves this date. The effective date may be either retrospective or prospective with reference to the application to the court. The effect of the requirement is that a mere order for the transfer of the properties/assets and liabilities to the merged firm would cause the vesting only from the date of order. For tax considerations, the date mentioned in the order of vesting is of material consequences.

(1) The scheme should state clearly the arrangement with secured and unsecured creditors including the debenture holders.

(2) It should also state the exchange ratio, at which the shareholders of the merging firm would be offered shares in the merged firm. The ratio has to be worked out based on the valuation of shares of the respective companies as per the accepted methods of valuation, guidelines and the audited accounts of company.

(3) In case where the merged firm or its subsidiaries hold the shares of the merging firm the scheme must provide for the reduction of share capital to that extent and the manner in which the compensation for share held in the merging firm should be given.

(4) The scheme should also provide for transfer of whole or part of the undertaking to the merged firm, continuation of level proceeding between the merging and the merged firm, absorption of employees of the merging firm, obtaining the consent of dissenting shareholders.
THE RULES FOR SUCCESSFUL MERGER

Peter Drucker identifies a financial stimulus for mergers activity and sets forth a set of rules for successful mergers:

1. Acquirer must contribute something to the merging firm.
2. A common core of unity is required.
3. Acquirer must respect the business of the merging firm.
4. Within a year or so, acquiring firm must be able to provide top management to the merging firms.
5. Within a first year of merger, management of both firms should receive promotions across the entities.

ANALYSIS OF MERGERS

There are three important steps involved in the analysis of mergers:

1. Planning.
2. Search and Screening
3. Financial Evaluation

Planning

The merged firms should review its objective of merger in the context of its strengths and weaknesses and corporate goals. This will help in indicating the product market strategies that are appropriate for the company. It will also force the firm to identify business units that should be dropped and those that should be added.
Planning merger will require the analysis of industry specific and the firm-specific information. The merged firm will need industry data on market growth, nature of competition, entry barriers, capital and labour intensity, degree of regulation.

Information needed about the merging firm will include the quality of management, market share, size, capital structure, profitability, production and marketing capabilities.

Search and Screening

Search focuses on how and where to look for suitable candidates for merger. Screening process short-lists a few candidates.

Merger objectives may include attaining faster growth, improving profitability, improving managerial effectiveness, gaining market power and leadership, achieving cost reduction. These objectives can be achieved in various ways apart from mergers alone. The alternatives to merger include joint ventures, strategic alliances elimination of inefficient operations, cost reduction and productivity improvement, hiring capable managers. If merger is considered as the best alternative, the merged firm must satisfy itself that it is the best available option in terms of its own screening criteria and economically most attractive.

Financial Evaluation

Financial evaluation of a merger is needed to determine the earnings and cash flows, areas of risk, the maximum price payable to the merging firm and the best way to finance the merger. The merged firm
must pay a fair consideration to the merging firm for merging its business. In a competitive market situation with capital market efficiency, the current market value is the correct and fair value of the share of the merging firm. The merging firm will not accept any offer below the current market value of its share. The merging firm may in fact, expect the offer price to be more than the current market value of its share since it may expect that merger benefits will accrue to the merged firm. A merger is said to be at a premium when the offer price is higher than the merging firm’s pre-merger value. The merged firm may pay the premium if it thinks that it can increase the merging firm’s after merger by improving its operations and due to synergy. It may have to pay premium as an incentive to the merging firm’s shareholders to induce them to sell their shares so that the merged firm is enabled to obtain control of the merging firm.

ESTIMATING THE ECONOMIC GAINS AND COSTS FROM MERGERS

When firm A acquires firm B it is making a capital investment decision and firm B is making a capital divestment decision. What is the NPV of this decision to firm A? What is the NPV of this decision to firm B?

To calculate the NPV to company A, we have to identify the benefit and the cost of merger. The benefit of merger is the difference between the PV of the combined entity PV and the sum of present value of the two entities if they remain separate PV (A) + PV (B). Hence,
Benefit = $PV(AB) - PV(A) + PV(B)$

The cost of merger, from the point of view of firm A, assuming that compensation to firm B is paid in cash, is equal to the cash payment made for merged firm B less the present value of firm B as a separate entity, Thus,

$$\text{Cost} = \text{Cash} - PV(B)$$

The NPV of merger from the point of view of firm A is the difference between the benefit and the cost as defined above so,

$$\text{NPV to A} = \text{Benefit} - \text{Cost}$$

$$= [PV(AB) - (PV(A) + PV(B))] - [\text{Cash} + PV(B)]$$

The NPV of the merger from point of view of firm B is simply, the cost of the merger from the point of view of firm A. Hence,

$$\text{NPV to B} = (\text{Cash} + PV(B))$$

Illustration

Market value of Sona Ltd. is Rs. 500 crores and market value of Rupa Ltd. is Rs. 200 crores. If both these firms merge, then benefit will be Rs. 50 crores. Sona Ltd. Proposes to offer Rs. 230 crores cash as compensation to merged Rupa Ltd. Calculate the NPV of the merger to the both firms from the point of view of Sona Ltd. And Rupa Ltd.

We will refer Rupa Ltd. as R and Sona Ltd. as S for calculation.

$PV(R) = \text{Rs. 200 crores.}$

$PV(S) = \text{Rs. 500 crores.}$
PV of benefit from merger = Rs. 50 crores.

Therefore

\[
\text{Cost} = \text{Cash} - \text{PV(R)}
\]

\[
= \text{Rs. 230 crores} - \text{Rs. 200 crores}
\]

\[
= \text{Rs. 30 crores}
\]

NPV to Sona Ltd. = Benefit - Cost

\[
= 50 - 30 = \text{Rs. 20 crores}
\]

NPV to Rupa Ltd. = Cash - PV(R)

\[
= \text{Rs. 230 crores} - \text{Rs. 200 crores}
\]

\[
= \text{Rs. 30 Crores}
\]

Answer

On account of merger NPV of Sona Ltd. will be Rs. 20 crores and that of Rupa Ltd. will be 30 crores. Thus total benefit from merger is Rs. 50 crores. From the above Illustration it is clear that both the companies can benefit from such merger.

Mode of Payment in Merger

This is most complex part of a merger deal and can be extremely difficult to decide whether payment of purchase consideration should be in all-stock deal the best; or is an all cash deal? If neither, then what is the optimum mix of the two?
The novelty is in the components of the mode of payment that has changed drastically. Cash deals are easy. There is a simple transfer of shares for cash and ownership is transferred.

In a stock deal however, the status is slightly hazy. We have seen where the stakeholders of the firm initially meant to be brought out, later end up owning a majority of the merged firm’s shares. Paying by stock means an inherent acceptance of the risks that come with the value that might come along.

Unfortunately in India, corporate and the media tend to focus only the amount of the deal and not the break-up of the components in it.

Cash vs. Stock: The Trade-offs

The basic difference is that in all cash deals, the merged firm’s shareholders take on the risk that expected aggregate synergy value will be less than the total price (market + premium) paid. However, in the merged and merging firms, shareholders own the shares.

The general trend till recently was that the merger was literally juggernaut as compared to the merged. Even all stock deals in such cases meant that the merged would end up with a close to negligible pare of the combined firm’s shares. However, a more recent trend is of financing such mergers with stock, especially in large deals. Risk for the target shareholders is high in such cases.

Pre-Decided Shares or Pre-Decided Value

It isn’t as simple as cash or stock. In a deal that involves stock, the management also has to decide if it is a pre-decided value of shares that will be exchanged as consideration.
Pre-decided Shares

The number of shares to be transferred is pre-decided here. The monetary value of the merger fluctuates with movement in the share price of the acquirer. In fact, both sets of shareholders are affected by these fluctuations. However, the affected on both goes n tandem with the proportion in which share are held while the VAS may not remain constant or as expected, the proportion in which it is shared. The biggest risk to the shareholders of the merging from the pre-announcement value.

Pre-decided value

Alternatively a monetary value could be pre-decided and the number of shares could be calculated based on the stock price prevailing on the closing date. This is a relatively ambiguous (or at least highly contingent) method; as the holding or ownership pattern of the new company is unknown till the closing date. Hence, the merged firm bears all the risk here and the merging firm appropriates all the VAS.

A recent trend has been sighted where underwriters pitch in and agree to takeover the inherent risk in case the share price fluctuates beyond a particular range. This could. In a way, be termed as a middle path where the advantages of both the above method trend tend to be realized.

What issues should be board consider?

We have seen that the mode of payment can have an almost sensational effect on the value to both the merging and merged. Both firms should therefore consider this factor in their strategic game plan
before consider this factor in their strategic game plan before reaching a final conclusion settlement.

Issues for the merged firm

The Board should be able to justify the payment they are committing to make and specifically outline the synergy or other value it hopes to generate from the deal. There are essentially two areas that a merged needs to look into: Estimation of the value of the merger’s shares and Risk perception.

The decision-process in all cash deal is fairly simple. Can the management of the firm generate profits, the NAV which is greater than the amount offered? This usually is not the case as it wouldn’t be up for grab at a premium if its stand-alone value were higher. However, all cash deals are rare and the inclusion of stock in the payment usually complicates the decision-process. The merging firm also needs to value the merged firm’s shares, as they would be shouldering the risk in the future. So, essentially the Board of the target goes through pretty much the same process as that of the merged and in a way endorses the view of the latter by agreeing on the stock as a part of the deal.

In the short it would only be wise to say that there is no one optional strategy to structure the payment of a merger deal. Individual firms need to decide what suits their strategic intent and situation the best considering their liquidity position, perception of risk, market feelers and risk taking capacity. The most important factor, however, is the relative bargaining power that each of the players in a merger deal
hold; a force that could render all technical valuation and analysis utterly useless.

So, an all stock deal, a all cash deal or the optimum mix of the two deal—— what is the best—— the choice is at hand of firms.

**SOURCES OF GAIN THROUGH MERGERS**

**Strategy**

In general, strategy means plan of action or bunch of actions to achieve desire objectives and targets. The company should develop and adopt such long term and short term well planned strategies on various issues so that it becomes the main source of gain through merger. The main concerns for the formulation of strategies includes: while going for merger the company should develop a new strategy, vision and mission. The company should also plan to achieve long term strategic goals. The company should acquire capabilities in new industries and to obtain dynamic talent for fast moving industries and add capabilities to expand role in a technology advancing industry.

**Economies of Scale**

The larger size is always thought to be better in industrial world. The lower operating cost advantage by spread out the total fixed cost over a larger quantum of output is one of the main sources of gain through merger.

This can be achieved by number of ways.
The company can achieve cut in production cost by implementing cost control and cost reduction techniques and also due to large volume of production. The companies can also take advantage of economies of large scale by combine R&D operations, increased sales force, and strengthens distribution system. The company can go for broaden product line and cut overhead cost up to great extent due sharing of central services like accounting and finance, administration and office expenses, executive and top level management, sales and promotional activities and so on. The company can provide one stop shopping for all services ad can offer complementary products. Thus, economies of scale may result in several critical activities, mainly production, marketing and finance.

Advantages of Large Scale

One of the main outcome of any merger is resulting in to larger size company. Obviously, the larger size company can gain number of advantages over smaller company.

It is possible for large size company to afford huge investment in high tech equipments. This is because the large size company can spread use of expensive equipments over more units or divisions.

In order to take advantages of economies of large scale the company produces large quantity of output. This makes possible to get quantity discounts on bulk purchases. The company can also employ best practices and better utilization of various resources.
It is possible for large size company to have better operating efficiencies by controlling and improving the management of receivables, inventories, fixed assets, etc. and by faster tactical implementations. It is also possible for large company to offer good incentives and other benefits to workers and employees of the company.

Market Expansion

It becomes possible for a merged company to gain a greater share of a market, or to gain entry in to new market or to prevent or to restrict the entry of the new company by acquiring new capabilities, managerial skills, applying broad range of capabilities and managerial skills, acquiring capabilities in new industry and to obtain new talent for fast moving industries.

The competitive pricing policy is perhaps the only tool in a market with limited product differentiation. The company having larger market share may be in dominating position to drive prices and its related forces. Due to the merger the company can increased market shares and obtain opportunities to access new markets.

Competition

It is rightly said that 21st century is full of competition. This is due to rapid development in the field of technology, transportation, infrastructure, communication and other facilities. In order to face and fight successfully it is necessary for a company to take measures like to achieve critical mass before rival, pre-empt acquisitions by competitor
and compete on EBIT growth for high valuations which is possible by merger.

Customers

In any business customer is always king. The success and existence of any business is largely depends on customers and their attitude and approach towards the business. The merger activity provides opportunities to develop new customer relationships. The combine company can meet customers demand for wide range of services with good quality, as per given schedule and at competitive price. This helps to develop good cordial relationship with new and potential customers and to maintain smooth relation with existing customers.

Technology

Merger and acquisition makes possible for the merged company to enter in to techno base dynamic industries to seize the opportunities in industries with developing technologies. It also leads to go for new R&D capabilities and to acquire technology for lagging areas. A merged company can adjust to deregulations- relaxing of Government barriers to geographic and product market extension. It helps to eliminate industry excess capacity which helps to cut cost.

Shift in Product Strategy

Shift from over capacity area to area with more favorable sales capacity. Exit a product area that has become commodities to area of specialty.
Industry Roll-ups

Taking fragmented industries, and because of improvement in communication and transportation, rolling up many individual companies into larger firms, obtaining the benefits of strong and experienced management teams over a large number of small units.

Globalization

Merger can be use as tool to face international competition and to establish presence in foreign market and to strengthen position in domestic market. Especially large size, economies of scale, diversification product differentiation and reduction in systematic risk and dependence on export due to merger is helpful to face global competitions.

DUBIOUS REASONS

Diversification

Diversification is yet another major advantage especially in conglomerate merger. The argument is that a merger between to unrelated firms would tend to reduce business risk, which in turn, reduces the discount rate /required rate of return of the firm’s earning and, thus, increase the market value. In other words, such mergers help stabilize or smoothen overall corporate income which would otherwise fluctuate due to seasonal or economic cycles. In operational terms, the greater the combination of statistically independent, or negatively correlated income streams of the merged companies, the higher will be
the reduction in the business risk factor and the greater will be the benefit of diversification.

However, individual shareholders on their own can also attain such diversification. Therefore, the financial managers should ensure that merger should not be at a cost higher than the one at which shareholders would have attained the same risk reduction by diversifying their individual investment portfolios, corporate diversification should be less expensive than personal diversification.

Lower Financing Costs

The consequence of larger size and greater earning stability, many argue, is to reduce the cost of borrowing for the merged firm. The reason for this is that the creditors of the merged firm enjoy better protection than the creditors of the merging firms independently.

If two firms, A and B, merge the creditors of the merged firm (call it firm AB) are protected by the equity of both the firms. While this additional protection reduces the cost of debt, it imposes an extra burden on the shareholders; shareholders of firm A must support the debt of firm B, and diversification. In an efficiently operating market, the benefit to shareholders from lower cost of debt would be offset by the additional burden borne by them- as a result there would be no net gain.

Earning Growth

A merger may create the appearance of growth in earnings. This may stimulate a price rise if the investors are fooled. Suppose, in case of
firms A and B. Firm A has superior growth prospects and commands a price per share Rs. 50, and firm B on the other hand, has inferior growth prospects and sell for a price per share Rs. 25. The merger is not expected to create any additional value. Based on the pre-merger market prices the exchange ratio is 1:2, that is one of share of firm A is given in exchange for two shares of firm-B.

If the market is smart the financial position of firm A, after the merger, even through the earnings per share rises, the price-earnings ratio falls because the market recognizes that the growth prospects of the combined firm will not be as bright as those of firm-A alone. So the market price per share remains unchanged Rs. 50. Thus, the market value of the combined company is simply the sum of the market value of the merging firms.

If the market is foolish it may regard increase in earning per share as reflection of true growth. Hence, the price-earnings ratio, the market price per share of firm A will rise. This will lead to an increase in total market value.

Thus, if the market is foolish, it may be mesmerized by the magic of earning growth. Such an illusion may work for a while in an efficient market, as the market becomes efficient and the illusory gains are bound to disappear.

LIMITATIONS OF MERGERS

We have seen the benefits that companies can achieve through merger. However, merger suffers from certain weaknesses also in particular cases. The chief ones are discussed as under:
(1) A merger may not turn out to be a financially profitable proposition in view of non realization of potential economies in terms of cost reduction.

(2) The management of the two firms may not go along because of friction.

(3) Dissenting minority shareholders may cause problems.

(4) It may attract government anti-trust action in terms of the MRTP Act, 1969.

REASONS FOR FAILURE OF MERGERS

Most corporate mergers have failed ... very high rate of merger failure ... rampant merger failure in US and Europe. Indeed, 83 per cent of mergers failed to produce any benefits and over half actually ended up reducing the value of the firms involved. The following are the stymies that come in the way of successful merger process.

Culture Clash

The cultures of the firms may not be compatible and compete for dominance. If the battle is drawn out, the businesses of the both companies suffer while attention is diverted to the contest. If the culture of one of the firms is totally subsumed, it may destroy a key element of its prior success.

Premium too high

Particularly in hostile takeovers, the acquirer may pay too high a premium. While the shareholders of the merging firm, particularly if
they receive cash, do well, the continuing shareholders are burdened with overpriced assets, which dilute future earnings.

Poor Business Fit

The conglomerate mergers of the 1960s are the most cogent examples, but the lessons seem to be forgotten periodically. Technology mergers where the architectures did not fit are a 1990s example, such as the rush by some firms to merge internet firms or other new era businesses they did not understand.

Management’s Failure to Integrate

Often the merger’s concern with respect to preserving the culture of the merging firm results in a failure to integrate, with the merging firm continuing to operate as before and many of the expected synergies not being achieved.

Over Leverage

Cash mergers frequently result in the acquirer assuming too much debt. Future interest costs consume too great a portion of the merging firm’s earnings. An even more serious problem results when the merger resorts to cheaper short-term financing and then has difficulty refunding on a long-term basis. A well-throughout capital structure is critical for a successful merger.

Boardroom Schemes

When mergers are structured with 50-50 board representations or substantial representations from the acquiring company, care must be
taken to determine the compatibility of the aspect of the merger can create or exacerbate a culture clash and retard or prevent integration. All too often, the continuing directors fail to meet and exchange views until after the merger is consummated.

In Merger Government Policies – A Major Facilitator

Government largely is the major role player in the destiny and direction of the business in any nation. The impact of the policy changes and reforms of the government are always resembled by the performance of business. The upsurge in the restructuring activity is clearly an indication of the reforms that the government has initiated in the early 1990s. The opening up of Indian economy and the increasing number of global players entering into India are the major reasons for Indian corporate restructuring.

The opening of the economy has brought many things for the corporate India. With increased exposure to international markets many firms suddenly saw profitable opportunities for their business. The new opportunities brought cheer for some, for some it meant, struggle for survival as many global players entered the country and competition increased. The impact of the reforms was widespread and forced a number of changes in the operating environments of firms and the way they approached business itself.

The greatest impact is felt on competition rather than on any other aspect of the field. Before the liberalization one could hardly see any
innovative product or service be it the private sector or from the public sector. The entry has changed completely the Indian corporate. The reforms and relaxation of entry norms for passenger car ventures brought to the country a variety of models of international quality standards and the competition and lowering of import duties on commodities brought the prices of the cars in line with the global prices.

Corporate sector in India operates in a way in which they felt more comfortable. The corporate sector has dominated the markets and management’s never bothered about the need to change. With the entry of investment funds and foreign players the corporate sector has suddenly felt the need for change in its style of functioning and their scale and standard of operations are closer to the global levels than ever before, thank to the reforms.

A classic example in this context would be that of Reliance Industries and Indian Petrochemicals Ltd. (IPCL) with the reforms came the reduction of import duties on major polymers and synthetic fibers signaling the death of smaller corporate sectors with uneconomic capacities. Smarter corporate sectors like Reliance and IPCL realized that the key was to restructure by upgrading their capacities to global levels along with the improvement in the production efficiencies. Today, these corporate sectors are comparable with the best in the world and now in such a position that they could weather any changes without much damage.

Series of reforms such as the formulation of the takeover code, simplification of the laws on mergers/amalgamations and the toning
down of the MRTP Act, all set off a series of restructuring efforts among corporate sector. The liberalization of foreign investment norms and the entry of the foreign players into Indian through a joint venture or investment added the spice in the restructuring.

MNCs who were in search of an excellent sourcing zone for the Asian countries suddenly found a heaven with the opening of the economy. Whatever the consequences might be the government went ahead with the reforms that the majority of business house were waiting for. In an attempt to adjust to the new global environment that the corporate are exposed to they speeded up the restructuring activity as they rightfully identified the need for such a move.

Mergers Norms may be Softened in India

Merger is set to get a boost in last budget to facilitate India current spree of corporate restructuring and consolidation. The government seems to be favorably inclined to wards further simplification of the existing norms. Some of the areas set to change include permitting firms to consolidate through special resolutions. Further, in line with changes made for venture capital funds in fiscal 1999-2000, approval where the financial Institutions are supervising the amalgamation plan. Corporate sector has been demanding a reduction in the levels of clearances for mergers/ amalgamations, in line with the demands raised by the venture capital funds, in fiscal 1999-2000 for single clearance windows, following which SEBI was made the sole regulator for the SEBI registered venture capital funds. A similar change is bound to happen as part of the simplification of norms and reducing the duplicity of the
regulatory authorities on mergers/amalgamations. The governments also likely to align the management control threshold with the ownership threshold prescribed for availing tax benefits.

The Indian Evidence so far Seems to be Fairly Positive

In maturity stage achieving economies of scale in research, marketing and production some mergers of smaller firms by larger firms take place to provide management skill and a broader financial base.

Most mergers experiences positive consequences in India. Some reasons for successful mergers are as follows:

First and foremost reason for this could be that the real big mergers have been within cohesive business group, and not between corporate sectors from diverse cultures. A classics example in this context would be that of Reliance Petroleum Ltd. (RPL) with Reliance Industries Ltd. (RIL) in 1992. Another example is Hindustan Lever Ltd. (HLL) with Brooke Bond Lipton India Ltd. (BBLIL) in 1996.

Second reason is that in India the most mergers usually of the larger firm is designated as the merged firms and the smaller firms as the merging firm.

Third is that earn substantial premiums trend of returns to targets has been upward. The reasons for the upward time trend may be summarized.

Fourth is that in India government norm and policies are very soft and optimum to the corporate sector are of international size as a result of their tendencies to merge and yet there is a need for mergers as part of the growing economic process before Indian corporate sectors can
compete with global giants. All the mergers undertaken by such corporate sectors of international size become successful.

Fifth one for, in most Indian mergers in target shareholders evidence is “probably understates the total gains to these shareholders.” overall the shareholders of targets benefited by a substantial degree.

Sixth one for, in India most mergers between merged firms and merging firm has preliminary communications.

Seventh one for, in most Indian mergers is critical for quantifying in communications to board of directors, shareholders, analysts and financial markets.

Eighth for, most Indian merger is communications to internal stakeholders and external stakeholders. Newly combined firms must develop a strategy for performance measurement rollout and then communicate these measures throughout the organization.

ACQUISITION

An acquisition involves acquiring ownership in a tangible property and/or intangible property. In the context of business combinations, an acquisition is the purchase by one company, of controlling interest in the share capital of an existing company.

An acquisition may be effected by either of the following:

(1) An agreement with the person holding majority interest in the company management.

(2) Purchase of new shares by private agreement.
(3) Purchase of shares in the open market (open offer).

(4) Acquisition of shares in the capital of a company by means of cash, issuance of share capital etc.

(5) Making a buyout offer to general body of shareholders.

When a company is acquired by another company, the acquiring company has two options: The first is to merge both the companies into one and operate as single entity and the second is to operate the taken over company as an independent company, probably with changed management and changed policies. The first option is known as merger and the second option is known as takeover.

AMALGAMATION

Amalgamation is an arrangement or reconstruction. It is a legal process by which two or more companies join together to form a new entity or one more companies are to be absorbed or blended with another. As a result, the amalgamating company loses its existence and its shareholders become shareholders of new company or the amalgamated company. In case of amalgamation, a new company may come into existence.

According to Halsbury’s Law of England, amalgamation is the bending of two or more of existing companies into one undertaking, the shareholder of each blending company becoming substantially the shareholder of company, which will carry on blended undertaking. There may be amalgamation by the transfer of one or more undertaking to a new company or transfer of one or more undertaking to an existing
company. Amalgamation signifies the transfer of all or some part of assets and liabilities, of one or more than one existing company to another existing company or two or more companies to a new company. Incorporation of a new company to effect amalgamation is permissible. So, a new company may be formed for takeover of old companies. Amalgamation, however, doesn’t involve formation of a new company to carry on the business of an old company. It is the description of transactions which, however carried out, result in substitution of one corporation for two or more uniting companies in effect of separate sets of members of uniting companies into a single set of members of one corporation. Amalgamation thus means mixing up more uniting together.

As per Companies Act, 1956, legislation that facilitates amalgamation in India, the terms merger and amalgamation are synonymous and defined anywhere in the Act. Sections 390-396A of Companies Act defines statutory provision relating to these terms. As per the mandatory Accounting Standards AS-14 issued by ICAI, amalgamation means an amalgamation pursuant to the provisions of Companies Act or other statute, which may be applicable to the companies. Two methods of amalgamation are contemplated.

Amalgamation in the Nature of Merger

Amalgamation in the nature of merger is an organic unification of two or more entities or undertakings or fusion of one with another. It is defined as an amalgamation which satisfies the following conditions.
(1) All the assets and liabilities of Transferor Company become, after amalgamation, the assets and liabilities of Transferee Company.

(2) Shareholders holding not less than 90% of the face value of equity shares of Transferor Company (other than equity shares already held by Transferee Company therein) become equity shareholders of the transferee company by virtue of amalgamation.

(3) The consideration is received for the amalgamation by those equity shareholders of Transferor Company who agree to become equity shareholders of Transferee Company by issue of equity shares in Transferee Company, except that cash may be paid for any fractional shares.

(4) The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.

(5) No adjustment is intended to be made in the book value of the asset 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.

Amalgamation in the Nature of Purchase

Amalgamation in the nature of purchase is where one company’s assets and liabilities are taken over by another and lump sum is paid by the latter to the former. It is defined as the one which does not satisfy anyone or more of the conditions satisfied above.
Both these amalgamation are within the purview of Section 390-396 A of the Companies Act, 1956.

It has been laid down by the Supreme Court in General Radio and Appliance Company Ltd. V.M.A. Khader that after the amalgamation of two companies, the transferor company ceases to have any identity and the amalgamation company acquires a new status arid it is not possible to treat the two companies as partners or jointly liable in respect of their assets and liabilities. The rue effect and character of amalgamation largely depends upon the terms and conditions of the scheme of merger.

As per Income Tax Act, 1961, merger is defined as amalgamation under section 2(1B) with the following three conditions to be satisfied:

(1) All the properties of amalgamating company should vest with the amalgamated company after amalgamation.

(2) All the liabilities of amalgamating company should vest with the amalgamated company after amalgamation.

(3) Shareholders holding not less than 75% in value or voting power in Amalgamation Company should become shareholders of amalgamated companies after amalgamation.

This does not however include shares already held by shareholders of amalgamating companies in the amalgamated company. Amalgamation does not mean acquisition of a company by purchasing its property and resulting in its winding up. According to income Tax Act, exchange of shares with 90% of shareholders of amalgamating company is required. This demarcates clearly from acquisition.
TAKEOVER

Acquisition can be undertaken through merger or takeover route. Takeover is a general term used to define acquisitions only and both terms are used interchangeably. A takeover may be defined as series of transactions whereby a person, individual, group of individuals or a company acquires control over the assets of a company, either directly by becoming owner of those assets or indirectly by obtaining the control of management of the company. Takeover is acquisition, by one company of controlling interest of the other, usually by buying all or majority of shares. Takeover may be of different types depending upon the purpose of management for acquiring a company.

A takeover may be straight takeover which is accomplished by the management of the taking over company by acquiring shares of another company with the intention of operating taken over company as an independent legal entity.

The second type of takeover is where ownership of company is captured to merge both companies into one and operate as single legal entity.

A third type of takeover is takeover of a sick company for its revival. This is accomplished by an order of Board for Industrial and Financial Reconstruction (BIFR) under the provisions of Sick Industrial Companies (Special Provisions) Act, 1985.

The forth kind is the bail-out takeover, which involves substantial acquisition of shares in a financially weak company, not being a sick
industrial company, in pursuance to a scheme of rehabilitation approved by public financial institution which is responsible for ensuring compliance with provisions Substantial Acquisition of Shares and Takeovers Regulations, 1997 issued by SEBI, which regulates the bail-out-takeover.

The regulatory framework for controlling takeover activities of a company consist of Companies Act, 1956, Listing Agreement and SEBI Takeover Code. Section 372A of Companies Act is applicable to acquisition of shares through a company. The takeover of listed companies is also regulated by Section 40A and 40B of listing Agreement which see to regulate takeover activities by imposing certain requirements of disclosures and transparency. The Securities and Exchange Board of India had earlier issued Substantial Acquisition of Shares and Takeovers Regulations, 1994 which was repealed by Substantial Acquisition of Shares and Takeovers Regulations, 1997 issued on 20th February, 1997 and further amended on 28th October, 1998.

Takeover Bid

This is a technique for affecting either a takeover or an amalgamation. It may be defined as an offer to acquire shares of a company, whose shares are not closely held, addressed to the general body of shareholders with a view to obtaining at least sufficient shares to given the off error, voting control of the company. Takeover bid is thus adopted by acquiring its controlling interest.
While a takeover bid is used for affecting a takeover, it is frequently against the wishes of the management of Offeree Company. It may take the form of an offer to purchase shares for cash or for share exchange or a combination of these two forms. Where a takeover bid is used for effecting merger or amalgamation, it is generally by consent of management of both companies. It always takes place in the form of share for share exchange offer, so that accepting shareholders of Offeree Company become shareholders of Offeror Company.

Takeover and Merger

A transaction or series of transactions by which a person acquires control over assets of the company is called takeover. On the other hand, an arrangement whereby the assets of two companies vest in one is known as merger. The distinction between merger and takeover has been pointed out in the following manner:

“The distinction between a takeover and merger is that, in a takeover, the direct or indirect control over the assets of the acquired company passes to the acquire; in a merger, the shareholding in the combined enterprises will be spread between the shareholders of the two companies.”

In both cases of takeover and merger, the shareholders of the company are as follows:

(1) Company should takeover or merge with another company only if in doing so, it improves it’s profits earning potential measured by earning per share.
(2) The company should agree to be taken over if and only if shareholders are likely to be better off with the consideration offered, whether cash or securities of the company, than by retaining their shares in the original company.

Types of takeover bid: There are two types of takeover bid:

1. Friendly takeover bid

2. Hostile takeover bid

Friendly Takeover

Takeover takes place generally through negotiations i.e. with willingness and consent of acquirer company’s executives or board of directors. Such takeover is called friendly takeover. This takeover is through negotiating and parties do not reach an agreement during negotiations, the proposal of takeover stands terminated and dropped out. Friendly takeover bid is thus with the consent of majority or all of the shareholders of target company.

Hostile Takeover

When a company does not propose to acquire another company but silently and unilaterally pursues efforts to gain controlling interest in it against the wishes of the management, it is called an attempt at hostile takeover. There are various ways in which the acquire company may pursue the matter to acquire controlling interest in another company. These acts are called takeover raids or hostile takeover bids. These raids, when organized in a systematic way, are called “takeover bids” and
company to be taken over is called Target Company. Both the raids and bid lead to takeover or merger. A takeover is hostile when it is in the form of a raid. In other words, when there is no mutual understanding between acquired and taken over company, it is termed as hostile takeover.

Hostile takeovers are small but significant part of global M&A market. They are frequently used in developed markets of US and UK to unlock value for shareholders. They have beneficial impact on the economy. They keep the company management on guard and compel them to perform at higher levels of efficiency. They encourage optimum utilization of resources. For minority shareholders, hostile takeovers are again beneficial since they ensure that management works for improving shareholder value.

However, hostile takeovers are fought over long period of time on different battle grounds starting from court room to media with the help of army of professional lawyers, investment bankers, corporate financiers etc. Due to this time consuming nature of Indian rules and regulation, there have not been too many hostile takeovers in the Indian context. In the late eighties, for the first time, Swaraj Paul brought this form of corporate expansion with his takeover bid of DCM and Escorts but did not succeed. This was followed by various takeover bids made by NRI’s such as Hinduja’s raided and took over Ashok Leyland, Chhabaria group acquired stake in Shaw Wallace, Mather and Platt, Hindustan Dock Driver, Dunlop India etc. Various industrial groups also made an attempt at hostile takeovers. Goenkas of Calcutta took over
Ceat Tyres in late eighties and Mahindra & Mahindra took over Guest Keen Williams Ltd (GKW) and Allwyn Nissan Ltd. India’s biggest corporate entities, Reliance Ltd., Tata Iron and Steel Company Ltd. (TISCO), ITC etc have been involved in takeover attempts. Tata Tea in 1988 made public offer to take over consolidated coffee Ltd. And were successful in acquiring 50% stake.

Until the new SEBI Takeover Code in 1997, Indian corporate managements could freely block transfer of share ownership to potential takeover tycoon. Swaraj Paul made an attempt with Escorts in 1988 and Dhirubhai Ambani was successful with Larsen and Toubro (L&T). There was no way anyone could try majority stake, outvote existing management at Annual General Meeting and replace it. Even if raider kept on buying in secondary market using intermediary to disguise intentions, the financial institution sided the existing management.

The new SEBI Takeover Code, 1997 has however changed things. Now the company’s management can not block shares. Anyone can buy 10% of shares and then after making open public offer acquire another 20% with financial institution supporting them, they can ouster existing management but not without giving them notice in the form of open public offer to take remedial steps, may be in the form of counter offers. So mechanism of takeover in India is such that any management short of 30% could lose control if support of financial institutions is not available or there is less cash to make counter bids.

LAWS AND STATUTES IN INDIA

Mergers and takeovers are regulated by various enactments .as amended from time to time through various prescribed provision made
therein. Various statutes which govern mergers and takeovers are given as under:

Laws governing Mergers: Various laws governing mergers in India are as follows:

Companies Act, 1956

Although amalgamation or merger is not defined anywhere in the Act it is understood to mean an arrangement by which transfer of undertaking is effected. The relevant provisions dealing with schemes of arrangement, amalgamations and mergers are continued in seven sections of the act, namely, Sec. 390-396A, all of which are included in Chapter-V of Companies Act, 1956.

Sec 390: This section incorporates in itself the definitions of expressions: company, arrangement etc.

See 390(b): Here, the expression arrangement is defined to include reorganization of share capital of company either by consolidation of different kind of shares division of different class of shares or by both ways.

See 390(c): According to this sub-section, unsecured creditors who may have filed suits or obtained decrees shall be deemed to be of the same class as other unsecured creditors. This is clarification amendment to clarify that decree holder unsecured creditors have no special rights over unsecured creditors.

Sec 391: This section incorporates the procedure to be followed by the company to obtain power to compromise or make arrangement with creditors and members.
Every person having a pecuniary claim against the company capable of estimate is a creditor.

See 41 of companies act defines member as: The subscribers to the memorandum of company shall be deemed to have agreed to become member of the company and on its registration, shall be entered as members in its register of members.

Every other person who agrees in writing tp become member of a company and whose name is entered in its register of members shall be member of company.

Sec 391(1): As per this sub-section, procedural aspects for effecting a compromise or arrangement are

Compromise or arrangement must be proposed between company and its creditors or any class of them or its members or any class of them.

An application to the court should be made by one of the following persons: creditors, members or in case of company which is being wound up, by the liquidator.

The court will order a meeting to be called, held and conducted in such a manner as the court directs of the creditors or class of the creditors or the members or class of the members.

See 391(2): This sub-section spells the consensus that emerges from the meeting of members or creditors, as the case may be. If the compromise or arrangement is approved by majority representing three
fourth in value of creditors or class of creditors or members or class of members as case be, present and voting either in person or proxy, then, subject to the sanction of court, the said scheme of compromise or arrangement will be binding on all the creditors or class of creditors or members or class of members and also by the company or in the case company is being wound up by liquidator and contributories of the company.

Sec 392 : This section defines the power of the High Court to enforce compromise or arrangement. It provides the following:

(a) After sanctioning the schemes of compromise or arrangement u/s 391, court shall have power to supervise the carrying out of compromise or arrangement.

(b) The court may, either at the time of making the order or any later time, give any directions or make modifications in compromise or arrangements may deemed required.

Sec 392(2) : If compromise or arrangement sanctioned u/s 391 can not be worked satisfactorily or without modifications, court may make an order for winding up of the company.

Sec 393 : This section incorporates the extent of disclosure norms to be observed during the scheme of compromise or arrangement with creditors or members.

Sec 393(1) : This sub-section provides the extent of disclosure norms to be observed while proposing scheme of compromise or arrangement. It requires that every notice calling a meeting of creditors
or members must be accompanied by the statement containing following information:

Following are terms of compromise or arrangement and their effects.

Any material interest of director, managing director or manager of the company in any capacity.

Effect of these interests on compromise or arrangement if any, and how it is different from interest of other persons.

In every notice of meeting given in advertisement, indicate notification of place and manner in which creditors or members can obtain copies of such statement.

Sec 393(2) : This provides that where compromise or arrangement affects the rights of debenture holders, the statement must give similar information and explanation with respect to trustees of any deed for securing issue of debentures.

Sec 393(3) : This provides that every creditor or member on making an application in the manner indicated in notice of advertisement to be furnished a copy of statement free of charge.

Sec 393(4) : This indicates a penalty in the form of fine extendable up to Rs. 5000 for non compliance of this section by the company or an officer.

Sec 393(5) : This provides that any director, managing director or trustees for debenture holders shall be punishable with fine up to
Rs. 500 if he fails to give notice to the company of such matters as relating to himself as may be required for the purpose of this section.

Sec 394 : This section defines provisions for facilitating reconstruction and amalgamation of companies.

The words reconstruction or amalgamation has no definite legal meaning. Reconstruction is where company transfers its assets to a new company with substantially the same shareholders. Amalgamation is merger of two more companies whose shareholders are issued appropriate number of shares in the new company.

Sec 394(1)

(a): This sub-section elaborates the power of the court while considering a scheme of compromise or arrangement which is in the nature of reconstruction or amalgamation and involves transfer of property and liability of one company to another.

(b): Even reconstruction or amalgamation may involve arrangement or compromise with members or creditors as the case is.

(c): The pre-requisite for invoking the power of the court u/s 394 is an application to be made to court u/s 391 i.e. for all cases of reconstruction and amalgamation; first an application has to be made to the court u/s 391.

(d): A reading of section 391 with section 394 proves that starting point of any form of restructuring viz arrangement, compromise, reconstruction or amalgamation is drawing up of a scheme.
Sec 394(2) : This sub-section provides that an order transferring property or liability passed by the court u/s 394 results in property transferred to and vest in transferee company and liability transferred to and become liability of transferee company and in case any property is ordered to be free from charge, then by virtue of compromise or arrangement, it cease to have effect.

See 394(3) : This sub-section provides that within 30 days of making of an order under this section, every company, in relation to which order is made, shall have to file a certified copy with registrar for registration.

Sec 394(4) : This sub-section defines the word transferee company which does not include any company other than a company within the meaning of this Act. However, Transferor Company includes any body corporate notified by the central government.

Sec 394A : This sub-section was introduced by Companies (Amendment) Act, 1965 making it obligatory for the court to give notice to the Central Government of every application made to it u/s 391 or 394 and take into consideration the representation made by government before passing any order on proposed compromise or arrangement or scheme of amalgamation.

Sections 390-394 (along with sec. 394A) cover the complete gamut of legal and procedural aspects of laws governing corporate restructuring. The remaining sections 395, 396, 396A are enacted to deal with specific situations.
Sec 395 : This section states the powers and duties of acquire shares of shareholders dissenting from the scheme or contract approved by majority.

Sec 395(1) : As per this sub-section, under a scheme or construct, if an offer made by transeree company to shareholders of transferor company is approved within four months of making the offer by 90% in value of shares involved (other than shares already held), the acquiring company can give notice within further two months to dissenting shareholders unless otherwise specified by the court.

Sec 396 : This section incorporates special provisions for amalgamation In national interest by the central government.

Sec 396(1) : As per this sub-section, if central government is satisfied that amalgamation is in public interest, it may, by notification in its official gazette, order the same provide for amalgamation of two companies into single company with such constitution, property, power, rights, interests, authorities, privileges, and with such liabilities, duties and obligations as may be specified in the order.

Sec 396(2) : As per this sub-section, the order of Central Government may provide for continuation by or against transeree company of any legal proceeding pending by or against transferor company and may also contain such consequential, incidental and supplementary provision as may, in opinion of central government, be necessary to give effect to amalgamation.
Sec 396A: This section spells out the laws relating to preservation of books and papers of amalgamated company. The books and papers of company which has been amalgamated or whose shares have been acquired by another company shall not be disposed off without prior permission of central government and before granting such permission, Central Government may appoint a person to examine the books or papers or any of them for the purpose of ascertaining whether they contain any evidence of commission of an offence in connection with promotion or formation or the management of affairs of the first mentioned company or its amalgamation or acquisition of shares.

Subsequent to amendments in Companies (Second Amendment) Act, 2002, a National Company Law Tribunal has to be established which shall be vested with the powers currently vested with the High Courts pursuant to the provisions of section 390-396A under Chapter-V of Companies Act, 1956.

Industries (Regulation and Development) Act, 1951 (IRDA 1951)

This is “An Act to provide for the development and regulation of certain industries” Chapter iii-C of this Act contains provisions for reconstruction of such companies where management or control of industrial undertaking is taken over as per direction of central government. The provisions of this act have a very restricted applicability in case of mergers. An application u/s 391 of Companies Act, initiating a merger proposal can not be proceeded with, where permission of High Court has been granted u/s 18FA of this Act to
appoint anyone to takeover the management of individual undertaking on the application of Central Government for the purpose of running or restarting it. However, the Central Government may review its order at the request of the parties to proceed with the scheme of merger. There is no requirement to get a new license as license of amalgamating company is treated adequate for amalgamated company since takeover of all assets includes license also.

Income Tax Act 1961

Acquisitions - An Income Tax Perspective: Under the Income Tax Act, 1961 (Act) tax is levied on a “person” in respect of income. Person is defined as an individual, a company, a firm an association of persons or a body of individuals whether incorporated or not. Company includes Indian companies and foreign companies. The category of person influences the tax treatment and the tax rates. The residential status of the person influences the scope of income liable to tax in India.

An acquisition by way of merger/ amalgamation would typically raise questions regarding the tax implications on: The continuity or otherwise of the tax benefits in the hands of the acquirer company that were enjoyed by the acquired company in respect of its business incomes/expenses.

(1) The gains from sale/transfer of the assets/ undertaking of the acquired company.

(2) Allotment of share in the acquirer company to shareholders of the acquired company.
(3) The above would principally impact the income-tax provisions relating to computation of Income from profits and gains of business impacting
- Expense claims
- Exempt incomes.

(4) Income under the head Capital Gains arising from transfer of capital assets of the acquired company for shares in the acquirer company.

Tax impact on the amalgamating company & its shareholders:
Gains on transfer of Capital Assets - Not liable to tax

For the purpose determining taxable capital gains under the Act, the transfer of capital assets by the target company to an amalgamated company is not an Indian company. Such transfers enjoy total exemption from capital gains tax.

Exchange/Sale of Shares

Pursuant to amalgamation shareholders of the target company would become the shareholders of the amalgamated company by receiving shares, in lieu of their existing shareholding. Typically, such an exchange is transfer. However, Act does not regard it as a transfer, where the exchange is in consideration of allotment of shares in the amalgamated company and such company is an Indian company any cash or other benefit given, fully or partially, in exchange for the shares would result in taxable capital gains.

Post amalgamation where shareholders subsequently decide to sell the share of the amalgamated company (acquired pursuant to the
merger), the gains on sale would be liable to tax as capital gains. For computing such capital gains, the cost of acquisition and the period of holding would be as under:

Cost of acquisition of their original holding in the amalgamating company prior to the amalgamation; and

Period of holding would include the period the shares of the amalgamating company were held before the amalgamation.

Tax impact on the amalgamated company:
Expenses in connection with amalgamation

Typically, certain costs like stamp duty, court fees, consultancy fees, etc. Incurred to effect a merger may be significant. The Act allows the amalgamated company to claim on a deferred basis, the expenditure incurred wholly and exclusively for the purpose of the amalgamation. The deduction allowed is 1/5\(^\text{th}\) of such expenditure over a period of 5 successive years, starting with the year of amalgamation.

Issue/Allotment of shares - whether liable to Dividend Distribution Tax (DDT)

As per the Act, certain distributions, payments, etc, made by a company are deemed to be dividends in the hands of the receiver, companies are liable to dividend distribution tax at specified rates on dividends, including deemed dividends. A view may be possible that issue/allotment of shares of the amalgamated company to the shareholders of amalgamating company may constitute deemed dividend and accordingly be liable to DDT payable by the amalgamated company.
However, the Central Board of Direct Taxes (CBDT) has clarified that where a company mergers with another company in a Scheme of Amalgamation, the provision relating dividend distribution {Section 2(22) (a) or (c) of the Act} are not attracted. Thus, the amalgamated company would not be liable to DDT on such allotment of shares.

Values of acquired Assets

Cost of acquisition for purpose of subsequent sale where the capital assets acquired pursuant to amalgamation, are subsequently sold/transferred by the amalgamated company, the same triggers a tax incidence. However, a relaxation has been provided to neutralize the impact of amalgamation on (a) cost of acquisition; and (b) period of holding. Accordingly;

Cost of acquisition would be the same as the cost of such asset in the hands of the amalgamating company;

The holding period would include the period for which the asset was held by the amalgamating company.

The above helps retain the characterization of the gain, viz, short term or long-term, thus ensuring a tax neutral charge in respect of the tax rates.

Cost of depreciable assets for claiming depreciation

The owner of a capital asset is entitled to claim depreciation on the tangible and intangible assets being used for the purpose of the business. As per the Act, depreciation is claimed on the written down value
(WDV) of the assets. Rates of depreciation are prescribed for specified blocks of assets and assets.

Pursuant to an amalgamation, the amalgamated Indian company becomes the Owner of the assets and thus entitled to claim depreciation.

The cost of the block of assets taken over by the amalgamated company shall be the WDV of that block as per the Act, in the hands of the target company as on the last day of the preceding previous year. It is on this value that the amalgamated company would be entitled to claim depreciation under section 32 of the Act.

Any goodwill or intangibles recognized in financial statements as a result of mere accounting entries shall not form part of the block of assets eligible for depreciation.

Depreciation Claims

Other than the asset values for purpose of depreciation as discussed above, the following may also be noted:

Depreciation for the year in which amalgamation takes place. Typically an amalgamation would take place during the course of a taxable year. Depreciation is allowable on a prorata basis to both the amalgamating and amalgamated company in the ratio of number of days for which they use the unabsorbed depreciation for prior years.

In the Finance Bill, 2007, has proposed to extend the benefit of carry forward and set-off of accumulated business losses/depreciation to a public sector undertaking engaged in the business of operation of aircraft with one or more public sector undertakings engaged in similar
business. This proposal is intended to facilitate the merger of Indian Airlines and Air India. The summarized conditions are:

(1) Conditions to be complied by the amalgamating company. Compliance with the following is required to be determined as on the Appointed Date.

(2) The amalgamating company should own an “industrial undertaking” or ship or hotel or be a banking company. The term industrial undertaking engaged in - the manufacture or processing of goods; the manufacture of computer software; the business of generation or distribution of electricity or any other form of power; the business of providing telecommunication services; mining; construction of ships, aircraft or rail system.

(3) The amalgamating company should have been engaged in the business for at least 3 years during which the business loss or depreciation have been accumulated.

(4) At least 75% of the book value of the fixed assets held by the amalgamating company should have been held by it for 2 consecutive years prior to the date of amalgamation.

(5) Conditions to be complied by the amalgamated company. The amalgamated company should hold at least 75% of the book value of the fixed assets of the amalgamating company for at least 5 consecutive years from the date of amalgamation.

(6) Carry on the business of the amalgamating company for at least 5 years.
(7) Fulfill prescribed conditions to ensure the revival of the business of the amalgamating company viz, the amalgamated company should achieve the level of production of at least 50% of the installed capacity of the undertaking of the amalgamating company before the end of 4 years from said minimum level of production till the end of 5 years from the date of amalgamation.

The conditions prescribed above require compliance over a period of time in order to avail the benefit of carry-forward and set-off of accumulated business losses and unabsorbed depreciation of the amalgamating company.

In case the above conditions are not complied with, the benefit claimed would be taxed in the hands of the amalgamated company in the years in which any of the conditions mentioned above are contravened.

There is no restriction of time for purpose of carry forward of unabsorbed depreciation, though unabsorbed business losses cannot be carried forward for more than 8 assessment years immediately succeeding the assessment year for which the loss was first computed.

Treatment of Unabsorbed Business Losses and Depreciation in Computation of Minimum Alternate Tax (MAT)

Minimum Alternate Tax (MAT) is payable by companies both foreign and domestic, @ 10% of book profits (including applicable surcharge and education cess). Book profit is derived by adjusting (positively and negatively) the net profit as per the Profit & Loss Account. One of the negative adjustments is on the book values of unabsorbed business loss or depreciation, whichever is less. In case the
book value of either the accumulated business loss or unabsorbed
depreciation is nil, no amount would be reduced from the book profit.

Other than the above, in post amalgamation a situation may arise
where the book loss of the amalgamating company ceases to be
recognized as loss brought forward in Profit & Loss Account of the
amalgamated company, it having been adjusted in the capital account.

In the absence of a brought forward business loss/ depreciation, as
belonging to the amalgamating company, in the Profit & Loss Account
of the amalgamated company the tax authorities may be reluctant to
allow