All About Mergers and Amalgamations

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MERGERS

The word merger hasn't been defined in the Companies Act, 1956. But in its literal sense it means joining two together.

According to the Transfer of Property Act, 1882 a merger occurs when two estates held in the same legal right become united in the same person. A merger in respect of mortgage arises commonly.

(i) by mortgagee acquiring the equity of redemption;
(ii) by mortgagor redeeming to mortgagee;
(iii) by the purchaser of the equity of redemption redeeming the mortgagee. Webster's dictionary explains merger as the combination of "Commercial or Q Industrial firms" or "to lose identity by being absorbed in something else

AMALGAMATION

Amalgamation takes place when two or more comapanies combine into one company, the shareholders in the amalgamting companies becoming substantially the shareholders in the amalgamted company

DIFFERENCES BETWEEN MERGERS AND AMALGAMATIONS

The terms merger, amalgamation and consolidation are sometimes used interchangeably and denotes the situation where two or more companies, keeping in view their long term business interest, combine into one economic entity to share risks and financial rewards. In strict sense, merger is commonly used for the fusion of two companies. Merger is normally a strategic vehicle to achieve expansion, diversification, entry into new markets, and acquisition of desired resources, patents and technology. It also helps companies in choosing business partners with a view to advance long term corporate strategic plans. Mergers are also considered as a revival measure of industrial sickness. Amalgamation is an arrangement for bringing the assets of two companies under the control of one company, which may or may not be one of the original two companies. Amalgamation signifies the transfer of all or some part of the assets and liabilities of one or more existing business entities to another existing or new company.

i. Amalgamation in the nature of merger:

In this type of amalgamation, not only is the pooling of assets and liabilities is done but also of the shareholders' interests and the businesses of these companies. In other words, all assets and liabilities of the transferor company become that of the transfer company. In this case, the business of the transfer or company is intended to be carried on after the amalgamation. There are no adjustments intended to be made to the book values. The other conditions that need to be fulfilled include that the shareholders of the vendor company holding atleast 90% face value of equity shares become the shareholders' of the vendee company.

ii. Amalgamation in the nature of purchase:

This method is considered when the conditions for the amalgamation in the nature of merger are not satisfied. Through this method, one company is acquired by another, and thereby the shareholders' of the company which is acquired normally do not continue to have proportionate share in the equity of the combined company or the business of the company which is acquired is generally not intended to be continued.

If the purchase consideration exceeds the net assets value then the excess amount is recorded as the goodwill, while if it is less than the net assets value it is recorded as the capital reserves.

TYPES OF MERGERS

There are five commonly-referred to types of business combinations known as mergers: conglomerate merger, horizontal merger, market extension merger, vertical merger and product extension merger. The term chosen to describe the merger depends on the economic function, purpose of the business transaction and relationship between the merging companies.

Conglomerate

A merger between firms that are involved in totally unrelated business activities. There are two types of conglomerate mergers: pure and mixed. Pure conglomerate mergers involve firms with nothing in common, while mixed conglomerate mergers involve firms that are looking for product extensions or market extensions.

Horizontal Merger

A merger occurring between companies in the same industry. Horizontal merger is a business consolidation that occurs between firms who operate in the same space, often as competitors offering the same good or service. Horizontal mergers are common in industries with fewer firms, as competition tends to be higher and the synergies and potential gains in market share are much greater for merging firms in such an industry.

Market Extension Mergers

A market extension merger takes place between two companies that deal in the same products but in separate markets. The main purpose of the market extension merger is to make sure that the merging companies can get access to a bigger market and that ensures a bigger client base.

Product Extension Mergers

A product extension merger takes place between two business organizations that deal in products that are related to each other and operate in the same market. The product extension merger allows the merging companies to group together their products and get access to a bigger set of consumers. This ensures that they earn higher profits.

Vertical Merger

A merger between two companies producing different goods or services for one specific finished product. A vertical merger occurs when two or more firms, operating at different levels within an industry's supply chain, merge operations. Most often the logic behind the merger is to increase synergies created by merging firms that would be more efficient operating as one.

Three Conditions for Merger to qualify as an amalgamation

- All the property of the amalgamating company (old) immediately before the amalgamation becomes the property of the amalgamated company (new) by virtue of amalgamation.
- All the liabilities of the amalgamating company immediately before the amalgamation become the property of the amalgamated company by virtue of amalgamation.
- Shareholders holding not less than three- fourth in value of the shares in the amalgamating company (other than shares already held therein immediately before the amalgamation by or by a nominee for the amalgamated company or its subsidiary) become shareholders of the amalgamated company by virtue of the amalgamation.

Benefits achieved from Merger and Amalgamation

- Coming together to produce a new or enhanced effect.
- Reduction in the average cost of production and hence in the unit costs when output is increased, to enable to offer products at more competitive prices and thus to capture a larger market share.
- Reduction in production, administrative, selling, legal and professional expenses.
- Mutual benefit by reducing competition, saving costs by reducing overheads, capturing larger market, pooling technical or financial resources.
- Optimum Use of capacities and factors of production
- Tax advantage – Carry forward and setoff of losses of a loss – making amalgamating company against profits of a profit – making amalgamated company
- Financial constraints for expansion can be removed
- Diversification
- Advantage of Brand – Equity
- Survival
- Revival of Sick Company
- Substantial Growth.

Indian Legal Issues involved in M&A

1. <u>SEBI Takeover Regulations/Company Law in M&A:</u>

Mergers are primarily supervised by the High Court(s) and the Ministry of Company Affairs. The SEBI regulates takeovers of companies that have shares listed on any stock exchange in India. The main corporate and securities law provisions governing mergers and takeovers are:

- Sections 108A to 108I of CA56, which place restrictions on the transfer and acquisition of shares where the shareholdings of the bidder or transformer would either:
    - Result in a dominant undertaking; or
    - In case of a pre-existing dominant undertaking, result in an increase in the production, supply, distribution or control of goods and services by it.
- Section 390 to 394 of CA56, which govern the schemes of arrangement between companies and their respective shareholders and creditors, under the supervision of the relevant High Court.

2. <u>Due Diligence in M&As:</u>

The purpose of the due diligence exercise is to identify any issues that may affect the bid including, but not limited to, the price of the bid. Generally, the bidder (in case of recommended as well as hostile bids) will want to determine the following about the target company:

- Its capital structure including shareholding pattern.
- The composition of its board of directors.
- Any shareholders' agreement or restrictions on the shares, for example, on voting rights or the right to transfer the shares.
- Its level of indebtedness.
- Whether any of its assets have been offered as security for raising any debt.
- Any significant contracts executed by it.
- The status of any statutory approvals, consents or filings with statutory authorities.

- Employee details.
- Significant litigation, show cause notices and so on relating to the target and/or its areas of business.
- Any other liability, existing or potential.

Public Domain

Information on a target that is in the public domain and is accessible to the bidder includes its:

- Constitutional documents;
- Annual reports and annual returns filed with statutory authorities, giving information on shareholdings, directors and so on.
- Quarterly and half-yearly reports, in the case of listed companies (in accordance with the standard listing agreement prescribed by the SEBI).

A listed company must inform the stock exchanges of important decisions taken by its board of directors.

3. Contractual Issues in M&As:

While economic and business reasons may be the factors behind both M&As, contractual and legal formalities involved are rather different. Share sale and purchase/acquisition agreement, asset and business transfer agreements, representations and warranties, indemnity, non-compete and non solicitation, confidentiality, governing law, post completion matters and indemnities are significant agreements and clauses to effectively execute M&As.

Contents of a Share Purchase Agreement

Condition precedent – The condition precedents incorporated in a share purchase agreement may include obtaining necessary approvals from various governmental regulatory bodies that may be necessary to effectively execute the share purchase agreement and the proper functioning of the target company.

Management and Control – The devising of an appropriate governance structure of the target company is of great importance for effective management, growth and success of the target company. The share purchase agreement should explicitly set out the participation of the acquirer and also the rights, obligations and duties of the management of the target company including that of the board of directors, nominee directors and the chairman.

Intellectual Property Rights – If the merger involves a transfer, assignment or right to use an intellectual property such as trademark, copyright, know-how, etc. the same should be protected in the share purchase agreement.

Non-Competition/Conflict of Interest – The non-compete clause in a share purchase agreement is incorporated with intent to restrain the contracting party from carrying out any independent activity in competition to that of the target company.

Deadlock Provision – The parties may have similar or dissimilar thinking patterns. Therefore, there has to be a mechanism for resolving any issues on which there is a deadlock between the parties. The chairman may be given a casting vote to avoid such a problem.

Confidential Information – The share purchase agreement can make all the provisions contained in or related to or arising from the share purchase agreement to be confidential in nature

Survival Clause – It may be prudent to provide for certain obligations contained in or related to or arising from the share purchase agreement to survive pursuant to the termination of the share purchase agreement.

4. <u>Intellectual Property Law and M&As:</u>

In case of M&A of companies, all the assets of the transferor company including intellectual property assets such as patents, copyrights, trademarks and designs vest in the transferee. Where the transferor company owns the intellectual property assets, such assets are transferred to the transferee company under the scheme of arrangement.

Unregistered trademark/copyright is transferable as any other right in a property under the scheme of arrangement framed under section 394 of CA56. In case of registered trademarks/copyrights and patents, the transferee company has to apply to the respective Registry for registering its title pursuant to the order of the High Court sanctioning the scheme.

The transmission/transfer of the trademark/copyright rights in the license may be permitted in an instance where the licensor himself assents to such transfer of a license subsequent to a merger.

5. Exchange Control Issues:

The Foreign Direct Investment ("**FDI**") regime in India has progressively liberalized and the Government of India recognizes the key role of FDI in economic development of a country. With very limited exceptions, foreign entities can now invest directly in India, either as wholly owned subsidiaries or as a joint venture. In an international joint venture, any proposed investment by a foreign entity/individual in an existing entity may be brought in either through equity expansion or by purchase of the existing equity.

Where the transfer of shares is by way of sale under a private arrangement, by a person resident in to a person resident outside India the price of the shares will not be less than the ruling market price in case of shares listed on a stock exchange or the value of the shares calculated as per the guidelines issued by the erstwhile Controller of Capital Issues and certified by a Chartered Accountant. In either of the cases the sale consideration must be remitted into India through normal banking channels. Lastly, to affect the transfer, a declaration in the form FC TRS should be filed with an authorized dealer along with the a consent letter indicating the details of transfer, shareholding pattern of the investee company after the acquisition of shares by a person resident outside India showing equity participation of residents and non residents, certificate indicating fair value of shares from a chartered accountant or in case of a public listed company copy of the broker's note and an undertaking from the buyer to the effect that he is eligible to acquire shares in accordance with the FDI policy.