A.R.A LAW

Advocates & Solicitors

Legal Eye

Your peek into the Indian Legal Scene

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Thought for the month

It is an unfortunate fact that we can secure peace only by preparing for war.

-Jonh F. Kennedy

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Note from the Editor

Dear Readers,

In India we have seen a number of cross-border as well as domestic Mergers & Acquisitions (M&A) activities over the last several months some of which have been mega mergers.

The new Competition Bill is an additional item for the regulatory framework for M&A activities in India. Current regulatory framework is undergoing frequent and consistent changes. Often there is overlapping legislation wherein compliance with one law infringes a violation of another law. In this complex arena of corporate restructuring exercise and the regulatory menace, the structuring of the transactions needs to be skillfully worded.

Securities and Exchange Board of India (SEBI) Substantial Acquisition of Shares Regulations, 1997, is an evolving one which requires an infusion of fresh thoughts in drafting the Regulations, whilst bearing in mind the international experiences which the other countries have undergone.

We trust you will find this issue of the Legal Eye interesting as usual.

- Rajesh N. Begur, Editor, Legal Eye

Corporate Restructuring: Direct Taxation Implications

Demerger & Slump Sale

The corporate world today has witnessed a considerable increase in restructuring and corporate reorganisation. The term Undertaking has been defined in an inclusive manner, to include any part or a unit or division of the undertaking or a business activity, but does not include individual assets and liabilities or any combination thereof not constituting a business activity.

Demerger is among the most common options available for any Indian corporate as a restructuring model. Under the Indian law, a 'demerged company'[4] is defined as a company whose undertaking is transferred and the company or companies to whom the undertaking is transferred as the 'resulting company'[5]. The term 'Slump Sale' has been defined in case of transfer of one or more undertakings, by way of sale for a lump sum consideration without values being assigned to the individual assets and liabilities in such sales.

The article seeks to identify some issues of direct taxation arising out of the demerger and slump sale options of corporate restructuring. The scheme of direct taxation relating to the above are captured under the Indian Income Tax Act, 1961.

Demerger

The benefits of demerger in terms of taxation has certain pre-requisites including that the,

- transfer of one or more undertakings of the demerged company on a going concern basis
- transfer must be pursuant to a scheme of arrangement under Ss. 391-394, Indian Companies Act, 1956
- all the property of the undertaking
- all the liabilities of the undertaking are transferred.
- properties & liabilities are transferred at values appearing in the books preceding the demerger.
- the resulting company issues shares to the shareholders of the demerged company on a proportionate basis as a consideration for the demerger.
- Three-fourths of the shareholders of the demerged company becomes shareholders of the resulting company.
- Any other conditions notified by the Central Government in this behalf are fulfilled.

The absence or no occurrence of any of the above conditions leads to the withdrawal of the tax neutral benefits available under the Indian Income Act, 1961.

Unconsidered Practicalities

The definitions and the preconditions for tax benefits have not considered certain practical issues of demerger namely,

[1] Section 2(19AAA)
[2] Section 2(19AAA)
[3] Section 2(41A)
[4] Section 2(19AAA)
[5] Section 2(41A)

- Treatment of common assets being used by more than undertaking, of which one is part of the demerger and the other being out of it.
- condition to transfer common or general borrowings in proportion to the assets may not reflect the accurate utilisation of liabilities when companies maintaining common pool of bank accounts such segregation of borrowing utilisation for any particular undertaking is difficult.
- transfer of assets at book values might result into under valuation especially, unaccounted assets including goodwill, brand name, trade marks and future earnings.
- treatment of transfer of a single undertaking to more than one resulting companies has notbeen provided for.

Unresolved Issues on Demerger

Block of Assets

Of the several considerations in computation of taxation in a demerger it is required that the demerged Company reduce from his block of assets the written down value of the assets transferred to the resulting company and that the resulting company shall add to its block of assets the written down value of the assets appearing in the books of the demerged company.[6] However, the provisions do not prescribe the basis for computation of written down value.

In other words, it is not explicit as to whether the computation of written down value is to be as per depreciation rate prescribed under the Indian Income Tax Act, 1961 or as prescribed under the Companies Act. The ambiguity as above provision will result in wide differences between the amount as reduced from the block of assets of the demerged company as compared to the amount added for the same assets in the block of the resulting company.

Accumulated losses & Unabsorbed depreciation

The law requires that the accumulated losses and unabsorbed depreciation directly relatable to the undertaking transferred shall be carried forward and set off in the hands of the resulting company and in cases where the accumulated losses and unabsorbed depreciation is not directly relatable to the undertaking transferred an amount thereof in proportion to the assets transferred shall be carried forward and set off in the hands of the resulting company.[7] The issue arising would be that, the losses incurred by the company might not be in the same proportion in which the assets of the undertaking is being transferred.

The term "industrial undertaking" in the Indian Income Tax Act, 1961 has been defined for the purpose of computation of carry forward of losses generally for some categories of businesses while there is a separate definition for the term "undertaking" for demerger. It is therefore unclear whether the conditions defining undertaking (in demerger) or those in industrial undertaking (in general) would be applicable for the computing carry forward of losses in a demerger.

[6] Explanation 2A and Explanation 2B to section 43(6)
[7] Section 72A(4)

Slump Sale

The legislative intent to provide tax benefits under the slump sale option impliedly suggests that as a precondition the transfer of undertaking should be by way of sale and for cash. However, any other form of consideration for slump sale being eligible for tax benefits is not express in the statutes governing the transactions.

The definition of slump sale lays down that determination of value of an asset or liability for the sole purpose of payment of stamp duty, registration fees or other similar taxes or fees shall not be regarded as assignment of values to individual assets and liabilities. The tests to determine what is lump sum consideration without assigning values to individual assets and liabilities are not clear.

Depreciable Assets

In a slump sale, the transferor under the Indian Income Act, 1961, is required to calculate the written down value of each depreciable asset which is being transferred and such value needs reduction from the respective block of assets. The said written down value shall be calculated by providing for depreciation actually allowed in respect of any previous year commencing before 1.4.88 and the depreciation that would have been allowable henceforth.

The Act however, is silent the value at which the transferee shall record the asset and compute the depreciation thereon. However, whether the assignment of values by the transferee to the individual assets for recording in their books has any impact on the conditions of the definition of 'Slump Sale' is not clear.

Capital Gains

The Capital Asset being Undertaking or Undertakings transferred under the Slump Sale held and owned by the assessee for not more than 36 shall be deemed to be a Short–term capital asset, and for periods more than 36 months, a long-term asset. The benefits of indexation is not available in a slump sale. The tests and determination of age of an undertaking for capital gains in a slump sale is practically difficult and the law has not laid down guidelines in respect of the same.

The 'net worth' of the undertaking for the purposes of determining cost in computing capital gains shall be deemed to be the cost of acquisition and cost of improvement of the undertaking. The net worth shall be the aggregate value of total assets (ignoring revaluation, if any) of the undertaking as reduced by the value of the liabilities of the undertaking as appearing in the books of account. The aggregate value of total assets shall be the tax written down value (for depriciable assets) and book value (for other assets).

The legislative legitimacy accorded to the business concepts of demerger & slump sale in the Income-tax Act has made the consequences thereof more concrete despite the inadequacies highlighted above. These concepts are gaining more importance especially in the context of emerging business transition from Diversification to Core Areas.

Narendra Joshi

Legal Issues In Determining Valuation And Exchange Ratio

In an effective and efficient amalgamation the valuation and exchange ratio plays a very important role and there has been considerable judicial activity in this regard. The articles aims to listout the various methods adopted in arriving at a fair valuation and exchange ratio and the judicial approach in India to some of the issues relating to valuation and exchange ratios.

Valuation and exchange ratio are primarily determined on the basis of three methods:

- asset value of the Company (the break up method).
- profit earning capacity.
- market value of the shares.

Determination criteria of the ratio

In any method the following criteria have been postulated in Weinberg and Blank in determining the share valuation and exchange ratio of the Companies:
- stock exchange prices at the start of negotiations.
- dividends previously paid on shares
- relative growth prospects
- value of the net assets
- past history of prices

They cover (ratio of the after tax earnings to dividends paid during the year) for the present dividends of the two companies.

Judicial Approach

- *Principles of Valuation*

In *Commissioner of Gift Tax* v. *Kusumben D. Mahadevia*[8], the Supreme Court observed that where the shares of a public limited company are quoted on a stock exchange and there are dealings in them the price prevailing on the valuation date would represent the value of the shares. But where the shares in a public company are not quoted on a stock exchange or the shares are in a private limited company the proper method of valuation to be adopted would be the profit earning method. In the case of a company which is a going concern and whose shares are not quoted on a stock exchange the profit earning capacity would ordinarily determine the value of the shares. The net asset value method would not be appropriate. The Court held that a combination of methods had no judicial sanction and cannot be accepted as a method of valuation.

In *Hindustan Lever Employees Union* v. *Hindustan Lever Ltd.*[9] the matter of valuation and exchange ratio came up before the Supreme Court. The exchange ratio had been fixed at 2 shares in HLL in

8 AIR 1980 SC 769
9 (1995) Supp (1) SCC 499.

return for 15 shares in TOMCO by adopting a combination of the three methods. It was contended by a shareholder that if the valuation was done in accordance with the net asset method then the ratio would have worked out differently. Moreover, the market value of the shares was taken at a point of time when the value of the TOMCO shares was at its lowest for 27 months. It was contended that the share ratio was entirely unsatisfactory and unfair An independent valuation also approved of the method and the ratio arrived at. The Court examined the profits of the companies. It emerged from these examinations that if the yield method was adopted the ratio was astronomically in favour of HLL. But if the book value was used the ratio would favour TOMCO tremendously. The attempt to evolve an equitable method of accounting resulted in the adoption of the combination of the three methods.

The Supreme Court distinguished the decision in *Kusumben Mahadevia* stating that considering the anomalous situation that arose as a result of using one of the methods a combination of the three could be used but only after considering all issues. But all three methods must be examined before establishing what may be described as a reasonable ratio. The Court further held that an overwhelming majority of shareholders had approved the scheme. There was no reason to assume that the shareholders did not know what they were doing.

- *Valuation for financially weak companies*

The Supreme Court in *CWT* v. *Mahadeo Jalan*[10] expressed the view that in the case of a private company the dividends should determined the value of the shares. If that does not reflect the proper value then the yield method should be used. In so far as valuation of shares of a company quoted on a stock exchange was concerned, the market price on the date of valuation would be the value of the shares. The Court also observed that the break-up method was used in the context of winding up.

In *Bihari Mills, In re*,[11] the Gujarat High Court was required to examine an amalgamation where the transferor-company was healthy and the transferee company was sick. The Gujarat High Court held that the dissolution of a company under section 394 was akin to its winding up and hence said that the net asset value should be used for the purposes of valuation.

- *Rights of Minority Shareholders*

In the case of *Bank of Baroda Ltd.* v. *Mahindra Ugine Steel Co. Ltd.12*, an issue that arose before the Court was as regards the shareholders who had chosen not to stay on in the amalgamated company and were being given cash consideration. The consideration payable was Rs. 143 per share again the market value of Rs. 130. The question arose as to whether this was fair especially since those who had agreed to stay on had been given Rs. 163 per share. The explanation given by the representatives of the transferee was that even if these shareholders were given Rs. 163 the post tax receipts would only be Rs. 137 per share. The cash option figure that was declared was therefore higher than the market value of the shares of the Transferor Company and the post-tax receipts. The Court on this basis held the valuation to be fair.

10 [1972] 86 ITR 621(SC).
11 [1985] 58 Comp Cas 7(Guj).
12 [1976] 46 Comp Cas 240(Guj.)

The Courts have been loathe to interfere in issues relating to the determination of valuation and exchange ratio primarily because they are reluctant to substitute the judgement of the shareholders with their own. The drift of judicial dictum indicates that the valuation and exchange ratio must be fair and reasonable. In order to arrive at this result all acceptable methods must be considered and a combination of all methods may be used for arriving at the same. As far as the use of the break up method was concerned Courts have held that it should be used only when a company is ripe for winding up.

Mrinal Chandran & C.K.Nandakumar

Competition Bill 2000

Overview & Scope

The cabinet has cleared the bill on competition law and policies named the Indian "Trade Related Competition Bill 2000" to replace the existing Indian Monopolies and Restrictive Trade Practices Act, 1956. The bill fundamentally seeks to incorporate and legislate on issues raised by the SVS Raghavan Committee appointed by the Department of Companies Affairs seeking to regulate anti-competitive practices and the abuse of dominance by corporate entities.

New Commission

The Bill seeks to appoint **Trade Related Competition Commission of India (TRCCI)** being a multi-member body comprised of not less than 10 members who will be eminent and erudite persons of integrity and objectivity from the fields of Judiciary, Economics, Law, International Trade, Commerce, Industry, Accountancy, Public Affairs and Administration. The TRCCI will have a Chairperson and a two member Mergers Commission.

Scope of the Bill

Abuse Of Dominant Power

An enterprise is prohibited from abusing its dominant position[13], if it

- directly or indirectly imposes unfair or discriminatory conditions in purchase or sale of goods or services, or its price in purchase or sale of the aforesaid
- limits or restricts production of goods or provision of services or market, technical or scientific developments relating to goods or services to the prejudice of the consumer, or indulges in a practice which results in denial of market access;
- makes conclusion of contracts subject to acceptance by other parties of supplementary obligations which by their very nature or according to commercial usage have no connection with the subject of such contracts

[13] Section 4 Expln (a) dominant position" means a position of strength, enjoyed by an enterprise, in the relevant market, whether in India or outside India, which enables it to -
(i) operate independently of competitive forces prevailing in the relevant market; or
(ii) affect its competitors or consumers or the relevant market in its favour;

- uses its dominant position in one relevant market to enter into or protect other relevant market .

Any enterprise engaged in abuse of dominant power shall be investigated by the Commission and the Commission may suggest various methods to prevent continuation of such abuse of dominant including breakup of the enterprise or the combination, restraint of continuing certain practises or the like. Such abuse of dominant power could either be by an enterprise or by one or more enterprises in combination.

Combination

A merger or amalgamation of one or more enterprises may amount to a combination if the following circumstances namely:

(i) the enterprise remaining after merger or the enterprise created as a result of the amalgamation, as the case may be, have, -

- either in India, the assets of the value of more than rupees one thousand crores or turnover more than rupees three thousand crores; or
- in India or outside India, in aggregate, the assets of the value of more than five hundred million US dollars or turnover more than fifteen hundred million US dollars;

(ii) the group, or its constituent enterprise remaining after merger or the enterprise created as a result of the amalgamation, as the case may be, have, -

- either in India, the assets of the value of more than rupees four thousand crores or turnover more than rupees twelve thousand crores; or
- in India or outside India, the assets of the value of more than two billion US dollars or turnover more than six billion US dollars.

The TRCCI is empowered to inquire into combinations wherein post-merger entities belong to a group[14] having assets either in India of more than rupees four thousand crores or turnover more than rupees twelve thousand crores; or having worldwide assets of the value of more than two billion US dollars or turnover more than six billion US dollars.

Competition & Fair Play

The underlying philosophy of the Bill is to ensure that mergers and amalgamations shall not in any manner have an "appreciable adverse impact" on competition and distort fair play in the market and if the same is prevalent to render them void. This section of the bill prescribes threshold limits for post-merger inquiry. These limits have been prescribed in terms of assets and/or turnover of the merged entity.

[14] The Bill defines a "group" as two or more enterprises which directly or indirectly have the ability to exercise 26% or more of the voting rights in the other enterprise or the ability to appoint more than half the members of the Board of Directors in the other enterprise, or the ability to control the affairs of the other enterprise.

Further, the Bill seeks to make it mandatory requirement for any person who proposes to enter into an agreement or combination to give notice to the TRCCI specifying the details within seven days of occurrence of certain events. As an example, notice must be given before the board of directors of the respective companies accepts a proposal of merger or amalgamation or the conclusion of negotiations of an agreement for acquisition or acquiring of control.

The new Trade Related Competition Act (proposed), seeks to provide impetus to the emerging globalization of Indian economy within the framework of the World Trade Organization. The Bill has proposed a number of far reaching measures that will help put in place a strong competition policy in India and make India an attractive destination for foreign investment. The Bill will help in better enforcement of discipline among the business community. The Government has suggested in its recent press releases that it would enforce the proposed Act only after a year, even if enacted, so as to enable the corporate sector to acclimatize itself with the new environment.

Ashu Thakur

Due Diligence: Necessary Evil in M & A

A Due Diligence exercise is one of the necessary evils prior to closing a "deal". However, more often than not, several post completion differences and disputes have arisen on account of no pre-deal due diligence or risk assessment. An effective and meaningful due diligence would avoid disputes and re-negotiation, subsequent to the transaction.

Due Diligence is a systematic approach that allows an acquirer to analyse a prospective target. It provides key information to help determine the level of effort, length of time and course of action required to bring two companies into alignment. An effective merger or acquisition transaction will at some stage require a Due Diligence of the various components of the target business. The exercise includes the gathering, analysis and interpretation of financial, commercial, operational and legal information, whereby the parties assess the risks pertaining to such Merger and acquisition.

The function of a law firm in a due diligence would relate to statutory compliance with the regulatory framework, contract law, employment laws, competition laws, intellectual property, taxation and asset verification of the business in focus and subject. The findings of the said due diligence process normally, culminates into a Letter of Disclosure and a Deed of Representations & Warranties to providing comfort to the acquirer.

[15] The Bill defines a "group" as two or more enterprises which directly or indirectly have the ability to exercise 26% or more of the voting rights in the other enterprise or the ability to appoint more than half the members of the Board of Directors in the other enterprise, or the ability to control the affairs of the other enterprise.

Objectives

The objective of a due diligence is about identifying and assessing risk. In order to minimise their risk and get the best terms, both the vendor and the acquirer need to take a proactive strategic approach to a Due Diligence.

The due diligence is normally undertaken with an objective of acquiring superior knowledge of the Target than already provided by the other Party. Especially in a multi-party bidding situation, the specific party that gains and acquires superior knowledge on the Target usually has a better understanding of the Target's business and is also at an advantage at the bidding & negotiation phases.

Focus of Due Diligence

The focus of the due diligence lies in identifying the risks associated with acquiring the Target and advising the acquirer of the consequences and liability subsequent to the investment by the acquirer.

The areas would differ depending on the nature of the Target, but typically will cover, general information, corporate structure, regulatory compliance, transactions/ reconstructions, trading activities, competition law, personnel, pension schemes, real estate, environmental compliance, software, intellectual property, third parties lending, financing facilities/borrowing from third parties, financial grants, guarantees, indemnities, letters of credit, product liability, investigations, litigation, disputes, insurance and taxation.

Risks

In terms of the acquirer and its financiers, a range of risks exist which are the matter of every due diligence, such as:

- The political risk associated with the countries in which the Target is based.
- The accuracy of the past financial accounts of the Target.
- Whether the Target's key personnel, suppliers and customers will remain.
- Whether the Target has good title to its assets.
- Whether those assets are of the value that the vendor attributes to them.
- Whether there are any existing liabilities that may manifest themselves in the future to disrupt the operation or financial performance of the Target.

The issues once identified and determined are subject matter of negotiation.

In conducting these negotiations, the acquirer is at a disadvantage since he does not have the data to identify and assess the risks accurately. Accordingly, one of the most important decisions that every acquirer has to make at the earliest stage of any transaction is the degree to which it wishes to

redress the knowledge imbalance between it and the vendor. Conversely, unless the vendor conducts its own Due Diligence in advance it is possible that the well-advised acquirer will eventually achieve information superiority.

Although the Vendor may provide warranties, which give assurances on these issues, the acquirer will nevertheless wish to check them. The verification approach also reduces the potential for conflict because problems are identified early on. All too often, the Vendor is not even aware of its own problems, until the acquirer discovers them during the Due Diligence.

Broadly, the due diligence exercise is programmed towards acquiring a comprehensive knowledge of the target in an M & A activity. In assessing the risks and implementing the objectives, an effective & efficient strategy is required. The next part of this article in our coming newsletter shall address the section on strategy in an M & A due diligence.

S R Arun, Radhika K & Vachan B

Effective Date of Amalgamation

The effective date of amalgamation in an amalgamation is of paramount importance as from this date the amalgamating companies discontinues its corporate existence and ceases to be an independent entity both in law, tax and for business. Upon amalgamation all the property rights and liabilities of the amalgamated companies stand vested in the merged entity.

In determining an effective dates there are some indicative guidelines under Indian law. These may include the date on which the shareholders of the Company specify that the scheme becomes effective, the date on which the High Court as required under S. 394 of the Indian Companies Act, 1956, grants approbation to the scheme or the date on which the company's name is actually struck off the Register of Companies.

Judicial Interpretation

In the case of *Marshall & Sons Ltd*. v. *ITO,* the Madras High Court was of the opinion that the date of amalgamation was the date on which the name of the company was struck of the Register of Companies. In the instant case, the assessee company based in Madras merged with its parent based in Calcutta. The date of amalgamation as proposed in the scheme put forth before the shareholders of

both companies was 1st January, 1982. The scheme was finalised and approved by the directors of both companies only in December ,1982. It was put before the shareholders for their seal of approval only in early 1983. The Calcutta and Madras High Courts accorded sanction to the scheme only in November,1983 and January,1984. Pursuant to the approval of the scheme by the Courts the orders to strike of the company's name was filed before the Registrars of Companies in Calcutta and Madras. The name of the company continued in the Register of Companies till June, 1986 before it was finally struck off.

The Supreme Court in this has pronounced that the date in the scheme as approved by the shareholders would be considered to be the date from which the scheme would take effect, irrespective of the date on which the allotment of shares or other events has taken place. The Supreme Court further stated that the logical extension of this is that from the date specified in the scheme the subsidiary company would continue its business operations for and on behalf of the holding company.

The implication of this judgement is that there may be, for legal purposes, a retrospective operation of a scheme of amalgamation as has happened in the instant case. This could result in the use of amalgamations as a method of tax avoidance. Mergers would be used by companies as a method of reducing their tax liabilities, especially in cases where a subsidiary company was operating at a loss while the holding company was showing substantial profits. Amalgamations and mergers would then become instruments of tax evasion.

The issue of the retrospective operation of amalgamations had earlier arisen before the High Courts of Gujarat and Madras. In *Union of India* v. *Ambalal Sarabhai Enterprises Ltd*., the Gujarat High Court held that the High Court had the power to approve a scheme even from a date anterior to the date of approval by the High Court. The Madras High Court had earlier taken the view in *United India Life Assurance v. CIT* that a scheme of amalgamation could not operate retrospectively. However the question on this point has been set at rest by the Supreme Court by the decision in the *Marshall & Sons* case, wherein the Court has approved the retrospective operation of the scheme of amalgamation albeit without considering the possible repercussions.

The other issue that arises from the judgement of the Supreme Court is the consequence that would ensue if the scheme were to be rejected by the Company Courts when it is already in effect. The question as to assessment for the purposes of tax liability then becomes a problem. The Supreme Court has suggested a very cumbersome procedure to set at rest any apprehension that may arise from an order disapproving the scheme of amalgamation. The Court advised the taxation department to make one assessment on the amalgamated company taking into account the income of both the amalgamating and amalgamated company and also to make separate protective assessments on both companies. Such a procedure is impractical because once the amalgamation comes into effect only a single account is maintained by the amalgamated company.

Mrinal Chandran & Manu Seshadri.

Focus Article: Venture Funds

Uncertainty in Exit

The slowdown and disappearance of the dot-coms' and fabulous investment returns, VCs have now realised that it is almost impossible to attain the level of revenues and profits forecast in the business plans submitted by their portfolio companies. Presently, large number of VC Fund Managers are gritting their teeth over lost investment and are now exploring means to recover or salvage whatever is remaining of their sinking investments.

VCs in doing this have considered miracles, which has become extinct in the e-world, as an option. With no end in sight they are now seeking legal help to recover whatever if left of their already vanished investments. The options suggested to VCs today vary from altering business models, synergy identification, partnerships, acquiring revenue earning business, or getting acquired and in worst case scenarios to seek return of the remaining portion of the money invested in the target companies.

VCs with their lawyers today are debating on recovering monies in any manner including by way of return of capital either through' buyback of shares or reduction of capital, suit for recovery of damages for mismanagement, company petitions, criminal complaints for breach of trust & misappropriation of funds, civil suit for specific performance and winding up in some cases for failure to pay off subordinate debt instruments.

Each of the options being debated by the VCs with their lawyers poses several impediments in terms of statutes, procedure and practicality. As an illustration, one of the options is for the portfolio company to return the invested capital, however, returning capital lowers the company's value and according to the Indian Companies Act, 1956, an approval of the Court is mandatory for the return of ordinary share capital and surely cannot be done without the knowledge and initiation of the portfolio company's management. Also, VC's are trying to see if such monies could be recovered by instituting civil suits and seek damages for mismanagement, loss of profits and breach of trust.

Another dilemma is that they preferred ordinary equity as a vehicle of investment over the lesser prevalent preferential route for their portfolio investments. The preferential route would have provided VCs with an arm to seek return of capital in preference over the promoters of the portfolio companies. In the ordinary mechanism, the promoters and the VC Funds stand on the same footing, with the promoter benefiting with no financial risk taken by them.

With no options available towards a comfortable exit, there seems to be no resolution to loss making for VCs in India. We have been actively involved with several VC clients of our in the past few months exploring options on possible recovery of monies invested.

S R Arun,
Radhika K
Vachan B

LEGAL SNAPSHOTS

SC: PSUs need not absorb Contract Labourers

On August 30, the Supreme Court quashed a 1976 notification issued prohibiting use of contract labour in certain type of jobs and maintaining that such labour need not be automatically absorbed.

The judgement delivered by a constitution bench has far-reaching implications. Establishments can now utilise contract labour without any obligation of their absorption in the event that contract labour is prohibited under Sec. 10 of the Contract Labour (Regulation & Abolition) Act, 1976. The direct consequences of the judgment primarily affects the the lowest strata of the labour ladder, however, the ruling is expected to provide the necessary impetus to the executive to pioneer greater flexibility in labour laws at other levels.

The judgement reversed its own earlier judgement in the Air India case where it had ruled on automatic absorption of contract labour. The judgment under discussion came on a petition filed by Steel Authority of India Limited challenging the July ''98 judgement of the Calcutta HC directing absorption of around 350 contract labourers. This judgement would be prospective in nature and any direction issued by any industrial adjudicator/any court for absorption of contract labour following the judgment of in Air India's case shall hold good and that the same shall not be set aside, altered or modified on the basis of this judgment in cases where such a direction has been given effect to and it has become final. ❖

The Companies (Amendment) Bill, 2001 receives Cabinet sanction

The Companies (Amendment) Bill, 2001 seeks to establish an insolvency fund where companies, with a paid up capital of over Rs 10 lakh will contribute 0.1% of their turnover for rehabilitation of sick companies and protection of assets.

Initially companies will be required to chip in only 0.05% of their turnover towards the fund. The Government also proposes to move a bill to repeal Sick Industrial Companies (Special Provisions) Act in the current session of the Parliament. The initial corpus of the fund, would be would be around Rs. 750 mill.

The amendments to the Companies Act would result in the establishment of a National Company Law Tribunal (NCLT) with the powers and jurisdiction of Board for Industrial and Financial Reconstruction, Appellate Authority for Industrial and Financial Reconstruction, Company Law Board and High Courts. The aim of the Bill is to reduce the funds locked up in the BIFR cases and it is the intention of the government to complete the process in two years. ❖

Telecom Acts made archaic by Convergence Bill

The Cabinet on August 27, approved the Communication Convergence Bill 2001 and seeks to repeal the Indian Telegraph Act, 1885, the Indian Wireless Telegraphy Act, 1933, Telegraph Wire Unlawful Possession Act, 1950, the Cable Television Networks (Regulation) Act 1995 and the Telecom Regulatory Authority of Indian Act, 1997.

The bill envisages the creation of a overall regulatory body called the Communications Commission of India (CCI) empowered to regulate carriage and licensing of communication services. The Government intends to introduce the bill in parliament during the current session. Upon being introduced in the Parliament, it is likely to be presented to the Standing Committee.

CCI would be an umbrella body which would look into issues relating licensing, spectrum management, dispute resolution and determination of regulation codes, technical standards, tariffs, rates for licensed services as well as determine the conditions for fair, equitable and non-discriminatory access to network facility and service.

The cabinet approval comes about 11 months after discussions began over the draft bill drafted by a team of experts led by distinguished jurist and Rajya Sabha member, Fali S Nariman. ❖

India's First Cyber police station set up

India's first police station to exclusively handle cyber crimes such as computer hacking, data damage and internet fraud will start work in Bangalore on 15th September, 2001. The station would cover crimes under the Information Technology Act, 2000. The station is aimed at taking quick action on solving cyber crimes, talking the burden off from local police. However, the local police stations would continue to register cyberspace crimes and would also carry out searches . The Cyber Crime Police Station (CCPS) has even hosted a web site to enable filing of online comlaints at http://ccps.karnatakastatepolice.org ❖

Amendment in Takeover Code exempts Corporates from making second open offer for acquiring additional shares in PSUs.

SEBI has amended the SEBI Substantial Acquisition of Shares & Transfer of Undertakings Regulations, 1997 to exempt corporates from making a second open offer for acquiring additional shares of a Public Sector Undertaking. This means that if a strategic partner acquires an additional stake in a PSU after acquiring an initial stake, it is now exempt from making another offer to the public. However the second round sale must be specified upfront. SEBI has ruled out the making of a counter offer at the time of the first open offer as the selection of buyer of government stake is made after competitive bids. The rationale being when the counter-bid offer is presented the disinvestment process could be influenced by unsuccessful bidders.

Non-compliance with the takeover Code by corporates who succeed in buying the government stake would result in the control of the PSU reverting to the government. A company would not be exempt from making the open offer in a disinvestment process as PSUs are also listed companies. Further, PSUs buying government stake in other PSU would however be exempt from making an open offer. ❖

IP Appellate Board to be set up within six weeks

A four member body which will hear appeals against intellectual property rights and which will assist the High Courts in intellectual property right matters is due to be established. This body, the Intellectual Property Appellate Board (IPAB) is due to be set up with two technical members, a chairman and a vice-chairman. ❖

CBDT issues liberal transfer pricing norms

CBDT has issued the circular clarifying the prospective application of documentation requirements in transfer pricing laws. The circular says that if the company's price differs from the assessing officer's estimate by 5% in either direction, then the price declared by the company will be accepted. The circular also clarifies that though the transfer pricing provisions will come into effect form April 1, 2002, and are applicable from the assessment year 2002-2003 onwards, the transfer pricing rules have just been notified, and hence failure to maintain documentation norms required for all international transactions will not be penalised.

The above relaxation does not mean that transactions of the companies need not follow the 'arms length' principle and is only with respect to the documentation required. The Board also clarifies that if the 'arms length' price arrived at by the assessing officer is 5% more or less than the price arrived at by the assessing officer, the price declared by the assessee will be accepted.

The rules have specified that the entire gamut of documentation requirements will not apply to companies where the aggregate value of international transactions do not exceed Rs. 10 mill. Any transaction below this amount will still be required to justify the price transacted at as the 'arms length' price. ❖

SEBI revises MFs disclosure norms for more transparency

SEBI has revised the disclosure standards in the following manner to be followed by mutual funds in their offer documents-

- A detailed disclosure date on key personnel of an asset management company
- MFs will have to tell their investors the rationale behind their investment decisions
- AMCs to disclose any other business activity apart from asset management
- Certification by the MFs that there is no conflict of interest between investment management and portfolio management services offered by them
- MFs to state that inter-scheme investments cannot be made beyond the 5% of the NAV of a scheme
- To disclose the limit upto which a scheme will invest in securitised debt instruments, which are typically considered to be less liquid than stand- alone corporate debt of top rated issuers
- Risk factors associated with ADRs and GDRs and any internal policy with respect to scrip wise exposure apart from those statutory
- To inform the investors when a review or re-balancing of the asset allocation patterns would be undertaken so as to enable the investors to get an idea of the investment strategy of the scheme
- AMCs are prohibited from investing in schemes managed by them unless the intention has been made clear in the offer documents❖

SEBI panel suggests cap on stock futures position

The SEBI Advisory Committee on derivatives has suggested a strict position limit for clients and brokers for trading in stock futures. The Committee has worked out a stringent risk containment framework for introduction of

stock futures. It has decided that cash- settled stock futures will be introduced in 31 stocks in which options are permitted.

The Committee has fixed the members trading limit for individual stock options and futures at Rs. 500 mill. The current limit for index futures is Rs. 1 bill. The client- level limit for position is pegged at 5% of the total open interest in the derivatives market or 1% per cent of the market capitalization. ❖

Co-operatives may be allowed to enter Insurance business

The Insurance Amendments Bill, 2001, envisaging amendments to the Insurance Regulatory & Development Authority Act, 1999, (IRDA) is likely to be introduced in the winter session of the Parliament. The amendment seeks a co-operative society under the Cooperative Societies Act 1912 or any other law for the time being in force in any other state relating to cooperative societies or under the Multi-State co-operative Societies Act, 1984 to do insurance business. The only pre-condition being that the corporate body registered outside India should hold more than 26% of the capital. As regards the IRDA, the individuals will be allowed to come together to form an insurance venture under a co-operative society and not necessarily form a joint stock company as envisaged in the IRDA.

Other developments : IRDA

Insurance brokerage firms will be allowed foreign participation upto 26% of their paid up capital and insurance companies will be allowed to pay up to 30% commission to them. Life insurers will now be allowed to distribute 10% of the surplus on the valuation of life insurance funds. The entry restrictions on institutional players such as banks is vague and will depend on the guidelines prescribed by the IRDA and the Reserve Bank of India. ❖

Overseas investors must bring in cash against FDI commitments

The FIPB has recently decided that foreign investors would have to bring in cash against their FDI commitments. However, the FIPB will continue to permit companies to swap shares and all non-cash payments against products and services. This in turn suggests that a domestic company could pay for its overseas acquisition with its domestic stake which is a popular mode adopted by IT companies for global acquisitions. This move effectively de-links the inward and outward remittances of a foreign company in India, treating each as an independent foreign exchange stream. ❖

FII investments in Indian Companies to go by sectoral caps

The RBI has issued a notification that Foreign Institutional Investors (FIIs) investments in Indian Companies can now be increased beyond 24% upto the sectoral cap/statutory ceiling, as applicable, provided this has the approval of the Indian Company's Board of Directors as also its general body.❖

Meet the A.R.A. LAW Team

In each issue, we will be profiling one person who is a part of A.R.A. LAW. They will also be sharing their experiences of working at A.R.A. LAW

C. K. Nandakumar obtained his Law Degree from the National Law School of India University, Bangalore in 2001, where he was involved in a number of activities. He was closely associated (as volunteer and later as convenor) with the Legal Services Clinic, both at the mediation centres and the legal literacy programmes that the clinic organised. His involvement with Alternate Dispute Resolution is evident from his teaching assistance in ADR and a seminar course in Negotiation Skills. His areas of interest include ADR, Arbitration, Corporate Restructuring and Mergers and Acquisitions, Securities Law, Intellectual Property Law, Environmental Laws and Banking Law. While at Law School, he participated in many literary and debating activities.

"For a person aspiring to be a corporate lawyer, A. R. A. LAW is the most evident choice. A formidable presence in the legal fraternity, A. R. A. LAW affords a person a wonderful opportunity to develop his/her legal skills and nurture those aspects of ones personality that are often taken for granted. The atmosphere, coupled with the opportunities afforded is very congenial to developing ones' overall personality Great emphasis on focus areas, time consciousness, knowledge management, an aggressive approach and teamwork make A. R. A. LAW a firm that looks into the future. Meetings with the partners and associates, where responsibility is shared and the idea of "everybody does everything" goes a long way in making one complete. Based on such strong values, there is only way that A. R. A. LAW can go- forward." ❖

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