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CAPITAL MARKETS

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» Cross Border Mergers

There has been a sharp rise in the number and value of cross-border mergers among multinational businesses in recent years. Some of the reasons for this recent increase are due to the growth in competition and global markets, and the rapid changes in technology.

Factors that may not be very crucial in domestic M&As, such as legal and regulatory framework, cultural issues, business dynamics, accounting treatment, tax regimes and treaties, become critical in international acquisitions. This article seeks to analyse the sanctity of cross border mergers, being one of the most sought form of cross border transactions, from an Indian law perspective.

In India, the Companies Act 1956 (“Act”) provides for cross- border merger where a foreign body corporate could merger with an Indian company. While the Act lays down the procedure for a foreign company or its branch to merge with an Indian company with the sanction of the jurisdictional High Court, the Act is not very clear as to the merger of an Indian company with a foreign company.

Sections 390 – 394 of the Act govern mergers and amalgamations. Section 394 of the Act provides that the Court may sanction the amalgamation of companies where the whole or any part of the undertaking, property or liabilities of the transferor company is transferred to the transferee company.

On an analysis of the above provisions, it may be concluded that for the purposes of Section 394, the term "Transferee Company" does not include any company, other than a company within the meaning of the Act. "Company" defined under the Act means a company that is formed and registered under the Companies Act, 1956. This would mean that a "Transferee Company" in an amalgamation governed by Section 394 has to be an Indian Company incorporated under the Act;

On the other hand, the term "Transferor Company" is defined under the Act includes any body corporate, whether a company within the meaning of the Act or not. The term "body corporate" is defined under Section 2 (7) of the Act to include a company incorporated outside India. This would mean that, a transferor company in an amalgamation governed by Section 394 of the Act can be a foreign company.

Therefore, it may be concluded that Section 394 recognises a merger of a company incorporated abroad with an Indian company on the condition that the transferee company (i.e. surviving entity) should be an Indian entity. The object is to facilitate arrangement between foreign companies as transferors and Indian companies as transferees.

However, analysis as to the treatment of cross border mergers under the laws of the transferor company, being the entity losing its existence becomes extremely relevant. If the law of the country, where the transferor company is incorporated, requires the filing of the scheme of amalgamation in the courts of that country also, the process may get tedious. On the other hand, if the law governing the transferor company stipulates that the merger is to be governed by laws of the country where the surviving entity is incorporated, then the scheme can be filed only in India and the transferor company would be wound up upon merger, by following simple reporting formalities with the statutory authorities of the country where the transferor company is situated.

In a cross-border merger, the issue of shares by the transferee company which is an Indian company, to the shareholders of the transferor foreign company who are non-resident, comes under the preview of FEMA. Regulation 7 of FEMA (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 envisages the issue of shares to foreign shareholders as a result of merger of two or more Indian companies. But this does not cover mergers between Indian and foreign companies. If the activities undertaken by the transferee company do not fall under the list of activities in which foreign investment is prohibited or restricted then the transaction of issue of shares to the shareholders of the transferor company, as part of the merger, should ideally fall under the automatic route, obviating the requirement of RBI approval. However, since there is no inflow of foreign funds into the transferee company, in cash, in exchange of issue of shares, it would be necessary to obtain the prior approval of Foreign Investment Promotion Board and Reserve Bank of India for the transaction.

It is also important to identify the debts, obligations, liabilities and assets of the transferor company before the consummation of a merger. This is because pursuant to a merger, such debts, obligations, liabilities and assets of the transferor company would become the debts, liabilities, obligations and assets of the transferee company. Hence, a detailed due diligence may be conducted before initiating any steps for the consummation of merger. As per the FEMA Regulations, approvals are necessary for lending and borrowing from non residents, holding foreign securities, holding foreign insurance and foreign currency accounts. However, the approval obtained from the Foreign Investment Promotion Board and Reserve Bank of India should be all encompassing and no separate approvals may be necessary.

Further, for the purpose of taxation, under the Income Tax Act, 1961 any transfer, in a scheme of amalgamation, of a capital asset by the amalgamating company to the amalgamated company is exempted from the purview of capital gains tax, provided the amalgamated company is an Indian company. However, with respect to transfer pricing guidelines, it needs to be verified by the transferee company's auditors as to whether the contemplated transaction complies with the transfer pricing guidelines.

Cross border mergers can be an effective tool of integration and consolidation of cross border entities and their respective businesses. However, the success of such mergers depends on the suppleness of the laws of the country where the transferee company is situated. At present, the Indian regulations only recognize a merger of a company incorporated abroad with an Indian company. However, a forward looking law on mergers and amalgamations also needs to recognize a merger of an Indian company with a foreign company being the 'surviving entity'. Both contract based mergers between an Indian company and a foreign company and court based mergers between such entities where the

foreign company is the transferee, need to be recognized in Indian Law.

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» Overseas Investment by Indian Companies

Globalization and non-discriminatory multilateral trade have opened new doors for Indian corporates. Earlier, there was an accent on inward flows - FDI, portfolio investments, joint ventures and collaborations to tap the growing Indian market, and also technology transfers for enhancing competitiveness of Indian firms. Exports were predominantly the main door to step out towards globalization. The scenario has now changed. There has been a growing realization that the future growth of Indian companies will be influenced by the share that they can garner in the world market, not only by producing in the country and exporting, but also by acquiring overseas assets, including intangibles like brands and goodwill, to establish overseas presence and to upgrade their competitive strength in the overseas markets.

The policy regime in respect of outward capital flows has accordingly evolved in spirit with the above trend. This note summarizes the present framework for overseas investment by Indian companies

Portfolio Investments.

Indian unlisted corporates are not permitted to invest on overseas stock markets without the prior approval of the Reserve Bank of India (" RBI"). Listed Indian companies also require prior RBI permission to invest on overseas stock markets, except if the overseas listed company has a shareholding of at least 10% in an Indian company that is listed on the Indian stock exchanges. Investment in overseas stock markets is restricted to 25% of the net-worth of the Indian listed company.

Strategic Investments

Indian corporates are permitted to invest in overseas subsidiaries and joint ventures with the general or specific permission of the RBI. In case the aggregate investment by the Indian corporate exceeds US$100 million (US$150 million for SAARC countries), prior specific permission of the RBI would be required.

The quantum of the overseas investment should not exceed 200% of the net-worth (i.e. paid-up capital and free reserves) of the Indian investing entity. This limit of 200% of the net worth is not applicable if the Indian corporate makes the overseas investments from the proceeds of an issue of American Depositary Receipts (ADRs) or Global Depositary Receipts (GDRs).

In order to qualify for general permission, the overseas investment must be in an operating company. Any investment in an overseas holding company or special purpose vehicle requires specific consent of the RBI.

The Indian regulators require that a valuation report is submitted in case of any overseas investment in excess of US$5 million.

Acquisition of shares of an overseas company otherwise than for cash is significantly restricted. Entry into share swap transactions generally requires the permission of the RBI. Only IT, pharma and biotech

companies are allowed to swap ADRs/GDRs for shares of an overseas subsidiary or joint venture company. Capitalisation of dues outstanding for more than 6 months requires prior permission from the RBI.

Overseas Direct Investment by Regulated Entities in the Financial Sector

Indian entities investing in entities engaged in financial services activities overseas have to comply with the additional conditions laid down in Regulation 7 of the Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004.

At present, entities engaged in financial services activities in India making investment in non-financial services activities overseas are not required to comply with the additional conditions mentioned in Regulation 7 of the said Regulations. However, with a view to assess the impact of the overseas operations of such entities on a consolidated basis, RBI has decided to regulated entities in financial sector in India investing overseas in any activity.

RBI has further clarified that trading in Commodities Exchanges overseas and setting up JV/WOS for trading in Overseas Commodities Exchanges will be reckoned as financial services activity and will require clearance from the Forward Markets Commission (FMC). The FMC has recently put in place guidelines for allowing FMC registered members of Commodity Exchanges to undertake commodity related activities abroad.

Funding.

Overseas acquisitions are funded through a variety of sources such as drawal foreign exchange in India, capitalization of exports, balances held in EEFC accounts, share swaps, ECBs, FCCBs, ADRs/GDRs, etc. An Indian corporate can only purchase foreign currency upto 100% of its net-worth for the overseas investment. An Indian corporate cannot borrow from Indian banks and financial institutions in excess of 100% of its net-worth for the overseas investment.

A substantial portion of investments takes place through special purpose vehicles (SPVs) set up for the purpose abroad. Existing WOS / JVs or the SPVs are being used to fund acquisitions through Leveraged Buy-Out (LBO) route and such transactions are not currently captured in overseas investment statistics. The major investment destinations appear to be the US and European markets. Tax havens like Mauritius and Cayman Islands also feature significantly in the Indian acquisitions or setting up of new WOS/JVs.

RBI Specific Approval

If a proposed investment is not consistent with the parameters based on which general approval is granted, an application could be made to the RBI seeking specific permission for an overseas investment. Elaborate details of the overseas investment, including funding pattern, valuation and business plan, must be provided to the RBI. The RBI is generally not reluctant to approve an overseas strategic investment by an Indian corporate if the necessary details are furnished to it.

Conclusion

The overseas acquisitions, which started of on a small scale, have reached to globally visible levels with big ticket acquisitions being announced by large corporates regularly. A report of the Boston Consulting Group (BCG) on the emerging multinationals in the world puts 21 Indian companies among the top 100 such multinationals. Only China with 44 companies is ahead of India. Tata group, Bharat Forge, Infosys,

Wipro, ONGC, Ranbaxy and such Indian companies are venturing overseas and expanding at breakneck speed.

With the latest acquisition of Corus by Asia's oldest steel company, Tata the internationalisation' of the Indian corporate sector has reached a new high. The merger of Corus with Tata Steel will create the sixth largest steel producer in the world and would amount to the biggest takeover of a foreign firm by an Indian company. This much talked about merger is an important milestone for India's globalization and is a symbol of India arriving on the world stage.

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» Demerger - Set-off of carry forward loss

Demerger, a converse of a merger or acquisition, is a corporate restructuring in which one or more undertakings of a ompany are spun off or separated as a new company or given to another transferee company. This is usually done to allow the company to focus on core business and create value for shareholders while enabling its other smaller businesses to raise their own capital. The company that ceases to own the undertaking is known as the 'demerged company' and the company which owns it by virtue of demerger is called 'resulting company'.

Demerger is covered under the 'arrangement', as defined under Companies Act. According to this definition, 'arrangement' includes a reorganization of the share capital of the company by the consolidation of shares of different classes or by the division of shares into shares of different classes, or by both. Demerger could be achieved by the sale of the whole or substantially the whole of an undertaking in terms of section 293 (1) (a) of the Companies Act, or as a part of a scheme of compromise or arrangement in terms of sections 391 to 393 of the Companies Act..

The term 'demerger' as defined under Income Tax Laws refers to the transfer, pursuant to a scheme of arrangement under the Indian Companies Act, by a demerged company of one or more of its undertakings to any resulting company in such a manner that all the assets and liabilities being transferred by the demerged company becomes the property of the resulting company and appear at its values and the resulting company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis.

Moreover, the shareholders holding at least 75% in value of the shares in the demerged company become shareholders of the resulting company and the transfer of the undertaking is on a going concern basis.

Thanks to the change in Income Tax Act in 1999, prohibition on loss being carried forward and set-off against income of previous year does not apply in the case where change in shareholding of an Indian subsidiary of a foreign company is due to demerger (or amalgamation) of a foreign company. It must be noted, however, that the demerger must satisfy the conditions of demerger under Income Tax Act, i.e.:

1. The demerger must only be of undertaking(s) belonging to the demerged company.
2. Demerger must be pursuant to a scheme of arrangement under the Companies Act. (ss. 391-393).
3. All the property and related liabilities of the undertaking transferred, immediately before the merger, must also be transferred by the virtue of the demerger, and not by virtue of sale or otherwise.

4. All properties and liabilities transferred must be transferred at values appearing in the books of account of the demerged company immediately before the demerger, ignoring any revaluation.
5. The consideration to be paid by the resulting company to the shareholders of the demerged company must only be in the form of shares of the resulting company and in the proportion to the shares held by them in the demerged company.
6. The shareholders holding not less than 75% in the value of the shares in the demerged company must become the shareholders of the resulting company by the virtue of this demerger.
7. The transfer of the undertaking must be on a going concern basis.

A demerger fulfilling these conditions facilitates the resulting company to carry forward the losses of the demerged company and set them off against their income.

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Prior Public Notice about change in control / management

The RBI has vide its Circular No. RBI/2006-07/162DNBS(PD)CCNo.82/03.02.02/2006-07 dated October 27, 2006, provided that when there is change of management and control of NBFCs, prior public notice should be given 30 days before effecting the sale, or transfer of the ownership by sale of shares, or transfer of control, whether with or without sale of shares or by way of amalgamation / merger of an NBFC with another NBFC or a non-financial company by the NBFC and also by the transferor, or the transferee or jointly by the parties concerned.

Foreign Exchange Management Act (FEMA), 1999 – Current Account Transactions – Liberalisation.

The RBI vide its circular dated November 28, 2006 had dispensed with the prior approval of the Reserve Bank is required for drawing foreign exchange for remittance for purchase of trademark or franchise in India. This has been done by omitting item number 16 in Schedule III and the entry relating thereto has been omitted.

Liberalized Remittance Scheme for Resident Individuals

The RBI has vide its Circular RBI/2006-2007/216 A.P. (DIR Series) Circular No.24 dated December 20, 2006 brought in the following flexibility to the Liberalised Remittance Scheme of US$ 25,000 (the "Scheme"):

1. Modification the limit of US$ 25,000 per calendar year has been enhanced to US$ 50,000 per financial year (April – March) for any current or capital account transactions or a combination of both;
2. The limit would also include remittances towards gifts and donation by a resident individual;
3. investments by resident individual in overseas companies would be subsumed under the scheme of US$ 50,000. The requirement of 10 per cent reciprocal shareholding in the listed Indian companies by such overseas companies has been dispensed with

Further, the existing facility of release of exchange by Authorised Persons up to US$10,000 or its equivalent in one calendar year on a declaration basis for one or more private visits to any country (except Nepal and Bhutan) will continue to be available on a self-declaration basis but would now be available on a financial year (April-March) basis

Additionally, all banks, both Indian and foreign, including those not having an operational presence in India would need to seek prior approval from the RBI for the schemes being marketed by them in India to residents either for soliciting foreign currency deposits for their foreign/overseas branches or for acting as agents for overseas mutual funds or any other foreign financial services company. The resident individual seeking to make the remittance would need to furnish an Application-cum-Declaration in the revised format as at Annex-1 to the said Circular.

Foreign investment in Infrastructure Companies in Securities Markets – Amendment to the Foreign Direct Investment Scheme

The RBI has vide its circular dated December 22, 2006, provided for foreign investment in Infrastructure Companies in Securities Markets, namely stock exchanges, depositories and clearing corporations, in compliance with SEBI Regulations and subject to the following conditions:

1. Foreign investment up to 49% will be allowed in these companies with a separate Foreign Direct Investment (FDI) cap of 26% and Foreign Institutional Investment (FII) cap of 23%;
2. FDI will be allowed with specific prior approval of FIPB; and.
3. FII will be allowed only through purchases in the secondary market.

Submission of Returns by MBFCs and MBCs

The RBI has vide its Notification No. RBI/2006-2007/226 DNBS(PD)CC.No.88/03.02.21/2006-07 dated January 4, 2007 clarified that in view of the fact that the Ministry of Company Affairs has taken over the entire regulation of Mutual Benefit Financial Companies ("MBFCs" and also known as Notified Nidhis) and Mutual Benefit Companies ("MBCs" and also known as Potential Nidhis), MBFCs and MBCs need not submit (i) Annual Return in First Schedule; (ii) audited balance sheet & profit and loss account; (iii) auditor's certificate; and (iv) other particulars as contained in paragraph 8 of Non-Banking Financial Companies Acceptance of Public Deposit (Reserve Bank) Directions, 1998 (hereinafter referred to as "Directions") to the RBI. However, once the application of MBCs for grant of 'nidhi' status is rejected by the Ministry of Company Affairs, the provisions of the Directions as applicable to NBFCs would apply to such companies.

Bank's exposure to Commodity Markets – Margin Requirements

The RBI has vide its Circular RBI.No.2006-07/228DBOD.Dir. BC.51/13.03.00/2006-07 dated January 9, 2007 clarified that the minimum margin of 50 per cent and the minimum cash margin of 25% within the said margin of 50% applicable to issue of guarantees on behalf of share and stock brokers in favour of stock exchanges in lieu of margin requirements would also apply to guarantees issued by banks on behalf of commodity brokers in favour of the national commodity exchanges viz. National Commodity & Derivatives Exchange ("NCDEX"), Multi Commodity Exchange of India Limited ("MCX") and National Multi-Commodity Exchange of India Limited ("NMCEIL"), in lieu of margin requirements as per the commodity exchange regulations.

Directors of AMC prohibited from being Trustees of the Mutual Fund;

The SEBI has vide its Notification No. F.No.SEBI/LAD/DOP/83065/2006 dated December 21, 2006 notified the SEBI (Mutual Fund) (Fifth Amendment) Regulations, 2006 which bring about the following changes to the law governing the regulation of mutual funds – (i) directors (including independent directors) of an asset management company have also been declared ineligible from being appointed as trustee of any mutual fund; and (ii) Regulation 16(4) of the SEBI (Mutual Fund) Regulations, 1996 has been modified to exclude ' independent trustees' from being recognized as a person eligible for appointment of a trustee of another mutual fund

Liberalization of External Commercial Borrowing (" ECB Guidelines"):

The RBI with has vide its Notification No. RBI/2006-07/194 A.P.(DIR Series)Circular No.17 liberalized the ECB Guidelines. Now the Corporates can avail ECB of an additional amount of USD 250 million with average maturity of more than 10 years under the approval route, over and above the existing limit of USD 500 million under the automatic route, during a financial year. Prepayment and call/put options, however, would not be permissible for such liberalized ECB up to a period of 10 years. Other ECB criteria such as end-use, all-in-cost ceiling, recognised lender, etc. need to be complied with. Further, it has been provided that prepayment of ECB up to USD 300 million, as against the existing limit of USD 200 million, will be allowed by AD Category - I banks without prior approval of the Reserve Bank subject to compliance with the minimum average maturity period as applicable to the loan.

The amended ECB Guideline would come into force with immediate effect. Necessary amendments to the Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000 dated May 3, 2000 would be issued separately by RBI.

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