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M&A: MERGER OF DEFAULTING COMPANIES WITH THEIR GROUP COMPANIES:

Applicability of companies act over IBC?

Ministry of Corporate Affairs (MCA) for the first time in the history of listed companies under private sector in India, in an unprecedented ruling in the popular case of NSEL, invoked Section 396 of the Companies Act, 1956 and ordered for the "forced" merger of the defaulting subsidiary with its holding company to protect the interest of the stakeholders in the defaulting company. Since then, it has been a mooted issue amongst the market players which are interestingly seeming to be equally divided in their opinions. Whereas one view is that this step by MCA will curb out the disguised floating of subsidiaries and carrying out high risk activities through them, the other being a direct infringement on the concept of "limited liability" of private companies. Before analysing the true impact of this order, it would be pertinent to understand the brief facts of the underlying case which gave rise to this debate.

Background: What led MCA pass the Merger Order?

The issue goes back to mid FY 2013, when National Spot Exchange Limited (**NSEL**), a popular spot exchange for trading in commodities, was reported to be under payment crisis to the tune of more than INR 5500 crores when commodities traded on the exchange were found to be not backed by stocks in its warehouses. This was followed by suspension of forward trading by NSEL pursuant to a Government's order in this regard. Event after committing a resolution plan of 33 weeks, NSEL failed to live it up to the same and ultimately led the Forward Market Commission (FMC) in August, 2014 recommending the merger of NSEL with its parent Financial Technologies (India) Ltd (*now, 63 Moons Technologies Limited*) to protect the interest of more than 13000 stakeholders involved in the scam- the recommendation which was initially assumed to be an impractical and theoretical suggestion by FMC and in all likelihood was not expected to see any day light.

Surprisingly, MCA went a step ahead than speculations and decided to mark this case as a deterrent measure for such instances in future and passed the draft merger order within 2 months of FMC's recommendations, the draft which was later in Februray,2 016 was converted into the final order by MCA. The order was in no time challenged in the Bombay High Court. However, the two-judge bench of Chief Justice Manjula Chellur and M S Sonak in December 2017 finally rejected the petition by upholding MCA order. The matter is finally under appeal in from of the Apex Court

Legal Provisions in question

The underlying legal provision under the MCA passed the merger order is Section 396 of the Companies Act, 1956 (i.e. Section 237 of the Companies Act, 2013). In terms of Section 396(1),

*"(1) Where the Central Government is satisfied that **it is essential in the public interest** that two or more companies should amalgamate, then, notwithstanding anything contained in sections 394 and 395 but subject to the provisions of this section, the Central Government may, by order notified in the Official Gazette, provide for the **amalgamation of those companies into a single company** with such constitution ; with such property, powers, rights, interests, authorities and privileges ; and with such liabilities, duties, and obligations; as may be specified in the order.."*

Further, in terms of Section 396(3),

*"(3) Every **member or creditor** (including a debenture holder) of each of the companies before the amalgamation shall have, as nearly as may be, the **same interest in or rights against the company** resulting from the amalgamation as he had in the company of which he was originally a member or creditor; and to the extent to which the interest or rights of such member or creditor in or against the company resulting from the amalgamation are less than his interest in or rights against the original company, he shall be entitled to compensation which shall be assessed by such authority as may be prescribed and every such assessment shall be published in the Official Gazette.."*

It is to be noted that the key highlights of the above provisions are (i) the power of amalgamation could be triggered only in the case of "public interest" (ii) the stakeholders will as far as possible continue to enjoy the same interest in the new company.

We note that prior to the NSEL case, the Government had used this provision only in four instances- all of which were in the public sector and necessitated the action in order to protect the public interest and involvement of Government in the given sectors. However, the use of Section 396 for a private sector company certainly raises a question of fulfilment of "public interest" pre-requisite under Section 396(1).

National Interest versus Limited Liability

As per MCA, the merger of NSEL with FTIL was propounded due to public interest and to protect 13000+ stakeholders.

To quote directly from the MCA order, ".to leverage combined assets, capital and reserves, achieve economy of scale, efficient administration, gainful settlement of rights and liabilities of stakeholders and creditors and to consolidate businesses, ensure co-ordination in policy, it is essential, in the public interest that FTIL and NSEL should be amalgamated into a single company.."

WHEREAS, the involvement of large public stake and as a measure to stop using subsidiary entities for exploiting the general investors in private sector in all probabilities demand a strict action from the Government - something similar to invoking Section 396 in the instant case,
HOWEVER at the same time it would be a noteworthy point that Section 396 is normally invoked only in "extra ordinary" circumstances and if every parent company is going to be made liable for its subsidiary, any investor investing in such a listed (holding) company would certainly be deterrent in there are underlying subsidiaries for which the investee company could anytime be made liable. There is a reason we have a "*corporate identity*" concept in place, any such action would question the entire "*parent-subsidiary*" relationship and demarcation under law This would not only call for an additional due diligence by the investors but would lead to fall in the entire "free environment" for the investors to in a "chosen company"- certainly raising more probability of reduction in foreign investors number!

All said and done, the collapse of a mid-size exchange involving more than 13000 stakeholders can't be ignored and demands for a well-considered step by the Government. This gains far more attention when the company has already failed to live up to its own settlement plan for the investors. To add on top, the possibility of underlying fraud in such arrangements can't be completely overruled - if not in the instant case, still could be in other similar cases! It's a notable case where the underlying commodities were to the surprise were not existing in the commodity exchange, the risk management mechanism of the exchange failed and ultimately followed by an inadequate settlement process- beyond any doubt, such cases can't escape in the vague of corporate concepts and require more meticulous approach - something like "Solomon's Lifting of Corporate Veil Theory"- which questioned the entire "corporate veil" concept for all good! Lastly, if the parent-subsidiary relationship can help in attracting investors and funds, why not such relationship should be there to protect the stakeholders' interest as well in such "not so" ordinary situations and default (if not "extra ordinary" for a common interpretation!) and

would it not be unjustified to restrict such actions merely on the ground of company being in private or public sector? - certainly calls for a thought and reason to not completely disregard MCA's action.

Applicability of Section 237 of the Companies Act, 2013 over the IBC

The Bombay High Court that validated the MCA's order under Section 396 in the aforesaid case, has issued notices to the MCA for taking actions under the said section in case of bank defaults by the companies as well. Having said that, if this goes through it would raise a new issue of applicability of actions under Section 237 of the Companies Act, 2013 vis-à-vis the insolvency proceedings under Insolvency & Bankruptcy Code of 2016 (IBC).

Hitherto, in case bank defaults and stressed assets, the remedial measures were under IBC (Note: till recently there were multiple laws and regulations, however recently RBI has overruled all and made IBC as the comprehensive code) wherein the creditors in possession would normally accept a hair-cut (thereby going with the liquidation valuation norm over the fair valuation norm). However, if MCA starts taking action under Section 237, then that would imply precedence of merger with group company remedy over the NCLT route under the IBC or for that matter the under developed provisions of "pre-pack sales" under Indian laws.

With this the burden will shift to the group entities to clear the defaults. At a glance it may sound like a fair proposition, however it not only raises the similar question of "corporate identity" and "limited liability" in a larger sphere but also makes the entire IBC and NCLT remedial process futile with MCA having an edge over the entire process. Further, such an uncertain climate would also discourage the foreign investors looking forward to investing in stressed assets in India.

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Analysing the implications of the action of MCA in NSEL case, whereas for similar defaults wherein demand of public interest could be directly established, plus there is no other resolution or effective remedial measure available, the action under Section 237 of the Companies Act, 2013 could be justified. However, certainly there is a strong need to limit the application of Section 237 by MCA only to the cases wherein national/ public interest at large is involved and wherein there is no other specific remedy prescribed under law, like in the case of bank defaults we have full-fledged IBC in place and the Government in all likelihood very soon will turn the bill on Fugitive Economic Offenders in to reality. Lastly, this is with prejudice to the acknowledgment of the fact that there are still missing links and loopholes under IBC, but the same should hopefully be provided by way of clarifications and amendments under IBC only going by the recent steps of overhauling the entire law by the RBI - instead of other generic and discretionary law taking precedence over the same.

SNAPSHOTS

LEGISLATIVE SNAPSHOTS

FUGITIVE ECONOMIC OFFENDERS BILL, 2017 With the recent uncovering of the 12,000 Cr. PNB fraud and subsequent escape of the prime accused, the man touted to have perpetrated the fiasco, our attention is drawn once again to the lax security measures in place against steal-and-fly tactics of financial offenders (other examples being

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