KARNATAKA STATE OPEN UNIVERSITY

Mukthagangotri, Mysore – 570 006

DEPARTMENT OF STUDIES AND RESEARCH IN MANAGEMENT

M.B.A III Semester

ELECTIVE-F: CORPORATE LAW

Course- MB116 F - CORPORATE LAW

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Dear learner,

It gives me immense pleasure to welcome you again to the department of management to study MBA second year in the esteemed university. I hope you have enjoyed the First and Second semester MBA.

I am extremely happy in placing this study material in your hand. The Department of Studies and Research in Management, Karnataka State Open University is providing you Self Learning Materials (SLM) for all the courses developed by team of experts drawn from conventional universities, B-Schools management institutions and professionals.

This study material explains even the most complicated topics in a very simple and user-friendly manner, it starts with the Objectives, explanation of concepts followed by Case Study, Notes, Summary, Key Words, Self-Assessment Questions and References. It is a sincere attempt to provide more value added information on contemporary issues.

Department has focussed on conceptual learning and on avoiding bulky and prolonged description. Every concept has been explained in the simplest manner. Some complicated concepts have been simplified in the study material, so that the learner can learn easily.

As you know, the Department of Management, Karnataka State Open University is offering seven specializations. You have already chosen the stream in which you wish to specialize i.e., Finance, Marketing, People Management, Operations, Tourism, Corporate Law and Information Technology. Hope you will gain expertise in your field.

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Corporate law is one of the most wanted specialisation law. Corporate Law comprises the rules, practices and regulations that administer the formation as well as the operation of corporate firms. Corporate Laws deal with forming, owning, operating and managing of a

corporation. Corporate Law characteristically regulates how corporations, investors, employees, shareholders, directors, creditors and other stakeholders like the community, consumers and the environment interact with one another.

In addition to the study material provided to you, I advise you to go through the books which are suggested in the reference of every unit. Further I also suggest you to make yourself acquainted by reading newspapers and journals.

Moreover, the curriculum designed by the board of studies helps you to prepare for UGC NET, various state commission examinations and UPSC examinations. With these words I welcome you for the wonderful learning experience of business education.

I wish all the best and good luck in your education and successful management career.

Prof C Mahadevamurthy
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BLOCK-1

UNIT-1 INTRODUCTION TO CORPORATE RECONSTRUCTION/RESTRUCTURING, KINDS OF RECONSTRUCTION, FACTORS AFFECTING CORPORATE RECONSTRUCTION; STRATEGIC PLANNING AND FORMULATION TOWARDS CORPORATE RECONSTRUCTION

Structure

1.0 Objectives

1.1 Introduction

1.2 Meaning of Reconstruction

1.3 Factors affecting corporate Reconstruction

1.4 Need of Scope of Corporate Reconstruction

1.5 Kinds of Reconstruction

1.6 Factors affecting corporate Reconstruction

1.7 Strategic Planning and Formulation towards corporate reformulation

1.8 Summary

1.9 Key words

1.10 Self Assessment Question

1.11 References

1.0 OBJECTIVES

1. To understand the meaning of Corporate Restructuring
2. To know the historical background of Corporate Restructuring
3. To analyse the present, Global & National Scenario
4. To know the need & scope of Corporate restructuring

1.1 INTRODUCTION

Corporate restructuring is one of the means employed to meet the challenges and problems that confront businesses. Section 391 to 394 of the Companies Act, 1956, provides a legitimate tool to facilitate corporate restructuring in a variety of ways. This chapter is an introduction to corporate restructuring. After going through this chapter, students will be able to understand:

Corporate Restructuring is an expression that connotes a restructuring process undertaken by business enterprises for the purpose of bringing about a change for the better and to make the businesses competitive. The term signifies the restructuring undertaken by a company and company secretaries play a predominant role in devising, designing, executing and completing the restructuring process. This study is intended to give a basic idea about the meaning, background, objectives, scope, modes, law and practice in relation to any chosen restructuring programme. The study also discusses the global and national scenario in corporate restructuring today. Corporate restructuring presents a significant challenge to companies; integrating previously distinct companies or business units requires a clear understanding of how each organization's process will affect communal structure, technology requirements, and employee morale. As each organization comes together, it brings its own diverse systems and applications, which contribute to an increasingly complex IT infrastructure.

1.2 MEANING OF CORPORATE RESTRUCTURING

The term corporate restructuring is a wide & varied term. It has no legal definition as the term has not been defined in any legal legislation. Hence, neither it has clear and precise meaning nor can it be defined with precision. Etymologically the term" Restructuring" means 'giving new structure or rebuild or rearrange'. In this perspective, 'Corporate Restructuring' is defined as a process of rearranging the organizational or business structure of the company for increased efficiency and profitable growth. Simply stated, Corporate Restructuring is a comprehensive process by which a company can consolidate or rearrange its organizational set up or business operations and strengthen its position so as to achieve its short-term or /and long term objectives and establish itself as a synergetic , dynamic , continuing as well as successful

independent corporate entity in the competitive environment. In the words of hon'ble Justice D.Y. Chandrachud "Corporate Restructuring" is the means that can be employed to meet challenges which confronts businesses.

To conclude, it is a process undertaken by a business / corporate/ any other such entity whether proprietorship or partnership for the purpose of bringing about changes for better and to make the business competitive. Having understood the meaning of the expression Corporate Restructuring, it is necessary to re-iterate that a restructuring exercise is not undertaken only by business enterprises which are run in the form of a company registered under the Companies Act, 1956. The restructuring could be undertaken by any entity or business unit, whether it is run as a sole proprietorship or partnership or society or in any other form of organization. In this study we are primarily concerned with the scope and objectives of and law and practice relating to Corporate Restructuring.

1.3 CORPORATE RESTRUCTURING: HISTORIC BACKGROUND AND PRESENT SCENARIO

In earlier years, India was a highly regulated economy. To set-up an industry various licenses and registration under various enactments were required. The scope and mode of corporate restructuring was, therefore, very limited due to restrictive government policies and rigid regulatory framework. Though Government participation was overwhelming, the economy was controlled in a centralized way by Government participation and intervention. In other words, economy was closed as economic forces such as demand and supply were not allowed to have a full-fledged liberty to rule the market. There was no scope of realignments and everything was controlled. In such a scenario, the scope and mode of Corporate Restructuring was very limited due to restrictive government policies and rigid regulatory framework. These restrictions remained in vogue, practically, for over two decades. These, however, proved incompatible with the economic system in keeping pace with the global economic developments if the objective of faster economic growth were to be achieved. The Government had to review its entire policy framework and under the economic liberalization measures removed the above restrictions by omitting the relevant sections and provisions. Consequently, financially strong entrepreneurs made their presence felt as industrialists — Ram Prasad Goenka, M.R. Chabria, Sudarshan Birla, Srichand Hinduja, Vijay Mallya and Dhirubhai Ambani etc., who were instrumental in undertaking certain major Corporate Restructuring exercises. The real opening up of the

economy started with the Industrial Policy, 1991 whereby ‘continuity with change’ was emphasized and main thrust was on relaxations in industrial licensing, foreign investments, and transfer of foreign technology etc. For instance, amendments were made in MRTP Act, within all restrictive sections discouraging growth of industrial sector. With the economic liberalization, globalization and opening up of economies, the Indian corporate sector started restructuring to meet the opportunities and challenged of competition.

Present Scenario: Today, a restructuring wave is sweeping the corporate sector over the world, taking within its fold both big and small entities, comprising old economy businesses conglomerates and new economy companies and even the infrastructure and service sector. Mergers, amalgamations, acquisitions, consolidation and takeovers have become an integral part of new economic paradigm. Conglomerates are being formed to combine businesses and where synergies are not achieved, Demergers have become the order of the day. With the increasing competition and the economy, heading towards globalization, the corporate restructuring activities are expected to occur at a much larger scale than at any time in the past, and are stated to pay a major role in achieving the competitive edge for India in international market place. The process of restructuring through mergers and amalgamations has been a regular feature in the developed and free economy nations like Japan, USA and European countries with special reference to UK where hundreds of mergers take place every year. The mergers and takeovers of multinational corporate houses across the borders has become a normal phenomenon. Corporate restructuring being a matter of business convenience, the role of legislation, executive and judiciary is that of a facilitator for restructuring on healthy lines. The stand of the Government is that monopoly is not necessarily bad provided market dominance is not abused. In this era of hyper competitive capitalism and technological change, industrialists have realized that mergers/acquisitions are perhaps the best route to reach a size comparable to global companies so as to effectively compete with them. The harsh reality of globalization has dawned that companies which cannot compete globally must sell out as an inevitable alternative.

The sweeping wave of economic reforms and liberalization, has transformed the business scenario all over the world. The most significant development has been the integration of national economies with ‘Market-oriented Globalized Economy’. The multilateral trade agenda and the World Trade Organization (WTO) have been facilitating easy and free flow of technology, capital and expertise across the globe. Globalization gives the consumer many

choices – technologies are changing, established brands are being challenged by value – for money products, the movement of goods across countries is on the rise and entry barriers are being reduced. As markets consolidate into fewer and larger entities, economies become more concentrated. In this international scenario, there is a heavy accent on the quality, range, cost and reliability of product and services. Companies all over the world have been reshaping and repositioning themselves to meet the challenges and seize the opportunities thrown open by globalization. The management strategy in turbulent times is to focus on core competencies – selling loss making companies and acquiring those, which can contribute to profit and growth of the group. The underlying objective is to achieve and sustain superior performance. In fact, most companies in the world are merging to achieve an economic size as a means of survival and growth in the competitive economy. There has been a substantial increase in quantum of funds flowing across nations in search of restructuring and takeover candidates. It is estimated that one-in-four US workers have been affected by the wave of mergers and acquisition activity. In the Japanese context, mergers and acquisitions are less relevant as they believe in alliances and joint ventures than mergers and acquisitions. Also, research has shown that Japanese are least preferred merger partner/acquirer. The reason being - incompatible on language.

National Scenario: The unleashing of Indian economy has opened up lucrative and dependable opportunities to business community as a whole. The absence of strict regulations about the size and volume of business encouraged the enterprises to opt for mergers and amalgamations so as to produce on a massive scale, reduce costs of production, make prices internationally competitive etc. Today Indian economy is passing through recession. In such a situation, corporates which are capable of restructuring can contribute towards economic revival and growth. Despite the sluggish economic scenario in India, merger and amalgamation deals have been on the increase. The obvious reason is – as the size of the market shrinks, it becomes extremely difficult for all the companies to survive, unless they cut costs and maintain prices. In such a situation, merger eliminates duplication of administrative and marketing expenses. The other important reason is that it prevents price war in a shrinking market. Companies, by merging, reduce the number of competitors and increase their market share. In the words of Justice Dhananjaya Y.Chandrachud, "Corporate restructuring is one of the means that can be employed to meet the challenges which confront business".

The going global is rapidly becoming Indian Company's mantra of choice. Indian companies are now looking forward to drive costs lower, innovate speedily, and increase their International presence. Companies are discovering that a global presence can help insulate them from the vagaries of domestic market and is one of the best ways to spread the risks. As mentioned earlier, Indian Corporate sector has witnessed several strategical acquisitions. Tata Steel's acquisition of Corus Group, Mittal Steel's acquisition of Arcelor, Tata Motors acquisition of Daewoo Commercial Vehicle Company, Tata Steel acquisition of Singapore's NatSteel, Reliance's acquisition of Flag is the culmination of Indian Companies' efforts to establish a presence outside India. Not only this, to expand their operations overseas, the Indian companies are acquiring their counterparts or are making efforts towards the end viz. the merger of Air India and Indian Airlines.

1.4 NEED AND SCOPE OF CORPORATE RESTRUCTURING

Today, corporate restructuring has become common to the corporate sector in order to grow and survive in the present ongoing corporate environment for increased efficiency and profitable growth. It is mainly concerned with reorganizing or restructuring or rearranging the organizational or business activities of the company as a whole in the form of Merger, Amalgamation or Takeover or Joint Venture etc, so as to achieve certain predetermined objectives at corporate level. The various needs of undertaking the scheme of corporate restructuring in this modern competitive business / corporate world are discussed briefly as follows:-

1. Orderly redirection of the firms activities
2. To focus on core strengths, operational synergy, and efficient allocation of managerial capabilities and infrastructure
3. Consolidation and economies of scale by expansion and diversion to exploit the extended domestic and international markets
4. Deploying the firm's surplus funds from one business to another for profitable growth.
5. Revival and rehabilitation of sick unit by adjusting the losses of such sick units with profits of healthy company
6. Acquiring the constant supply of raw materials and access to scientific research and technological development
7. Capital restructuring by appropriate mix up of loans and equity capital to reduce cost of servicing and to increase return on capital employed
8. Improve the corporate performances to bring it at par with competitors.
9. Exploiting the inter dependence among the present and perspective business within corporate Portfolio.

10. Risk reduction and
11. Development of core competencies.

Therefore, when the corporate enterprises consider the scheme of restructuring their business activities they have to take a wholesome view of the business activities so as to introduce a scheme of restructuring at all level in a phase manner. It also aims at improving the competitive position of an individual business, maximizing its contribution to the corporate level objectives and exploiting the strategic assets accumulated by a business to enhance the competitive advantage. Thus, restructuring would help bringing an edge over competitors.

1.5 KINDS OF RESTRUCTURING

Corporate Restructuring means any change in the business capacity or portfolio that is carried out by inorganic route or any change in the capital structure of a company that is not in the ordinary course of its business or any change in the ownership of a company or control over its management or a combination of any two or all of the above.

Types of Corporate Restructuring

1. Mergers / Amalgamation
2. Acquisition and Takeover
3. Divestiture
4. Demerger (spin off / split up / split off)
5. Reduction of Capital
6. Joint Ventures
7. Buy back of Securities

1. Merger / Amalgamation: A merger is a combination of two or more businesses into one business. Laws in India use the term 'amalgamation' for merger. Amalgamation is the merger of one or more companies with another or the merger of two or more companies to form a new company, in such a way that all assets and liabilities of the amalgamating companies become assets and liabilities of the amalgamated company.

- **Merger through Absorption**:- An absorption is a combination of two or more companies into an 'existing company'. All companies except one lose their identity in such a merger. For example, absorption of Tata Fertilisers Ltd by Tata Chemicals Ltd.
- **Merger through Consolidation:-** A consolidation is a combination of two or more companies into a 'new company'. In this form of merger, all companies are legally

dissolved and a new entity is created. Here, the acquired company transfers its assets, liabilities and shares to the acquiring company for cash or exchange of shares. For example, merger of Hindustan Computers Ltd, Hindustan Instruments Ltd, Indian Software Company Ltd and Indian Reprographics Ltd into an entirely new company called HCL Ltd.

2. **Acquisitions and Takeovers:** An acquisition may be defined as an act of acquiring effective control by one company over assets or management of another company without any combination of companies. Thus, in an acquisition two or more companies may remain independent, separate legal entities, but there may be a change in control of the companies. When an acquisition is 'forced' or 'unwilling', it is called a takeover.

3. **Divestiture:** Divestiture means an out sale of all or substantially all the assets of the company or any of its business undertakings / divisions, usually for cash (or for a combination of cash and debt) and not against equity shares. In short, divestiture means sale of assets, but not in a piecemeal manner. Divestiture is normally used to mobilize resources for core business or businesses of the company by realizing value of non-core business assets.

4. **Demerger:** Demerger is a form of corporate restructuring in which an entity's business operations are segregated into one or more components.

   Demerger can take three forms:

   - Spin-off
   - Split-up
   - Split-off

5. **Reduction of Capital:** Reduction of Capital is a process by which a company is allowed to extinguish or reduce liability on any of its shares in respect of share capital not paid up, or is allowed to cancel any paid-up share capital which is post or is allowed to pay-off any paid –up capital which is in excess of its requirements.

6. **Joint Venture:** Joint Venture is an arrangement in which two or more companies (called joint venture partners) contribute to the equity capital of a new company (called joint venture) in pre-decided proportion. For e.g. Maruti Suzuki

7. **Buy back of Securities**: When a company is holding excess cash, which it does not require in the medium term (say three to five years); it is prudent for the company to return this excess cash to its shareholders. Buy-back of securities is one of the methods used to return the excess cash to its shareholders.

1.6 FACTORS AFFECTING CORPORATE RECONSTRUCTION

In every merger or amalgamation or demerger, as part of a corporate reconstruction programme, there has to be a study of the various factors affecting reconstruction and implementation of the scheme. Cost is one of the most important factor affecting the corporate reconstruction. Most of the schemes provide for transfer of assets and liabilities from one company to another. Whenever there is a transfer, there has to be a study of the taxes and duties payable thereon. In that perspective, every such scheme has to be considered from the point of view of the following cost elements:

From the Income Tax Point of View:
— The liability to pay capital gains tax.
— The ability to carry forward the accumulated losses and unabsorbed depreciation of the transferor company to the transferee company.

From Sales Tax Point of View:
— The liability to pay state and central sales taxes.

From Stamp Duty Point of View:
— The liability to pay stamp duty on the assets conveyed from the transferor company to the transferee company.

Other Factors:
Besides the above, there are several other factors which have to be studied in depth. One such major factor would be the ability to utilize the licences, consents and permissions and other rights of the transferor company in or by the transferee company. It may include an industrial licence or a consent under the pollution control laws, other regulatory approvals. These aspects have to be taken into account before finalizing the scheme.

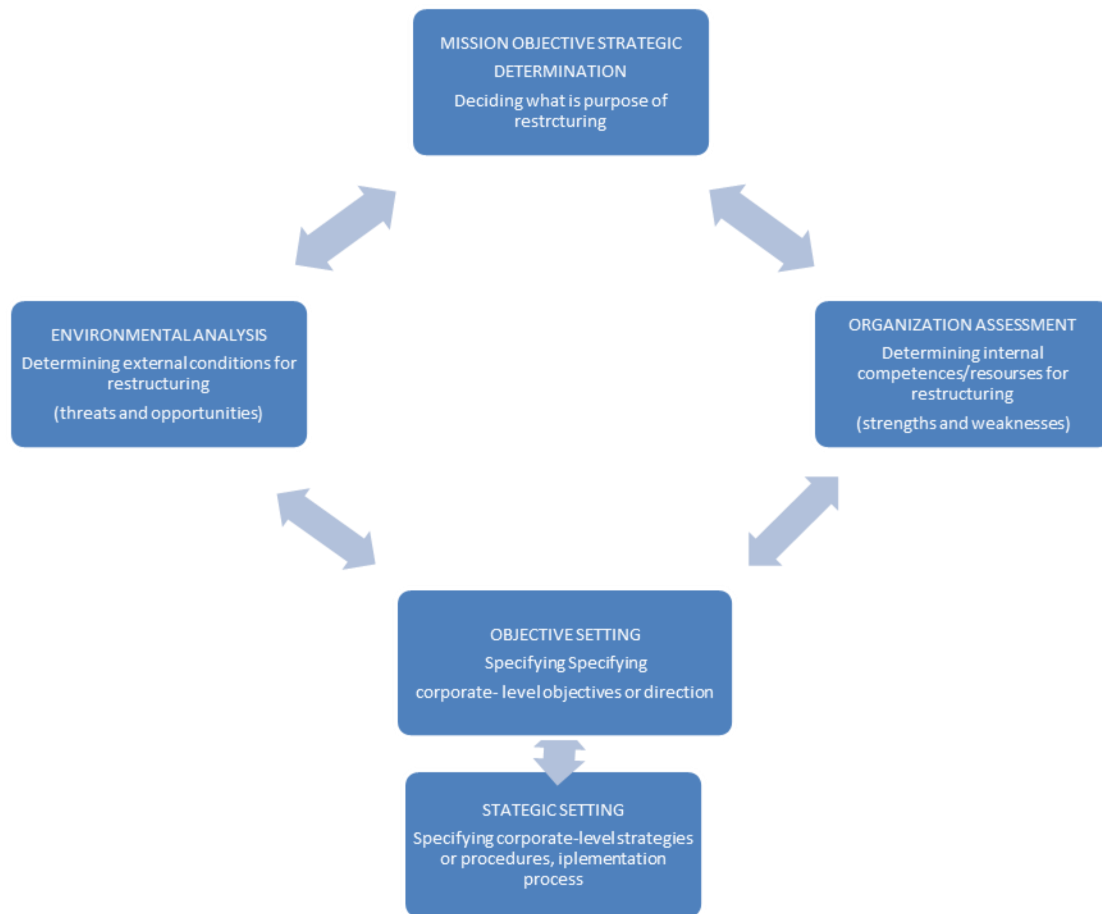
1.7 STRATEGIC PLANNING AND FORMULATION TOWARDS CORPORATE RECONSTRUCTION

The environment in which business organizations operate today is becoming uncertain. In the emerging competitive global environment, an enterprise can neither have its way to prosperity nor afford to remain at a standstill if it would like to avoid stagnation; it must grow on, or be absorbed into a growing entity. Profitable growth constitutes one of the prime objectives of most of the business organisations. Different organisations may have to use different growth strategies depending on the nature of complexity of the field in which they are operating. The top management of the organisation ordinarily provides the strategic framework,

policies based on the same with suitable directions. This will depend upon several factors, including the corporate objectives of the organisation. The strategic alternative, which an organisation pursues, is crucial to the success of the organisation and achievement of established goals. However, many times these are influenced by factors external to the organisation over which the management has limited control. Strategic planning is a management tool, used to help an organisation do a better job to assess and adjust the organisation's direction in response to a changing environment. Strategic planning is likely to be beneficial particularly in organizations when there is a long time lag between managerial decisions and results thereof. Strategic planning is a disciplined effort to produce fundamental decisions and actions that shape and guide as to what an organisation is, what it does, and why it does, with a focus on the future at the same time. Strategic planning enables management to improve the chances of making decisions which will stand the test of time, and revising the strategy on the basis of monitoring the progress of R&D and the changes in product-market conditions. A strategic plan is visionary, conceptual and directory in nature.

In case of planning for corporate reconstruction, management must understand the holistic nature of strategy, and have the determination to adhere to it steadily and steadfastly by using strategic planning as a guide in times of uncertainty. In order to derive the maximum benefit of strategic planning, the companies must review the various strategic alternatives and recognize that the methodology requires sustained commitment, an understanding of its complexity and the ability to harness its strategic opposites.

Strategic planning can be represented as shown in following chart:



Strategic planning happens in many stages. Strategy cannot be constant, though it could appear to be so in a given period of time. There has to be an inbuilt mechanism to take care of certain uncertain things and probabilities so that the strategy is able to withstand the forces of such unexpected developments and results. In the strategic planning job involves identification of the themes for such planning. There will be strategic implementation plan. There will be an analysis of all types of competitive forces and factors. The organization could be divided into various small units based on divisions or functions and for each such sub-division or unit, there will be strategic specific plan. The strategy should include a mechanism to ensure that the divisions or units move only in the direction of the goals set for them. Strategy also includes planning for the required resources, budgeting and periodical review and correction programmes. Invariably a strategist plans for managing the risks also. The strategic planning and implementation.

Provisions on Mergers and acquisitions under the Companies Act, 2013:

The 2013 Act features some new provisions in the area of mergers and acquisitions, apart from making certain changes from the existing provisions. While the changes are aimed at simplifying

and rationalising the procedures involved, the new provisions are also aimed at ensuring higher accountability for the company and majority shareholders and increasing flexibility for corporate. The changes proposed would require companies to consider the scale and extent of compliance requirements while formulating their restructuring plans once the 2013 Act is enacted. These changes are quite constructive and could go a long way in streamlining the manner in which mergers and other corporate scheme of arrangements are structured and implemented in India.

1. Streamlining requirements

The section dealing with compromises and arrangements, deals comprehensively with all forms of compromises as well as arrangements, and extends to the reduction of share capital, buy-back, takeovers and corporate debt restructuring as well. Another positive inclusion within this section is that objection to any compromise or arrangement can now be made only by persons holding not less than 10% of share holding or having an outstanding debt amounting to not less than 5% of the total outstanding debt as per the latest audited financial statements. [section 230 of the 2013 Act] Further, currently, under the 1956 Act, an order does not have any effect until the same is filed with the ROC. However, such requirement has been done away with under the 2013 Act. The 2013 Act merely requires filing of the order with the ROC.

2. Mergers or division of companies

There are certain additional documents mandated to be circulated for the meeting to be held of creditors or a class of members (section 232 of the 2013 Act). These include the following:

1. Draft of the proposed terms of the scheme drawn-up and adopted by the directors of the merging company
2. Confirmation that a copy of the draft scheme has been filed with the ROC
3. Report adopted by the directors of the merging companies explaining the effect of the compromise
4. Report of the expert with regard to valuation
5. Supplementary accounting statement if the last annual accounts of any of the merging company relate to a financial year ending more than six months before the first meeting of the company summoned for the purpose of approving the scheme

3. Certifying the accounting treatment

Currently, under the 1956 Act, , there is no mandate requiring companies to ensure compliance with accounting standards or generally accepted accounting principles while

proposing the accounting treatment in a scheme. However, listed companies are required to ensure such compliance as the Equity Listing Agreement mandates such companies to obtain an auditor's certificate regarding appropriateness of the accounting treatment proposed in the scheme of arrangement. The 2013 Act requires all companies undertaking any compromise or arrangement to obtain an auditor's certificate (section 230 and 232 of the 2013 Act). This requirement will help in streamlining the varied practices as well as ensuring appropriate accounting treatment. However, another aspect that is yet to be addressed is that the applicable notified accounting standards in India, currently, address only amalgamations and not any other form of restructuring arrangements.

4. Simplifying procedures

The current procedural requirements in case of a merger and acquisition in any form are quite cumbersome and complex. There are no exemptions even in the case of mergers between a company and its wholly owned subsidiaries. The 2013 Act now introduces simplification of procedures in two areas, firstly, for holding wholly owned subsidiaries and secondly, for arrangements between small companies (section 233 of the 2013 Act). Small companies is a new category of companies, introduced within the 2013 Act, with defined capital and turnover thresholds, which has been given certain benefits, including simplified procedures.

One of the significant restrictions proposed in case of these situations is the restriction on the transferee company to hold any shares either in its own name or in the name of a trust, subsidiary or associate, since all shares will need to be cancelled or extinguished on merger or amalgamation. This requirement will stem the practice followed by several companies which have in the past followed this route. Further, in certain cases, it has also rationalised the requirements, for example in the case of the reduction of the share capital, which is part of compromise or arrangement, the company will need to comply with the provisions of this section only, as against the existing requirement under the 1956 Act, where the company is required to comply with the provision of section 108 in case of reduction of share capital as well those relating compromise.

5. Cross-border mergers

The 1956 Act, allows the merger of a foreign company with an Indian company, but does not allow the reverse situation of merger of an Indian company with a foreign company. The 2013

Act now allows this flexibility, with a rider that any such mergers can be effected only with respect to companies incorporated within specific countries, the names of which will be notified by the central government. With prior approval of the central government, companies are now allowed to pay the consideration for such mergers either in cash or in depository receipts or partly in cash and partly in depository receipts as agreed upon in the scheme of arrangement. (section 234 of the 2013 Act). These new provisions can be greatly beneficial to Indian companies which have a global presence by providing them structuring options which do not exist currently.

6. Squeeze out provisions

The 2013 Act has introduced new provisions for enabling the acquirer of a company (holding 90% or more shares) by way of amalgamation, share exchange, etc to acquire shares from the minority holders subject to compliance with certain conditions. This has also introduced the requirement for 'registered valuers', since the price to be offered by majority shareholder needs to be determined on the basis of valuation by a registered valuer (section 236 of the 2013 Act).

Changing contours of mergers and acquisitions under Companies Act, 2013

The task of enacting a new law to regulate companies in India is complete. The Companies Act, 2013, ("New Act") in its new avatar, mirrors several changes when compared to the law contemplated under the Companies Act, 1956 ("Old Act"). It brings in a whole new set of expected and unexpected changes to the existing regime governing Indian company law. Under the Old Act, sections 391 to 396 deal with Compromises, Arrangements and Amalgamation, whereas Chapter XV of the Old Act encompasses Sections 230 to 240 governing Compromises, Arrangement and Amalgamations. This article highlights a few key changes made in the New Act on mergers and amalgamations and the likely impact on industry.

Retained provisions: Although substantial changes have been incorporated in the New Act, several key provisions remain unchanged. For example, the acceptance of a scheme or merger or amalgamation by three-fourths of the shareholders, like in section 391(2) of the Old Act, is still a pre-condition to a merger or amalgamation. The power of the Central Government to order a merger or amalgamation in the interest of the nation is untouched and is placed in Section 237. Further, the obligation to maintain records of the mergers/amalgamations is retained in Section 239 as its importance cannot be ignored. Other matters like convening meetings, obtaining the

permission of the regulatory authorities and the Central Government in cases of mergers or amalgamations remain unaltered.

Mergers and Amalgamations: the distinction remains unexplained

While the Income Tax Act 1961 ("IT Act") distinguishes clearly between mergers and amalgamations, the Old Act and the New Act the two are used interchangeably and the procedures for both are identical. Section 234 of the New Act states that the provisions of the New Act shall apply mutatis mutandis to both mergers and amalgamations, thus acknowledging that a merger and amalgamation may be conceptually different but are deemed to be the same for all purposes. As a result, no statute, except the IT Act, exists to differentiate a merger from an amalgamation, and the reason explained in the IT Act, shall remain to be the sole provision explaining the distinction between a merger and an amalgamation.

National Company Law Tribunal to perform erstwhile functions of High Courts: Under the Old Act, the High Courts were endowed with the power to sanction a scheme of merger/amalgamation. However, as per the provisions of the New Act the power given to the High Courts would be invested with the National Company Law Tribunal (NCLT). This change should help in shortening the time taken in obtaining sanctions in cases of mergers and amalgamations.

Voting through postal ballot

Under the Old Act, the shareholders or the creditors, as the case may be, may be present either in person or in proxy for approving the scheme of amalgamation/merger. The New Act goes a step further and provides another mode of voting. Sub-clause (4) of Section 230 envisions adoption of a scheme under Chapter XV by postal ballot.

Notice of the meetings: Sub-clause (5) of Section 230 of the New Act obligates companies to send a notice of meeting to approve a merger/amalgamation to various government authorities such as Central Government, the Income Tax Department, SEBI, RBI, Registrar of Companies, the respective stock exchanges, the official liquidator, the Competition Commission of India, and if the need be, to any other regulatory authority likely to be affected by the merger/amalgamation for seeking representations from the respective authorities if any within a period of 30 days from the date of receipt of such notice. Under the Old Act, notices are to be sent mandatorily to the Central Government, Registrar of Companies and Official Liquidator and the concerned stock

exchanges. Further, under the Old Act if no report is provided by the authorities then it is not deemed to have been approved. Whereas, as per the New Act, if the representations are not provided within 30 days from the date of receipt of the notice then, it is presumed that the authorities have no representations to make on the proposals. Further, the 'thirty days' requirement might spring up a few procedural inconsistencies For instance, Section 6(2a) of the Competition Act, 2002 allows 210 days for the CCI to pass an order after verifying the proposed merger, whereas the New Act gives only a time period of thirty days to reply for any authority likely to be affected.

Objections to mergers/amalgamations: Sub-clause (4) of Section 230 of the New Act provides that only persons holding not less than 10% of the shareholding; or having not less than 5% of the total outstanding debt can object to a merger/amalgamation. In stark contrast, the Old Act specifies no minimum-ownership-condition to object to a merger/amalgamation. The impact of the New Act is two-fold: genuine claims of shareholders may go unrepresented, while mala fide and frivolous claims will no longer act as dampeners. An important feature that may delay the merger process is the provision allowing all statutory authorities to intervene in the NCLT process and use this tactic effectively to seek payment of all pending demands, even the disputed amounts. Indian companies allowed merging into foreign companies The Old Act allows domestic companies to merge into each other, besides allowing foreign companies to merge into Indian companies. The New Act goes a step further, as it allows foreign companies to merge into Indian companies and vice-versa, meaning Indian companies wanting to merge into foreign companies may press ahead with their intention. The approval of the RBI is a pre-requisite in the both the cases. However, by virtue of Section 234 of the New Act, the license to merge into foreign companies comes with a rider that Indian companies can only merge into foreign companies domiciled in any of the jurisdictions notified by the Central Government.

Fast Track Mergers: Under the Old Act, mergers/amalgamations between group companies and subsidiaries are placed on the same pedestal on which mergers/amalgamations between entirely unrelated companies are placed. This meant that, mergers between group companies, and subsidiaries have to also conform to the normal procedure. However, under the New Act, Section 233 allows mergers between two small companies and holding companies and their wholly owned subsidiaries may not have to go through the normal procedure. Mergers/amalgamations may be completed, if the official liquidator and the members approve, and if sanctioned by the

Central Government, without having to wait for the order of the NCLT confirming the merger/amalgamation. This leeway helps cut costs involved in complying with the procedures, saves time and simplifies the procedure of mergers between two small companies or wholly owned subsidiaries and their parent companies.

Takeover offers:

Under the Old Act, no takeover can be a part of any Compromise or Arrangement involving a merger or amalgamation. But, under the New Act, a scheme of compromise or arrangement involving a merger/amalgamation may include a takeover offer. Thus, the Central Government is to promulgate rules to govern the takeover offers that may be announced as a part of a merger/amalgamation or change the Takeover Code to suitably govern the takeover offers that may be made under this section.

1.8 SUMMARY

Corporate restructuring is an expression that connotes a restructuring process undertaken by business enterprises for the purpose of bringing about a change for the better and to make the business competitive. Restructuring may be financial restructuring, technological, market and organizational restructuring. The most commonly applied tools of corporate restructuring are amalgamation, merger, demerger, acquisition, joint venture, disinvestments etc. Strategy has been defined as the very soul of any action and activity. Every executive and owner needs to be a 'strategist'. Strategic planning is a disciplined effort to produce fundamental decisions and actions that shape and guide what an organization is, what it does, and why it does, with a focus on the future at the same time. In strategic planning, key ingredients include creating vision and direction, creating clear and simple plan, great execution and clearly communicating to individuals their roles. Strategic planning will leave the organization with focus, accountability and more time for the important activities. The benefits of strategic planning include better decisions, increased energy, increased capacity, improved customer satisfaction, competitive advantage, better solution, market recognition etc.

1.9 KEY WORDS

1. MRTP: Monopolistic and Restrictive Trade Practice
2. NCLT: National Company Law Tribunal
3. CCI: Competition Commission of India
4. ROC: Registrar of Companies
5. IT Act : Income Tax Act

1.10 SELF ASSESSMENT QUESTIONS

1. What do you mean by Corporate Restructuring?
   ……………………………………………………………………………………………………
   ……………………………………………………………………………………………………..

2. What are the kinds of Corporate Restructuring?

……………………………………………………………………………………………………
……………………………………………………………………………………………..

3. Briefly explain the process of strategic planning and formulation towards corporate reconstruction

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UNIT-2 INTRODUCTION AND MEANING OF AMALGAMATION AND MERGER; REASONS AND OBJECTIVES OF MERGER; CATEGORIES OF MERGER

Structure

2.0 Objectives

2.0 Introduction

2.1 Meaning of Amalgamation and merger

2.2 Reasons and objective of merger

2.3 Categories of merger

2.4 Practical Instances of mergers and amalgamation

2.5 Summary

2.6 Key words

2.7 Self Assessment Questions

2.8 References

2.0 OBJECTIVES

1. To understand the concept of mergers and amalgamations.
2. To know reasons and objective for mergers and amalgamations.
3. To analyse the legal aspects of mergers and amalgamations.

2.1 INTRODUCTION

A company may decide to accelerate its growth by developing into new business areas, which may or may not be connected with its traditional business areas, or by exploiting some competitive advantage that it may have. Once a company has decided to enter into a new business area, it has to explore various alternatives to achieve its aims. Basically, there can be three alternatives available to it:

(i) the formation of a new company;

(ii) the acquisition of an existing company;

(iii) Merger with an existing company.

The decision as to which of these three options are to be accepted will depend on the company's assessment of various factors including in particular:

(1) the cost that it is prepared to incur;

(2) the likelihood of success that is expected;

(3) The degree of managerial control that it requires to retain.

For a firm desiring immediate growth and quick returns, mergers can offer an attractive opportunity as they obviate the need to start from 'scratch' and reduce the cost of entry into an existing business. However, this will need to be weighed against the fact that unless the shareholders of the transferor company (merging company) are paid the consideration in cash, part of the ownership of the existing business remains with the former owners. Merger with an existing company will, generally, have the same features as an acquisition of an existing company. However, identifying the right candidate for a merger or acquisition is an art, which requires sufficient care and calibre. Once an organization has identified the various strategic possibilities, it has to make a selection amongst them. There are several managerial factors which moderate the ultimate choice of strategy. This would depend upon its growth objectives, attitude towards risk, the present nature of business and technology in use, resources at its command, its own internal strengths and weaknesses, Government policy, etc. The changing economic

environment is creating its own compulsions for consolidation of capacities. With growing competition and economic liberalization, the last two decades have witnessed a large number of corporate mergers. The terms merger and amalgamation have not been defined in the Companies Act, 1956. For the purpose of this act the terms ‘Merger’ and ‘Amalgamation’ are synonymous. The statutory provisions relating to merger and amalgamation are contained in sections 390 to 396A. However, in different context, meaning of merger and amalgamation may be explained as under:

2.2 MEANING OF AMALGAMATION AND MERGER

As per General Dictionary Meaning: According to Oxford Dictionary, the expression “merger” or “amalgamation” means “combining of two commercial companies into one” merging of two or more business concerns into one” respectively. ‘Merger’ is a fusion between two or more enterprises, whereby the identity of one or more is lost and the result is a single enterprise whereas ‘Amalgamation’ signifies blending of two or more existing undertakings into one undertaking, the blended companies losing their identities and forming themselves into a separate legal identity. There may be amalgamation either by the transfer of two or more undertaking to a new company, or by the transfer of one or more undertaking to an existing company.

As per Income Tax Act, 1961: Amalgamation as defined in section 2 (1B) of the Income Tax Act, 1961 means the merger of one or more companies with another company or the merger of two or more companies to form one company in such a manner that the following conditions are satisfied:

a) All the property of the amalgamating company or companies immediately before the amalgamation becomes the property of the amalgamated company by virtue of the amalgamation.
b) All the liabilities of the amalgamating company or companies immediately before the amalgamation becomes the liabilities of the amalgamated company by virtue of the amalgamation
c) Shareholders holding at least three-fourths in value of the shares in the amalgamating company or companies (other than shares already held therein immediately before the amalgamated company or its nominee) becomes the shareholders of the amalgamated company by virtue of the amalgamation.

As Per Accounting Standard: According to the mandatory Accounting Standard 14 (AS-14) issued by the Institute of Chartered Accountants of India (ICAI), ‘amalgamation’ means an amalgamation pursuant to the provisions of the Companies Act, 1956 or any other statute which

may be applicable to companies. Under the said AS-14 the following two methods of amalgamation have been contemplated:

1) **Amalgamation in the nature of merger:-** Amalgamation in the nature of merger is an amalgamation which satisfies all the following conditions:-
   a. All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.
   b. Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.
   c. The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.
   d. The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.
   e. No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

2) **Amalgamation in the nature of purchase:-** Amalgamation in the nature of purchase is an amalgamation which does not satisfy any one or more of the conditions specified in (1) above

2.3 REASONS AND OBJECTIVES OF MERGER

Following are the main reasons and objectives for the companies to go for mergers and amalgamation:

1. **To achieve economies of Scale:-** The combination of two or more companies and their resources – production facilities, marketing outlets, managerial skills, liquidity etc. could be used to achieve economies of scale and thus, improve the profitability, and attain synergetic operating economies. It will result in reduction in advertising costs, administration costs and production costs.
2. **To reduce the gestation period for new business:-** To develop new business will need a gestation period and might amount to re-investing the wheel. If, however, a company can acquire another company which has a profitable business running and merged with it, it is possible to avoid the initial teething trouble period of a new business and venture into new field with relative ease.

3. **To compete globally:-** In this era of globalization, unless a company is large in size and capital, it will be very difficult to compete with global companies where the cost of production is lower due to the benefits of economies of scale. In a free competitive world, it is necessary to position oneself in such a manner to compete with the best and prove oneself as better than the others. This could be achieved only by merger and amalgamation of companies in the same line of business and create a niche world market for oneself.
4. **To utilize the liquidity available with the company for achieving growth through diversification:-** Finance is a scarce resource. Liquidity can be better used by acquiring competing and complementary businesses. Sometimes mergers take place by a financially strapped company with a financially rich company and thus take advantage of the finance available with the merged company.
5. **To acquire and maximize the available managerial skills to increase the profitability:-** It is possible that a company may have expertise and skilled managerial personnel, but for the reasons beyond their control, the company may not be able to compete with another company. In such cases, the other company would benefit by merging with the former company and take full advantage of the available managerial skills and thus, save costs to improve its own profitability and at the same time, the skilled persons are also gainfully employed.
6. **To Diversify the risk:**- Another reason for merger is to diversify the company's dependence on a number of segments of the economy. Diversification implies growth through the combination of firms in unrelated businesses. All the businesses go through cycles. So in decline stage the company can find it difficult to sustain itself and therefore looks to diversify into the unrelated area of business. Such diversification helps to open up the avenues of growth. In short - We are all aware of the famous saying: "Don't put all your eggs in one basket." When a firm operates in many businesses, the downs in one can be compensated by the ups in another. A good example of an Indian company attempting to diversify and develop a new core is ITC. Among the businesses which ITC has entered in recent years are apparel retailing and branding, ready-to-eat packaged foods, confectionery items, InfoTech, paper and boards, Hotel Chain etc.
7. **To avail the taxation advantages under the Income Tax Act, 1961:**- Mergers and amalgamation also take place to avail the taxation benefits available to amalgamating companies (subject to fulfillment of certain conditions) under the Income Tax Act, 1961.

These benefits are available mainly by virtue of Sec 72A (Provisions relating to carry forward and set off of accumulated loss and unabsorbed depreciation allowance in amalgamation). Apart from these tax benefits are also available to amalgamating companies and the shareholders of the amalgamated companies.

8. **In the Public Interest:-** Where the Central Government is satisfied that it is essential in public interest that two or more companies should amalgamate, it may, by notified order in the Official Gazette, provide for the amalgamation of those companies into a single company. This power is vested in the hands of Central Government under section 396 of the Companies Act, 1956.

2.4 CATEGORIES OF MERGER

Mergers may be broadly classified as follows:

(i) Cogeneric – within same industries and taking place at the same level of economic activity – exploration, production or manufacturing wholesale distribution or retail distribution to the ultimate consumer.

(ii) Conglomerate – between unrelated businesses.

Cogeneric Mergers: Cogeneric mergers are of two types:

(a) Horizontal merger: This class of merger is a merger between business competitors who are manufacturers or distributors of the same type of products or who render similar or same type of services for profit. It involves joining together of two or more companies which are producing essentially the same products or rendering same or similar services or their products and services directly competing in the market with each other. It is a combination of two or more firms in similar type of production/distribution line of business. Horizontal mergers result in a reduction in the number of competing companies in an industry, increase the scope for economies of scale and elimination of duplicate facilities. However, their main drawback, is that they promote monopolistic trend in the industrial sector as the number of firms in an industry is decreased and this may make it easier for the industry members to collude for monopoly profits.

(b) Vertical merger: Vertical mergers occur between firms which are complementary to each other, e.g. one of the companies is engaged in the manufacture of a particular product and the other is established and expert in the marketing of that product. In this merger the two companies merge and control the production and marketing of the same product. Vertical

merger may take the form of forward or backward merger. When a company combines with the supplier of material, it is called a backward merger and where it combines with the customer, it is known as forward merger. A vertical merger may result into a smooth and efficient flow of production and distribution of a particular product and reduction in handling and inventory costs. It may also pose a risk of monopolistic trend in the industry.

Conglomerate merger: This type of merger involves coming together of two or more companies engaged in different industries and/or services. Their businesses or services are neither horizontally nor vertically related to each other. They lack any commonality either in their end product, or in the rendering of any specific type of service to the society. This is the type of merger of companies which are neither competitors, nor complimentaries nor suppliers of a particular raw material nor consumers of a particular product or consumable. A conglomerate merger is one which is neither horizontal nor vertical. In this, the merging companies operate in unrelated markets having no functional economic relationship.

Mergers may further be categorised as:

Cash Merger: A merger in which certain shareholders are required to accept cash for their shares while other shareholders receive shares in the continuing enterprise.

Defacto Merger: Defacto merger has been defined as a transaction that has the economic effect of a statutory merger but is cast in the form of an acquisition of assets.

Down Stream Merger: The merger of parent company into its subsidiary is called down stream merger.

Up stream Merger: The merger of subsidiary company into its parent company is called an up stream merger.

Short-form Merger: A number of statutes provide special company rules for the merger of a subsidiary into its parent where the parent owns substantially all of the shares of the subsidiary. This is known as a short form merger. Short form mergers generally may be effected by adoption of a resolution of merger by the parent company, and mailing a copy of plan of merger to all shareholders of subsidiary and filing the executed documents with the prescribed authority under the statute. This type of merger is less expensive and time consuming than the normal type of merger.

Triangular Merger: Triangular merger means the amalgamation of two companies by which the disappearing company is merged into subsidiary of surviving company and shareholders of the disappearing company receive shares of the surviving company.

Reverse Merger: Reverse merger takes place when a healthy company amalgamates with a financially weak company. In the context of the provisions of the Companies Act, 1956, there is no difference between regular merger and reverse merger. It is like any other amalgamation. Reverse merger automatically makes the transferor-company entitled for the benefit of carry forward and set-off of loss and unabsorbed depreciation of the transferee-company. There is no need to comply with Section 72A of Income Tax Act, 1961.

2.5 PRACTICAL INSTANCES OF MERGERS AND AMALGAMATION

1. Tata Steel's mega takeover of European steel major Corus for $12.2 billion. The biggest ever for an Indian company. This is the first big thing which marked the arrival of India Inc on the global stage.

2. In March 2011, the Vodafone Group announced that it would buy 33 percent stake in its Indian joint venture for about 5 billion dollars after the Essar Group sold its holding and exited Vodafone. Healthcare giant Piramal Group too, bought about 5.5 percent in the Indian arm of Vodafone for about 640 million dollars. This brings Vodafone’s current stake to about 75 percent.
3. Hindalco of Aditya Birla group's acquisition of Novellis for $6 billion.
4. Ranbaxy's sale to Japan's Daiichi for $4.5 billion. Sing brothers sold the company to Daiichi and since then there is no real good news coming out of Ranbaxy.
5. ONGC acquisition of Russia based Imperial Energy for $2.8 billion. This marked the turnaround of India's hunt for natural reserves to compete with China.
6. NTT DoCoMo-Tata Tele services deal for $2.7 billion. The second biggest telecom deal after the Vodafone.
7. HDFC Bank acquisition of Centurion Bank of Punjab for $2.4 billion.
8. Tata Motors acquisition of luxury car maker Jaguar Land Rover for $2.3 billion. This could probably the most ambitious deal after the Ranbaxy one.

9. The largest deal in the first quarter for 2012 has been Sesa Goa acquisition of Sterlite Industries valued at $ 3.9 billion. In February 2012 the partner company Vedanta Resources announced the restructuring plans. According to the restructuring plan, Sesa Sterlite will become the holding company of Vedanta's all group firms, except Konkola Copper Mines. As per the scheme of arrangements, Sterlite shareholders will get three shares of Sesa Goa for every five shares held according to the swap ratio. Sterlite Industries’s shareholders would be meeting in second half of June 2012 to consider the proposed.

10. Beyond above mentioned inbound and domestic deals; India companies were also involved in outbound deals. The largest deal in this category was Aditya Birla Management's acquisition of Northern Iron Ltd for $ 499.6 million.

11. The much talked about Reliance – BP deal finally came through in July 2011 after a 5 month wait. Reliance Industries signed a 7.2 billion dollar deal with UK energy giant BP, with 30 percent stake in 21 oil and gas blocks operated in India. Although the Indian government's approval on two oil blocks still remains pending, this still makes it one of the biggest FDI deals to come through in India Inc.

12. In September 2011, India's second largest hospital chain, Fortis Healthcare (India) Ltd, announced that it will merge with Fortis Healthcare International Pte Ltd., the promoters' privately held company. This will make Fortis Asia's top healthcare provider with the approximate total revenue pegged at Rs. 4,800 crore. Fortis India will buy the entire stake of the Singapore based Fortis International. This company is currently held by the Delhi-based Singh brothers (Malvinder Singh and Shivinder Singh).

13. In May 2011, IT firm iGate completed its acquisition of its midsized rival Patni Computers for an estimated 1.2 billion dollars. For iGate, the main aim of this acquisition was to increase its revenue, vertical capability and customer base. iGate now holds an approximate stake of 82.5 percent in Patni computers, now called iGate Patni.

14. In one of the biggest overseas acquisitions initiated by India in September 2011, Hyderabad-based GVK Power bought out Australia's Hancock Coal for about 1.26 billion dollars. The acquisition includes a majority of the coal resources, railway line and port infrastructure of Hancock Coal, along with the option for long term coal supply contracts.

15. The Ruias' flagship company for its oil business, Essar Energy completed its 350 million dollar acquisition of the UK based Stanlow Refinery of Shell in August 2011. In addition to a direct access to the UK market, Essar is planning to make optimum utilization of this deal with its '100 day plan' to improve operations at the UK unit.

2.6 SUMMARY

A merger can be defined as the fusion or absorption of one company by another. In a merger, one of the two existing companies merges its identity into another existing company. Also, one or more existing companies may form a new company and merge their identities into a new company by transferring their assets and liabilities to the new company. Amalgamation is a legal process by which two or more companies are joined together to form a new entity. Merger and amalgamation have various advantages e.g. synergy, economies of scale, reduction in production

and other expenses, tax advantages, competitive advantage etc. The categories of merger, and purpose and objective of merger has been explained in detail in the chapter.

2.7 KEY WORDS

1. ONGC: Oil and Natural Gas Corporation Limited
2. ICAI: Institute of Chartered Accountants of India
3. AS: Accounting Standards

2.8 SELF ASSESSMENT QUESTIONS

1. What do you mean by 'amalgamation'?
   …………………………………………………………………………………………………
   …………………………………………………………………………………………………

2. What are the underlying objectives in merger?
   …………………………………………………………………………………………………
   ………………………………………………………………………………………………..

3. Briefly explain the various categories of merger.
   …………………………………………………………………………………………………
   ………………………………………………………………………………………………..

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UNIT-3 INTRODUCTION AND MEANING OF TAKEOVERS; TYPES AND OBJECTS OF TAKEOVERS

Structure

3.0 Objectives

3.1 Introduction

3.2 Meaning of takeovers

3.3 Types of takeovers

3.4 Objective of takeovers

3.5 Practical Instances to takeovers

3.6 Summary

3.7 Key words

3.8 Self Assessment Questions

3.9 References

3.0 OBJECTIVES

1 To understand the meaning and concept of takeover
2 To know the objects of Takeover
3 To analyse practical Instances of Takeovers

3.1 INTRODUCTION

Takeovers are increasingly gaining importance and significance in Indian as well as global scenario. Takeover of a company attracts compliance of company law provisions as well as the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997. Takeover implies acquisition of control of a company, which is already registered, through the purchase or exchange of shares. Takeovers usually take place when shares are acquired or purchased from the shareholders of a company at a specified price to the extent of at least controlling interest in order to gain control of that company. Takeover of management and control of a business enterprise could take place in different modes. The management of a company may be acquired by acquiring the majority stake in the share capital of a company. The acquisition could take place through different methods. A person may acquire the voting shares of a listed company. A company may acquire shares of an unlisted company through what is called the acquisition under Section 395 of the Companies Act, 1956. Where the shares of the company are closely held by a small number of persons, a takeover may be effected by agreement with the holders of those shares. However, where the shares of a company are widely held by the general public, it involves the process as set out in the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997.

In India, the process of economic liberalisation and globalisation ushered in the early 1990's created a highly competitive business environment, which motivated many companies to restructure their corporate strategies. The restructuring process led to an unprecedented rise in strategies like amalgamations, mergers including reverse mergers, demergers, takeovers, reverse takeovers and other strategic alliances.

3.2 MEANING OF TAKEOVERS

The concept of takeover picked up and in the meantime the Securities and Exchange Board of India (SEBI) also notified the Substantial Acquisition of Shares and Takeover Regulations, which laid down a procedure to be followed by an acquirer for acquiring majority shares or controlling interest in another company. The takeover code is not meant to ensure proper

management of the business of companies or to provide remedies in the event of mismanagement. It’s main objective is to ensure equal opportunity to all shareholders and offer protection to them, in the event of substantial acquisition of shares and takeovers. When an “acquirer” takes over the control of the “target company”, it is termed as takeover. When an acquirer acquires “substantial quantity of shares or voting rights” of the Target Company, it results into substantial acquisition of shares. The term “Substantial” which is used in this context has been clarified subsequently. A takeover bid is understood to imply the acquisition of shares carrying voting rights in a company, in a direct or indirect manner, with a view to gaining control over the management of the company.

3.3 TYPES OF TAKEOVERS

Substantial acquisition of shares in an Indian listed company (“Company”), is regulated by the Securities Exchange Board of India (“SEBI”) (Substantial Acquisition of Shares and Takeovers) Regulations 1997 (“Takeover Code”). The fundamental premise of the Takeover Code is to provide equality of treatment and opportunity to all shareholders and to provide transparency to the process of takeovers through the mandatory disclosure requirements.

I. Legal contest

From legal perspective, takeover is of two types:

1. Friendly or Negotiated Takeover
2. Hostile Takeover
3. Bail out takeover

1. Friendly or Negotiated Takeover:

Friendly takeover means takeover of one company by change in its management & control through negotiations between the existing promoters and prospective investor in a friendly manner. Thus it is also called Negotiated Takeover. This kind of takeover is resorted to further some common objectives of both the parties. Generally, friendly takeover takes place as per the provisions of Section 395 of the Companies Act, 1956.

2. Hostile Takeover:

Hostile takeover is a takeover where one company unilaterally pursues the acquisition of shares of another company without being into the knowledge of that other company. The most dominant purpose which has forced most of the companies to resort to this kind of takeover is increase in market share. The hostile takeover takes place as per the provisions of SEBI (Substantial Acquisition of Shares and Takeover) Regulations, 2011.

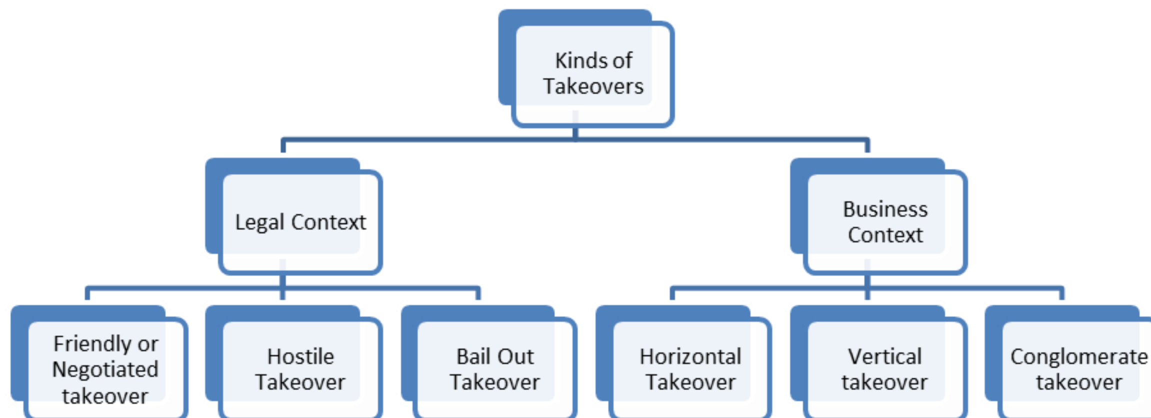
3. **Bail Out Takeover:** Takeover of a financially sick company by a profit earning company to bail out the former is known as bail out takeover. There are several advantages for a profit making company to takeover a sick company. The price would be very attractive as creditors, mostly banks and financial institutions having a charge on the industrial assets, would like to recover to the extent possible. Banks and other lending financial institutions would evaluate various options and if there is no other go except to sell the property, they will invite bids. Such a sale could take place in the form by transfer of shares. While identifying a party (acquirer), lenders do evaluate the bids received, the purchase price, the track record of the acquirer and the overall financial position of the acquirer. Thus a bail out takeover takes place with the approval of the Financial Institutions and banks.

II. <u>Business context</u>

In the context of business, takeover is of three types:

1. **Horizontal Takeover:** Takeover of one company by another company in the same industry. The main purpose behind this kind of takeover is achieving the economies of scale or increasing the market share. E.g. takeover of Henkel by Jyothy Laboratories, Patni Computers by iGate.
2. **Vertical takeover:** Takeover by one company of its suppliers or customers. The former is known as Backward integration and latter is known as Forward integration. E.g. takeover of Sona Steerings Ltd. By Maruti Udyog Ltd
3. **Conglomerate takeover:** Takeover of one company by another company operating in totally different industries. The main purpose of this kind of takeover is diversification.

Graphical presentation of types of takeover:



3.4 OBJECTS OF TAKEOVERS

The objects of a takeover may inter alia be:

i. To effect savings in overheads and other working expenses on the strength of combined resources;

ii. To achieve product development through acquiring firms with compatible products and technological/manufacturing competence, which can be sold to the acquirer's existing marketing areas, dealers and end users;

iii. To diversify through acquiring companies with new product lines as well as new market areas, as one of the entry strategies to reduce some of the risks inherent in stepping out of the acquirer's historical core competence;

iv. To improve productivity and profitability by joint efforts of technical and other personnel of both companies as a consequence of unified control;

v. To create shareholder value and wealth by optimum utilisation of the resources of both companies;

vi. To eliminate competition;

vii. To keep hostile takeover at bay;

viii. To achieve economy of numbers by mass production at economical costs;

ix. To secure advantage of vertical combination by having under one command and under one roof, all the stages or processes in the manufacture of the end product, which had earlier

been available in two companies at different locations, thereby saving loading, unloading, transportation costs and other expenses and also by affecting saving of time and energy unnecessarily spent on excise formalities at different places and stages;

x. To secure substantial facilities as available to a large company compared to smaller companies for raising additional capital, increasing market potential, expanding consumer base, buying raw materials at economical rates and for having own combined and improved research and development activities for continuous improvement of the products, so as to ensure a permanent market share in the industry;

xi. To increase market share;

xii. To achieve market development by acquiring one or more companies in new geographical territories or segments, in which the activities of acquirer are absent or do not have a strong presence.

3.5 PRACTICAL INSTANCES OF TAKEOVERS

1. The Essel Group, controlled by media baron Subhash Chandra had steadily accumulated around 12.27% shares of IVRCL to become the single largest shareholder in IVRCL. The original proposal of Essel Group was to acquire the entire shareholding of the existing promoters of IVRCL and thereby acquire control of IVRCL. However, now it appears that Essel Group has decided to put the proposal on hold and observe the target company for some more time before any comprehensive action is taken. This is a clear indication of the beginning of an era of hostile takeovers and takeover battles in India.

2. In 2000,Tata Tea took over Tetley Tea, the company which was twice Tata Tea's size and had introduced the world to tea bags, for £271 million via a leverage buyout. Themove turned the company into the world's second-largest tea marketer. While Tata was strong on the production front, Tetley's strengths lay in marketing.

   At the time of acquisition,The two companies were merged a year later. The Tetley brand name would give Tata Tea access to markets in Saudi Arabia, Iran, Iraq, and the CIS countries, said the company's vicechairman, R.K. Krishna Kumar,whose mandate for the acquisition was simple: to eliminate the competition, Unilever. "Tata Tea's transformation is an eloquent example of the group becoming market-focused and consumer centric".
3. Arcelor Mittal deal is an example of hostile takeover, where the LN Mittal group acquired management control of Arcelor against the wishes of the Arcelor management.

India Cements takes over Rassi Cements in 1998. ITC Ltd takes over East India Hotels Ltd in 2000 are also other instances of takeovers.

4. Case study: Kraft's takeover of Cadbury:

Facts: In 2009, US food company Kraft Foods launched a hostile bid for Cadbury, the UK-listed chocolate maker. As became clear almost exactly two years later in August 2011, Cadbury was the final acquisition necessary to allow Kraft to be restructured and indeed split into two companies by the end of 2012: a grocery business worth approximately $16bn; and a $32bn global snacks business. Kraft needed Cadbury to provide scale for the snacks business, especially in emerging markets such as India. The challenge for Kraft was how to buy Cadbury when it was not for sale.

The history: Kraft itself was the product of acquisitions that started in 1916 with the purchase of a Canadian cheese company. By the time of the offer for Cadbury, it was the world's second-largest food conglomerate, with seven brands that each generated annual revenues of more than $1bn.

Cadbury, founded by John Cadbury in 1824 in Birmingham, England, had also grown through mergers and demergers. It too had recently embarked on a strategy that was just beginning to show results. Ownership of the company was 49 per cent from the US, despite its UK listing and headquarters. Only 5 per cent of its shares were owned by short-term traders at the time of the Kraft bid.

The challenge: Not only was Cadbury not for sale, but it actively resisted the Kraft takeover.

Sir Roger Carr, the chairman of Cadbury, was experienced in takeover defences and immediately put together a strong defensive advisory team. Its first act was to brand the 745 pence-per-share offer "unattractive", saying that it "fundamentally undervalued the company". The team made clear that even if the company had to succumb to an unwanted takeover, almost any other confectionery company (Nestlé, Ferrero and Hershey were all mentioned) would be preferred as the buyer. In addition, Lord Mandelson, then the UK's business secretary, publicly declared that the government would oppose any buyer who failed to "respect" the historic confectioner.

The response: Cadbury's own defence documents stated that shareholders should reject Kraft's offer because the chocolate company would be "absorbed into Kraft's low growth conglomerate business model – an unappealing prospect that sharply contrasts with the Cadbury strategy of a pure play confectionery company". Little did Cadbury's management know that Kraft's plan

was to split in two to eliminate its conglomerate nature and become two more focused businesses, thereby creating more value for its shareholders?

The result: The Cadbury team determined that a majority of shareholders would sell at a price of roughly 830 pence a share. A deal was struck between the two chairmen on January 18 2010 at 840 pence per share plus a special 10 pence per share dividend. This was approved by 72 per cent of Cadbury shareholders two weeks later.

The key lessons: In any takeover, especially a cross-border deal in which the acquired company is as well known as Cadbury was in the UK, the transaction will be front-page news. In this case, it was the lead business story for at least four months. Fortunately, this deal had no monopoly or competition issues, otherwise those regulators could also have been involved. But aside from any regulators, most other commentators will largely be distractions. It is important for the acquiring company's management and advisers to stay focused on the deal itself and the real decision-makers – the shareholders of the target company. As this deal demonstrates, these shareholders may not (and often will not) be the long-term traditional owners of the target company stock, but rather very rational hedge funds and other arbitrageurs (in Cadbury's case, owning 31 per cent of the shares at the end), who are swayed only by the offer price and how quickly the deal can be completed. Other stakeholders may have legitimate concerns that need to be addressed but this can usually be done after the deal is completed, as Kraft did.

3.6 SUMMARY

Takeover is a corporate device whereby one company acquires control over another company, usually by purchasing all or a majority of its shares. Takeovers may be classified as friendly takeover, hostile takeover and bail out takeover. Takeover bids may be mandatory, partial or competitive bids. Consideration for takeover could be in the form of cash or in the form of shares. Takeover of companies whose securities are listed or one or more stock exchanges is regulated by the provisions of listed agreements and SEBI (Substantial Acquisition of Shares and Takeovers) Regulation, 1997.

3.7 KEY WORDS

1. SEBI: Securities Exchange Board of India
2. CIS: Commonwealth of Independent States

3.8 SELF ASSESSMENT QUESTIONS

1. What do you mean by term Takeover? What are the objectives which takeovers seeks to achieve?
   …………………………………………………………………………………………………
   …………………………………………………………………………………………………

2. Briefly explain types of takeover?
   …………………………………………………………………………………………………
   …………………………………………………………………………………………………

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UNIT-4 VALUATION OF BUSINESS; VALUATION OF SHARES; OBJECT AND METHODS OF VALUATION OF SHARES;

Structure:

4.0 Objectives

4.1 Introduction

4.2 meaning of valuation of shares

4.3 Valuation of Business

4.4 Object and Methods of valuation of shares

4.5 Summary

4.6 Key words

4.7 Self Assessment Questions

4.8 References

4.0 OBJECTIVES

- To understand Need and purpose of valuation
- To know the factors influencing valuation
- To valuation of motives
- To understand the non financial consideration in valuation
- To understand the Judicial pronouncements.

4.1 INTRODUCTION

Valuation is an exercise to assess the worth of an enterprise or a property. In a merger or amalgamation or demerger or acquisition, valuation is certainly needed. It is essential to fix the value of the shares to be exchanged in a merger or the consideration payable for an acquisition. As per Section 82 of the Companies Act, 1956, the shares or debentures or other interest of any member in a company shall be movable property. A share carries with itself a bundle of rights such as the right to elect directors, the right to vote on resolutions in general meetings of a the company, the right to share in the surplus, if any, on liquidation etc.

The value of every share is printed in front of the shares. Such a value is called as par value or face value of shares. The face value is assigned by the promoters of Joint Stock Company and is given in the memorandum of association. Except the face value, it has also get market value on stock exchange market which may be differ from face value. The market value of a share is determined by the demand and supply. Such a value is affected by the action and opinions of investors and their fear, guess, investment policy etc. Hence, the market price does not reflect the true value of shares and requires a proper valuation of shares. Specially, in the case of private limited company the shares of such a company are not freely purchased and sold to the public. In that case, the valuation becomes absolutely necessary. The value of shares can be determined in different ways. It can be valued either by taking the earning of a company or net assets that comprise the company. The choice is governed by the reasons for investment.

4.2 MEANING OF VALUATION OF SHARES

Need and Purpose:

There are a number of situations in which a business or a share or any other property may be required to be valued. Valuation is essential for:

(i) strategic partnerships

(ii) mergers or acquisitions of shares of a company and / or acquisition of a business

(iii) Valuation is also necessary for introducing employee stock option plans (ESOPs) and joint ventures.

From the perspective of a valuer, a business owner, or an interested party, a valuation provides a useful base to establish a price for the property or the business or to help determine ways and means of enhancing the value of his firm or enterprise. The main objective in carrying out a valuation is conclude a transaction in a reasonable manner without any room for any doubt or controversy about the value obtained by any party to the transaction. Acquisition of Business or Investment in the Equity of an enterprise could be understand by the following two illustrations in this regard.

Illustration: A Party who enters into a transaction with another for acquiring a business would like to acquire a business as a going concern for the purpose of continuing to carry the same business, he might compute the valuation of the target company on a going concern basis. On the other hand if the intention of the acquirer is to acquire any property such as land, rights, or brands, the valuation would be closely connected to the market price for such property or linked to the possible future revenue generation likely to arise from such acquisition. In every such transaction, therefore the predominant objective in carrying out a valuation is to put parties to a transaction in a comfortable position so that no one feels aggrieved.

Meaning of Valuer:

As per Regulation 2(r) of the SEBI (Issue of Sweat Equity) Regulations, 2002, valuer' means a Chartered Accountant or a Merchant Banker appointed to determine the value of the intellectual property rights or other value addition. The same definition has been utilized for the valuation requirements under the SEBI (Disclosure and Investor Protection) Guidelines, 2000. As per the said sweat equity regulations, valuation of intellectual property rights or of the know-how provided or other value shall be carried out by a merchant banker. The merchant banker may consult such experts and valuers, as he may deem fit having regard to the nature of the industry and the nature of the property or other value addition. The merchant banker shall obtain a certificate from an independent Chartered Accountant that the valuation of the intellectual property or other value addition is in accordance with the relevant accounting standards.

4.3VALUATION OF BUSINESS

Definition of 'Business Valuation'

Simply defined, a business valuation is an examination conducted towards rendering an estimate or opinion as to the fair market value of a business interest at a given point in time. Generally, when valuing a business, a notional transaction is assumed, that is, one which has not been subjected to the bargaining process. The concept of notional is examined later. Like accounting,

valuation is an art rather than an exact science, and a properly conducted valuation is nothing more than an expression of informed opinion, which is based on fact and judgment. By their very nature, valuations are not precise. Consequently, valuation estimates and opinions are generally stated as a range of values.

When is a valuation required?

Examples of when a business valuation may be required include any of the following instances:

- Shareholder disputes
- purchase/sale of a business interest
- non-arm's length transaction
- oppressed minority shareholder actions
- damage claims
- buy/sell agreements • marital disputes
- estate planning • deemed disposition at death
- litigation support

The process of determining the economic value of a business or company. Business valuation can be used to determine the fair value of a business for a variety of reasons, including sale value, establishing partner ownership and divorce proceedings. Often times, owners will turn to professional business valuators for an objective estimate of the business value. The process of examining various economic factors of a business using predetermined formulas to assess the value of the business or an owner's interest in a company. Business valuation may be conducted to provide an accurate snapshot of the company's financial standing to present to current or potential investors. The Internal Revenue Service requires that a business be valued based on fair market value.

KindsofValuation:

1. Market value: An item's **market value** is the highest price which the owner could fetch in an open market transaction. Market value is "the power which an article confers upon its possessor irrespective of legal authority or personal sentiments, of commanding in exchange for itself, the labour or the products of labour of others." As we are all aware, markets can be inconsistent as they are impacted by numerous considerations from without and within. In "Untermyer Estate v Attorney General (BC) 1929," Justice Mignault said, "it may, perhaps, be open to question whether the expression 'fair' adds anything to the meaning of the words 'market value,' except possibly to this extent that the market price must have some consistency and not be the effect of a transient boom or sudden panic on the market." The adjective "fair" in fair market value

qualifies the word “market.” That is, a **fair** market value is something other than market value. It is then generally accepted that a fair market (value) is not one in which the owner would sell under the prevailing conditions, but one which is consistent and unaffected by boom or panic.

2. Fair value: Various federal and provincial corporate legislation, notably the Business Corporations (or Companies) Act, speaks of **“fair value”** rather than fair market value. None of the legislation defines fair value, although through various court decisions it has come to be defined as something other than fair market value. While still evolving, fair value can be thought of as “just and equitable in the circumstances.” This flows from, but is not limited to, the fact that it is often the standard applied, under the Business Corporations (or Companies) Act, when compensating shareholders under the available oppression remedies. An oppressed shareholder is generally an unwilling participant who wishes to divest himself or herself of their investment, hence the desire to be “fair.” The term “fair market value” appears many places in the Income Tax Act, but the term “fair value” does not appear at all. When offering an opinion as to value, a business valuator must always include in their report, a definition of the **type** of value they are estimating or upon which they are giving an opinion.

4.4 OBJECT AND METHODS OF VALUATION OF SHARES

Object of Valuation of Shares:

The following are some of the usual circumstances when valuation of shares or enterprise becomes essential:

1. When issuing shares to public either through an initial public offer or by offer for sale of shares of promoters or for further issue of shares to public.
2. When promoters want to invite strategic investors or for pricing a first issue or a further issue, whether a preferential allotment or rights issue.
3. In making investment in a joint venture by subscription or acquisition of shares or other securities convertible into shares.
4. For making an ‘open offer for acquisition of shares.
5. When company intends to introduce a ‘buy back’ or ‘delisting of share.
6. If the scheme of merger or demerger involve issue of shares. In Schemes involving Mergers/Demergers, share valuation is resorted to in order to determine the consideration for the purpose of issue of shares or any other consideration to shareholders of transferor or demerged companies.
7. On Directions of Company Law Board or any other Tribunal or Authority or Arbitration Tribunals directs.
8. For determining fair price for effecting sale or transfer of shares as per Articles of Association of the Company.
9. As required by the agreements between two parties.

10. For purposes of arriving of Value of Shares for purposes of assessments under the Wealth Tax Act.
11. To determine purchase price of a 'block of shares', which may or may not give the holder thereof a controlling interest in the company.
12. To value the interest of dissenting shareholders under a scheme of Amalgamation merger or reconstruction.
13. Conversion of Debt Instruments into Shares.
14. Advancing a loan against the security of shares of the company by the Bank/Financial Institution.
15. As required by provisions of law such the Companies Act, 1956 or Foreign Exchange Management Act, 1999 or Income Tax Act, 1961 or the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 [the Takeover Code] or SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999 or SEBI (Buy Back of Securities) Regulations, 1998 or Delisting Guidelines.

Methods of Valuation of Shares:

There are basically three methods of valuation:
(i) Net Asset Value (NAV);
(ii) Profit Earning Capacity Value (PECV); and
(iii) Market Value (MV) in the case of listed shares.

(i) Net Asset Value (NAV);

Under this method, a business is valued on the basis of its net assets i.e. total assets less liabilities and preferred claims and by dividing the remainder by the number of equity shares outstanding on a particular date. A look at the said guidelines reveal that the net asset value, as at the latest audited balance sheet date, will be calculated starting from the total assets of the company deducting therefrom all debts, dues, borrowings and liabilities including current and contingent liabilities and preference capital, if any. In other words, it should represent the true "net worth" of the business after providing for all outside present and potential liabilities. In the case of companies, the net asset value as calculated from the asset side of the balance sheet will be cross checked with equity share capital plus free reserves and profit and loss account surplus minus the contingent liabilities. While considering the value of the shares of a company under the above method, it is necessary to note that the valuation of assets could also be done based on (a) Book values, (b) Net replacement values, or (c) Net realizable values. While sellers would like to ensure that the assets, particularly immovable properties are properly valued so as to reflect the present market value of such properties, buyers have to be cautious to note that the mere presence of high value properties do not mean anything, as immovable properties do not contribute anything to generate revenue streams. That is because, whatever be the value of such

properties, in a going concern, such properties do not change the profit earning capacity of the company. Consider the case of sick textile mills in Mumbai. Most of them are closed for long. The immovable properties, particularly the land of such companies can fetch phenomenal price as those properties are in the heart of today's Mumbai. This method is rarely used for valuing a going concern, as it does not consider the future earning capacity of the business.

An asset-based valuation can be further separated into four approaches:

1. Book value: The tangible book value of a company is obtained from the balance sheet by taking the adjusted historical cost of the company's assets and subtracting the liabilities; intangible assets (like goodwill) are excluded in the calculation. Statutes like the Gift Tax Act, Wealth Tax Act, etc., have in fact adopted book value method for valuation of unquoted equity shares for companies other than an investment company. Book value of assets does help the valuer in determining the useful employment of such assets and their state of efficiency. In turn, this leads the valuer to the determination of rehabilitation requirements with reference to current replacement values. In all cases of valuation on assets basis, except book value basis, it is important to arrive at current replacement and realization value. It is more so in case of assets like patents, trademarks, know-how, etc. which may possess value, substantially more or less than those shown in the books. Using book value does not provide a true indication of a company's value, nor does it take into account the cash flow that can be generated by the company's assets.
2. Replacement cost: Replacement cost reflects the expenditures required to replicate the operations of the company. Estimating replacement cost is essentially a make or buy decision.
3. Appraised value: The difference between the appraised value of assets, and the appraised value of liabilities is the net appraised value of the firm. This approach is most commonly used in a liquidation analysis because it reflects the divestiture of the underlying assets rather than the ongoing operations of the firm.
4. Excess earnings: In order to obtain a value of the business using the excess earnings method, a premium is added to the appraised value of net assets. This premium is calculated by comparing the earnings of a business before a sale and the earnings after the sale, with the difference referred to as excess earnings. In this approach, it is assumed that the business is run more efficiently after a sale; the total amount of excess earnings is capitalized (e.g., the difference in earnings is divided by some expected rate of return) and this result is then added to the appraised value of net assets to derive the value of the business.

(ii) Profit Earning Capacity Value (PECV);

Under this method, a reasonable estimate of the average future maintainable operating profits is made by taking (a) past earnings, and (b) the trend and the future plans of the company as a base. This, after deducting preferred rights, if any, is capitalized at an appropriate rate to arrive at the value of the equity shares of the company. As per the said guidelines, the profit earning capacity value will be calculated by capitalizing the average of the after tax profits at the following rates:

(i) 15% in the case of manufacturing companies;

(ii) 20% in the case of trading companies;

(iii) 17.5% in the case of "intermediate companies", i.e, companies whose turnover from trading activity is more than 40%, but less than 60% of their total turnover.

The guidelines clearly state that the crux of estimating the profit earning capacity value lies in the assessment of the future maintainable earnings of the business. While the past trends in profits and profitability would serve as a guide, it should not be overlooked that the valuation is for the future and that the future maintainable stream of earnings that is greater of significance in the process of valuation. All relevant factors that have a bearing on the future maintainable earnings of the business must, therefore, be given due consideration.

(iii) Market value method;

The guidelines clearly state that question of market value acting as a guiding factor for valuation will obviously arise only in those cases where the shares being valued are listed on the stock exchange. Under this method, the average market prices of quoted shares for a certain length of time is taken as the value.

Valuation for Slump Sale (Sale of business as a going concern) under Income Tax Act:

As the subject under discussion pertains to valuation of business for acquisitions and other such transactions, it would be necessary to apply appropriate mode of valuation so that the parties to a transaction are able to assess the likely tax impact from such transaction. One of frequently considered method of sale of business as a going concern is what is known under the Income Tax Act as "Slump Sale". A direct sale of business, assets and liabilities entirely from one person (the Seller) to another (the Acquirer) on a lock, stock and barrel basis can be described as a "Slump Sale" within the meaning of Section 50B of the Income Tax Act. Section 50B of the Income Tax Act is a special provision for computation of capital gains arising to a seller in a slump sale. In a

“Slump Sale”, the consideration for the transaction should be fixed up for the whole deal without assigning values for individual assets or identifying the extent of individual liability. If the sale consideration exceeds the ‘net worth’ of the business being transferred (as on the date of transfer), then the Seller would suffer capital gains tax on such transfer to the extent of such excess. ‘Net worth’ for the purposes of computing capital gains shall be the aggregate of the total assets of the Undertaking/Business under acquisition after deducting the value of liabilities of that Undertaking/Business as appearing in the books of accounts of the Seller.

The Explanation 1 given under Section 50B of the Income Tax Act, 1961 reads as under:

Explanation 1: “For the purposes of this section, “net worth” shall be the aggregate value of total assets of the undertaking or division as reduced by the value of liabilities of such undertaking or division as appearing in its books of account: Provided that any change in the value of assets on account of revaluation of assets shall be ignored for the purposes of computing the net worth.

Explanation 2:“For computing the net worth, the aggregate value of total assets shall be—

(a) in the case of depreciable assets, the written down value of the block of assets determined in accordance with the provisions contained in sub-item
(b) of item (i) of sub-clause (c) of clause (6) of Section 43; and
(c) in the case of other assets, the book value of such assets.

A bare look at the above provisions reveals as follows:

(i) these are special provisions for computing capital gains chargeable to tax in case of slump sale and, therefore, would prevail over the general provisions in case of any conflict;
(ii) net worth of the undertaking transferred shall be deemed to be the cost of acquisition and cost of improvement for the purpose of Sections 48 and 49, and
(iii) net worth shall be computed in accordance with the provisions of Explanations 1 and 2.

In the matter of Foster’s Australia Limited, A.A.R. No. 736 of 2006, the Authority for Advance Rulings (AAR) under the Income Tax Act considered the question whether the applicant is justified in contending the tax should be computed based on the consideration as per the independent valuation obtained by the applicant. The AAR observed that it is the case of the applicant that it has obtained an independent valuation report relating to trademarks and Foster’s brand intellectual property as on 30th April, 2006 and the Applicant contended that the Income Tax Department should rely upon the independent valuation obtained by the applicant. In the said case, the AAR held in Para 15.2 that “that ‘independent valuation report’ can certainly be relied upon by the applicant. It is for the concerned Income-tax Authority to examine whether it represents true and correct value and apply such relevant factors that have material bearing on

quantification of the consideration related to the taxable items. Thus for the purpose of determining the consideration for any transaction, a valuation is absolutely necessary. Where parties to a transaction arrive a valuation in a reasonable manner by adopting recognized modes of valuation, the Income Tax Department may accept such valuation and proceed to assess the capital gains arising on that basis if such valuation represents true and correct value. Valuation helps determination of tax liability arising from a transaction.

Factors Influencing Valuation:

Many factors have to be assessed to determine fair valuation for an industry, a sector, or a company. The key to valuation is finding a common ground between all of the companies for the purpose of a fair evaluation. Determining the value of a business is a complicated and intricate process. Valuing a business requires the determination of its future earnings potential, the risks inherent in those future earnings, Strictly speaking, a company's fair market value is the price at which the business would change hands between a willing buyer and a willing seller when neither are under any compulsion to buy or sell, and both parties have knowledge of relevant facts.

The other salient factors include:

(1) The stock exchange price of the shares of the two companies before the commencement of negotiations or the announcement of the bid.
(2) Dividends paid on the shares.
(3) Relative growth prospects of the two companies.
(4) In case of equity shares, the relative gearing of the shares of the two companies. ('gearing' means ratio of the amount of Issued preference share capital and debenture stock to the amount of issued ordinary share capital.)
(5) Net assets of the two companies.
(6) Voting strength in the merged (amalgamated) enterprise of the shareholders of the two companies.
(7) Past history of the prices of shares of the two companies.

Also the following key principles should be kept in mind:

(1) There is no method of valuation which is absolutely correct. Hence a combination of all or some may be adopted.
(2) If possible, the seller should evaluate his company before contacting potential buyers. In fact, it would be wiser for companies to evaluate their business on regular basis to keep themselves aware of its standing in the corresponding industry.
(3) Go for a third party valuation if desirable to avoid over valuation of the company which is a common tendency on the seller's part.

(4) Merger and amalgamation deals can take a number of months to complete during which time valuations can fluctuate substantially. Hence provisions must be made to protect against such swings.

4.5 SUMMARY

There are number of situations in which a business or a share or any other property may be repaired to be valued. Valuation is an exercise to assess the worth of an enterprise or a property. According to valuation guidelines issued by Ministry of Finance, Department of Economic Affairs, there are three methods of valuation namely net asset value, Profit Earning Capacity value and Market value. In practice, investors attach a lot of importance to the earnings per shares and the price earnings ratio. The product of EPS & P/E ratio is market price per share. Valuation is an important aspect in merger and acquisition and it should be done by a team of experts keeping into consideration the basic objectives of acquisition.

4.6 KEY WORDS

1. Employee stock option plans (ESOPs)
2. Net Asset Value (NAV)
3. Profit Earning Capacity Value (PECV)
4. Market Value (MV) in the case of listed shares.

4.7 SELF ASSESSMENT QUESTIONS

1. What do you mean by valuation of business? Briefly explain the need of valuation.

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2. Explain methods of valuation

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3. State the factors influencing valuation.

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UNIT-5 RECONSTRUCTION OF SICK INDUSTRIAL COMPANIES; IMPORTANT PROVISIONS OF SICK INDUSTRIAL COMPANIES (SPECIAL PROVISIONS) ACT, 1985; REVIVAL OF SICK COMPANIES

Structure

5.0 Objectives

5.1Introduction

5.2 Problems of sick industrial companies

5.2.1 Need for legislation

5.2.2 Major causes of sickness of Industrial

5.2.3 Why revival should be Undertaken

5.3 Important provisions of sick industrial companies

5.4 Revival of sick companies

5.5 Summary

5.6 Key words

5.7 Self Assessment Questions

5.8 References

5.0 OBJECTIVES

To understand the major causes of sickness of industrial companies
• To know the Sickness indicators
•To analyse the causes identified by Tiwari Committee
• To able to knowrevival of sick companies – Companies (Amendment) Act, 2002

5.1 INTRODUCTION

Certain degree of industrial sickness is an inevitable factor of industrialization process of any country. The factors contributing to such sickness can be identified as controllable and non-controllable factors. Being a company secretary, if one knows the controllable factors and other provisions for revival of a sick company well in advance, then the sickness can be controlled to a great extent. Thus, there is an absolute need for awareness of such provisions and specially the terms like sick companies, BIFR (Board for Industrial and Financial Reconstruction) etc.

Corporate Sector, by implication, exhibits exuberance. 'Enterprising' implies activity. Sickness affects activity. Sickness denotes lack of life and if a loss making entity is permitted to continue to make losses, it will be a drain of valuable economic resources. Whether the directors are responsible for the same or whether the sickness is due to any other factor beyond the control of the management of the company is a different question altogether. The harsh reality is absence of profitable economic activity indicating accumulation of losses. Any business enterprise might become sick due to various factors. When an industrial enterprise becomes sick, it assumes different proportions. The main impact would be felt by the large number of workers whose lives will be thrown out of gear if the company or the said sick industrial unit were to be closed. In addition, there would be other economic issues and therefore it is necessary to make all attempts to revive the company rather than close it. While primarily, being a commercial enterprise, it is the responsibility of the Board of Directors of a company to make all necessary attempts to revive the fortunes of the company, it would not be proper if regulatory environment does not facilitate revival and rehabilitation.

5.2 PROBLEMS OF SICK INDUSTRIAL COMPANIES

Prior to the globalisation and liberalization of Indian economy, it was observed that most of the companies owning industrial undertakings were facing numerous problems and becoming virtually sick. This drove them to the brink of closure, resulting in serious repercussions, both economic and social. The incidence and magnitude of ill effects of sickness and the resultant closure of industrial companies such as loss of production, loss of employment, loss of revenue

to the Central and State Governments and locking up of investible funds of banks and financial institutions, was a matter of serious concern to the Government. It was recognized that in order to fully utilize the productive industrial assets, to afford maximum protection of employment and optimize the use of the funds of banks and financial institutions, it would be imperative to revive and rehabilitate the potentially viable sick industrial companies as quickly as possible. However, the multiplicity and complexity of laws and agencies present made the adoption of a co-ordinated approach in dealing with sick industrial companies, difficult. It was realized that the measures, till then adopted by the government, viz.nationalization or takeover of management, had not been able to achieve the desired results. Both these measures needed periodic and constant financial and other support. Inspite of all the possible investments and support, many sick industrial undertakings, did not show any symptoms of viability. A large number of undertakings did not become healthy inspite of their management being continued with the Government or a Government nominated agency for several years as huge sums of money were required to meet their past liabilities of unpaid wages, taxes, duties etc. and for working capital. Hence, even the sick industrial undertakings whose managements were taken over, were forced to be wound up.

5.2.1 Need for legislation

Prevention is better than cure. Going by this adage, it was held prudent that timely and advance measures should be taken either by legislation or by administrative orders and machinery, to keep a strict vigil on the symptoms of corporate sickness with particular reference to such companies as are prone to any kind of corporate sickness, so that preventive and remedial measures can be taken before a company goes sick. A need was therefore felt, to enact in public interest, a legislation to provide for timely detection of sickness in industrial companies and for expeditious determination by a body of experts of the preventive, ameliorative, remedial and other measures that would need to be adopted with respect to such companies and for enforcement of the measures considered appropriate. It was in this background that the Sick Industrial Companies (Special Provisions) Act, 1985 was enacted, which provided for the establishment of the Board for Industrial and Financial Reconstruction (BIFR) and also its appellate authority, Appellate Authority for Industrial and Financial Reconstruction (AAIFR). The legislation was predominantly remedial and ameliorative, in so far as it empowered the quasi-judicial body, the BIFR to take appropriate measures for revival and rehabilitation of potentially viable sick companies and for liquidation of non-viable companies and was regulatory only to a certain extent. The latter aspect was reflected in the provisions of the Act

providing for obligation of sick industrial companies and potentially sick industrial companies, to make references to the Board and treating any non-compliance as a punishable offence. The major constraint of the Act was that it was applicable only to sick industrial companies keeping away other companies which are in trading, service or other activities. The Act was modified in 1991 to include within its purview the Government companies by Industrial Companies (Special Provisions) Amendment Act, 1991 which came into force w.e.f. 28.12.91. However, the overall experience was not satisfactory and hence these provisions were proposed to be merged in Companies Act, 1956, vide Companies (Second Amendment) Act, 2002. Accordingly, powers of BIFR (Board for Industrial and Financial Reconstruction) were to be exercised by NCLT (National Company Law Tribunal) to be constituted under Section 10FB of Companies Act, 1956 and appeal against order of NCLT could be referred to NCLAT (National Company Law Appellate Tribunal) to be constituted under Section 10FR of Companies Act, 1956. Students may note that though amendments in Companies Act have been passed by Parliament, SICA has not yet been repealed and Companies (Second Amendment) Act, 2002 has not been brought into force. Till SICA is repealed, the sick companies (including government companies) will continue to be under BIFR. Also, Part VI A, consisting of Section 424A to 424L, inserted by the Companies (Second Amendment) Act, 2002 has not yet been made effective. Before studying the legal provisions in detail, let us first analyse the causes of industrial sickness.

5.2.2 Major causes of sickness of industrial companies

1. Inability of the management of the company to keep a constant vigil over competitive forces;
2. Inability of the management to focus on continued viability of the industrial unit;
3. Inability of the management to introduce dynamic changes to suit the developments taking place in the industry;
4. Lack of serious efforts to combat sickness at the initial stage and thereafter to take efforts to revive the company;
5. Lack of adequate and quality manpower;
6. Lack of funds required for meeting replenishment and much needed modernization and upgradation programmes;
7. Technological obsolescence;
8. Sweeping changes across the industry;
9. Political and economical factors;
10. Change in Consumer behaviour;
11. Lack of Timely Government Support;
12. Belligerent workforce and unions;
13. Family disputes between major shareholders groups;
14. Mismanagement by Directors;
15. Diversion and Misapplication of Funds;

16. Disproportionate Investment in unproductive Fixed Assets;
17. Reckless investments in other businesses.

The major reasons for industrial sickness could be categorized into two parts as given below:
(A) Internal Causes
(B) External Causes
(A) Internal Causes – Internal Causes are those that are within the control of the management of an industrial company and therefore attempt could be made by the management to rectify them at the earliest. They relate to the functioning of the company and they could be conveniently grouped into three broad headings:
(1) Project Related
(2) Human Resource Related
(3) Performance Related

1. Project Related Causes:
(a) Under-estimation of the project cost
(b) Non-availability or inadequate availability of critical information having a vital bearing on the project
(c) Delayed project implementation and resultant cost escalation

2. Human Resource Related Causes:
(a) Poor quality of management:
  (i) Excessive conservatism
  (ii) Excessive complacence
  (iii) Poor functional controls
  (iv) Excessive centralization
  (v) Weak Board
  (vi) Authoritarianism
  (vii) Weak watchdog functions
  (viii) Lack of management depth
  (ix) One-man Rule
  (x) Bureaucratic, unplanned and inappropriate management
(b) Excessive Commitment to Policies which worked well at one time but are no longer appropriate.
(c) Poor financial/marketing/management control.
(d) Management succession problems.
(e) Poor inter-personal and inter-departmental coordination, dimensions, interdepartmental coordination, dissensions, inter-departmental squabbles, wrong organizational policies etc.
(f) Poor industrial relations including existence of 'pampered' labour.

3. Performance Related:
(a) Faulty choice of product/technology
(b) Under utilization of plant, machinery and other available resources
(c) Inadequacy of working capital
(d) Diversion of funds
(e) Inadequate market forecast and sales planning

(B) External Causes – These relate to the environmental and other factors which are not within the control of the given industry or given unit as such. They include the following causes:
1. Non-co operative Government policies /price control schemes etc.
2. Recession/adverse economic conditions
3. Powerful competitors in the market
4. Non-availability/shortage of inputs
5. Regional phenomenon including local environmental factors
6. Industry-wise phenomenon
7. Technological advancements
8. Frequent and long power cuts
9. Delayed financial assistance

Inability to adjust or accommodate in changed environment is one of the major causes of sickness for any undertaking. Once a company becomes sick, until and unless the sickness is arrested at such stage, it creates a spiral affect and as a consequence, revival of such unit becomes difficult. The management of such undertaking has a big role to play and the organization should not wait till the sickness is reported as per law; rather the control mechanism should be in-built and pro-active.

5.2.3 <u>Why revival should be undertaken?</u>

The Gujarat High Court in Navjivan Trading Finance Private Limited, In re [1978] 48 Comp Cas 402 while considering a petition for winding up of a company on the ground that it was unable to pay its debts held that winding up of a company would result in—

(1) closing down of a unit which produces some goods or provides some services;

(2) it would throw out of employment numerous persons and result in grave hardship to the members of families of such employees;

(3) loss of revenue to the State by way of collection that the State could hope to make on account of customs or excise duties, sales tax, income-tax etc.;

(4) scarcity of goods and in diminishing of employment opportunities.

While rejecting the petition for the winding up of the company, the Court emphasized the fact that winding up would be a heavy blow if the company could be resurrected through a scheme of arrangement. Therefore, all attempts must be made to revive the fortunes of the company rather than declaring it as a sick industrial company and letting the same to be wound up. Winding up of an industrial company would be imminent if there is complete erosion of its net worth. Insolvency of a person takes away his right to contract. Similarly, if a company becomes insolvent with its assets being insufficient to meet its liabilities, the company should not be

permitted to carry on its business or contract further liabilities. In such circumstances, a company is as much an insolvent as a natural person. However, with heavy investment in fixed assets and with so many workmen on the brink of losing their means of livelihood, the economic system and social system will suffer, if an industrial company is allowed to be wound up. If an elephant falls, it takes some time to get up. The legislature takes care of such larger issues in public interest before permitting such a company to be wound up.

5.3 IMPORTANT PROVISIONS OF SICK INDUSTRIAL COMPANIES (SPECIAL PROVISIONS) ACT, 1985 [SICA]

The preamble of SICA reads as follows:

The Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) is an act which makes in public interest, special provisions, with a view to securing timely detection of sick and potentially sick companies owning industrial undertakings, speedy determination by a Board of experts of the preventive, ameliorative, remedial and other measures which need to be taken with respect to such companies and expeditious enforcement of measures so determined and for matters connected therewith or incidental thereto.

Principal objectives of SICA:

SICA was enacted with the following principal objectives:

1. To evaluate the techno-economic viability of sick industrial companies with a view either to rehabilitate them, if the public interest so demanded and their rehabilitation was possible, or to close them down, if continuing them would be impossible.
2. To stop continued drain of public and private resources for the overall economy of the country.
3. To protect employment as far as practicable.

Supreme court in Namit R Kamani v. R.R. Kamani (1988) 4 SCC 387 (1989) 2 Comp LJ 391/AIR 1989 SC 9/(1989) 66 Comp Cas 132(SC) had explained the object of SICA as (a) affording maximum protection to employment (b) optimising the use of funds and available production assets (c) realising amounts due to banks, institutions, creditors and (d) providing efficient authority consisting of experts for expeditious determination of measures to avoid time consuming procedures. The Statement of Objects and Reasons for enacting the Sick Industrial Companies (Special Provisions) Act, 1985, (SICA) stated that in order to fully utilise the productive industrial assets, to afford maximum protection of employment and optimise the use

of the funds of the banks and financial institutions, it would be imperative to revive and rehabilitate the potentially viable, sick industrial companies as quickly as possible. It also stated that it would be also equally imperative to salvage any productive assets and realise the amounts due to the banks and financial institutions, to the extent possible, from the non-viable sick industrial companies. As per the preamble, SICA is "An Act to make in the public interest, special provisions with a view to securing the timely detection of sick and potentially sick companies owning industrial undertakings, the speedy determination by a Board of experts of the preventive, ameliorative, remedial and other measures which need to be taken with respect to such companies and the expeditious enforcement of the measures so determined and for matters connected therewith or incidental thereto."

Though it was conceived very well, SICA, failed as it could not be successfully implemented. Section 32 of SICA gave overriding provisions to the Act, whereby BIFR could pass orders even if they were against provisions of other laws. Also, rehabilitation of sick companies was with BIFR; while winding up was with High Court. Therefore, when BIFR passed an order recommending winding up, the matter went to High Court and the whole process had to be started again thereby delaying the matter. The overall experience under SICA was not satisfactory and hence these provisions are now merged in Companies Act, 1956, vide Companies (Second Amendment) Act, 2002. Accordingly, powers of BIFR (Board for Industrial and Financial Reconstruction) will now be exercised by NCLT (National Company Law Tribunal) to be constituted under Section 10FB of Companies Act, 1956 and appeal against order of NCLT may be referred to NCLAT (National Company Law Appellate Tribunal) to be constituted under Section 10FR of Companies Act, 1956. **Students may once again note that though amendments in Companies Act have been passed by Parliament, SICA has not yet been repealed. Till SICA is repealed, the sick companies (including Government Companies) will continue to be under BIFR.** Part VIA, consisting of Sections 424A to 424L, have been inserted by the Companies (Second Amendment) Act, 2002 to deal with sick industrial companies. However, this part VI has not yet been made effective.

Sick industrial company

According to Section 3(1)(o) of the Sick Industrial Companies (Special Provisions) Act, 1985, "sick industrial company" means an industrial company (being a company registered for not less than five years), which has at the end of any financial year accumulated losses equal to or exceeding its entire net worth.

Explanation: For the removal of doubts, it is hereby declared that an industrial company existing immediately before the commencement of the Sick Industrial Companies (Special Provisions) Amendment Act, 1993 registered for not less than five years and having at the end of any financial year accumulated losses equal to or exceeding its entire net worth, shall be deemed to be a sick industrial company.

Net worth: "Net worth" means the sum total of the paid-up capital and free reserves. For this purpose, "free reserves' means all reserves credited out of the profits and share premium account but does not include reserves credited out of re-evaluation of assets, write back of depreciation provisions and amalgamation.

Operating agency: "Operating agency" means any public financial institution, State level institution, scheduled bank or any other person as may be specified by general or special order as its agency by the Board for Industrial and Financial Reconstruction (BIFR).

Criteria of sickness: According to the Act, the sickness of a company was related to the age of the company, i.e., the date of its registration as per the certificate of incorporation issued by the Registrar of Companies and not the date on which the company was granted the certificate of commencement of business. Also, the date of actual commencement of its activities, i.e., commercial production or rendering services in which the company was engaged was not considered relevant.

The practical effect of this condition was that even if a company had eroded its entire net worth, but the prescribed period of five years from registration had not been completed, the BIFR was precluded from taking cognizance of the sickness of the company. There had been many instances when the BIFR had to refuse registration of companies on this ground. This was a matter of grave concern because in capital intensive industries where the incidence of depreciation was quite high in the initial years, it was quite possible for a company to completely erode its net worth in less than five years. This was the reason most of the cases referred to BIFR involved almost dead companies, which had either ceased to be operative long ago or were on the verge of closure. In such situations, the problem of rehabilitating such critically-sick industrial companies became all the more difficult.

It was felt that a sick company should be able to seek registration with the BIFR as and when the sickness sets in irrespective of the fact that it has not completed the prescribed period of five years from its registration. Before going into the provisions of the law on the anvil, one needs to understand the provisions of SICA as these are presently applicable.

Reference to the Board: Under Section 15 of the Act, where an industrial company has become sick, the Board of Directors of the company shall, within 60 days from the date of finalization of duly audited accounts of the company for the financial year at the end of which the company has become sick, make a reference to the Board (BIFR) for determination of measures to be adopted with respect to the company. Interestingly, if the Board of Directors had sufficient reason even before such finalization to form opinion that the company had become a sick unit after the Board of Directors shall, within 60 days after it has formed such opinion, make a reference to the Board for determination of measures which shall be adopted in respect of the company.

Further, the Central Government or Reserve Bank or State Government or a public financial institution or a State level institution or a scheduled bank may provide sufficient reason that any industrial company has become sick industrial company, may make a reference to the Board for determination of measures which shall be adopted in respect of the company. However, the State Government can make a reference in respect of any industrial undertaking which are situated in such state only. Similarly, a public financial institution or state level institution or a scheduled bank can make a reference only if it has provided any financial assistance or some obligation rendered by it or undertaking by it in respect of the referred company. The finalization of the accounts for the above purpose imply that the date on which the accounts have been approved by the members at the Annual General Meeting of the Company is in accordance to the Companies Act. Once a company is determined to be referred to BIFR, it needs to file a formal application as specified in BIFR Regulations, 1987 as amended from time to time.

Inquiry into Working of Sick Industrial Companies – Section 16

The salient features of the inquiry into the status of sick industrial companies contained in Section 16 of SICA are as follows:

BIFR, upon receipt of a reference with respect to such company under Section 15; or upon information received with respect to such company or upon its own knowledge as to the financial condition of the company, may make such inquiry as it may deem fit for determining whether the industrial company has become a sick industrial company.

BIFR may require, by order, any operating agency to enquire into and make a report and complete its inquiry as expeditiously as possible.

Endeavour should be made to complete the inquiry within sixty days from the commencement of the inquiry. As per the explanation given under this section, an inquiry shall be deemed to have commenced upon the receipt by BIFR of any reference or information or upon its own knowledge reduced to writing by BIFR.

BIFR has powers to appoint one or more persons to be a special director or special directors of the company if it deems it necessary to make an inquiry or to cause an inquiry as mentioned above to be made into any industrial company.

BIFR may issue necessary directions to special directors for proper discharge of duties.

The appointment of a special director referred to in Sub-section (4) shall be valid and effective notwithstanding anything to the contrary contained in the Companies Act, 1956, or in any other law for the time being in force or in the memorandum and articles of association or any other instrument relating to the industrial company.

Any provision regarding share qualification, age limit, number of directorships, removal from office of directors and such like conditions contained in any such law or instrument aforesaid, shall not apply to any special director appointed by BIFR.

The special director will hold office only during the pleasure of BIFR. He does not incur any obligation or liability by reason only of his being a director or for anything done or omitted to be done in good faith in the discharge of his duties as a director or anything in relation thereto. He is not liable to retirement by rotation and shall not be taken into account for computing the number of directors liable to such retirement. He is not liable to be prosecuted under any law for anything done or omitted to be done in good faith in the discharge of his duties in relation to the sick industrial company.

Powers of Board to make suitable order on the completion of inquiry – Section 17

If, after making an inquiry under Section 16, the Board is satisfied that a company has become a sick industrial company, the Board shall, after considering all the relevant facts and circumstances of the case, decides, whether it is practicable for the company to make its net worth exceed the accumulated losses within a reasonable time. If the Board decides that it is practicable for a sick industrial company to make its net worth exceed the accumulated losses within a reasonable time, the Board, shall, by order in writing, give time to the company to make its net worth exceed the accumulated losses. What is reasonable time depends on the facts and circumstances of each case. A period of 7 to 10 years, within which the company should be able to wipe off its accumulated losses is normally regarded by the Board as a reasonable time. This is

also the time within which under a sanctioned scheme of the Board, the sick industrial company can be expected to have been revived or rehabilitated. If the Board decides under Sub-section (1) that it is not practicable for a sick industrial company to make its net worth exceed the accumulated losses within a reasonable time by order in writing, directs any operating agency specified in the order to prepare, a scheme for revival/rehabilitation of sick industrial company. The operating agency would normally be a public financial institution notified as such by the Board through a general or special order.

Preparation and sanction of scheme for revival – Section 18

If the Board appoints an operating agency under Section 17(3) of the Act, then the operating agency is required to prepare and submit a schedule in respect of the referred company by providing any or more of the following measures:

(a) The financial reconstruction of the sick industrial company;

(b) The proper management of the sick industrial company by change in, or takeover of, the management of the sick industrial company;

(c) The amalgamation of—

(i) the sick industrial company with any other company, or

(ii) any other company with the sick industrial company.

(d) the sale or lease of a part or whole of any industrial undertaking of the sick industrial company;

(d) (a) the rationalisation of managerial personnel, supervisory staff and workmen in accordance with law;

(e) such other preventive, ameliorative and remedial measures as may be appropriate;

(f) such incidental, consequential or supplemental measures as may be necessary or expedient in connection with or for the purposes of the measures specified in clauses (a) to (e).

The Board may finalise the scheme after considering the views and suggestions of the company, the operating agency and the public by publishing the draft scheme in the newspaper and thereafter formally sanction the same which is referred to as the “sanctioned scheme”.

Winding up of Sick Industrial Company – Section 20

The salient features of Section 20 of SICA are as follows:

1. After making necessary inquiry under Section 16 and after giving an opportunity to all concerned parties, if BIFR is of the opinion that the sick industrial company is not likely to make its net worth exceed the accumulated losses within a reasonable time and it is not likely to become viable in future and as such it is just and equitable to wind up the company, BIFR may record and forward its opinion to the concerned High Court.

2. The High Court shall, on the basis of the opinion of the Board, order winding up of the sick industrial company and may proceed and cause to proceed with the winding up of the sick industrial company in accordance with the provisions of the Companies Act, 1956.

- In Re. Anmol Diary Ltd. (2002) 5 Comp LJ 43 (Tuj.) it was held by the High Court that the opinion of BIFR should be given due weightage but it is not binding on the High Court and High Court can go into the correctness of the opinion so submitted by the BIFR. The High Court independently decides as to whether it should proceed with the winding-up of sick industrial company.
- Once an order of winding up is made by the High Court under Section 20(2) of Sick Industrial Companies Act (SICA), acting on the opinion of BIFR under Section 20(1), the control and jurisdiction over the company, its affairs and assets passes over to the High Court and BIFR ceases to have any power to pass any orders or give any directions as held by division bench of High Court in BPL Ltd., Bangalore v. Inter Modal Transport Technology Systems (Karnataka) Ltd., Bangalore (in liquidation) & others (2001) (3) Kar LJ 622 (DB).
- For the purpose of winding up, the High Court may, with the consent of the operating agency, appoint any officer of the operating agency, as the liquidator and such officer, if appointed shall be deemed to be, and have all the powers of, the official liquidator under the Companies Act, 1956.
- When BIFR recommends the winding up of a sick industrial company pursuant to Section 20(1) of the SICA, 1985 and forwards its opinion to the connected High Court, the High Court is bound to order the winding up of the company on the basis of the opinion of BIFR.
- Once BIFR forwards its opinion to the connected High Court, the role of BIFR comes to an end in respect of the said sick industrial company.
- As per Sub-section (4) of Section 20, the BIFR has the power to direct the sale of assets of the sick industrial company in such manner as it may deem fit. The power of BIFR under

sub-section is exercisable notwithstanding anything contained in Sub-section (2) or (3) of Section 20. The Supreme Court in V.R. Ramaraju v. Union of India & others [1997] 89 Comp Cas 609 (SC) in relation to Section 20(2) of SICA held that the High Court in deciding the question of winding up of the company has to take into account the opinion of BIFR forwarded to it and is not to abdicate its own function of determining the question of winding up.

- Adding clarity to the end of jurisdiction of BIFR and beginning of jurisdiction of High Court, the Division Bench of the Karnataka High Court in BPL Limited, Bangalore v. Inter Modal Transport Technology Systems (Karnataka) Limited, Bangalore (in liquidation) & others [2001] (3) Kar LJ 622 (DB); ILR 2001 Kar 5373 (DB) held that the scheme of SICA as contained in Sections 22, 22A, 20 and 32 of that makes it clear that from the date of commencement of an inquiry in regard to any reference received under Section 15, till passing of an order of winding up by the High Court under Section 20(2) of SICA, BIFR retains absolute control over the affairs of the company and can either prevent any sale or permit any sale and the sick industrial company is entirely governed by the provisions of SICA. On the other hand, once an order of winding up is made by the High Court under Section 20(2) of SICA, acting on the opinion of BIFR under Section 20(1), the control and jurisdiction over the company, its affairs and assets passes over to the High Court and BIFR ceases to have any power to pass any orders or give any directions." The division bench further held that the company court does not sit in appeal over the orders of BIFR nor exercise power under Articles 226 and 227 of the Constitution.
- In the BPL Limited's case cited above, the court held that the sale of assets of a company by a secured creditor as per directions of BIFR, prior to the date of winding up order, is not void for want of leave of the court and there is no question of obtaining any leave or permission of this court.
- In National Organic Chemical Industries Limited and Ors. v. N.O.C.I.L. Employees Union 2005 (126) Companies Cases 922, Sharp Industries Limited (2006) 131 Company Cases, 535 (Bom.) and in Pharmaceutical Products of India Ltd. in re (2006) 131 Company Cases 747, the Bombay High Court have held that during pendency of a reference before BIFR, a scheme under Section 319 could be sanctioned. However in Ashok Organic Industries Ltd v. ARCIL, [2008] 114 Comp Cas 144 (Bom.), the Bombay High Court had set aside all the above decisions and held that once the Industrial Company makes a reference under Section

15 of the SICA, the Company Court would have no jurisdiction for sanctioning the scheme of arrangement of compromise with its creditors and shareholders and neither will it have jurisdiction to take cognisance of such an application during the pendency of the reference.

- The High Court has no jurisdiction to sanction a scheme of arrangement presented by a sick company when the revival scheme of the company was pending before the AAIFR. [Tata Motors Ltd. v. Pharmaceutical Products of India Ltd. & Anr. (2008) 144 Comp Cas 178 (SC)].

Immunity from Certain Litigations – Section 22

One of the most important provisions of SICA is Section 22. In certain circumstances, no proceedings for the winding up of the industrial company or for execution, distress or the like against any of the properties of the industrial company or for the appointment of a receiver in respect thereof and no suit for the recovery money or for the enforcement of any security against the industrial company or of any guarantee in respect of any loans or advance granted to the industrial company shall lie or be proceeded with further, except with the consent of BIFR or, as the case may be, the Appellate Authority. The protection under Section 22 of SICA is a superior protection as it operates notwithstanding anything contained in the Companies Act, 1956, or any other law or the memorandum and articles of association of the industrial company or any other instrument having effect under the said Act or other law.

The above protection is available in respect of an industrial company when an inquiry under Section 16 is pending in relation to the said industrial company or when any scheme referred to under Section 17 is under preparation or consideration or a sanctioned scheme is under implementation or where an appeal under Section 25 relating to an industrial company is pending. Where the management of the sick industrial company is taken over or changed in pursuance of any scheme sanctioned under Section 18, notwithstanding anything contained in the Companies Act, 1956, or any other law or in the memorandum and articles of association of such company or any instrument having effect under the said Act or other law:

(a) it shall not be lawful for the shareholders of such company or any other person to nominate or appoint any person to be a director of the company;

(b) no resolution passed at any meeting of the shareholders of such company shall be given effect to unless approved by BIFR. BIFR may by order declare with respect to the sick industrial company concerned that the operation of all or any of the contracts, assurances of property, agreements, settlements, awards, standing orders or other instruments in force, applicable to the

sick industrial company in question shall remain suspended or that all or any of the rights, privileges, obligations, and liabilities accruing or arising thereunder before the said date, shall remain suspended or shall be enforceable with such adaptations and in such manner as may be specified by BIFR. Provided that such declaration shall not be made for a period exceeding two years which may be extended by one year at a time so, however, that the total period shall not exceed seven years in the aggregate. Any such declaration is valid and is protected notwithstanding anything contained in the Companies Act, 1956, or any other law or agreement or instrument or any decree or order of a court, Tribunal, officer or other authority or of any submission, settlement or standing order. Accordingly, any remedy for the enforcement of any right, privilege, obligation and liability suspended or modified by such declaration, and all proceedings relating thereto pending before any court, Tribunal, officer or other authority shall remain stayed or be continued subject to such declaration. On the declaration ceasing to have effect – (i) any right, privilege, obligation or liability so remaining suspended or modified, shall become revived and enforceable as if the declaration had never been made; and (ii) any proceeding so remaining stayed shall be proceeded with, subject to the provisions of any law which may then be in force, from the stage which had been reached when the proceedings became stayed. Obviously from a perusal of the language contained in Section 22(1) of SICA, it is clear that Section 22 does not grant any immunity against criminal proceedings against the company or its directors.

The apex court Maharashtra Tubes Limited v. State Industrial and Investment Corporation of Maharashtra Limited [1993] 78 Comp Cas 803 (SC) held that the idea underlying Section 22(1) of SICA is that every such action (against the company or its guarantors for recovery of money or enforcement of security) should be frozen unless expressly permitted by the specified authority until the investigation for the revival of the industrial undertaking is finally determined. The apex court in Patheja Bros. Forgings and Stamping v. ICICI Limited AIR 2000 CLC 1492: (2000) 4 Comp LJ 9 (SC) held that the words Section 22 are clear and unambiguous and that they provide that no suit for the enforcement of a guarantee in respect of any loan or advance granted to the concerned industrial company will lie or can be proceeded with without the consent of BIFR or the appellate authority. When the words of a legislation are clear, the court must give effect to them as they stand and cannot demur on the ground that the legislature must have intended otherwise. The apex court clearly held that any suit for enforcement of the

guarantee in respect of loans granted to a sick industrial company cannot be proceeded with unless consent as required under Section 22 of SICA is obtained.

Direction against disposal of assets – Section 22A

In the interest of the sick industrial company or creditors or shareholders or in the public interest, Section 22A of SICA empowers BIFR to order not to dispose off any assets of the company in the interest of creditors, shareholder or in public interest. Such order can be passed (a) during the period of preparation or consideration of the scheme under Section 18; and (b) during the period beginning with the recording of opinion by the board for winding up of the company under Sub-section (1) of Section 20 and upto commencement of the proceedings relating to the winding up before the concerned High Court.

5.4 REVIVAL OF SICK COMPANIES

Law on the anvil, the companies (second amendment) act, 2002*: *

Part VIA of the Companies Act, 1956 introduced by the Companies (Second Amendment) Act, 2002 contains provisions for revival and rehabilitation (R&R Scheme) of sick industrial companies. This Part of the Act contains 12 Sections, viz, Sections 424A to 424L. This Part appears to have been rightly placed immediately before Part VII of the Act that relates to Winding Up. Thus, if it is possible, there could be a time bound attempt for revival and rehabilitation. If the efforts for revival and rehabilitation fail, Part VII will take care. A peep into the provisions of the Act would reveal that there is no trace of Section 22 of SICA. The absence of a provision similar to Section 22 of SICA will go a long way as a progressive legislative step in preventing abuse of process of law. The Amendment Act has done away with a provision, which has more often been misused. Laying down a time schedule is another feature of the new legislation.

Salient Features of the law on the anvil are as follows

Section 2(29A) of the Companies (Second Amendment) Act, 2002 contains a definition to the expression 'Net worth'. As per the definition, the "net worth" of a company will be determined as per formula given below: [1+2+3] – [4+5+6+7+8+9]

1.0 Paid up Capital (1)
2.0 Free Reserves (2)
3.0 Share Premium Account (3)
4.0 Revaluation Reserves (4)
5.0 Accumulated Losses (5)
6.0 Unabsorbed Depreciation (6)
7.0 Expenses not written off (7)

8.0 Depreciation write back (8)
9.0 Provisions (9)

* These provisions are not in force at present. Their enforcement is yet to be notified by the Government.

As per Section 2(46AA) of the Companies (Second Amendment) Act, 2002 "Sick Industrial Company" means an industrial company, which has (i) the accumulated losses in any financial year equal to 50% or more of its average net worth during 4 years immediately preceding such financial years; or (ii) failed to repay its debts within any three consecutive quarters on demand made in writing for its repayment by a creditor or creditors of such company. One of the laudable changes in the definition is the need for averaging the net worth in a period of 4 years preceding the financial year in which the question has arisen. In SICA, the requirement was to ascertain at the end of a Financial Year, the extent of erosion of net worth. The averaging concept has been introduced after enough application of mind and a company cannot any longer book every possible thing at the end of a Financial Year and declare, as a bolt from the blue, sickness and expect the creditors to wait and watch.

Managements of companies earlier, managed to keep aside the pressing creditors in this process. This opportunity has now been clipped. The erosion should have been to the extent of 50% or more of the net worth of the company and the erosion is calculated with reference to the average net worth in a period of 4 consecutive years. Catch them young seems to be the concept introduced by the amendments to the Act. Another laudable achievement of this amendment in so far as this definition is concerned is that it has included another criterion for determination of sickness. The new definition contains two parts. The first part refers to the actual financial position as per books. If books were to be perceived to be real, the first part is real. But the second part assumes sickness if the company fails to repay its debts within any three consecutive quarters, on demand made in writing for its repayment by a creditor or creditors of such company. This should be considered to be the real indicator of sickness because the failure to repay debts contracted by the company would endanger the status of a company as a going concern. There will be only growing concern among creditors.

Section 2(31AA) of the Companies (Second Amendment Act, 2002 defines the expression "Operating Agency". Operating Agency means any group of experts consisting of persons having special knowledge of business or industry in which the sick industrial company is

engaged and includes public financial institution, state level institution, scheduled bank or any other person as may be specified as the operating
agency by the Tribunal.

The scope of the expression has undergone growth. It is possible to think of experts group emerging as turnaround consultants. Probably, the Tribunal will empanel private professional firms who have with them experts in every field. Such firms can also outsource the expertise of men experienced in the industry in which the sick industrial company is engaged. Rating of professional agencies having special expertise as turnaround consultants would help the Tribunal to empanel such agencies and select one or more of them.

Reference to National Company Law Tribunal (NCLT)

(i) By Company's Board: Section 424A of the Companies Act, 1956 lays down that where an industrial company becomes sick industrial company for the purpose of the Act, the Board of Directors should, within a period of 180 days from the date on which the Board of Directors of the company come to know, of the relevant facts giving rise to cause of such reference or within 60 days of final adoption of accounts, whichever is earlier, make a reference to NCLT constituted under Sub-section (1) of Section 10FB of the Companies Act, 1956 for determination of measures which may be adopted with respect to such company. The Board of Directors of such company shall prepare a scheme of its revival and rehabilitation and submit the same to the Tribunal along with application containing such particulars as may be prescribed.

However, Sub-section (1) of Section 424A shall not apply to a Government Company.

The application shall be accompanied by a certificate from an Auditor from a Panel of Auditors prepared by Tribunal indicating: (a) the reasons of the net worth of such company being fifty per cent or less than fifty percent; or (b) the default in repayment of its debt making such company a sick industrial company, as the case may be. Thus, the certificate is to be given only by Auditor who is on a panel approved by Tribunal.

(ii) By Central/State Government/RBI/Public Financial Institution/State level Institution/Scheduled bank: Central/State Government/RBI/Public Financial Institution/State level Institution/ Scheduled bank may if it has sufficient reasons to believe that any industrial company has become a sick industrial company for the purpose of the Act, may make a reference in respect of such company to the Tribunal for determination of the measures which may be

adopted with respect to such company. However, State Government may make such reference only if all or any of the industrial undertaking belonging to such company are situated in such state. A public financial institution or a state level institution or a scheduled bank may make a reference only if it has, by reason of any financial assistance or obligation rendered by it or undertakings by it, with respect to such company, an interest in such company. The reference as aforesaid shall be within such period as prescribed above in case of reference made by company's Board.

Inquiry into working of sick industrial companies: Upon the receipt of a reference under Section 424A of the Act with respect to a sick industrial company or upon information received with respect to such company or upon its own knowledge as to the financial condition of the company, the Tribunal may make such inquiry as it may deem fit for determining whether any industrial company has become a sick industrial company.

Operating agency to inquire and report to Tribunal:

'Operating Agency' means any group of experts consisting of persons having special knowledge of business or industry in which the sick industrial company is engaged and includes public financial institution, state level institution, scheduled bank or any other person as may be specified as the Operating Agency by the Tribunal [Section 2(31A)]. 'State level institution' means any of the following institutions namely: (a) State Financial Corporations established under Section 3 or Section 3A and institutions notified under Section 46 of the State Financial Corporation Act, 1951 (63 of 1951) (b) the State Industrial Development Corporations registered under this Act. [Section 2(46AB)].

The functions of operating agency include:

(a) Conduct of inquiry on reference received, as per Section 424 B(2);
(b) Preparation of a scheme of rehabilitation as per Section 424C(3) and 424D(1);
(c) Apply to Tribunal for review of its order under Section 424C(4)(b);
(d) Recommend to the Tribunal, on the various steps to be taken to implement the scheme and remove the difficulties therein under Section 424D(14);
(e) Implementation of rehabilitation scheme, ordered by Tribunal [Section 424D(15)];
(f) Appointment as liquidator in case of winding up of industrial company [Section 424G(2)];
(g) Preparation of detailed inventory and lists of any industrial company ordered by Tribunal [Section 424H].

An inquiry shall be deemed to have commenced upon the receipt by the Tribunal of any reference or information or upon its own knowledge reduced to writing by the Tribunal.

According to Section 424B, the Tribunal may, if it deems necessary or expedient so to do for the expeditious disposal of an inquiry under Sub-section (1), require by order any operating agency to inquire into the scheme for revival and make a report with respect to such matters as may be specified in the order. The operating agency shall complete its inquiry as expeditiously as possible and submit its report to the Tribunal within twenty – one days from the date of such order. However, the Tribunal may extend the said period to forty days for reasons to be recorded in writing for such extension. The Tribunal shall conclude its inquiry as expeditiously as possible and pass final orders in the proceedings within sixty days from the commencement of the inquiry. Provided that the Tribunal may extend the said period to ninety days for reasons to be recorded in writing for such extension.

Appointment of Special Director(s): If the Tribunal deems it fit to make an inquiry or to cause an inquiry to be made into any industrial company by an operating agency, it may appoint one or more persons who possess knowledge, experience and expertise in management and control of the affairs of any other company to be a special director (or special directors) on the board of such industrial company on such terms and conditions as may be prescribed for safeguarding its financial and other interests, or in the public interest [Section 424B(5)]. The special director(s) appointed under Section 424B(5) shall submit a report to the Tribunal within sixty days from the date of his/their appointment about the state of affairs of the company in respect of which reference has been made. Such special director or directors shall have all the powers of a director of a company under this Act, necessary for discharge of his or their duties. The Tribunal may issue such directions to special directors appointed as it may deem necessary or expedient for proper discharge of his/their duties [Section 424B(7)].

The appointment of a special director shall be valid and effective notwithstanding anything to the contrary contained in any other provision of this Act or in any other law for the time being in force or in the memorandum and articles of association or any other instrument relating to the industrial company. Any provisions regarding share qualification, age limit, number of directorships, removal from office of directors and such like conditions contained in any such law or instrument as aforesaid, shall not apply to any special director or directors appointed by the Tribunal.

Any special director appointed, shall:

a. hold office during the pleasure of the Tribunal and may be removed or substituted by any person by order of the Tribunal;
b. not incur any obligation or liability by reason only of his being a director or for anything done or omitted to be done in good faith in the discharge of his duties as a director or anything in relation thereto;
c. not be liable to retirement by rotation and shall not be taken into account for computing the number of directors liable to such retirement;
d. not be liable to be prosecuted under any law for anything done or omitted to be done in good faith in the discharge of his duties in relation to the sick industrial company.

Continuing operations during inquiry: An application may be made to Tribunal, during the continuation of inquiry for: (a) agreeing to an arrangement for continuing operations of the sick company or (b) suggesting a scheme of financial reconstruction of the sick industrial company. Such application may be made by (a) company (b) Central government (c) State government (d) Bank (e) Financial institution, (f) any authority providing or intending to provide any financial assistance to the company. On receipt of such application, Tribunal may pass such orders as it may deem fit, within 60 days (Section 424F).

Preparation of proforma, accounts, lists, inventory etc.: According to Section 424H the Tribunal may, if the circumstances so require and for proper discharge of its functions, require an operating agency to prepare the following – (a) a complete inventory of all assets and liabilities of any nature, all books of account, registers, maps, plans, records, documents of title or ownership of property and other documents relating thereto. (b) List of shareholders, list of secured and unsecured creditors (showing each category seperately). (c) Valuation report in respect of shares and assets so as to arrive at the reserve price for the sale of a part or whole of undertaking or for fixing lease rent or fixing share exchange ratio. (d) Estimate of reserve price, lease rent or share exchange ratio. (e) Proforma accounts — if upto date audited accounts are not available. This provision is similar to Section 21 in SICA.

Power of Tribunal to call for periodic information: On receipt of reference under Section 424A, the Tribunal may call for any periodic information from the company regarding the steps taken by the company to make its networth exceed the accumulated losses or to make repayment of its debt, as the case may be and the company shall furnish such information. [Section 424J] This provision is similar, to Section 23 B of SICA. Also, the Tribunal may on receipt of a reference under Section 424A(1) pass an order as to whether a company in respect of which a reference has been made has become a sick industrial company and such order shall be final

[Section 424A(5)]. The Tribunal can accept or reject the reference at that stage itself, on prima facie basis i.e. order can be passed without making an inquiry. No such order is required, if reference is made by Bank/FI/Government.

Completion of inquiry: After the inquiry is complete, the Tribunal is required to decide whether it is possible for the company to revive within a reasonable time i.e. whether it can make its net worth exceed the accumulated losses or make repayment of debts to the creditors within a reasonable time. The Tribunal may come to any of the following conclusions:

a. the Company can revive on its own given a particular period of time.
b. Company will not be able to revive on its own and some measures are required (a scheme will have to be formulated).
c. if scheme requires any financial assistance to be sought, consent of concerned Bank/Fls to be obtained.
d. if revival is not at all possible, winding up needs to be passed under Section 424G(1).

The various alternatives are discussed hereunder:

Tribunal may give time to company to revive: If the Tribunal decides after an inquiry that it is practicable for a sick industrial company to make its net worth exceed the accumulated losses or pay its debt within a reasonable time, the Tribunal shall, by order in writing and subject to such restrictions or conditions as may be specified in the order, give such time to company as it may deem fit, to make its net worth exceed the accumulated losses or make repayment of the debts. [Section 424C(2)]. Thus, if the Tribunal decides that the company shall be able to revive on its own, it will pass such orders as it may deem expedient, giving reasonable time to the company and making it subject to such restrictions and conditions as required. If any of the restrictions or conditions specified in such an order are not complied with, by the company concerned, or if the company fails to revive in pursuance of the said order, Tribunal may review such order on a reference in that behalf from any agency or on its own motion and pass a fresh order in respect of such company.

Preparation and sanction of Scheme: If on the other hand, the Tribunal decides that it is not practicable for the sick industrial company to make its net worth exceed the accumulated losses or make the repayment of its debts within a reasonable time and that it is necessary or expedient in the public interest to adopt all or any of the measures specified in Section 424D in relation to the said company, it may, as soon as may be, by order in writing, direct any operating agency specified in the order to prepare, having regard to such guidelines as may be specified in the

order, a scheme providing for such measures in relation to such company. [Section 424C(3)] If the operating agency specified in an order makes a submission in that behalf, the Tribunal may review such order and modify the order in such manner as it may deem appropriate. Where an order is made under Sub-section (3) of Section 424C in relation to any sick industrial company, the operating agency specified in the order shall prepare as expeditiously as possible and ordinarily with in a period of sixty days from the date of such order, having regard to the guidelines framed by the Reserve Bank of India in this behalf, a scheme with respect to such company providing for any one or more of the following measures, namely:

a. the financial reconstruction of such industrial company;
b. the proper management of such industrial company by change in, or take over of, the management of such industrial company;
c. the amalgamation of— (i) such industrial company with any other company ; or (ii) any other company with such industrial company (referred to as "transferee company");
d. the sale or lease of a part or whole of any industrial undertaking of such industrial company;
e. the rationalisation of managerial personal, supervisory staff and workmen in accordance with law;
f. such other preventive, ameliorative and remedial measures as may be appropriate;
g. repayment of debt;
h. such incidental, consequential or supplemental measures as may be necessary or expedient in connection with or for the purposes of the measures specified in clauses (a) to (g);

Provided that the Tribunal may extend the said period of sixty days to ninety days for reasons to be recorded in writing for such extension. [Section 424D(1)].

The scheme may provide for any one or more of the following, namely:

a. the constitution, name and registered office, the capital, assets, powers, rights, interests, authorities and privileges, duties and obligations of the sick industrial company or, as the case may be, of the transferee company;
b. the transfer to the transferee company of the business, properties, assets and liabilities of the sick industrial company on such terms and conditions as may be specified in the scheme;
c. any change in the Board of directors, or the appointment of a new Board of directors, of the sick industrial company and the authority by whom, the manner in which and the other terms and conditions on which, such change or appointment shall be made and in the case of appointment of a new Board of directors or of any director, the period for which such appointment shall be made;
d. the alteration of the memorandum or articles of association of the sick industrial company or, as the case may be, of the transferee company for the purpose of altering the capital structure thereof, or for such other purposes as may be necessary to give effect to the reconstruction or amalgamation;
e. the continuation by or against the sick industrial company or, as the case may be, the transferee company of any action or other legal proceeding pending against the sick industrial company immediately before the date of the order made under Sub-section (3) of Section 424C;

f. the reduction of the interest or rights which the shareholders have in the sick industrial company to such extent as the Tribunal considers necessary in the interests of the reconstruction, revival or rehabilitation or repayment of debts of such sick industrial company or for the maintenance of the business of such industrial company;
g. the allotment to the shareholders of the sick industrial company, of shares in such company or, as the case may be, in the transferee company and where any shareholder claims payment in cash and not allotment of shares or where it is not possible to allot shares to any shareholder, the payment of cash to those shareholders in full satisfaction of their claims: (i) in respect of their interest in shares in the sick industrial company before its reconstruction or amalgamation; or (ii) where such interest has been reduced under clause in respect of their interest in shares as so reduced;
h. any other terms and conditions for the reconstruction or amalgamation of the sick industrial company;
i. sale of the industrial undertaking of the sick industrial company free from all encumbrances and all liabilities of the company or other such encumbrances and liabilities as may be specified, to any person, including a co-operative society formed by the employees of such undertaking and fixing of reserve price for such sale;
j. lease of the industrial undertaking of the sick industrial company to any person, including a co-operative society formed by the employees of such undertaking;
k. method of sale of assets of the industrial undertaking of the sick industrial company such as by public auction or by inviting lenders or in any other manner as may be specified and for the manner of publicity therefor;
l. issue of the shares in the sick industrial company at the face value or at the intrinsic value which may be at discount value or such other value as may be specified to any industrial company or any person including the executives and employees of such sick industrial company;
m. such incidental, consequential and supplemental matters as may be necessary to secure that the reconstruction or amalgamation or other measures mentioned in the scheme are fully and effectively carried out.

Circulation of Scheme: The scheme prepared by the operating agency shall be examined by the Tribunal. A copy of the scheme with modification, if any, made by the Tribunal shall be sent, in draft, to the sick industrial company and the operating agency and in the case of amalgamation, also to any other company concerned. The Tribunal may publish or cause to be published the draft scheme in brief in such daily newspapers as it may consider necessary, for suggestions and objections, if any, within a specified time. The complete draft scheme shall be kept at the place where registered office of the company is situated or at such place as mentioned in the advertisement. [Section 424D(3)]

Modification by Tribunal: The Tribunal may make such modifications, if any, in the draft scheme as it may consider necessary in the light of the suggestions and objections received from the sick industrial company and the operating agency and also from the transferee company and any other company concerned in the amalgamation and from any shareholder or any creditors or

employees of such companies. However, where the scheme relates to amalgamation, the said scheme shall be laid before the company other than the sick industrial company in the general meeting for the approval of the scheme by its shareholders. No such scheme shall be proceeded with unless it has been approved, with or without modification, by a special resolution passed by the shareholders of the transferee company. If the scheme requires financial assistance or reliefs to sick industrial company, the scheme cannot be sanctioned unless approved by Government/FIs/Bank etc in the manner set out in Section 424E.

Sanction of Scheme: The scheme may be sanctioned, within sixty days by the Tribunal and shall come into force on such date as the Tribunal may specify in this behalf:

The Tribunal may extend the said period of sixty days to ninety days for reasons to be recorded in writing for such extension. The Tribunal may specify different dates for different provisions of scheme [Section 424D(4)].

Transfer of property or liability: According to Sub-section (7) of Section 424D, where a sanctioned scheme provides for the transfer of any property or liability of the sick industrial company in favour of any other company or person or where such scheme provides for the transfer of any property or liability of any other company or person in favour of the sick industrial company, then, by virtue of, and to the extent provided in, the scheme, on and from the date of coming into operation of the sanctioned scheme or any provision thereof, the property shall be transferred to, and vest in, and the liability shall become the liability of, such other company or person or, as the case may be, the sick industrial company.

Review of Scheme at the instance of operating agency or otherwise: Any scheme sanctioned by Tribunal may be reviewed or modified. The Tribunal may, on the recommendations of the operating agency or otherwise, review any sanctioned scheme and make such modifications as it may deem fit. It may by order in writing, direct any operating agency specified in the order, having regard to such guidelines including those framed by the Reserve Bank of India in this behalf, in order to prepare a fresh scheme providing for such measures as the operating agency may consider necessary. [Section 424D(5)]. When a fresh scheme is prepared, the provisions of Sub-sections (3) and (4) of Section 424D, as outlined above, shall apply in relation thereto as they apply to in relation to a scheme prepared under Sub-section (1).

Sanction is conclusive evidence: The sanction accorded by the Tribunal shall be conclusive evidence that all the requirements of this scheme relating to the reconstruction or amalgamation, or any other measure specified therein have been complied with. A copy of the sanctioned scheme certified in writing by an officer of the Tribunal to be a true copy thereof, shall be admitted as evidence in all legal proceedings (whether in appeal of otherwise). A copy of the sanctioned scheme shall be filed with the Registrar within the prescribed time by the company in respect of which such scheme relates.

Binding nature of sanctioned Scheme: Section 424D(10) provides that on and from the date of the coming into operation of the sanctioned scheme or any provision thereof, the scheme or such provision shall be binding on the sick industrial company and the transferee company or, as the case may be, the other company and also on the shareholders, creditors and guarantors and employees of the said companies. The creditors of a sick industrial company may also prepare a scheme for revival or rehabilitation of such sick industrial company and submit the same to the Tribunal for its sanction. No scheme shall be submitted by the creditors to the Tribunal unless such scheme has been approved by at least three-fourth in value of creditors of the sick industrial company. All the provisions relating to the preparation of scheme by the operating agency and sanction of such scheme by the Tribunal shall as far as may be, apply to the scheme referred herein. Such scheme if sanctioned by the Tribunal shall be binding on all the creditors and on others concerned.

Difficulty in operation: If any difficulty arises in implementing the sanctioned scheme, the Tribunal may, on the recommendation of the operating agency or otherwise, by order, modify or, do anything, not inconsistent with such provisions, which appears to it to be necessary or expedient for the purpose of removing the difficulty.

The provisions for Revival of Sick Industries under the Companies Act, 2013:

Chapter XIX of the 2013 Act lays down the provisions for the revival and rehabilitation of sick companies. The chapter describes the circumstances which determine the declaration of a company as a sick company, and also includes the rehabilitation process of the same. Although it aims to provide comprehensive provisions for the revival and rehabilitation of sick companies, the fact that several provisions such as particulars, documents as well as content of the draft

scheme in respect of application for revival and rehabilitation, etc. have been left to substantive enactment, leaves scope for interpretation.

The coverage of this chapter is no longer restricted to industrial companies, and the determination of the net worth would not be relevant for assessing whether a company is a sick company.

Companies Act, 2013, The coverage of Sick Industrial Companies Act, 1985 (SICA) is limited to only industrial companies, while the 2013 Act covers the revival and rehabilitation of all companies, irrespective of their sector.

The determination of whether a company is sick, would no longer be based on a situation where accumulated losses exceed the net worth. Rather it would be determined on the basis whether the company is able to pay its debts. In other words, the determining factor of a sick company has now been shifted to the secured creditors or banks and financial institutions with regard to the assessment of a company as a sick company. The 2013 Act does not recognise the role of all stakeholders in the revival and rehabilitation of a sick company, and provisions predominantly revolve around secured creditors. The fact that the 2013 Act recognises the presence of unsecured creditors is felt only at the time of the approval of the scheme of revival and rehabilitation. In accordance with the requirement of section 253 of the 2013 Act, a company is assessed to be sick on a demand by the secured creditors of a company representing 50% or more of its outstanding amount of debt under the following circumstances:

- The company has failed to pay the debt within a period of 30 days of the service of the notice of demand
- The company has failed to secure or compound the debt to the reasonable satisfaction of the creditors
- To speed up the revival and rehabilitation process, the 2013 Act provides a one year time period for the finalisation of the rehabilitation plan.

Overview of the process

In response to the application made by either the secured creditor or by the company itself, if the Tribunal is satisfied that a company has become a sick company, it shall give time to the company to settle its outstanding debts if Tribunal believes that it is practical for the company to make the repayment of its debts within a reasonable period of time. Once a company is assessed to be a sick company , an application could be made to the Tribunal under section 254 of the 2013 Act for the determination of the measures that may be adopted with respect to the revival

and rehabilitation of the identified sick company either by a secured creditor of that company or by the company itself. The application thus made must be accompanied by audited financial statements of the company relating to the immediately preceding

5.5 SUMMARY

The chapter deals with major causes of sickness of industrial companies in detail. Identified the causes of the industrial sickness. SICA was enacted to evaluate the viability of sick industrial companies with a view to rehabilitate them and to protect the interest of employees as far as practicable. Once a company becomes sick, a reference is made to BIFR for determination of measures to be adopted with respect to company. Enquiry under Section 16 into working of sick industrial company is made. After being satisfied of sickness and if there is a scope to make the net worth exceed the accumulated losses, it appoints an operating agency for preparation of scheme for revival under Section 18. Otherwise an opinion of Board is forwarded to High Court for winding up.

5.6 KEY WORDS

1. SICA: Sick Industrial Companies (Special Provisions) Act, 1985
2. BIFR: the Board for Industrial and Financial Reconstruction
3. NCLT: National Company Law Tribunal

5.7 SELF ASSESSMENT QUESTIONS

1. Briefly explain Important Provisions of Sick Industrial Companies (Special Provisions) Act, 1985

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5.8 REFERENCES

1. Bare Act: Sick Industrial Companies (Special Provisions) Act, 1985

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BLOCK: II

UNIT-6 LEGAL PROVISIONS INVOLVED IN AMALGAMATION AND MERGER; SCHEME OF MERGER AND AMALGAMATION

Structure

Objectives

6.1 Objectives

6.2 Introduction

6.3 Legal provisions of Amalgamation and Merger

6.4 Summary

6.5 Key words

6.6 Self Assessment Questions

6.7 References

6.0 OBJECTIVES

1. We able to understand concept of mergers and amalgamations.
2. To understand the legal aspects of mergers and amalgamations.
3. To analyse the latest judicial pronouncements including some conflicting pronouncements.
4. To know the accounting aspects of mergers and amalgamations.
5. To know the financial aspects of mergers and amalgamations.
6. To understand the human aspects of mergers and amalgamations.
7. To know the taxation aspects of mergers and amalgamations.

6.1 INTRODUCTION

This lesson explains the concept of mergers and amalgamations and the respective provisions under the Companies Act, 1956 which govern mergers or amalgamations of two companies. The lesson also discusses the various important aspects of mergers and amalgamations. A merger is a combination of two or more businesses into one business. Laws in India use the term 'amalgamation' for merger. Amalgamation is the merger of one or more companies with another or the merger of two or more companies to form a new company, in such a way that all assets and liabilities of the amalgamating companies become assets and liabilities of the amalgamated company.

Merger through Absorption:- An absorption is a combination of two or more companies into an 'existing company'. All companies except one lose their identity in such a merger. For example, absorption of Tata Fertilisers Ltd by Tata Chemicals Ltd.

Merger through Consolidation:- A consolidation is a combination of two or more companies into a 'new company'. In this form of merger, all companies are legally dissolved and a new entity is created. Here, the acquired company transfers its assets, liabilities and shares to the acquiring company for cash or exchange of shares. For example, merger of Hindustan Computers Ltd, Hindustan Instruments Ltd, Indian Software Company Ltd and Indian Reprographics Ltd into an entirely new company called HCL Ltd.

6.2 LEGAL PROVISIONS OFAMALGAMATION AND MERGER

The Companies Act, 1956 has provided for a set of provisions specially dealing with amalgamation of companies, to facilitate the transactions. The statutory provisions relating to Merger and Amalgamations are contained in Sections 390 to 396A of the Companies Act, 1956.* While Section 390 interprets the expressions "company", "arrangement" and explains unsecured

creditors", as used under Sections 391 and 393, Section 391 lays down in detail the power to make compromise or arrangements with creditors and members. Under this section, a company can enter into a compromise or arrangement with its creditors or its members, or any class thereof without going into liquidation. Section 392 lays down the power of the High Court while Section 393 specifies the information as to compromises or arrangements that is to be sent with every notice calling the meetings of members and creditors. The provisions for facilitating reconstruction and amalgamation of companies are contained in Section 394. Section 395 prescribes the power and duty of the transferee company to acquires shares of shareholders dissenting from scheme or contract approved by majority. Powers of Central Government to provide for amalgamation of companies in national interest is laid down under Section 396. Section 396A specifies provisions for preservation of books and papers of amalgamated company.

The salient features of Sections 391 and 394 are:

- There should be a scheme of compromise or arrangement for restructuring or amalgamation.
- An application must be made to the court for direction to hold meetings of shareholders/creditors. However, as per clause 24(f) of the Listing Agreement, a copy of the scheme has to be filed with all the stock exchanges where the shares of the company are listed at least one month prior to it being submitted to the court.
- Court may order a meeting of shareholders/creditors.
- Meeting(s) of shareholders/creditors should be held as per court's order.
- Scheme of compromise or arrangement must be approved by 3/4th in value and majority in number of creditors, class of creditors, members, class of members.
- Another application must be made to the court (after the results of the meetings are submitted with the court) sanctioning the scheme of compromise or arrangement.
- An approved scheme duly sanctioned by court is binding on all the shareholders/creditors/company(ies).
- Court's order takes effect only after a certified copy of it has been filed with the Registrar of Companies. This filing date being called as the effective date.
- Copy of court's order should be annexed to every copy of memorandum of association of the company.
- Court may stay commencement or continuation of any suit or proceeding against the company after application has been moved in the court.
- Court's order is appealable in a superior court.

The Companies (Second Amendment) Act, 2002 has transferred to the National Company Law Tribunal the powers vested in the Court under Sections 391 to 396 of the Companies Act, 1956. However, the Amendment Act has not become effective as yet. Accordingly, relevant references to the "High Court or Court" will stand replaced with 'Tribunal' after the relevant provisions of

the Companies (Second Amendment) Act, 2002 are enforced. Likewise, all references to the Company (Court) Rules, 1959 will stand replaced by the rules/regulations that will be framed to enforce compromises and arrangements.

Section 394: It is only in Section 394 of the Act there is reference to reconstruction of any company or companies or amalgamation of any two or more companies.

Sub-section (1): Where the scheme involves reconstruction of any company or companies or amalgamation of any two or more companies and vesting of the whole or substantially the whole of the properties or liabilities of any company concerned in the scheme (Transferor Company) to another company (Transferee company), the court may make provision for the following matters also:

- Transfer to the Transferee Company of the whole or any part of the undertaking, property or liabilities of any transferor company;
- The allotment or appropriation by the Transferee company of any shares, debentures to any person under the scheme.
- Continuation of proceedings by or against the Transferee Company of any legal matters pending by or against any Transferor Company.
- The dissolution, without winding up, of any Transferor Company.
- Provision to be made for any person who does not agree to the scheme.
- Such incidental, consequential and supplemental orders passed by the court as it may think fit so that the reconstruction or amalgamation could be fully and effectively carried out.

As per the proviso under this sub-section, it is necessary to have the report from the Registrar of companies in case the scheme involves a company that is being wound up and the report of the liquidator, in case the scheme involves the dissolution of a company. These reports are mandatory in order to ensure that the affairs of the company in question have not been conducted in a manner prejudicial to the interests of its members or to public interest.

Sub-section (2): The sub-section provides for the order of the Court and the vesting of the properties and liabilities of the transferor company to the transferee company.

Sub-section (3): Under this sub-section, the time limit for filing the order of the Court for registration by the Registrar is 30 days after the making of the order.

Sub-section (4): As per clause (a), the expression ‘property’ has been defined to include property, rights and powers of every description and the expression ‘liabilities’ includes duties of every description. As per clause (b), ‘Transferee Company’ does not include any company other than a company within the meaning of this Act but ‘Transferor company’ includes any body corporate, whether a company within the meaning of this Act or not. Thus, the transferee

company in a scheme of merger or amalgamation has to be necessarily a company within the meaning of the Act.

Section 394A: The court is supposed to give notice of every scheme under Section 391 or 394 to the Central Government and consider representation, if any by the said Government. Therefore, merger or amalgamation under a scheme of arrangement as provided under Sections 391-394 of the Act is the most convenient and most common method of a complete merger or amalgamation between the companies. There is active involvement of the Court and an amalgamation is complete only after the Court sanctions it under Section 394(2) and takes effect when such order of court is filed with the Registrar of Companies. In fact, Sections 391 to 394 of the Act read with Companies (Court) Rules, 1959 serve as a complete code in themselves in respect of provisions and procedures relating to sponsoring of the scheme, the approval thereof by the creditors and members, and the sanction thereof by the Court.

Accordingly, amalgamation can be effected in any one of the following ways:

(ii) Transfer of undertaking by order of the High Court (Section 394 of the Companies Act, 1956): Under Section 394 of the Companies Act, the High Court may sanction a scheme of amalgamation proposed by two or more companies after it has been approved by a meeting of the members of the company convened under the orders of the court with majority in number of shareholders holding more than 75 percent of the shares who vote at the meeting, approve the scheme of amalgamation, and the companies make a petition to the High Court for approving the Scheme. The High Court serves a copy of petition on the Regional Director, Company Law Board and if they do not object to the amalgamation, the Court sanctions it. Once the Court sanctions the scheme, it is binding on all the members of the respective companies.

(iii) Purchase of shares of one company by another company (Section 395 of the Companies Act, 1956): Under Section 395 of the Companies Act, 1956, the undertaking of one company can be taken over by another company by the purchase of shares. This section obviates the need to obtain the High Court's sanction. While purchasing shares, the company which acquires shares should comply with the requirements of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 and Section 372A of the Companies Act, 1956. This Section also provides the procedure for acquiring the shares of dissenting members.

(iv) Amalgamation of Companies in National Interest (Section 396): Where the Central Government is satisfied that an amalgamation of two or more companies is essential in the public interest, then the Government may, by an order notified in the Official Gazette, provide for the amalgamation of those companies into a single company. The amalgamated company shall have such constitution, property, powers, rights, interest and privileges as well as such liabilities, duties and obligations as may be specified in the Government's order.

(v) Amalgamation of Companies under Section 494: Amalgamation of two companies is also possible under Section 494 of the Companies Act, where the liquidator of a company transfers its assets and liabilities to another company.

(vi) Amalgamation for Revival and Rehabilitation: The Board for Financial and Industrial Reconstruction (BIFR) can in exceptional cases order amalgamation for the revival and rehabilitation of a sick industrial company under the provisions of Sick Industrial Companies (Special Provisions) Act, 1985.

New Era: Mergers and Acquisition under the Companies Act, 2013

Merger is a restructuring tool available to Indian conglomerates aiming to expand and diversify their businesses for various reasons whether it is to gain competitive advantage, reduce costs or unlock values. In commercial parlance, merger essentially means an arrangement whereby one or more existing companies merge their identity into another existing company or form a distinct new entity. Company law in India is undergoing a complete overhaul and a new law was finally passed in 2013. However, only 98 sections of the new Companies Act, 2013 ("2013 Act") have been brought into force and the provisions relating to mergers covered in Sections 230 to 240 are yet to be notified. Until then, this court driven process will continue to be governed by Section 391-396A of the Companies Act, 1956 and the Companies (Court) Rules, 1959 (collectively referred to as "1956 Act"). This newsletter describes selective key changes introduced by the 2013 Act in relation to mergers, which term, in common parlance, is used interchangeably with amalgamations under Indian law. Additionally, it aims to compare those changes with the 1956 Act.

1. The Framework: Chapter XV of the 2013 Act deals with "Compromises, Arrangements and Amalgamations." In this chapter, the Act consolidates the applicable provisions and related

issues of compromises, arrangements and amalgamations; however, other provisions are also attracted at different stages of the process. Amalgamation means an amalgamation pursuant to the provisions of the Act. In an amalgamation the undertaking comprising of property, assets and liabilities, of one (or more) company are absorbed by and transferred either to an existing company or a new company. Simply put, the transferor integrates with the transferee and the former loses its entity and dissolves without winding-up. The 2013 Act creates a new regulator, the National Law Company Tribunal ("Tribunal") who, upon its constitution, will assume jurisdiction (the High Courts will no longer have any jurisdiction) of the court for sanctioning mergers. Once the Tribunal is constituted, expected to be formed sometime this year, and related rules finalized, the provisions under the 2013 Act would be implemented.

Before detailing the key changes under the new law, a brief overview of the existing process will be useful. Under the 1956 Act, companies which have reached a consensus to merge must prepare a "scheme" of amalgamation/merger ("Scheme"). The lenders (financial institutions or banks) of the transferor and the transferee must approve1 the Scheme in-principle, followed by the subsequent approval of the respective Board of Directors of the merging entities. If the merging entities are listed companies, then the listing agreements executed with the stock-exchanges require the company to communicate price-sensitive information to the stock exchange immediately, to seek an approval from the capital market regulator, Securities and Exchange Board of India ("SEBI") simultaneous with the public notification. This essentially happens after the approval of the Board to the Scheme. The next step is to apply2 to the High Court having jurisdiction over the registered office of the company seeking an order to convene shareholders and creditors meeting. Without getting into further details of the process, the key point is that any objector amongst the stakeholders can object to the Scheme in the court proceedings.

The element of preparing the Scheme has been retained under the 2013 Act. Unlike the 1956 Act, the new regime (a) recognizes cross border mergers, (b) sets out separate procedure for merger of small companies and those of holding with wholly-owned, (c) prescribes thresholds for objections, and (d) describes mandatory filings to ensure legal compliance.

2. The Changes to the process

a. Regulatory/Third party approvals: As shareholders' and creditors' consents are essential, the 1956 Act, therefore, contemplates issue of a notice to them. The 2013 Act requires service of

the notice of the merger along with documents (such as copy of the Scheme and valuation report) not only upon the shareholders and creditors but also on various regulators including the Ministry of Corporate Affairs (through Regional Director, Registrar of Companies and Official Liquidator),4 Reserve Bank of India ("RBI") (where non-resident investors are involved), SEBI (only for listed companies), Competition Commission of India (where the prescribed fiscal thresholds are crossed and the proposed merger could have an adverse effect on competition), Stock Exchanges (only for listed companies), Income Tax authorities and other sector regulators or authorities which are likely to be affected by the merger.5 This ensures compliance of the Scheme with other regulatory requirements imposed on the merging entities. In fact, under the 1956 Act the courts have made mergers subject to approval of the regulators. The 2013 Act prescribes a 30 day time frame for the regulators to make representations, failing which the right would cease to exist. This is a positive step because in the 1956 Act no such time frame was provided leading to considerable delays in the court proceedings.

b. Approval of the Scheme through postal ballot: The 1956 Act required presence of the shareholders and creditors in the physical meetings, either in person or by proxy, to cast vote for/against the Scheme. In the 2013 Act, the shareholders and creditors also have the option to cast vote through postal ballot while considering a Scheme. The 1956 Act did not allow this and the shareholders and creditors could only cast votes physically. This right will ensure wider participation of the shareholders and creditors, particularly for those who are scattered all over the country and who find it difficult to be either physically present or provide a proxy. Postal ballot, therefore, will offer them a greater flexibility to cast their votes.

c. Valuation Report: Though the 1956 Act is silent on disclosing the valuation report to the stakeholders, as a matter of transparency and good corporate governance, the listed companies used to make available the valuation report for inspection and also during the course of the meetings. Courts also required annexing of the valuation report to the application submitted before them. The 2013 Act now mandates annexing of the valuation report to the notices for the meetings to enable ready access to the shareholders and creditors.

d. Objections: A bane under the 1956 Act was that it permitted the individual shareholders and creditors to raise frivolous objections to arm-twist and unnecessarily harass the companies following the meetings. Such right to object to the Scheme would no longer be available to any and every person. Objections can be raised by shareholders holding 10% or more equity and creditors whose debt represent 5% or more of the total debt as per the last audited financial statements. By raising the bar, the new law aims to ensure that the frivolous objections/litigation can be avoided.

e. Accounting Standards: As a matter of practice, frequently the Scheme provided for accounting treatment that would deviate from the prescribed accounting standards necessitating a note to this effect in the balance sheet of the company. This was frowned upon by the tax authorities. Consequently, in case of listed companies, the listing agreement was amended to provide that an auditor's certificate stating that the accounting treatment is in accordance with the accounting standards was required to be filed for seeking approval of the stock exchanges. The 2013 Act makes such prior certification from an auditor mandatory for both listed and unlisted companies.

f. Merger of a listed company into an unlisted one: The 2013 Act specifically provides for the Tribunal's order to state that the merger of a listed company into an unlisted company will not ipso facto make the unlisted company listed. It will continue to be unlisted until the applicable listing regulations and SEBI guidelines in relation to allotment of shares to public shareholders are complied with. Further, in case the shareholders of the listed company decide to exit, the unlisted company would facilitate the exit with a pre-determined price formula which shall be within the price specified by SEBI regulations. The Indian securities law prescribes strict enforcement of listing requirements by companies intending to get listed. SEBI had, however, eased these requirements for listed companies proposing merger by granting them exemptions from complying with the initial public offering requirements11 on a case-to-case basis. Recently SEBI had issued guidelines12 stating that if the Scheme provides for listing of shares of an unlisted company without complying with the initial public offering requirements, then, upon court approval of the Scheme, the unlisted company has to file a specific application seeking such exemption from SEBI. Such an application has to be filed upon, inter-alia, allotment of equity shares to the holders of

securities of the listed company.13 The changes under the 2013 Act are in line with SEBI requirements. The 1956 Act was silent on this aspect.

3. The New Kinds of Mergers

Apart from the aforesaid changes, the 2013 Act provides for separate provisions for cross border mergers, merger of two small companies and that of holding with wholly-owned subsidiaries. These are described briefly below:

i. Cross-border mergers14: The 1956 Act permits cross-border mergers only where the transferor is a foreign company. In contrast, the 2013 Act permits in-principle mergers between an Indian and a foreign company located in a jurisdiction notified by the central government in periodic consultation with RBI. Such a merger would be subject to RBI approval and Scheme may provide payment in cash or depository receipts or both. The payment in cash or depository receipts would facilitate exit to the shareholders of the merging entity who do not want to be a part of the merged entity. These changes reflect the legislature's intent to facilitate cross-border business. The Income Tax Act presently grants tax exemptions15 on mergers if the transferee is an Indian company and does not recognize a situation where the transferee will be a foreign company, as contemplated under the 2013 Act. The introduction of cross-border mergers under the 2013 Act may, therefore, require corresponding changes in other laws, including foreign exchange and tax.

ii. Merger of "small companies" and holding with wholly-owned subsidiaries: Unlike the 1956 Act under which merger of all companies, irrespective of nature and size requires court approval, the 2013 Act carves out a separate procedure for small companies16 and the holding and wholly-owned subsidiaries. Section 233 of the 2013 Act prescribes a simplified fast track procedure for their merger which requires consent of shareholders holding 90% in value and creditors representing 9/10th of debt in value as well as approval of the Scheme by the Regional Director, Ministry of Corporate Affairs in case no objections are received from the Official Liquidator and Registrar of Companies. Approval of the Tribunal is not required for such mergers. This could be good news for the merging entities who may not be required to (i) file documents required to be filed under the listing agreement, in the case of listed companies, (ii) give notice to various authorities, (iii) provide auditor's certificate of compliance with applicable accounting standards. However, if the Regional Director is of

the opinion that the Scheme is not in the interest of the stakeholders, he may approach the Tribunal who could follow the merger procedure prescribed under the 2013 Act. This ability to transfer to the Tribunal has the potential to change fast-track to a normal merger and make such mergers less appealing.

4. Penalties

The penalties for contravention of the provisions under the 1956 Act were a maximum of INR 50,000 (approximately US$ 80617) which apply to the company as well as officer-in-default. However under the 2013 Act, separate penalties have been levied on the company and its defaulting officer. To bring in more accountability, quantum for companies has been increased from the aforesaid sum to a minimum of INR 100,000 (approximately US$ 1,612) and maximum of INR 2,500,000 (approximately US$ 40,322). Defaulting officer(s) will also be punishable with imprisonment up to one year or with a minimum fine of INR 100,000 (approximately US$ 1,612) and maximum INR 300,000 (approximately US$ 4,838) or both.18 Such stringent penal provisions will not apply to mergers of small companies and that of a holding company with its wholly-owned subsidiaries unless their merger is transferred to the Tribunal and approved by it.

While several noteworthy changes have been proposed, corporations could perceive the need to get multiple approvals from different regulators as onerous. However, the thirty days time limit imposed on the regulators will, hopefully, ensure that they respond in a time bound manner. On the face of it, the 2013 Act offers comprehensive and better transparency ensuring protection of stakeholders' interest, while simultaneously avoiding frivolous objections. The exact time frame that the entire merger process would involve will be known once it is tested and which will happen after the Tribunal is constituted and the rules implemented. It would be fair to say that the 2013 Act seeks to streamline and make M&A more smooth and transparent. The new provisions should make it easier for corporations proposing mergers as it spears to have a good system of checks & balances to prevent abuse of these provisions. The provisions are pending for notification and once these provisions are notified, the practical impact of the changes will be tested.

6.4 SUMMARY

Corporate restructuring is an expression that connotes a restructuring process undertaken by business enterprises for the purpose of bringing about a change for the better and to make the business competitive. Restructuring may be financial restructuring, technological, market and organizational restructuring. The most commonly applied tools of corporate restructuring are amalgamation, merger, demerger, acquisition, joint venture, disinvestments etc. Chapter V of the Companies Act containing Sections 390 to 396A is a complete code in itself which provides for law and procedure to be complied with by the companies for compromises, arrangements and reconstruction. If a compromise or arrangement is not bona fide but is intended to cover misdeeds of delinquent directors, the Court shall not sanction the scheme. In accordance with sub-section (3) of Section 391, the order of the Court becomes effective only after a certified copy thereof is filed with the Registrar of Companies in e-form 21. The Companies Act, 2013, is in the process of implementation and will see a procedural ease in the space of mergers and amalgamations

6.5 KEY WORDS

1. SEBI: Securities and Exchange Board of India
2. AS: Accounting Standard
3. RBI: Reserve Bank of India
4. ROC: Registrar of Companies

6.6 SELF ASSESSMENT QUESTIONS

1. Briefly explain the provisions involved in the process of mergers and amalgamation
   ………………………………………………………………………………………………
   ……………………………………………………………………………………………...
2. What are the key provisions in the area of mergers and amalgamation in the Companies Act, 2013
   ………………………………………………………………………………………………
   ………………………………………………………………………………………………

6.7 REFERENCES

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UNIT-7 APPROVALS FOR AMALGAMATION AND MERGER; CONSIDERATION AND FUNDING FOR MERGER AND AMALGAMATION;

Structure

7.0 Objectives

7.1 Introduction

7.2 Approvals for amalgamation and merger

7.3 Consideration and funding for merger

7.4 Summary

7.5 Key words

7.6 Self Assessment Questions

7.7 References

7.0 OBJECTIVES

1. To understand the process of funding
2. To analyse the funding through equity shares, preference shares, swaps
3. To understand the funding through options and securities with differential rights
4. To analyse Funding through employees stock option scheme
5. Funding through external commercial borrowings (ECBs), financial institutions and banks.
6. To understand the funding through rehabilitation finance
7. To understand the funding through management buyout/leveraged buyouts

7.1 INTRODUCTION

The lesson explains the process of approval for mergers and amalgamation and financial alternatives available for funding the mergers and takeovers. The lesson also discusses various merits and demerits of financial alternatives. The lesson further discusses the various modes of funding the mergers and takeovers through different types of financial instruments. At the end of lesson, you should be able to understand

7.2 APPROVALS FOR AMALGAMATION AND MERGER

The companies are required to obtain following approvals in respect of the scheme of amalgamation:

(i) Approval of Board of Directors

The first step in carrying out amalgamation is approval of scheme of amalgamation by the Board of both the companies. Board resolution should, besides approving the scheme, authorise a\Director/Company Secretary/other officer to make application to court, to sign the application and other documents and to do everything necessary or expedient in connection therewith, including changes in the scheme.

(ii) Approval of Shareholders/Creditors

Members' and creditors' approval to the scheme of amalgamation is sine qua non for Court's sanction. Without that the Court cannot proceed. This approval is to be obtained at specially convened meetings held as per court's directions [Section 391(1)]. However, the court may dispense with meetings of members/creditors. Normally, creditors' meetings are dispensed with subject to certain conditions. For\\ instance, members' meeting may be dispensed with if all the members' individual consent is obtained. However, it is a discretionary power of the court for which a separate application must be made for court's order. The scheme of compromise or arrangement has to be approved as directed by the High Court, by– — the members of the company; or — the members of each class, if the company has different classes of shares; and —

the creditors; or — each class of creditors, if the company has different classes of creditors. The approval of the members and creditors (or each class of them) has to be obtained at specially convened meetings as per High Court directions. [Section 391(1)]. An application seeking directions to call, hold and conduct meetings is made to the High Court, which has jurisdiction having regard to the location of the registered office of the company. A learned Judge of Bombay High Court in Kaveri Entertainment Ltd. in re., (2003) 117 Comp Cas 245 (Bom) expounded the procedure required to be followed by a company which seeks the court's sanction to a scheme of compromise or arrangement as: "A company which desires to enter into any arrangement with its members and/or creditors first makes an application to the court under Sub-section (1) of Section 391 of the Act for directions for convening of the meeting or meetings of the members and/or creditors, as the case may be, for considering the proposed scheme of arrangement. The court, on receiving such an application, issues directions for convening of separate meetings of the members and/or creditors or different classes of members and/or creditors, as the case may be. In those meetings, the scheme of arrangement is required to be approved by majority in number representing 3/4th in value of the creditors or class of creditors or members or class of members as the case may be. After the scheme is approved by all concerned, a petition is presented to the court for sanctioning of the scheme of arrangement. If the court is satisfied that the scheme is just and fair and not prejudicial to the interest of the members/class of members or creditors/class of creditors, as the case may be, then the court may sanction it." A subsidiary company being a creditor cannot be included along with other unsecured creditors; their interest in supporting a scheme proposed by the holding company would not be the same as the interest of the other unsecured creditors [Hindustan Development Corporation Ltd. v. Shaw Wallace & Co. Ltd. (supra)]. Secured creditors should not be clubbed together with the unsecured creditors. Their interest would not be the same. Scheme to be approved by special majority The Scheme must be approved by a resolution passed with the special majority stipulated in Section 391(2), namely a majority in number representing three-fourths in value of the creditors, or class of creditors, or members, or class of members, as the case may be, present and voting either in person or, by proxy. Thus, 51% majority in number, and 75% in value present and voting at the meeting must approve the scheme. [Section 391(2)]. For example, if at the meeting 100 persons (members in person and proxies) are present, at least 51 of them must vote in favour the resolution and they must be holding at least 75% of the paid-up share capital carrying voting rights. In the case of creditors, those voting in favour must have

the claim not less than 75% of the total amount of claim of all the creditors present and voting. The majority is dual, in number and in value. A simple majority of those voting is sufficient, whereas the 'three - fourths' requirement relates to value. The three-fourths value is to be computed with reference to paid-up capital held by members (or to total amount owed by company to creditors) present and voting at the meeting. [Re Maknam Investments Ltd. (1995) 6 SCL 93 Cal; Re Mafatlal Industries Ltd. (1995) 84 Comp Cas 230 (Guj)]. A full bench of the Punjab and Haryana High Court in Hind Lever Chemicals Limited and Another[2005] 58S CL 211(Punj. &Har.) held that In our view, the language of Section 391(2) of the Act is totally unambiguous and a plain reading of this provision clearly shows that the majority in number by which a compromise or arrangement is approved should represent three-fourth in value of the creditors/ shareholders who are 'present and voting' and not of the total value of the shareholders or creditors of the company. This is neither an ordinary resolution nor a special resolution within the purview of Section 189 of the Act. This is an extraordinary resolution. A copy of this resolution need not be filed with the Registrar of Companies under Section 192. Where a Scheme is not approved at a meeting, by the requisite majority, but is subsequently approved by individual affidavits, the court may sanction the Scheme as Section 391(2) is not mandatory but is merely directory and there should be substantial compliance thereof. [SM Holdings Finance Pvt Ltd. v. Mysore Machinery Mfrs Ltd. (1993) 78 Comp Cas 432 (Kar)]. In Kaveri Entertainment Ltd., in re. (2003) 17 Comp Cas 245 (Bom.): (2003) 45 SCL 294 (Bom): (2003) 57 CLA 127 (Bom), a learned Judge of the Bombay High Court expounded the requirement of Sub-section (2) as: "Sub-section (2) of Section 391 of the Act requires that the resolution approving the scheme of arrangement should be passed by majority in number representing 3/4th in value of the creditors or class of creditors and/or members or class of members as the case may be. If the resolution granting approval to the scheme of arrangement is passed by more than 3/4th in value of the creditors but, is not carried by the majority in number of the creditors, the scheme would not be approved by the court. The majority in number of the creditors is provided in the section for safeguarding the interests of the large number of small creditors whose voice is often lost amongst small number of big creditors. The conditions of approval by majority in number and 3/4th in value of credit are cumulative." In determining whether a resolution has been passed by the requisite majority or not, the members remaining neutral or not participating in voting are to be ignored. This is because the section clearly provides that the votes of only the members present and voting either in person or, by proxy, are to be taken into account. Where in

a meeting for the sanction of a scheme, holders of shares of the value of Rs. 6,42,700 were present but holders of shares of the value of Rs.4,42,700 alone voted in favour of the resolution and the others remained neutral, voting neither in favour of, nor against, the resolution, it was held that there was a unanimous passing of the resolution and the requisite majority contemplated by Section 391(2) agreed to the scheme. [Hindustan General Electric Corporation Ltd., in re. (1959) 29 Comp Cas 46 (Cal)]. In Re: Kirloskar Electric Company Ltd., [2003] 116 Com Cas 413 (Kar): The Karnatka High Court held that the three-fourth majority required under Sub-section (2) of Section 391 of the Act was of the value represented by the members who were not only present but who had also voted. In fact, it went a step further to hold that the creditors who were present and had even voted but whose votes had been found to be invalid, could not be said to have voted because casting an invalid vote is no voting in the eyes of law. Thus, it was held that "the proper construction to be placed in calculating whether any resolution is approved or passed by a three-fourth majority present and voting necessarily mean the value of the valid votes and out of the same whether the resolution has been passed with three-fourth the majority"

(iii) Approval of the Stock Exchanges

As per Clause 24(f) of the Listing Agreement all the listed companies are required to file the scheme of merger or amalgamation with all the stock exchanges where it is listed at least one month prior to filing it with High Court and obtain it's No Objection to scheme. Other stock exchange compliances which the listed companies are required to adhere to are given as below:
Intimation as to the proposed amalgamation to the Stock Exchange should be given within 15 minutes after the Board meeting where the proposal is approved. [Cl. 22(d), 29, LA, BSE].
Amalgamation involves issue and allotment of shares of Transferee Company to shareholders of Transferor Company in exchange of shares held by them in Transferor Company as per share exchange ratio. This requires compliance with Section 81(1A) of Companies Act by Transferee Company. Three copies of notices, circulars, etc. issued/advertised concerning amalgamation is to be forwarded to the Stock Exchange. [Cl. 31(e), 29, LA, BSE].

Shareholders of Transferor Company are allotted transferee company's shares. Share certificates held by transferor company's shareholders are called back to be exchanged after fixing a record date in accordance with the Listing Agreement. Fresh share certificates may be issued after trading of the shares of Transferor company are cancelled. Shares of transferor company are delisted and shares of transferee company are listed. During intervening period, trading of shares at Stock Exchange may be suspended. The fact that shares of the transferor

company will have to be delisted should not come in the way of sanctioning scheme of amalgamation. [Re Sumitra Pharmaceuticals Ltd. (1997) 25 CLA 142 (AP)]. If transferor company is a listed company but transferee company is not listed, then the latter's shares allotted to the former's shareholders need not be listed; thus transferee company would become unlisted company. But if Transferee Company is listed, those shares will be listed on all exchanges where transferee company's shares are listed. However, stock exchanges on which transferor company's shares are listed cannot compel to list the new shares allotted in pursuance of the amalgamation, if transferee company's shares are not listed on such exchange.
Return of allotment in e-form 2 should be filed with ROC within 30 days of allotment. SEBI (Substantial Acquisition of Shares and Take-over) Regulations are inapplicable.

(iv) Approval of Financial Institutions

The approval of the Financial Institutions, trustees to the debenture holders and banks, investment corporations would be required if the Company has borrowed funds either as term loans, working capital requirements and/or have issued debentures to the public and have appointed any one of them as trustees to the debenture holders.

(v) Approval from the Land Holders

If the land on which the factory is situated is the lease-hold land and the terms of the lease deed so specifies, the approval from the lessor will be needed.

(vi) Approval of the High Court

Both companies (amalgamating as well as amalgamated) involved in a scheme of compromise or arrangement or reconstruction or amalgamation is required to seek approval of the respective High Courts for sanctioning the scheme.
i) Every amalgamation, except those, which involve sick industrial companies, requires sanction of High Court which has jurisdiction over the State/area where the registered office of a company is situated.
ii) If transferor and transferee companies are under the jurisdiction of different High Courts, separate approvals are necessary.
iii) If both are under jurisdiction of one High Court, joint application may be made. [Mohan Exports Ltd.

Tarun Overseas P. Ltd. (1994) 14 CLA 279 (Del) dissenting from Re Electro Carbonium P. Ltd. (1979) 49 Comp Cas 825 (Kar) wherein it was held that a joint application cannot be made]. Alternatively, where both the companies are situated in the same State and only one company moves the court under Section 391, the other company may be made a party to the petition (DCA Circular No.14 of 1973 dated 5th June, 1973). — The notice of every application filed with the Court has to be given to the Central Government (Regional Director, having jurisdiction of the State concerned). — After the hearing is over, the Court will pass an order sanctioning the Scheme of amalgamation, with such directions in regard to any matter and with such modifications in the Scheme as the Judge may think fit to make for the proper working of the Scheme. [Section 391(2); Rule 81, Companies (Court) Rules]. The court under Section 391-394 of the Act is also empowered to order the transfer of undertaking, property or liabilities either wholly or in part, allotment of shares or debentures and on other supplemental and incidental matters.

(vii) Approval of Reserve Bank of India

Where the scheme of amalgamation envisages issue of shares/cash option to Non-Resident Indians, the amalgamated company is required to obtain the permission of Reserve Bank of India. Position regarding issue of shares to NRIs under a scheme of amalgamation under the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000
is as below: Regulation 7 of the above mentioned Regulations states as under: Issue and Acquisition of Shares after Merger or Demerger or Amalgamation of Indian Companies Where a scheme of merger or amalgamation of two or more Indian Companies or a reconstruction by way of demerger or otherwise of an Indian Company, has been approved by a Court in India, the transferee company or, as the case may be, the new company may issue shares to the shareholders of the transferor company resident outside India, subject to the following conditions, namely:

(a) the percentage of shareholding of persons resident outside India in the transferee or new company does not exceed the percentage specified in the approval granted by the Central Government or the Reserve Bank, or specified in these Regulations: Provided that where the percentage is likely to exceed the percentage specified in the approval or the Regulations, the

transferor company or the transferee or new company may, after obtaining an approval from the Central Government, apply to the RBI for its approval under these Regulations;

(b) the transferor company or the transferee company or new company shall not engage in agriculture, plantation or real estate business or trading TDRs; and

(c) the transferee or new company files a Report within 30 days with the RBI giving full details of the shares held by persons resident outside India by the transferor and the transferee or the new company, before and after the merger/amalgamation/reconstruction, and also furnishes a confirmation and all the terms and conditions stipulated in the scheme approved by the Court have been complied with.

(viii) Approval of Central Government under MRTP Act

The Monopolies and Restrictive Trade Practices Act, 1969 is on the verge of being phased out with the passing of the Competition Act, 2002. Substantial amendments were carried out to the MRTP Act in the year 1991 and pursuant to the said amendments, approval of Central Government under MRTP Act is no longer required. MRTP Commission has no jurisdiction for pre-scrutiny of amalgamation scheme on the ground of potential monopolistic or restrictive trade practices. If working of the company is found to be prejudicial to the public interest or relates to adoption of monopolistic or restrictive trade practices, Central Government or MRTP Commission will be entitled to act according to law. [Hindustan Lever Employees' Union v. Hindustan Lever Ltd. (1995) 83 Comp Cas 30 (1994) 15 CLA 318 (SC)]. Under the Competition Act regulation of combinations as provided under Sections 5 and 6 of the Act would also be required to be complied by companies, if applicable, after the Act comes into force.

(ix) Combination under the Competition Act, 2002

The provisions relating to regulation of combination as provided under Sections 5and 6 of the Competition Act, 2002 would also be required to be complied with by companies, if applicable, after the Act comes into force.

7.3 CONSIDERATION AND FUNDING FOR MERGER AND AMALGAMATION

Growth is essential for sustaining the viability, dynamism and value enhancing capability of a company. A company can expand and/or diversify its markets internally or externally. If it

cannot grow internally due to lack of physical and managerial resources, it can grow externally by mergers and acquisitions of companies engaged in same or similar industry or service sector in a convenient and inexpensive manner. However, mergers and acquisitions involve cost and can be an expensive mode if the company pays an excessive price for shares in company proposed to be merged with itself. It should be borne in mind that benefits should exceed the cost of acquisition in fact. It is necessary that price may be carefully determined and negotiated so that merger enhances the value of shareholders. While valuing the cost of acquisition, it is necessary to bear in mind the fact that the entire cost of acquisition should be treated as capital cost while revenues arising out of the acquisition will only be generated over a period of time. The payback period will vary depending upon the entity or activity acquired and the market position at the time of acquisition and in post acquisition period. The benefits of a merger can be defined as the difference between (i) the total present value of the merged firms; and (ii) the sum of their values if they do not merge. Example: Benefit of merger = $\Delta V = VAB - VA - VB$ where, V = present value; A&B are two firms willing to continue to form a new company called C. 233. In other words, combined value of the merged companies should be more than the value obtained by a mere addition of the present values of each individual companies. In other words, 2 + 2, in a merger, should not be 4. It should be more to make merger a gainful preposition. Cost may be defined as the difference between the amount paid for the acquired firm and the amount it is worth as a separate entity. If B's owners receive cash for their shares then: Cost = Cash – VB. If the merger is financed by cash, attempt should be made so that Benefit – Cost = $\Delta V - (Cash - VB) > O$. If there is no merger, aggregate value of their shares is VA for firm A. If merger goes through, their position is VB – Cash. Net gain is given by: Net gain = VB – Cash – VA. = $\Delta V + VA + VB - Cash - VA - \Delta V - (Cash - VB)$ Cost however will depend on how a merger is funded or financed. If it is funded by borrowing loans, the interest paid will have to be added to cost.

Financial alternatives

Financing of mergers and takeovers involve payment of consideration money to the acquire shares for acquiring the undertaking or assets or controlling power of the shareholders as per valuation done and exchange ratio between shares of acquiring and merging company arrived at. Payment of consideration by the acquirer company to the acquiree company amounts to be the investment which is done on commercial basis with an aim to optimize return and to keep the cost of investment minimum. Care should be taken to select an optimum mix of the available

modes of payment of purchase consideration such that the financial package chosen suits the financial structures of both the acquirer and acquiree companies, and also provide a desirable gearing level thereby proving economical to the acquirer. The cost of capital or investment shall differ as per different financial packages selected. Selection of financial package shall depend upon many factors as mentioned below:

(i) It should suit to the financial structures of both the acquirer and the acquire companies.

(ii) It should provide a desirable gearing level which may suit to the financial structure of the acquirer.

(iii) The package should be found acceptable by the vendors.

(iv) The package should also prove economical to the acquirer.

Financial Package

The acquirer can select a suitable financial package to make payment of consideration to acquiree from the following alternatives:

(i) Payment of cash or by issue of securities.

(ii) Financial package of loans etc. involving financial institutions and banks.

(iii) Rehabilitation finance.

(iv) Management buyouts.

Process of Funding

Mergers and takeovers may be funded by a company (i) out of its own funds, comprising increase in paid up equity and preference share capital, for which shareholders are issued equity and preference shares or (ii) out of borrowed funds, which may be raised by issuing various financial instruments. (iii) A company may borrow funds through the issue of debentures, bonds, deposits from its directors, their relatives, business associates, shareholders and from public in the form of fixed deposits, (iv) external commercial borrowings, issue of securities, loans from Central or State financial institutions, banks, (v) rehabilitation finance provided to sick industrial companies under the Sick Industrial Companies (Special Provisions) Act, etc.

Form of payment may be selected out of any of the modes available such as (a) cash payment, (b) issue of equity shares, (c) mix of equity and cash, (d) debt or loan stock, (e) preference shares, convertible securities, junk bonds etc. Well-managed companies make sufficient profits and retain them in the form of free reserves, and as and when their Board of Director propose

any form of restructuring, it is financed from reserves, i.e. internal accruals. Where available funds are inadequate, the acquirer may resort any one or more of the options available for the purpose of raising the required resources. The most prominent routes are the borrowing and issue of securities. The required funds could be raised from banks and financial institutions or from public by issue of debentures or by issue of shares depending upon the quantum and urgency of their requirements. Generally a cash rich company use their surplus funds for taking over the control of other companies, often in the same line of business, to widen their product range and to increase market share.

Funding Through various types of financial instruments

A. Funding Through Equity Shares

Equity share capital can be considered as the permanent capital of a company. Equity needs no servicing as a company is not required to pay to its equity shareholders any fixed amount return in the form of interest which would be the case if the company were to borrow issue of bonds or other debt instruments. In issue of shares, the commitment will be to declare dividends consistently if profits permit. Raising moneys from the public by issue of shares to them is a time consuming and costly exercise. The process of issuing equity shares or bonds/debentures by the company takes a lot of time. It would require several things to be in place and several rounds of discussion would take place between the directors, and key promoters having the controlling stake, between the Board of Directors and consultants, analysts, experts, company secretaries, chartered accountants and lawyers. Moreover it requires several legal compliances. Therefore planning an acquisition by raising funds through a public issue may be complicated and a long drawn process. One cannot think of raising moneys through public issue without identifying the company to be acquired.

B. Funding Through Preference Shares

Another source of funding a merger or a takeover may be through the issue of preference shares, but unlike equity capital, issue of preference share capital as purchase consideration to shareholder of merging company involves the payment of fixed preference dividend (like interest on debentures or bonds or) at a fixed rate. Therefore, before deciding to raise funds for this purpose, by issue of preference shares, the Board of directors of a company has to make sure that the merged company or the target company would be able to yield sufficient profits for covering discharging the additional liability in respect of payment of preference dividend. Burden of

preference dividend A company funding its merger or takeover proposal through the issue of preference shares is required to pay dividend to such shareholders as per the agreed terms. While raising funds through this mode, the management of the company has to take into consideration the preference dividend burden, which the profits of the company should be able to service.

C. Funding Through Options or Securities with Differential Rights

Companies can restructure its capital through derivatives and options as a means of raising corporate funds. Indian companies are allowed to issue derivatives or options as well as shares and quasi-equity instruments with differential rights as to dividend and/or voting. Companies may also issue non-voting shares or shares with differential voting rights to the shareholders of Transferor Company. Such issue gives the companies an additional source of fund without interest cost and without an obligation to repay, as these are other forms of equity capital. The promoters of companies may be interested in this form of consideration as it does not impose any obligation and there is no loss of control in the case of non-voting shares.

D. Funding Through Swaps or Stock to Stock Mergers

In stock swap mergers, or stock-for-stock mergers, the holders of the target company's stock receive shares of the acquiring company's stock. The majority of mergers during the past few years have been stock-for-stock deals. A merger arbitrage specialist will sell the acquiring company's stock short, and will purchase a long position in the target company, using the same ratio as that of the proposed transaction. (If the purchasing firm is offering a half share of its stock for every share of the target company, then the merger arbitrageur will sell half as many shares of the purchasing firm as he or she buys of the target company.) By going long and short in this ratio, the manager ensures that the number of shares for which the long position will be swapped is equal to the number of shares sold short. When the deal is completed, the manager will cover the short and collect the spread that has been locked in. As with all mergers, stock swap mergers may involve event risk. In addition to the normal event risks, stock swap mergers involve risks associated with fluctuations in the stock prices of the two companies. The terms of the deal involve an exchange of shares and are predicted on the prices of the two companies' stock at the time of the announcement, drastic changes in the shares prices of one or both of the companies can cause the entire deal to be re-evaluated. Merger arbitrageurs derive returns from stock swap mergers when the spread or potential return justifies the perceived risk of the deal's failing.

E. Funding Through Employees Stock Option Scheme

This option may be used along with other options. The share capital that may be raised through a Scheme of Employees' Stock Option can only be a fraction of the entire issue. Hence no company can imagine of funding any scheme of merger or takeover entirely through this route. Merits and demerits of funding of merger or takeover through the equity issue have already been discussed earlier under the heading "Funding through equity issue". Employees' stock option scheme is a voluntary scheme on the part of a company to encourage its employees to have a higher participation in the company. Stock option is the right (but not an obligation) granted to an employee in pursuance of a scheme, to apply for the shares of the company at a pre-determined price. Suitable percentage of reservation can be made by a company for its employees or for the employees of the promoter company or by the promoter company for employees of its subsidiaries, as the need may arise. Equitable distribution of shares among the employees will contribute to the smooth working of the scheme. Only bona-fide employees of the company are eligible for shares under scheme the offer of shares to the employees on preferential basis has been misused by some companies by allotting shares to non-employees or in the joint names of employees and non-employees. The companies are therefore, advised to ensure that the shares reserved under the employees' quota be allotted only to the bona fide employees, subject to the SEBI guidelines issued in this regard and the shares remaining unsubscribed by the employees may be offered to the general public through prospectus in terms of the issue, if any [Press release dated 30.1.1996]. The option granted to any employee is not transferable to any person.

F. Funding through External Commercial Borrowings (ECBS) under Section 6 of Foreign Exchange Management act, 1999 (FEMA)

External Commercial Borrowings (ECB) are regulated by the ECB Guidelines issued by the External Commercial Borrowing Division, Department of Economic Affairs, Ministry of Finance, Government of India as modified from time to time. External Commercial Borrowings (ECB), being capital account transactions within the meaning of the Foreign Exchange Management Act, 1999 (FEMA). They are governed by Section 6 of FEMA. ECB refers to commercial loans in the form of bank loans, buyers' credit, suppliers' credit, securitised instruments such as Floating Rate Notes and Fixed Rate Bonds, etc., availed from non resident lenders with minimum average maturity of 3 years. ECB can be accessed under two routes, viz.,

(i) automatic route; and (ii) approval route. ECB under the automatic route is permitted for investment in the real sector, industrial sector including small and medium enterprises and especially infrastructure sector.

Automatic route implies the ECB will not require approval of Reserve Bank of India or the Government of India. Corporate (Companies registered under the Companies Act) except financial intermediaries (such as banks, financial institutions (FIs), housing finance companies and NBFCs) are eligible for accessing ECB under the automatic route. Individuals, trusts, and non-profit organizations are not eligible to raise ECB. ECB can be accessed only for investment (such as import of capital goods, new projects, modernization/expansion of production units) in real sector – industrial sector including small and medium enterprises (SME) and infrastructure sector in India.

Limitations of ECB Route: (a) Accessing ECB is not permitted under both the automatic route and the approval route for on-lending or investment in capital market or acquiring company (or a part thereof) in India by a corporate.

(b) Utilisation of ECB proceeds is also not permitted in real estate. The term 'real estate' excludes development of integrated township.

(c) End users of ECBs for working capital, general corporate purpose and repayment of existing rupee loans are also not permitted.

ECBs are permitted by the Government as a source of finance for Indian corporates for expansion of existing capacity as well as for fresh investment. Utilisation of ECB proceeds is permitted in the first stage; acquisition of shares in the disinvestments process and also in the mandatory second stage; offer to the public under the Government's disinvestments programme of PSU shares.

Limitation on utilisation of proceeds of ADR/GDR issue for funding Mergers/Takeovers

Any money that is raised from a foreign source whether in the form of equity or debt, whether as a foreign direct investment or by way of an external commercial borrowings, compliance of the provisions of Foreign Exchange Management Act is essential. These are capital account transactions and therefore they have to accordingly understand. Specifically in respect of moneys raised through issue of ADRs/GDRs, there are certain restrictions with regard to end use of funds so raised. The following are to be incurred within one year from the date of Issue of GDR:

1. Financing capital goods imports.

2. Financing domestic purchase/installation of plant, equipment and buildings.

3. Prepayment or scheduled repayment of earlier external commercial borrowing.

4. Making investments abroad where these have been approved by competent authorities. Companies would be required to submit quarterly statements of utilisation of funds duly certified by their auditors. The issuer companies would be required mandatorily to retain the Euro issue proceeds abroad to be repatriated as and when expenditure for the approved end uses (including 15% earmarked for general corporate restructuring purposes) are incurred. ADR's and GDR's are identical from a legal, operational, technical and administrative standpoint.

L. Funding through financial institutions and banks

Funding of a merger or takeover with the help of loans from financial institutions, banks etc, has its own merits and demerits. Takeover of a company could be achieved in several ways and while deciding the takeover of a going concern, there are matters such as the capital gains tax, stamp duty on immovable properties and the facility for carrying forward of accumulated losses. With parameters playing a critical role, the takeover should be organized in such a way that best suits the facts and circumstances of the specific case and also it should meet the immediate needs and objectives of the management. While discussing modes of acquisition, certainly there would be a planning for organizing the necessary funding for the acquisition. If borrowings from domestic banks and financial institutions have been identified as the inevitable choice, all the financial and managerial information must be placed before the banks and financial institutions for the purpose of getting the necessary resources. The advantage of funding is that the period of such funds is definite which is fixed at the time of taking such loans. Therefore, the Board of the company is assured about continued availability of such funds for the pre-determined period. On the negative side, the interest burden on such loans, is quite high which must be kept in mind by the Board while deciding to use borrowed funds from financial institution. Such funding should be thought of and resorted to only when the Board is sure that the merged company or the target company will, give adequate returns i.e., timely payment of periodical interest on such loans and re-payment of the loans at the end of the term for which such loans have been taken. However, in the developed markets, funding of merger or takeover is not a critical issue. There are various sources of finance available to an acquirer. In the Indian market, it was not easy to obtain takeover finance from financial institutions and banks because they are not forthcoming to finance securities business. Takeover involves greater risk. There is no other organised sector to

provide finance for takeover by a company. Justice P.N. Bhagwati Committee on takeovers in its report of May 2002 has recommended that Banks/Financial Institutions are to be encouraged to consider financial takeovers. There are two aspects in it. (i) The first one relates to cost of acquiring ownership over the assets. If it is a going concern, the shares of the company could be purchased. In that process, the acquired entity might become a wholly owned subsidiary. Funding the acquisition would mean the funds required for paying up the consideration payable to the sellers of those shares. This will be worked on the basis of the net worth of the acquired entity. In addition to the said cost, there might be a huge requirement for funding the operations, modernization, up gradation, installing balancing equipments, removal of bottlenecks and a host of other requirements. Hence the borrowings would be required for meeting such cost also. The acquisition may also require a rehabilitation or restructuring scheme implying a meeting with existing secured creditors and major unsecured creditors. As a whole, borrowing would be a major exercise involving a lot of study of the actual financial support needed. Care must be taken to ensure that the existing revenue streams are not affected due to the proposed acquisition. The combined net worth, combined financial projections and revenue streams might also be needed for persuading the banks and financial institutions to pick up a stake in the acquisition.

M. Funding through rehabilitation finance

Sick industries get arranged marriage through BIFR with healthy units with financial package to the acquirer from the financial institutions and banks having financial stakes in the acquiree company to ensure rehabilitation and recovery of dues from the acquirer. BIFR has been arranging such takeover from time to time in which creditor financial institutions and banks have been providing consortium financial packages in promoting mergers. Merger or takeover may be provided for in a scheme of rehabilitation under the Sick Industrial Companies (Special Provisions) Act, 1985. The Sick Industrial Companies (Special Provisions) Act, 1985 provides for reference to the Board for Industrial and Financial Reconstruction (BIFR) of a sick industrial company. Once a reference is made, BIFR will cause an enquiry, appoint an operating agency for determination of measures necessary for rehabilitation of the sick company, direct the preparation of a rehabilitation scheme, which may provide, inter alia, for

(i) rehabilitation finance for the sick company;

(ii) merger of the sick company with a healthy company or merger of a healthy company with the sick company;

(iii) takeover of the sick company by a healthy company;

(iv) such other preventive, ameliorative and remedial measures as may be appropriate. The scheme is prepared by the operating agency, and after the same is sanctioned becomes operative and binding on all the concerned parties including the sick company and other companies – amalgamating, merging, the amalgamated or the merged companies.

N. Funding through leveraged and management buyouts

There are various options available for the revival of a 'sick company'. One is buyout of such a company by its employees. This option has distinct advantages over Government intervention and other conventional remedies. Buyout by employees provides a strong incentive to the employees in the form of personal stake in the company. The employees become the owners of the company by virtue of the shares that are issued and allotted to them. Moreover, continuity of job is the greatest motivating force which keeps them on their toes to ensure that the buyout succeeds. Such a buyout saves mass unemployment and unrest among the working class. Relations between the workers management and the employees are expected to be cordial without any break, strike or other such disturbing developments. Hence chances of success are more. However, such a buyout can be successful only if necessary financial support is extended by the Government or the financial institutions and banks.

Definition of Management Buyout (MBO): A Management Buyout (MBO) is simply a transaction through which the incumbent management buys out all or most of the other shareholders. The management may take on partners, it may borrow funds or it can organize the entire restructuring on its own. A MBO begins with arrangement/raising of finance. Thereafter, an offer to purchase all or nearly all of the shares of a company not presently held by the management has to be made which may necessitate a public offer and even delisting. Consequent upon this, restructuring may be affected and once targets have been achieved, the company can go public again.

Case Law on Leveraged Buyout: In Navnit R. Kamaniv. R.R. Kamani, two schemes of rehabilitation came before the BIFR for consideration and approval. One of the schemes was presented by a shareholder holding 24% shares in the company and the other scheme was submitted by the workmen's union of the company. When the two schemes were viewed in juxta-position, there was no doubt that the scheme presented by the applicant shareholder appeared in a rather poor light. The BIFR sanctioned the scheme which was presented by the

workers' union because, in the opinion of the BIFR, that scheme was more suited for the revival of the company. The matter went to the Supreme Court. Turning to the merits of the scheme presented by the workers and sanctioned by BIFR, it was considered to be feasible and economically viable by experts. It envisaged the management by a Board of directors consisting of fully qualified experts and representatives of banks, Government and employees. The scheme had the full backing of the nationalised banks and the encouragement from the Central and State Governments which had made commitments for granting tax concessions. The backing and the concessions were forthcoming essentially because it was a scheme framed by the employees who themselves were making tremendous wage-sacrifice and trying to salvage the company which has been almost wrecked by others. The above decision of the Supreme Court brought about a significant change in workers' attitude towards their own role in the revival and rehabilitation of sick industrial companies, a change from collective bargainers to collective performers. In the case before the Supreme Court, the facts were quite favourable for the workers of the company. Though the workers can, through collective effort, achieve the objective of reviving sick industrial units, their own stakes being no less, yet they need all the help and encouragement from the Government, financial institutions and banks for sustained efforts for revival and rehabilitation. Change in attitude of workers' unions in such an endeavour is all the more important.

7.4 SUMMARY

A merger can be defined as the fusion or absorption of one company by another. In a merger, one of the two existing companies merges its identity into another existing company. Also, one or more existing companies may form a new company and merge their identities into a new company by transferring their assets and liabilities to the new company. Merger and amalgamation have various advantages e.g. synergy, economies of scale, reduction in production and other expenses, tax advantages, competitive advantage etc. Amalgamation can be effected in various ways viz., transfer of undertaking by order of the High Court, purchase of shares of one company by another company, amalgamation of companies in national interest, amalgamation of companies under Section 494 of the Companies Act, where the liquidator of a company transfers its assets and liabilities to another company and amalgamation for revival and rehabilitation under the provisions of SICA, 1985. For mergers and amalgamations, the procedure as detailed in the chapter needs to be complied with. Financial aspects of merger/amalgamation include valuation of shares and selection of ideal method for valuation.

7.5 KEY WORDS

1. TDRs: Transfer of Developmental Rights
2. ECB: External Commercial Borrowings
3. ADR: American Depository Receipt
4. GDR: Global Depository Rights
5. FEMA: Foreign Exchange Management Act
6. SICA: Sick Industrial Companies Act

7.6 SELF ASSESSMENT QUESTIONS

1. What are the approvals required for Mergers and Amalgamation
   …………………………………………………………………………………………………
   ………………………………………………………………………………………………..
2. What are all the alternatives available for funding for mergers and amalgamation? Briefly explain the options
   …………………………………………………………………………………………………
   …………………………………………………………………………………………………

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UNIT-8 FINANCIAL AND ACCOUNTING, STAMP DUTY AND TAXATION IN CASE OF MERGER AND AMALGAMATION

Structure

8.0 Objectives

8.1 Introduction

8.2 Financial and Accounting in Amalgamation and Merger

8.3 Stamp duty and taxation in Amalgamation and Merger

8.4 Summary

8.5 Key words

8.6 Self Assessment Questions

8.7 References

8.0 OBJECTIVES

- To analyse the accounting aspects of mergers and amalgamations.
- To understand the financial aspects of mergers and amalgamations.
- To know the taxation aspects of mergers and amalgamations.

8.1 INTRODUCTION

Financial accounting is used to prepare accounting information for people outside the organization or not involved in the day-to-day running of the company. Management accounting provides accounting information to help managers make decisions to manage the business. In short, financial accounting is the process of summarizing financial data taken from an organization's accounting records and publishing in the form of annual (or more frequent) reports using Historical Cost Accounting during low and high inflation and deflation and Constant Purchasing Power Accounting during hyperinflation for the benefit of people outside the organization. Financial accountancy is governed by both local and international accounting standards.

8.2 FINANCIAL AND ACCOUNTING IN AMALGAMATION AND MERGER

Financial and accounting aspects of takeover

Accounting considerations are vital in planning a takeover. While many such transactions are based upon industrial or other operation considerations, others depend upon the financial impact of transactions on the financial position of the parties. In a takeover, if the acquirer is an individual, he has to write in his personal books of account the amounts invested in the shares of the company, whose majority shares or control has been taken over by him. This investment in the shares of the target company shall be reflected in his personal Return of Income at the end of the financial year. Where the acquirer is a company, on the registration of the acquired shares in the register of members of the target company, the acquirer company will become the holding company and the target company will become its subsidiary company by virtue of its holding more than half in nominal value of its equity share capital, as per provisions of Section 4 of the Companies Act, 1956.

Holding company’s books of account

The books of account of the holding company will be accordingly written as under:

If consideration for the acquired shares has been paid in cash only, the Cash Account will be credited and the Investments Account will be debited. If only fully paid shares have been allotted by the acquiring company to the shareholders of the target company, whose shares have been acquired, in exchange for their shares, then the Share Capital Account will be credited and the Investments Account will be debited. If the consideration has been paid partly in cash and partly in the form of fully paid shares, then for the cash portion, Cash Account will be credited and the Investments Account will be debited and for the fully paid shares portion, Share Capital Account will be credited and the Investments Account will be debited. Besides, the books of account, the acquiring or the holding company shall also maintain a Register of Investments in accordance with the provisions of Section 372A(5) of the Companies Act, 1956.

Subsidiary companies books of account

There will be no accounting entry in the books of account of the target company or the subsidiary company.

However, in the register of members of the subsidiary company, the transfer of shares of the shareholders, whose shares have been acquired by the holding company, shall be registered as soon as the relevant instruments of transfer along with the relevant share certificates have been received and the registration of their transfer. The share certificates shall be sent to the holding company after making due endorsement of the transfer under the authentication of the authorised signatory of the subsidiary company.

Accounting aspects of merger and amalgamation

Writing of books of account in mergers and amalgamations:

For the purpose of merger or amalgamation the amalgamating or the merging company is regarded as the seller and the amalgamated or the merged company is considered as the buyer. The books of account are prepared accordingly. Merger and amalgamation accounting is done on the traditional basis as in the case of the vendor and purchaser. The transferor is taken as vendor whose books of accounts are to be closed as the business goes into liquidation. The transferee or the acquirer assumes the status as purchaser in whose books of accounts the acquisition is recorded as purchase transaction.

The Institute of Chartered Accountants of India has formulated Accounting Standard (AS) 14 for accounting and disclosure requirements of mergers and amalgamation. This said Accounting

Standard became effective from April 1, 1995. For the purpose of accounting statement and related records, amalgamation means an amalgamation pursuant to the provisions of the Companies Act, 1956 and other laws applicable to companies. Accounting Standard 14 is based on the International Accounting Standard 22, captioned “Accounting for Business Combinations”. The Accounting Standard 14 deals with the accounting requirements of amalgamations and mergers and treatment of all aspects of the amalgamation, e.g., valuation of goodwill, assets revaluation reserves etc. It does not deal with substantial acquisition of shares carrying controlling interest in the target company. In the case of acquisition, both the companies remain in existence whereas in the case of an amalgamation or a merger, the merging or the amalgamating company loses its independent legal identity. Therefore, there is a vital difference in the accounting standard and practices to be followed in the case of substantial acquisition of shares of one company by another company and in the case of an amalgamation or merger of companies.

Types of Amalgamation

Accounting Standard (AS)-14, recognizes two types of amalgamation:

(i) amalgamation in the nature of merger.

(ii) amalgamation in the nature of purchase.

An amalgamation should be considered to be an amalgamation in the nature of merger when all the following conditions are satisfied:

(i) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.

(ii) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.

(iii) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.

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

(v) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.
An amalgamation should be considered to be an amalgamation in the nature of purchase, when any one or more of the conditions specified above is not satisfied.

These amalgamations are in effect a mode by which one company acquires another company and hence, the equity shareholders of the combining entities do not continue to have a proportionate share in the equity of the combined entity or the business of the acquired company is not intended to be continued after amalgamation.

Methods of Accounting for Amalgamation

There are two main methods of accounting for amalgamations:

(a) the pooling of interests method; and

(b) the purchase method.

The pooling of interest method is used in case of amalgamation in the nature of merger. The purchase method is used in accounting for amalgamations in the nature of purchase.

The Pooling of Interest Method

Since merger is a combination of two or more separate business, there is no reason to restate carrying amounts of assets and liabilities. Accordingly, only minimal changes are made in aggregating the individual financial statements of the amalgamating companies. In preparing the transferee company's financial statements, the assets, liabilities and reserves (whether capital or revenue or arising on revaluation) of the transferor company should be recorded at their existing carrying amounts and in the same form as at the date of the amalgamation. The balance of the Profit and Loss Account of the transferor company should be aggregated with the corresponding balance of the transferee company or transferred to the General Reserve, if any. If, at the time of the amalgamation, the transferor and the transferee company having conflicting accounting policies, a uniform set of accounting policies should be adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies should be reported in accordance with Accounting Standard (AS-5), Net Profit or Loss for the Period 'Prior Period Items and Changes in Accounting Policies'.

The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company should be adjusted in reserves. It has been clarified that the difference between the issued share capital of the transferee company and share capital of the transferor company should be treated as capital reserve. The reason given is that this difference is akin to share premium. Furthermore, reserve created on amalgamation is not available for the purpose of distribution to shareholders as dividend and/or bonus shares. It means that if consideration exceeds the share capital of the transferor company (or companies), the unadjusted amount is a capital loss and adjustment must be made, first of all in the capital reserves and in case capital reserves are insufficient, in the revenue reserves. However, if capital reserves and revenue reserves, are insufficient the unadjusted difference may be adjusted against revenue reserves by making addition thereto by appropriation from profit and loss account. There should not be direct debit to the profit and loss account. If there is insufficient balance in the profit and loss account also, the difference should be reflected on the assets side of the balance sheet in a separate heading.

The Purchase Method

In preparing the transferee company's financial statements, the assets and liabilities of the transferor company should be incorporated at their existing carrying amounts or, alternatively, the consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation. The reserves (whether capital or revenue or arising on revaluation) of the transferor company, other than the statutory reserves, should not be included in the financial statements of the transferee company except as in case of statutory reserve. Any excess of the amount of the consideration over the value of the net assets of Transferor Company acquired by the transferee company should be recognised in the transferee company's financial statements as goodwill arising on amalgamation. If the amount of the consideration is lower than the value of the net assets acquired, the difference should be treated as Capital Reserve.

The goodwill arising on amalgamation should be amortised to income on a systematic basis over its useful life. The amortisation period should not exceed five years unless a somewhat longer period can be justified. The reserves of the transferor company, other than statutory should not be included in the financial statements of the transferee company. The statutory reserves refer to those reserves which are required to be maintained for legal compliance. The

statute under which a statutory reserve is created may require the identity of such reserve to be maintained for a specified period. Where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with such statutory reserves of the transferor company should be recorded in the financial statements of the transferee company by crediting the relevant statutory reserve account. The corresponding debit should be given to a suitable account head (e.g., 'Amalgamation Adjustment Account') which should be disclosed as a part of "miscellaneous expenditure" or other similar category in the balance sheet. When the identify the
Statutory reserves are no longer required to be maintained, both the reserves and the aforesaid account should be reserved.

Consideration for Amalgamation

The consideration for amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company. In determining the value of the consideration, assessment is made of the fair value of its various elements. The consideration for the amalgamation should include any non-cash element at fair value. The fair value may be determined by a number of methods. For example, in case of issue of securities, the value fixed by the statutory authorities may be taken to be the fair value. In case of other assets, the fair value may be determined by reference to the market value of the assets given up, and where the market value of the assets given up cannot be reliably assessed, such assets may be valued at their respective book values. While the scheme of amalgamation provides for an adjustment to the consideration contingent on one or more future events, the amount of the additional payment should be included in the consideration if payment is probable and a reasonable estimate of the amount can be made. In all other cases, the adjustment should be recognised as soon as the amount is determinable.

Goodwill on Amalgamation

Goodwill arising on amalgamation represents a payment made in anticipation of future income and it is appropriate to treat it as an asset to be amortised to income on a systematic basis over its useful life. Due to nature of goodwill, it is difficult to estimate its useful life, but estimation is done on a prudent basis. Accordingly, it should be appropriate to amortise goodwill over a period

not exceeding five years unless a somewhat longer period can be justified. The following factors are to be taken into account in estimating the useful life of goodwill:

(i) the forceable life of the business or industry;

(ii) the effects of product obsolescence, changes in demand and other economic factors;

(iii) the service life expectancies of key individuals or groups of employees;

(iv) expected actions by competitors or potential competitors;

(v) legal, regulatory or contractual provisions affecting the useful life.

Reserves

Where the treatment to be given to the reserves of the transferor company after its amalgamation is specified in scheme of amalgamation sanctioned under the provisions of the Companies Act, 1956 or any other statute, the same is to be followed.

Disclosure Requirements

(a) For amalgamations of every type, the following disclosures should be made in the first financial statements following the amalgamations:
(i) names and general nature of business of the amalgamating companies;
(ii) effective date of amalgamation for accounting purposes;
(iii) the method of accounting used to reflect the amalgamation; and
(iv) particulars of the scheme sanctioned under a statute.

(b) In case of amalgamations accounted for under the pooling of interests method, the following additional disclosures are required to be made in the first financial statements following the amalgamation:
(i) description and number of shares issued, together with the percentage of each company's equity shares exchanged to effect the amalgamation;
(ii) the amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof.

(c) In case of amalgamations accounted for under the purchase method the following additional disclosures are required to be made in the first financial statements following the amalgamations:
(i) consideration for the amalgamation and a description of the consideration paid or contingently payable, and
(ii) the amount of any difference between the consideration and the value of net identifiable assets required, and the treatment thereof including the period of amortization of any goodwill arising on amalgamation.

Amalgamation after the Balance Sheet Date

While an amalgamation is effected after the balance sheet date but before the issuance of the financial statements of either party to the amalgamation, disclosure should be made as per the provisions of AS-4, 'Contingencies and Events Occurring after the Balance Sheet Date', but the

amalgamation should not be incorporated in that financial statements. In certain circumstances, the amalgamation may also provide additional information affecting the financial statements themselves, for instance, by allowing the going concern assumption to be maintained.

8.3 STAMP DUTY AND TAXATION IN AMALGAMATION AND MERGER

Stamp Duty on Takeover Documents:

In a takeover the dutiable document is the Instruments of Transfer executed by and between the transferors of the shares and the transferee of the shares in the form prescribed in the Companies (Central Government's) General Rules and Forms, 1956. The duty on the Instruments of Transfer is paid in the form of Share Transfer Stamps. These are affixed and cancelled on each Instrument of Transfer at the rate of 0.50 P. per one hundred rupees or a fraction thereof of the sale value of the shares. No stamp duty is payable in case of transfer of shares through Depository.

Taxation Aspects of Takeover:

Taxation aspect is not involved in a takeover at the time of acquisition of shares by the holding company in the company which becomes its subsidiary company by virtue of acquisition of majority of shares. However, if and when the holding company sells the shares, the sale would involve the payment of Capital Gains Tax (short-term or long-term) under the Income Tax Act, 1961 depending on the period for which the shares are held by the holding company.

8.4 SUMMARY

For mergers and amalgamations, the procedure as detailed in the unit needs to be complied with. There are two main methods of accounting for amalgamation – the pooling of interests method and the purchase method. They have been suitably illustrated under the unit. Financial aspects of merger/amalgamation include valuation of shares and selection of ideal method for valuation. Taxation aspects of merger and acquisition especially come into play during the merger of a sick industrial company with another company in order to reap the benefits of the facility for carrying forward and setting off of accumulated losses and unabsorbed depreciation. Stamp duty is required to be paid on High Court's Order sanctioning amalgamation.

8.5 KEY WORDS

1. AS: Accounting Standard
2. Pooling of Interest Method
3. Purchase method.

8.6 SELF ASSESSMENT QUESTIONS

1. Briefly explain methods of mergers and amalgamation
   …………………………………………………………………………………………………
   ………………………………………………………………………………………………….
2. Explain accounting treatment in case of mergers and amalgamation
   …………………………………………………………………………………………………
   …………………………………………………………………………………………………..
3. Explain taxation & stamp duty aspects of mergers and amalgamation
   …………………………………………………………………………………………………
   …………………………………………………………………………………………………..

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UNIT-9 PROCEDURE AND DOCUMENTATION OF AMALGAMATION AND MERGER

Structure

9.0 Objectives

9.1 Introduction

9.2 Procedure and documentation on of Amalgamation and merger

9.3 Summary

9.4 Key words

9.5 Self Assessment Questions

9.6 References

9.0 OBJECTIVES

- To able understand the procedural aspect of mergers and amalgamation.
- To able to understand procedure to be followed in case of mergers and amalgamation and action plan to be done in case of mergers and amalgamation.

9.1 INTRODUCTION

Mergers and amalgamations is a subject of interest for corporate professionals. On the basis of experience of handling a new amalgamation cases, here tried to pin down the step by step procedure for amalgamation. The procedure has been stated for a listed company. In case of unlisted company, the steps pertaining to Stock Exchange Company will not be required.

9.2 PROCEDURE AND DOCUMENTATION OF AMALGAMATION AND MERGER

The procedure commencing with an application for seeking directions of the Court for convening, holding and conducting meetings of creditors or class of creditors, members or class of members, as the case may be, to the stage of the court's order sanctioning the scheme of compromise or arrangement is contained in Sections 391 to 395 of the Companies Act, 1956 and rules 67 to 87 of the Companies (Court) Rules, 1959. The Rules also prescribe Forms for various purposes relating to compromise or arrangement:

Authority to amalgamate, merge, absorb, etc.

The memorandum of association of most of the companies contains provisions in their objects clause, authorising amalgamation, merger, absorption, take-over and other similar strategies of corporate restructuring. If the memorandum of a company does not have such a provision in its objects clause, the company should alter the objects clause, for which the company is required to hold a general meeting of its shareholders, pass a special resolution under Section 17 of the Companies Act, 1956 and file e-Form No. 23 along with a certified copy of the special resolution along with copy of explanatory statement under Section 173 and Memorandum of Association & Articles of Association and a copy of agreement with the concerned Registrar of Companies and the prescribed filing fee. The procedural aspects of mergers and amalgamations are summarised below:

Observing Memorandum of Association of Transferee Company

It has to be ensured that the objects of the Memorandum of Association of the transferee company cover the objects of the Transferor Company or companies. If not then it will be necessary to follow the procedure for amendment of objects by passing a special resolution at an

Extraordinary General Meeting convened for this purpose. It has been held by various decisions of the courts that there is no necessity to have special power in the object clause of the Memorandum of Association of a company for its amalgamation with another company. It has been laid down that to amalgamate with another company is power of the company and not an object of the company. Since the amalgamation will involve issue of shares by the transferee company to the shareholders of the transferor companies, a general meeting convened for the purpose of the amendment of the Object Clause of Memorandum of Association of the transferee company to incorporate the object of the transferor company, should also cover resolutions relating to the increase of authorised capital, consequential changes in the Articles of Association and resolution under Section 81(1-A) of the Companies Act, 1956 authorising the Directors to issue shares of the shareholders of the transferor companies without offering them to the existing shareholders of the company. It is also a normal practice that alongwith the special resolution for amendment of the Object Clause, special resolution is also passed under Section 149(2-A) of the Companies Act, 1956 authorising the transferee company to commence the business of the transferor company or companies as soon as the amalgamation becomes effective.

Convening a Board Meeting

A Board Meeting is to be convened and held to consider and approve in principle, amalgamation and appoint an expert for valuation of shares to determine the share exchange ratio. Consequent upon finalisation of scheme of amalgamation, another Board Meeting is to be held to approve the scheme.

Preparation of Valuation Report

Simultaneously, Chartered Accountants are requested to prepare a Valuation Report and the swap ratio for consideration by the Boards of both the transferor and transferee companies and if necessary it may be prudent to obtain confirmation from merchant bankers on the valuation to be made by the Chartered Accountants.

Preparation of scheme of amalgamation or merger

All the companies, which are desirous of effecting amalgamation of or merger must interact through their companies auditors, legal advisors and practicing company secretary who should report the result of their interaction to their respective Board of directors. The Boards of the involved companies should discuss and determine details of the proposed scheme of

amalgamation or merger and prepare a draft of the scheme of amalgamation or merger. If need be, they can obtain opinion of experts in the matter. The drafts of the scheme finally prepared by the Boards of both the companies should be exchanged and discussed in their respective Board meetings. After such meetings a final draft scheme will emerge. The scheme must define the "effective date" from which it shall take effect subject to the approval of the High Courts.

Contents of Amalgamation Scheme

Any model scheme of amalgamation should include the following: Transfer Date: This is usually the first day of the financial year preceding the financial year for which audited accounts are available with the companies. In other words, this is a cut-off date from which all the movable and immovable properties including all rights, powers, privileges of every kind, nature and description of the transferor-company shall be transferred or deemed to be transferred without any further act, deed or thing to the transferee company. Effective Date: This is the date on which the transfer and vesting of the undertaking of the transferor-company shall take effect i.e., all the requisite approvals would have been obtained. Arrangement with secured and unsecured creditors including debenture-holders. Arrangement with shareholders (equity and preference): This refers to the exchange ratio, which will have to be worked out based on the valuation of shares of the respective companies as per the audited accounts and accepted methods and valuation guidelines. Cancellation of share capital/reduction of share capital: This will be necessitated when the shares of the transferor-company (ies) are held by the transferee-company and/or its subsidiary (ies) or vice versa. Pending receipt of the requisite approvals to the amalgamation, the transferor company(ies) possesses the property to be transferred and to carry on the business for and on behalf and in trust for the transferee-company.

The Scheme should suitably provide for:

1. Brief details of transferor and transferee companies.
2. Appointed date.
3. Main terms of transfer of assets and liabilities from transferor to transferee, with power to execute on behalf or for transferee, the deed/documents being given to transferee.
4. Effective date of the scheme.
5. Details of happenings and consequences of the scheme coming into effect on effective date.
6. The terms of carrying on the business activities by transferor between appointed date' and 'effective date'.
7. Details of share capital of transferor and transferee company.
8. Proposed share exchange ratio, conditions attached thereto, fractional certificates to be issued to transferee company, approvals and consent required etc.

9. Conditions about payment of dividend, ranking of equity shares, prorate dividend declaration and distribution.
10. Status of employees of transferor companies and various schemes or funds created for their benefit, from the effective date.
11. Agreement between transferor and transferee companies towards making applications/petitions under Sections 391 and 394 and other provisions to the respective High Courts.
12. Impact of various provisions covering income tax dues, contingencies and other accounting entries deserving attention.
13. Statement to bear costs, expenses etc. in connection with the scheme by transferee company.
14. Qualifications attached to the Scheme, requiring various approvals and sanctions etc.
15. Enhancement of borrowing limits of the transferee company upon the scheme coming into effect.
16. Surrender of shares by shareholder of transferor company for exchange into new share certificates.

Approval of Scheme

— It would be necessary to convene a Board Meeting of both the transferor and transferee companies for approving the Scheme of Amalgamation, Explanatory Statement under Section 393 and the Valuation Report including the swap ratio.

— Notice has to be given to the regional Stock Exchanges and other Stock Exchanges where shares of the Company are listed under the listing requirements at least two days before the Board Meeting is proposed to be held for purpose of approving the Amalgamation.

— Within 15 minutes after the Board Meeting, the Regional Stock Exchange and all other Stock Exchanges are required to be given intimation of the decision of the Board as well the swap ratio before such information is given to the shareholders and the media.

— Pursuant to clause 24 of the listing agreement, all listed companies shall have to file scheme/petition proposed to be filed before any Court/Tribunal under Sections 391, 394 and 101 of Companies Act, 1956, with the stock exchange, for approval, at least a month before it is presented to the Court or Tribunal.

Application to High Court seeking direction to hold meetings

Rule 67 of the Companies (Court) Rules, 1959 lays down that an application under Section 391(1) of the Companies Act, 1956 for an order seeking direction for convening meeting(s) of creditors and/or members or any class of them shall be by way of Judge's summons supported by an affidavit. A copy of the proposed scheme should be annexed to the affidavit as an exhibit thereto. The summons should be moved ex parte in Form No. 33 of the Companies (Court) Rules, 1959. The affidavit in support of the application should be in Form No. 34.

Jurisdiction of High Court

As explained earlier if the registered offices of both the companies are situated in the same State, a joint application or separate applications should be moved to the High Court having jurisdiction over the State in which registered offices of the companies are situated. However, if the registered offices of the companies involved are situated in different States, they should make separate applications to their respective High Courts. Accordingly, an application should be made to the concerned High Court under Section 391(1) of the Companies Act, 1956 in accordance with the provisions of rule 67 of the Companies (Court) Rules, 1959, for an order directing convening of meeting(s) of creditors and/or members or any class of them, by a Judge's summons supported by an affidavit. Normally, an application under Section 391 of the Act is made by the company, but a creditor or a member may also make the application. Although a creditor or a member or a class of creditors or a class of members may move an application under Section 391(1) of the Act, yet, such an application may not be accepted by the court because the scheme of compromise or arrangement submitted to the court along with the application will not have the approval of the Board of directors of the company or of the company in general meeting. However, the court has the discretion to give such directions as it may deem proper. Where the company is not the applicant Rule 68 lays down that where the company is not the applicant, a copy of the summons and of the affidavit shall be served on the company, or, where the company is being wound up on the liquidator not less than 14 days before the date fixed for the hearing of the summons. Where an arrangement is proposed for the merger or for the amalgamation of two or more companies, the petition must pray for appropriate orders and directions under Section 394 of the Act for facilitating the reconstruction or amalgamation of the company or companies.

Obtaining order of the court for holding class meeting(s)

On receiving a petition the court may order meeting(s) of the members/creditors to be called, held and conducted in such manner as the court directs. Once the ordered meetings are duly convened, held and conducted and the scheme is approved by the prescribed majority in value of the members/creditors, the court is bound to sanction the scheme. The court looks into the fairness of the scheme before ordering a meeting because it would be no use putting before the meeting, a scheme containing illegal proposals which are not capable of being implemented. At that stage, the court may refuse to pass order for the convening of the meeting. According to

Rule 69 of the said Rules, upon hearing of the summons, or any adjourned hearing thereof, the judge shall, unless he thinks fit for any reasons to dismiss the summons, give directions as he may think necessary in respect of the following matters:

(i) determining the members/creditors whose meeting or meetings have to be held for considering the proposed scheme of merger or amalgamation;
(ii) fixing time and place for such meetings;
(iii) appointing a chairman or chairmen for the meetings;
(iv) fixing quorum and procedure to be followed at the meetings including voting by proxy;
(v) determining the values of the members/creditors, whose meetings have to be held;
(vi) notice to be given of the meetings and the advertisement of such notice; and
(vii) the time within which the chairman of the meeting or chairmen of the meetings are to report to the Court the result of the meeting or meetings as the case may be.

The order made on the summons shall be in Form No. 35 of the said rules, with such variations as may be necessary. Draft Notice, Explanatory statement under Section 393 of the Companies Act, 1956 and form of proxy are required to be filed and settled by the concerned High Court before they can be printed and dispatched to the shareholders. After obtaining the court's order containing directions to hold meeting(s) of members/creditors, the company should make arrangement for the issue of notice(s) of the meeting(s). The notice should be in Form No. 36 of the said Rules and must be sent by the person authorised by the court in this behalf. The person authorised may be the person appointed by the court as chairman of the meeting, or if the court so directs by the company or its liquidator if the company is in liquidation, or by any other person as the court may direct. The court usually appoints an advocate to be the chairman of such a meeting. Notice of the meeting should be sent under certificate of posting to the creditors/members of the company, at their last known addresses at least twenty-one clear days before the date fixed for the meeting. The notice must be accompanied by a copy of the scheme for the proposed compromise or arrangement and of the statement required to be furnished under Section 393 setting forth the terms of the proposed compromise or arrangement explaining its effects and an explanatory statement in terms of the provision of clause (a) of Sub-section (1) of Section 393 of the Companies Act. A form of proxy in Form No. 37, as prescribed in the said rules, is also required to be sent to the shareholders/creditors to enable them to attend the meeting by proxy, if they so desire.

Notice by advertisement

Generally, the Court directs that the notice of meeting of the creditors and members or any class of them be given through newspapers advertisements also. Where the court has directed that the

notice of the meetings should also be given by newspaper advertisements, such notices are required to be given in the prescribed Form No. 38 and published once in an English newspaper and once in the regional language of the state in which the registered office of the company is situated. The Court may also direct the notices of the meetings to be published in Official Gazette of the state. The notice of the advertisement will indicate that a copy of the notice is available free of charge to every member. It will also be made available within 24 hours of the requisition made by the creditor or shareholders. The notice must particularly disclose any material interest of the directors, managing director or manager whether as shareholders or creditors or otherwise and the effect on their interests on the compromise or arrangement, if, and in so far as, it is different from the effect on the like interests of other persons. Such information must also be included in the form of a statement in the notice convening the meeting, where such notice is given by a newspaper advertisement, or, if this is not practicable, such advertised notice must give notification of the place at and the manner in which creditors or members entitled to attend the meeting may obtain copies of such a statement. If debenture holders are affected, the statement must give like information as far as it affects the trustees for the debenture holders. Statements which have to be supplied to creditors and members as a result of press notification must be supplied by the company to those entitled, free of charge [Refer Section 393]. The Chairman appointed by the High Court has to file an affidavit atleast 7 days before the meeting confirming that the direction relating to issue of notices and the advertisement has been duly complied with, as required under Rule 76 of the said Rules.

Information as to merger or amalgamation

Section 393(1) of the Companies Act, 1956 lays down that where a meeting of creditors or members or any class of them is called under Section 391:

(a) with every notice calling the meeting which is sent to a creditor or a member, there shall be sent also a statement setting forth the terms of the compromise or arrangement and explaining its effects and in particular, stating any material interests of the directors, managing director or manager of the company, whether in their capacity as such or as members or creditors of the company or otherwise and the effect on those interests, of the compromise or arrangement, if, and in sofar as, it is different from the effect on the like interests of other persons; and

(b) in every notice calling the meeting which is given by advertisement, there shall be included either such a statement as aforesaid or a notification of the place at which and the manner in which creditors or members entitled to attend the meeting may obtain copies of such a statement

as aforesaid. Sub-Section (2) lays down that where the arrangement affects the rights of debenture holders of the company, the said statement should give the like information and explanation as respects the trustees of any deed for securing the issue of the debentures as it is required to give as respects the company's directors.

According to Sub-section (3) of Section 393, where a notice given by advertisement includes a notification that copies of the statement setting forth the terms of the compromise or arrangement proposed and explaining its effect can be obtained by creditors or members entitled to attend the meeting, every creditor or member so entitled shall, on making an application in the manner indicated by the notice, be furnished by the company, free of charge, with a copy of the statement. Every director, managing director or manager of the Company and every trustee for debenture holders of the company, must give notice to the company of such matter relating to himself as may be necessary for the purposes of this section. A failure to do so is an offence punishable under Section 393(5).

Holding meeting(s) as per Court's direction

The meetings are to be held as per directions of the Court under the chairmanship of the person appointed by the Court for the purpose. Normally, the Court appoints a Chairman and alternate Chairman of each meeting.

Convening of General Meeting

— At the General Meeting convened by the High Court, resolution will be passed approving the scheme of amalgamation with such modification as may be proposed and agreed to at the meeting. The Extraordinary General Meeting of the Company for the purpose of amendment of Object Clause (Section 17), commencement of new business [Section 149(2A)], consequent change in Articles (Section 31) and issue of shares [Section 81(1A)] can be convened on the same day either before or after conclusion of the meeting convened by the High Court for the purpose of approving the amalgamation.

— Following points of difference relating to the holding and conducting of the meeting convened by the High Court may be noted:

(a) Proxies are counted for the purpose of quorum;

(b) Proxies are allowed to speak;

(c) The vote must be put on poll [Rule 77 of the Companies (Court) Rules].

In terms of Section 391, the resolution relating to the approval of amalgamation has to be approved by a majority of members representing three-fourths in value of the creditors or class of creditors or members or class of members as the case may be present and voting either in person or by proxy. The resolution will be passed only if both the criteria namely, majority in number and three fourth in value vote for the resolution.

— The minutes of the meeting should be finalised in consultation with the Chairman of the meeting and should be signed by him once it is finalised and approved. Copies of such minutes are required to be furnished to the Stock Exchange in terms of the listing requirements.

Reporting of the Results

The chairman of the meeting will submit a report of the meeting indicating the (c)\ results to the concerned High Court in Form 39 of the Court Rules within 7 days of the conclusion of the meeting or such other time as fixed by the Court. The Report must state accurately

(a) the number of creditors or class of creditors or the number of members or class of members, as the case may be, who were present at the meeting;

(b) the number of creditors or class of creditors or the number of members or class of members, as the case may be, who voted at the meeting either in person or by proxy;

(c) their individual values; and

(d) the way they voted.

Petition to court for confirmation of scheme

When the proposed scheme of compromise or arrangement is agreed to, with or without modifications, as provided in Section 391(2) of the Act, a petition must be made to the court for confirmation of the scheme of compromise or arrangement. The petition must be made by the company and if the company is in liquidation, by the liquidator, within seven days of the filing of the report by the chairman. The petition is required to be made in Form No. 40 of the said rules. On hearing the petition the Court shall fix the date of hearing and shall direct that a notice of the hearing shall be published in the same newspapers in which the notice of the meeting was advertised or in such other papers as the court may direct, not less than 10 days before the date fixed for hearing. (Rule 80) The court also directs that notices of petition be sent to the concerned Regional Director, Registrar of Companies and the official liquidator.

Obtaining order of the court sanctioning the scheme

An order of the court on summons for directions should be obtained which will be in Form No. 41 (Refer Rule 69).

Filing of copy of Court's order with ROC

According to the provisions of Section 391(3) and Section 394(3) of the Companies Act, a certified copy of the order passed by the Court under both the subsections is required to be filed with the concerned Registrar of Companies. This is required to be filed with e-Form No. 21 as prescribed in the Companies (Central Government's) General Rules and Forms, 1956.

Conditions precedent and subsequent to court's order sanctioning scheme of arrangement

The court shall not sanction a scheme of arrangement for amalgamation, merger etc. of a company which is being wound up with any other company or companies unless it has received a report from the Company Law Board (Central Govt. Acting through Regional Director) or the Registrar of Companies to the effect that the affairs of the company have not been conducted in a manner prejudicial to public interest. When an order has been passed by the court for dissolution of the transferor company, the transferor company is required to deliver to the Registrar a certified copy of the order for registration within thirty days and the order takes effect from the date on which it is so delivered. Copies of the order of High Court are required to be affixed to all copies of Memorandum and Articles of Association of the transferee company issued after certified copy has been filed as aforesaid. The transferor company or companies will continue in existence till such time the court passes an order for dissolution without winding up, prior to which it must receive a report from the official liquidator to the effect that the affairs of the company have not been conducted in a manner prejudicial to the interest of the members or to public interest. The practice in India is that in certain High Courts the Order on amalgamation is passed only after the Report of the Official Liquidator is received, whereas in certain cases the order of dissolution is passed after which amalgamation is approved by the concerned High Court. The above sets out briefly the procedure relating to merger and amalgamation in India. It will be obvious from the foregoing that considerable amount of paper work and documents are required to be prepared during the course of the process of merger. Since the law requires approval of the shareholders both in majority in number and three-fourth in value, it has to be ensured that adequate number of shareholders, whether in person or by proxy attend the meeting so that the resolution can be passed by the requisite majority as mentioned above. Normally the

time frame for such merger will depend on the opposition, if any, to the proposed merger from shareholders or creditors but in normal case it may take anything between six months to one year to complete the merger from the time the Board approves the scheme of amalgamation till the merger becomes effective on filing of the certified copies of the Court's Order.

Activity schedule for planning a merger

Sl. Activity Action to be taken for completion of activity Time required for (1) (2) (3) (4)

1. Objects clause to be examined Check the object clause of the transferor and transferee company with regard to the power of amalgamation. Min. 4 months Max. 8 months Check the object clause of the transferee company regarding power to carry on the business of the transferor company; if not, it is necessary to amend the Objects Clause. Check if authorised capital of the transferee company is sufficient; if not it is to be amended.

2. Preparation of Scheme of Amalgamation. Max. 30 days after the draft of scheme of amalgamation is complete - preferably within a month of effective date.

3. Board meeting of both the transferor and transferee companies to be held. Notice, Agenda of the Board Meeting to be sent. Board Meeting to be held. Agenda for Board Meeting will include the following items:

Effective date to be announced: Approval of the scheme of amalgamation Approval of Ratio (1) (2) (3) (4) Directors/Officers to be empowered to make application to appropriate High Courts and to take necessary action.

4. Stock Exchange Immediately after the board meeting approving the scheme/ exchange ratio, both companies will have to inform the respective stock exchanges. It is to be done on the same day as the day of Board meeting.

5. Press Release The news may be released to the press for information and others.

6. Financial Institutions/ Banks/Trustees to Debenture holders, if any, to be formally advised their consent sought. Financial institutions/trustees to Debenture holders, if any to be formally advised and their consent sought. At least 45 days before Board meeting at 3 above so that at the time of Board Meeting, formal approval is received.

7. Application to the High Court An application to the High Court concerned both to the transferor and transferee companies will have to be made under Companies (Court) Rules, 1959, for summons for direction to convene the meeting in Form No. 33 of he Companies (Court) Rules, 1959. Affidavit in support of summons will be in Form 34 of the Companies (Court) Rules, 1959. Appointing chairman of the meeting. Fix quorum of the meeting. It normally takes

10 days after application for the matter to come up. During the month of June/Dec., Court vacation time to be borne in mind. An order by judge in summons convening meeting of the members of the transferor and transferee companies to approve the scheme and for (1) (2) (3) (4) approval. This will be in Form No. 35 of Companies (Court) Rules, 1959. If the transferee/ transferor company is a potentially sick company, the provisions of SICA to be borne in mind. If there are any calls in arrears of transferor company, the High Court direction to be sought specifically. In case of a merger of a potentially sick company with a healthy company, the possibility of reducing the share capital of the sick company to the extent of losses to be considered and procedure for reduction to be undertaken. This would have an effect on the EPS of the merged company.

8. Notices of Extra Ordinary General Meeting. Notices and Statements under Section 393 of the Act will have to be printed. It will be in Form No. 36 of Companies (Court) Rules, 1959. Take approval of the draft of notice from Registrar of High Court - period involved 5 days. Max. 20 days. Proxy Forms in Form No. 37 will have to be sent along with the notice. Hall for the meetings to be finalised. (1) (2) (3) (4) Notices will be in Form No. 36 and will be sent to individual members in the name of the Chairman of the meeting concerned, as required by Rule 73. Notice should be accompanied with

— the statement.

— a copy of the scheme.

— form of proxy.

The Notice will be advertised in the newspapers in such manner as the court may direct not less than 21 clear days before the meeting. The advertisement will be in Form No. 38.

9. Meetings of Members The meetings will be held as scheduled. The management will answer the queries of the members, permitted by the Chair. The decision of the meeting will ascertained by poll only (Rule 77). Approval is required of a majority in number of persons present and voting representing three-fourths in value of the members. Within 30 days of Notice of meeting. Chairman of each meeting will within the time fixed by the Judge (or within 7 days of the meeting) submit a report in\ No. 39. Within 1 to 7 days of meeting. (1) (2) (3) (4)

10. Petition to Court Where the scheme is approved by members, the companies will within 7 days of filing of the\ report by the Chairman present a petition to the Court for confirmation of the scheme. The petition will be in Form No. 40. A copy of the petition will be served on the Regional Director, Company Law Board and others as directed by the Court.

11. Directions on the Petition. The Court will fix a date for the hearing of the petition. The Court will also direct official liquidator to scrutinize the books of the transferor company and submit a report thereon in terms of Section 394 of the act. Within 4 to 5 months of general meeting.

12. Notice of the hearing Notice of the hearing will be advertised in the same papers as the Court may direct not less than 10 days before the date fixed for the hearing.

13. Official Liquidator's Report. The Official liquidator upon directions of the Court will be required to inspect the books of the transferor company and report that the affairs of the company have not been conducted in a manner prejudicial to the interest of its members or to public interest. The official liquidator may nominate a chartered accountant from his panel to conduct the inspection and report to him. He may direct that inspection should cover 3- 5 years. The fees payable will also be fixed. 2 to 5 months depending upon the size of the company. (1) (2) (3) (4)\ The official liquidator's\ representative will visit the company's office and particulars required will be furnished to him. On the basis of the reports of the representatives, the official liquidator will submit his report to the court. Thereupon the Court will order dissolution.

14. Hearing and Order. Any person interested including creditors and employees may appear before the Court and make submissions. The order of the Court may include such directions with regard to any matter and such modifications in the scheme as the Judge may think fit to make for the proper working of the Scheme. The order will direct that a certified copy of the same should be filed with the Registrar of companies within 14 days from the date of the order or such other time as may be fixed by the Court. The order will be in Form 41 with such variations as may be necessary. The order may include order for dissolution of the transferor company if the Official Liquidator\ has submitted the report. The Court may make any provision for any person who dissents from the scheme. The order will not have any effect till a certified copy is filed with the Registrar. Within 10 to 14 days from the date of Court order.

15. Filing/Annexing Within 30 days of the making of the order, a certified copy thereof will be filed with the Registrar of Companies. In computing the period of 30 days the time taken in obtaining certified copy has to be excluded.\ A copy of the Court's order will be annexed to every copy of the memorandum and articles of association of the transferee company.

16. FEMA Approval of Reserve Bank of India will be obtained for allotment of shares to non-residents under FEMA. To be done around the time of Court order.

17. Effective Date As soon as the scheme has become effective, particulars will be intimated through press and to the government authorities, banks, creditors, customers and others. Certified copy of the Court order will be given where necessary.

Judicial pronouncements and important factors

Broad Principles evolved by Courts in Sanctioning the Scheme

(a) The resolutions should be passed by the statutory majority in accordance with Section 391(2) of Companies Act, at a meeting(s) duly convened and held. The court should not usurp the right of the members or creditors;

(b) Those who took part in the meetings are fair representative of the class and the meetings should not coerce the minority in order to promote the adverse interest of those of the class whom they purport to represent;

(c) the scheme as a whole, having regard to the general conditions and background and object of the scheme, is a reasonable one ; it is not for court to interfere with the collective wisdom of the shareholders of the company. If the scheme as a whole is fair and reasonable, it is the duty of the court not to launch an investigation upon the commercial merits or demerits of the scheme which is the function of those who are interested in the arrangement;

(d) There is no lack of good faith on the part of the majority;

(e) The scheme is not contrary to public interest;

(f) The scheme should not be a device to evade law.

In Miheer H Mafatlal v. Mafatlal Industries Ltd. (1996) 4 Comp. LJP. 124, The Supreme Court explained the contours of the court jurisdictions, as follows:

(i) The sanctioning court has to see to it that all the requisite statutory procedures for supporting such a scheme have been complied with and that the requisite meetings as contemplated by Section 391(1)(a) of the Companies Act, 1956 have been held.

(ii) That the scheme put up for sanction of the court is backed up by the requisite majority vote as required by Section 391(2) of the Act.

(iii) That the concerned meetings of the creditors or members or any class of them had the relevant material to enable the voters to arrive at an informed decision for approving the scheme in question. That the majority decision of the concerned class of voters is just and fair to the class as a whole so as to legitimately bind even the dissenting members of that class.

(iv) That all the necessary material indicated by the Section 393(1)(a) of the Act is placed before the voters at the concerned meetings as contemplated by Section 391(1) of the Act.

(v) That all the requisite material contemplated by the proviso of Sub-section (2) of Section 391 of the Act is placed before the court by the concerned applicant seeking sanction for such a scheme and the court gets satisfied about the same.

(vi) That the proposed scheme of compromise and arrangement is not found to be violative of any provision of law and is not contrary to public policy. For ascertaining the real purpose underlying the scheme with a view to be satisfied on this aspect, the court, if necessary, can pierce the veil of apparent corporate purpose underlying the scheme and can judiciously x-ray the same.

(vii) That the Company Court has also to satisfy itself that members or class of members or creditors or class of creditors, as the case may be, were acting bona fide and in good faith and were not coercing the minority in order to promote any interest adverse to that of the latter comprising of the same class whom they purported to represent.

(viii) That the scheme as a whole is also found to be just, fair and reasonable from the point of view of prudent men of business taking a commercial decision beneficial to the class represented by them for whom the scheme is meant.

(ix) Once the aforesaid broad parameters about the requirements of a scheme for getting sanction of court are found to have been met, the court will have no further jurisdiction to sit in appeal over the commercial wisdom of the majority of the class of persons who with their open eyes have given their approval to the scheme even if in the view of the court, there could be a better scheme for the company and its members or creditors for whom the scheme is framed. The court cannot refuse to sanction such a scheme on that ground as it would otherwise amount to the court exercising appellate jurisdiction over the scheme rather than its supervisory jurisdiction.

9.3 SUMMARY

For mergers and amalgamations, the procedure as detailed in the chapter needs to be complied with. Amalgamation can be effected in various ways viz., transfer of undertaking by order of the High Court, purchase of shares of one company by another company, amalgamation of companies in national interest, amalgamation of companies under Section 494 of the Companies Act, where the liquidator of a company transfers its assets and liabilities to another company.

9.4 KEY WORDS

1. FEMA: Foreign Exchange Management Act
2. ROC: Registrar of Companies

9.5 SELF ASSESSMENT QUESTIONS

1. Briefly explain procedure in mergers and amalgamation
   …………………………………………………………………………………………………
   …………………………………………………………………………………………………..
2. Explain the jurisdiction of High Court in mergers and amalgamation
   …………………………………………………………………………………………………
   ………………………………………………………………………………………………….
3. Briefly state documentation process for mergers and amalgamation
   …………………………………………………………………………………………………
   …………………………………………………………………………………………………

9.6 REFERENCES

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UNIT-10 DEMERGER; INTRODUCTION AND MEANING; DIFFERENCE BETWEEN DEMERGER AND RECONSTRUCTION; STEPS INVOLVED IN DEMERGER; ACCOUNTING AND TAXATION ASPECT IN DEMERGER; REVERSE MERGER

Structure

10.0 Objectives
10.1 Introduction
10.2 Demerger; Introduction and meaning
10.3 Difference between demerger and reconstruction
10.4 Accepts Involved in demerger.
10.5 Accounting and Taxation aspect in demerger.
10.6 Reverse mergers.
10.7 Summary.
10.8 Key words.
10.9 Self Assessment Questions
10.10 References

10.0 OBJECTIVES

1. To understand the difference between demerger and reconstruction
2. To understand the legal aspects of demerger
3. To know spin off and split off
4. To analyse the reverse merger

10.1 INTRODUCTION

Demergers are recognized and accepted as a mode of industrial restructuring. In the wake of liberalisation and globalisation, various tax incentives like carry forward of accumulated losses and unabsorbed depreciation have been provided. Modes, procedural and taxation aspects of demerger are covered under this study. After going through this chapter, students will be able to understand.

10.2 DEMERGER; INTRODUCTION AND MEANING

In the era of globalization, corporate all over the world are moving towards consolidation and redefining core competencies to survive and achieve their objectives. The corporate sector in India is also resorting to various mechanism of corporate restructuring to improve efficiency. Over the last few years, different modes of corporate restructuring such as stock splits, capital restructuring, mergers and acquisitions etc. have been adopted by companies in India. Companies have to downsize or 'contract' their operations in certain circumstances such as when a division of the company is performing poorly or simply because it no longer fits into the company's plans or to give effect to rationalisation or specialisation in the manufacturing process. This may also be necessary to undo a previous merger or acquisition which proved unsuccessful. This type of restructuring can take various forms such as demerger or spin off, split off, etc. Large entities sometimes hinder entrepreneurial initiative, side-line core activities, reduce accountability and promote investment in non-core activities. There is an increasing realisation among companies that demerger may allow them to strengthen their core competence and realise the true value of their business. 'Demerger' is often used to describe division or separation of different undertakings of a business, functioning hitherto under a common corporate umbrella. The Companies Act, 1956 does not contain the concept of 'de-merger' as such, but it does indirectly recognize it in:

(a) Section 391/394 (as a scheme of compromise, arrangement or reconstruction) and,
(b) Section 293(1)(a) (sale, lease or otherwise dispose of—
    (i) the whole of the undertaking of the company; or
    (ii) substantially the whole of the undertaking of the company; or

(iii) if the company owns more than one undertaking, of the whole, or substantially the whole, of any such undertaking).

"A scheme of demerger, is in effect a corporate partition of a company into two undertakings, thereby retaining one undertaking with it and by transferring the other undertaking to the resulting company. It is a scheme of business reorganization," Justice N.V. Balasubramaniam J in Lucas TVS Ltd. in Re. CP No. 588 and 589 of 2000 (Mad-Unreported). Such a split or division may take place for various reasons e.g. a conglomerate company carrying out various activities might transfer one or more of its existing activities to a new company for carrying out rationalisation or embarking specialisation in the manufacturing process. Also, such a transfer might be of a less successful part of the undertaking to a newly formed company. The new company and transferee, need not be the subsidiaries of the parent company which has affected/undergone such split or division. The term "Demerger" has not been defined in the Companies Act, 1956. However, it has been defined in Sub-section (19AA) of Section 2 of the Income-tax Act, 1961. According to the said Sub-section, "demerger" in relation to companies, means transfer, pursuant to a scheme of arrangement under Sections 391 to 394 of the Companies Act, 1956, by a demerged company of its one or more undertakings to any resulting company in such a manner that—

(i) all the property of the undertaking being transferred by the demerged company, immediately before the demerger, becomes the property of the resulting company by virtue of the demerger;
(ii) all the liabilities relatable to the undertaking, being transferred by the demerged company, immediately before the demerger, become the liabilities of resulting company by virtue of the demerger;
(iii) the property and the liabilities of the undertaking or undertakings being transferred by the demerged company are transferred at values appearing in its books of account immediately before the demerger;
(iv) the resulting company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis;
(v) the shareholders holding not less than three fourths in value of the shares in the demerged company (other than shares already held therein immediately before the demerger or by a nominee for, the resulting company or, its subsidiary) become shareholders of the resulting company or companies by virtue of the demerger, otherwise than as a result of the acquisition of the property or assets of the demerged company or any undertaking thereof by the resulting company;
(vi) the transfer of the undertaking is on a going concern basis;
(vii) the demerger is in accordance with the conditions, if any, notified under Subsection (5) of Section 72A of the Income Tax Act, 1961 by the Central Government in this behalf.

From the above, the following points emerge about demergers:

1. Demerger is essentially a scheme of arrangement under Sections 391 to 394 of the Companies Act, 1956 requiring approval by:

    (i) majority of shareholders holding shares representing three-fourths in value in meeting convened for the purpose; and

    (ii) sanction of High Court.

2. Demerger involves 'transfer' of one or more 'undertakings'.

3. The transfer of 'undertakings' is by the demerged company, which is otherwise known as transferor company. The company to which the undertaking is transferred is known as resulting company which is otherwise known as 'transferee company'.

10.3 DIFFERENCE BETWEEN DEMERGER AND RECONSTRUCTION

As discussed above, "demerger" means transfer, pursuant to a scheme of arrangement under Sections 391 to 394 of the Companies Act, 1956, by the demerged company of its one or more undertakings to a new company formed for the purpose, known as the resulting company, in such a manner that all the property of the undertaking, being transferred by the demerged company becomes the property of the resulting company by virtue of the demerger; all the liabilities relatable to the undertaking, being transferred by the demerged company become the liabilities of the resulting company by virtue of the demerger; the property and the liabilities of the undertaking or undertakings being transferred by the demerged company are transferred at values appearing in its books of account immediately before the demerger. In the case of reconstruction, a new company (hereinafter referred to as 'transferee company') is formed, the existing company (hereinafter referred to as 'transferor company') is dissolved by passing a special resolution for members' voluntary winding up and authorising the liquidator to transfer the undertaking, business, assets and liabilities of the transferor company to the transferee company. The transferee company pays the consideration by issue and allotment of its shares to the shareholders of the transferor company in accordance with the pre-determined share exchange ratio. In this process, the old company is liquidated and is reconstructed in the form of a new company with substantially the same shareholders, same undertaking and business. The difference between the two terms comes to the light only when a scheme of arrangement is made for sanction by the court. Demerger forms part of a scheme of compromise or arrangement within the ambit of Sections 391 to 394A of the Companies Act, 1956. In addition, demergers

which envisage the reduction of share capital, will attract other provisions of the Companies Act, 1956, including Sections 100 to 104. The company will have to pass a special resolution for reduction of its share capital, which is subject to confirmation by the Court as per Section 101 of the Companies Act, 1956. The articles of association of the company should have a provision permitting reduction of share capital and its memorandum of association should provide for demerger, split, etc. Section 390(b) of the Companies Act, 1956 interprets 'arrangement' appearing in Sections 391 or 393 as including 'division' of shares into shares of different classes. The expression 'reconstruction' on the other hand has been used in Section 394 of the Companies Act along with the term amalgamation. One of the methods of achieving a demerger is through a scheme of reconstruction. A demerger represents a milestone and is not the final step in the process of corporate restructuring. After the demerger, companies can pursue their separate strategies to enhance shareholder value and further streamline their respective portfolios.

Difference between demerger and reconstruction;

As discussed above, "demerger" means transfer, pursuant to a scheme of arrangement under Sections 391 to 394 of the Companies Act, 1956, by the demerged company of its one or more undertakings to a new company formed for the purpose, known as the resulting company, in such a manner that all the property of the undertaking, being transferred by the demerged company becomes the property of the resulting company by virtue of the demerger; all the liabilities relatable to the undertaking, being transferred by the demerged company become the liabilities of the resulting company by virtue of the demerger; the property and the liabilities of the undertaking or undertakings being transferred by the demerged company are transferred at values appearing in its books of account immediately before the demerger. In the case of reconstruction, a new company (hereinafter referred to as 'transferee company') is formed, the existing company (hereinafter referred to as 'transferor company') is dissolved by passing a special resolution for members' voluntary winding up and authorising the liquidator to transfer the undertaking, business, assets and liabilities of the transferor company to the transferee company. The transferee company pays the consideration by issue and allotment of its shares to the shareholders of the transferor company in accordance with the pre-determined share exchange ratio. In this process, the old company is liquidated and is reconstructed in the form of a new company with substantially the same shareholders, same undertaking and business. The difference between the two terms comes to the light only when a scheme of arrangement is made

for sanction by the court. Demerger forms part of a scheme of compromise or arrangement within the ambit of Sections 391 to 394A of the Companies Act, 1956. In addition, demergers which envisage the reduction of share capital, will attract other provisions of the Companies Act, 1956, including Sections 100 to 104. The company will have to pass a special resolution for reduction of its share capital, which is subject to confirmation by the Court as per Section 101 of the Companies Act, 1956. The articles of association of the company should have a provision permitting reduction of share capital and its memorandum of association should provide for demerger, split, etc. Section 390(b) of the Companies Act, 1956 interprets 'arrangement' appearing in Sections 391 or 393 as including 'division' of shares into shares of different classes. The expression 'reconstruction' on the other hand has been used in Section 394 of the Companies Act along with the term amalgamation. One of the methods of achieving a demerger is through a scheme of reconstruction. A demerger represents a milestone and is not the final step in the process of corporate restructuring. After the demerger, companies can pursue their separate strategies to enhance shareholder value and further streamline their respective portfolios.

10.4 STEPS INVOLVED IN DEMERGER

1. Preparation of scheme of demerger
   - (i) Prepare a scheme of demerger in consultation with all interested parties and have the same approved in principle by the Board of Directors of the company at a meeting.
   - (ii) Appoint an expert for valuing the shares to determine the share exchange ratio.
   - (iii) Engage an advocate for the preparation of scheme and for appearing subsequently before the High Court.
   - (iv) In case of listed companies, the stock exchanges where the shares are listed should be intimated.

2. Application to court for direction to hold meetings of members/creditors

Both the companies should make an application under Section 391(1) of the Companies Act, 1956 to respective High Courts for an order to convene and hold meeting(s) of members/creditors or any class of them, by a Judge's summons supported by an affidavit. A copy of the proposed scheme of demerger should be annexed to the affidavit as an exhibit thereto. The summons should be moved ex parte.. When the company is not the applicant, a copy of summons and of affidavit shall be served on the company or where it is being wound up, on its liquidator, not less than 14 days before the date fixed for hearing the summons. Application is

to be filed to the High Court, where the Registered Office is situated, for directions to convene a meeting along with the following documents:

1. Judge's Summons [Form No. 33] under order XIV.
2. An affidavit in support of summons in Form No. 34 of Companies (Court) Rules, 1959.
3. Memorandum and Articles of Association of the company.
4. Latest Audited Balance Sheet.
5. List of Shareholders and Creditors (Optional) Scheme.
6. Extract of Board Resolution approving the scheme.
7. Draft notice of meeting, explanatory statement, proxy under Section 393 of Act. (Above documents are to be prepared separately for both transferor and transferee companies and any Director may be authorized to sign the applications).

Normally, an application under Section 391 of the Act is made by the company, but a creditor or member may also make the application. Although a creditor or a member may move an application under Section 391(1) of the Act, yet, such an application may not be accepted by court because the scheme of arrangement submitted to the court along with the application will not have the approval of the Board of directors of the company or of the company in general meeting. However, the court has the discretion to give whatever directions that it may deem proper. Before an application under Section 391 of the Act is made by a company, as a matter of common procedure, the Chairman of the Board of directors of the company which is proposed to be reconstructed by demerger should send a circular letter to the members of the company explaining details of the scheme of reconstruction and the reasons which have prompted the Board to propose reconstruction. The circular letter should specify how the scheme would affect the shareholdings of the members. Copies of the circular should also be sent to the stock exchanges, where the shares of the company or companies are listed. The petition must pray for appropriate orders and directions under Section 394 of the Act for facilitating the reconstruction (by demerger) of the company.

3. Obtaining court's order for holding meetings of members/creditors

On receiving a petition the court may order meeting(s) of the members/creditors of the company, to be called, held and conducted in a prescribed manner. Once the ordered meeting(s) is/are duly convened, held and conducted and the scheme is approved by the prescribed majority in value of the creditors or number of members, as the case may be, the court is bound to sanction the scheme. The court shall look into the fairness of the scheme before ordering meeting(s) because it would be no use putting before the meeting(s), a scheme containing proposals which are not capable of being implemented. At that stage, the court may refuse to pass an order for the

convening of the meeting(s). The court must also ensure that the circular about the details of the scheme which is sent to the members and creditors should give a fair picture of the proposed scheme.

Upon the hearing of the summons, or any adjourned hearing thereof, the judge shall, unless he thinks fit for any reason to dismiss the summons, give directions as he may think necessary in respect of the following matters:

(i) determining the class or classes of creditors and/or members whose meeting or meetings have to be held for considering the proposed scheme of demerger;
(ii) fixing the time and place for such meeting or meetings;
(iii) appointing a Chairman or Chairmen for the meeting or meetings to be held, as the case may be;
(iv) fixing the quorum and procedure to be followed at the meeting or meetings, including voting by proxy;
(v) determining the values of the creditors and/or the members, or the creditors or members of any class, as the case may be whose meetings have to be held;
(vi) notice to be given of the meeting or meetings and the advertisement of such notice; and
(vii) the time within which the Chairman of the meeting or Chairmen of the meetings should report to the Court the result of the meeting or meetings, as the case may be; and such other matters as the Court may deem necessary.

The order made on the summons should be within 3 days being received by the Companies from the Court, the companies are required to get the draft explanatory statement, notice of meeting, draft resolutions, proxy forms, publication also translated in regional language in Form No. 38 vouched by Registry of High Court.

An application under Sub-section (6) of Section 391 for stay of commencement or continuation of any suit or proceeding against the company may be moved by a Judge’s summons ex-parte, provided where a petition for winding up or that under Section 397 or 398 is pending, notice of application shall be given to petitioner where a stay order has been made. Any person aggrieved by such order may apply to the
court by a Judges summons to vacate or vary such order.

4. Notice of the meetings of members/creditors

After obtaining the court’s order containing directions to hold the meeting(s) of the creditors/members of company, the company should make arrangement for the issue of notice of the meeting(s) to them. The notice of such meeting(s) should be sent individually and must be sent by the person authorised by the court in this behalf, who may be the Chairman appointed by the court for the meeting, or if the court so directs, by the company or by any other person as the

court may direct. The notice should be sent by post under certificate of posting to their last known address at least twenty-one clear days before the date fixed for the meeting. The notice must be accompanied by a copy of the scheme for the proposed demerger and of the statement required to be furnished under Section 393 setting forth the terms of the proposed compromise or arrangement explaining its effects, and a form of proxy in Form No. 37 of the said rules. According to Rule 70 voting by proxies shall be permitted provided a proxy in the prescribed form duly signed by the person entitled to attend and vote at the meeting is filed with the company at its registered office not later than 48 hours before the meeting. Also Rules 227 to 229 relating to proxies apply to proxies lodged under this rule. The notice must particularly disclose any material interest of the directors, managing director or manager whether as shareholders or creditors or otherwise and the effect on their interests of the compromise or arrangement, if, and in so far as, it is different from the effect on the like interests of other persons. Such information must also be included in the form of a statement in the notice convening the meeting, where such notice is given by advertisement, or, if this is not practicable, such advertised notice must give notification, of the place at and the manner in which creditors or members entitled to attend the meeting may obtain copies of such a statement. If debenture holders are affected, the statement referred to must give like information as far as it affects the trustees for the debenture holders. Statements which have to be supplied to creditors and members as a result of press notification must be supplied by the company to those entitled, free of charge. (Section 393) The notice of the meeting shall be advertised in such newspapers and in such manner as the Judge may direct, not less than 21 clear days from the date fixed for the meeting. Advertisement shall be in Form No. 38. Every creditor or member entitled to attend the meeting shall be furnished by the company, free of charge and within 24 hours of a requisition being made for the same, with a copy of the proposed compromise or arrangement together with a copy of the statement required to be furnished, unless the same had already been furnished to such member/creditor. According to Rule 76, the Chairman appointed for the meeting or other person directed to issue the advertisement and the notices of the meeting shall file an affidavit not less than seven days before the date fixed for the holding of the meeting or first of the meetings, showing that the directions regarding the issue of notices and the advertisement have been duly complied with. Along with the affidavit, the paper publications, one in English and another in vernacular daily and proof of certificate of posting are to be filed one week before the date of meeting.

5. Holding meeting(s) of members/creditors

Pursuant to the directions, the meeting(s) should be held. The chairman of the meeting, or where there are separate meetings, the chairman of each meeting, shall report the result thereof to the court. The report shall state accurately the number of creditors or class of creditors or the number of members or class of members, as the case may be, who were present and who voted at the meeting either in person or by proxy, their individual values and the way they voted.

6. Reporting the result of the meeting by the Chairman to the court

The result of the meeting must be decided only by taking poll and by separately counting the votes in favour and against the resolution. The chairman of the meeting should within the time fixed by the court or where no time has been fixed, within seven days after the conclusion of the meeting, report the result of the meeting in the prescribed Form 39 to the Court. (Rule 78)

7. Petition to the court for sanctioning the scheme of demerger

When the scheme of demerger has been approved by the required majority of shareholders/creditors, i.e. majority in number representing three-fourths in value of the creditors, or class of creditors, or members or class of members, as the case may be, present and voting either in person, or, where proxies are allowed, by proxy, at the meeting, a petition must be made to the court for sanctioning the scheme of demerger. The petition must be made by the company. The petition is required to be made in Form No. 40 of the said rules. The Court shall fix a date for the hearing of the petition, and notice of hearing shall be advertised in the same papers in which notice of the meeting was advertised, or in such other papers, as the court may direct not less than 10 days before the date fixed for hearing.

8. Obtaining order of the court sanctioning the scheme

Obtain an order of the court sanctioning the scheme of demerger. Where the Court sanctions the compromise or arrangement, the order shall include such directions in regard to any matter and such modifications as the Judge may think fit. The order shall direct that a certified copy of the same shall be filed with the Registrar of Companies within 14 days from the date of the order or such other time as may be fixed by the Court. (Rule 81)

9. Court's order on petition sanctioning the scheme of demerger

Section 394 of the Act provides that where the application is made to the court under Section 391 for the sanctioning of a scheme proposed between a company and its shareholders and it is shown to the court. However, no order sanctioning any compromise or arrangement shall be made by the court unless the court is satisfied that the company or any other person by whom an application has been made has disclosed to the court, by affidavit or otherwise, all material facts relating to the company, such as the latest financial position of the company, the latest auditor's report on the accounts of the company, the pendency of any investigation proceedings in relation to the company under Sections 235 to 251 and the like. The order made by the court will have effect only after a certified copy has been filed with the Registrar of Companies in e-form 21 and will be binding on all the creditors/members, or all the creditors/members of the class, as the case may be and also on the company or, in the case of a company which is being wound up, on the liquidator and contributories of the company.

10.5 ACCOUNTING AND TAXATION ASPECT IN DEMERGER

Tax aspects of demergers: The concept of demerger of companies under the income-tax law was introduced by 'The Finance Act, 1999' with effect from assessment year 2000-01. The amendments were introduced so as to enable the Corporate Bodies to ensure that

(a) Demergers should be tax neutral and should not attract any additional liability to tax.
(b) In demergers, tax benefits and concessions available to any undertaking should be available to the said undertaking on its transfer to the resulting company.
(c) Tax benefits to such business reorganisations should be limited to the transfer of business as a going concern and not to the transfer of specific assets which would amount to the sale of assets and not a business reorganisation.
(d) The accumulated losses in a demerger should be allowed to be carried forward by the resulting company if these are directly relatable to the undertaking proposed to be transferred. However, if it is not possible to relate these to the undertaking, such losses and depreciation should be apportioned between the demerged company and the resulting company in a reasonable manner.

The benefits available for demergers have been extended to authorities or Board set up by the Central or State Governments. The Income Tax Act, 1961 provides for the following tax reliefs to the demerged company, the shareholders of the demerged company, who are issued and allotted shares in the resulting company in the exchange for the shares held by them in the demerged company and the resulting company which emerges as a result of a demerger.

Tax reliefs to demerged company

I Capital gains tax not attracted

According to Section 47(vib) of the Income-tax Act, 1961, where there is a transfer of any capital asset in a demerger by the demerged company to the resulting company, such transfer will not be regarded as a transfer for the purpose of capital gains provided the resulting company is an Indian company.

II Tax relief to a foreign demerged company

According to Section 47(vic) of the Income-tax Act, 1961, where a foreign company holds any shares in an Indian Company and transfers the same during the course of a demerger to the resulting foreign company, such transaction will not be regarded as a transfer for the purpose of capital gains under Section 45, if the following conditions are satisfied:

(a) the shareholders holding not less than three-fourths in value of the shares of the demerged foreign company continue to remain shareholders of the resulting foreign company; and

(b) such transfer does not attract tax on capital gains in the country in which the demerged foreign company is incorporated.

However, the provisions of Sections 391 to 394 of the Companies Act, 1956 will not apply in the case of demergers referred to in this clause. As per Section 47(vi d), any transfer or issue of shares by resulting company in a scheme of demerger to the shareholders of the demerged company is not regarded as if the transfer or issue is made in consideration of demerger of the undertaking.

III Tax reliefs to the shareholders of the demerged company

Consequent to the demerger, the existing shareholders of the demerged company will hold shares in the resulting company. In case the shareholder transfers these shares subsequent to the demerger, the cost of such shares will be calculated as under:

The cost of acquisition of shares in the resulting company will be the amount which bears to the cost of acquisition of shares held by the assessee in the demerged company in the same proportion as the net book value of the assets transferred in a demerger bears to the net worth of the demerged company immediately before such demerger. In other words, Cost of acquisition of Cost of acquisition of shares Net book value of assets shares in resulting = held by assesse in the

× transferred in a demerger company demerged company Net worth of the demerged company immediately before demerger.

According to Section 49(2D), the cost of acquisition of the original shares held by the shareholder in the demerged company will be deemed to have been reduced by the amount as so arrived as above. For this purpose, 'net worth' has been defined to mean the aggregate of the paid up share capital and general reserves as appearing in the books of account of the demerged company immediately before the demerger. In determining the period for which any capital asset is held by the assessee, Section 2(42A)(g) provides that in the case of a capital asset, being a share or shares in an Indian company, which becomes the property of the assessee in consideration of a demerger, there shall be included the period for which the share or shares held in the demerged company were held by the assessee.

Tax reliefs to the resulting company: The resulting company is eligible for tax reliefs if:

(a) the demerger satisfies all the conditions laid down in Section 2(19AA) of the Income-tax Act, 1961; and
(b) the resulting company is an Indian company.

The reliefs which are available to a resulting company pursuant to a scheme of demerger have been discussed in detail in the subsequent paragraphs.

Depreciation on assets transferred to resulting company: Section 32(1) of the Income-tax Act, 1961, provides that in respect of depreciation of:

i. buildings, machinery, plant or furniture being tangible assets;
ii. know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, being intangible assets acquired on or after the 1st day of April, 1998;

owned wholly or partly, by the assessee and used for the purposes of the business or profession, the following deductions shall be allowed:

(i) in the case of assets of an undertaking engaged in generation or generation and distribution of power, such percentages on the actual cost thereof to the assessee as may be prescribed;

(ii) in the case of any block of assets, such percentage on the written down value thereof as may be prescribed.

The fifth proviso to clause (ii) of Section 32(1) of the Income Tax Act, 1961, lays down that the aggregate deduction, in respect of depreciation of buildings, machinery, plant or furniture, being tangible assets or know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, being intangible assets allowable to the demerged company and the resulting company in the case of demerger, shall not exceed in any previous year the deduction calculated at the prescribed rates as if the demerger had not taken place, and such deduction shall be apportioned between the demerged company and the resulting company, in the ratio of the number of days for which the assets were used by them.

Amortisation of expenditure in case of demerger: Section 35DD(1) of the Income-tax Act, 1961 provides that where an assessee, being an Indian company, incurs any expenditure on or after the 1st day of April, 1999, wholly and exclusively for the purposes of demerger of an undertaking, the assessee will be allowed a deduction of an amount equal to one-fifth of such expenditure for each of the five successive previous years beginning with the previous year in which the demerger takes place. According to Sub-section (2), no deduction will however, be allowed in respect of such expenditure under any other provisions of the Income Tax Act.

Deduction for expenditure on prospecting etc. of certain minerals: Sub-section (7A) of Section 35E of the Income-tax Act, 1961, provides that where the undertaking of an Indian company which is entitled to the deduction under Subsection

(1) is transferred, before the expiry of the period of ten years specified in Subsection (1), to another Indian company in a scheme of demerger—
    - (i) no deduction shall be admissible under Sub-section (1) in the case of the demerged company for the previous year in which the demerger takes place; and
    - (ii)the provisions of this section shall, as far as may be, apply to the resulting company, as they would have applied to the demerged company, if the demerger had not taken place.

Sub-section (1) provides that where an assessee, being an Indian company, is engaged in any operations relating to prospecting for, or extraction or production of, any mineral and incurs after the 31st day of March, 1970, any expenditure specified in Sub-section (2), the assessee shall, in accordance with and subject to the provisions of this section, be allowed for each one of the relevant previous years a deduction of an amount equal to one-tenth of the amount of such expenditure.

Sub-section (2) lays down that the expenditure referred to in Sub-section (1) incurred by the assessee after the date specified in that sub-section at any time during the year of commercial production and any one or more of the four years immediately preceding that year, wholly and exclusively on any operations relating to prospecting for any mineral or group of associated minerals specified in Part A or Part B, respectively, of the Seventh Schedule or on the development of a mine or other natural deposit of any such mineral or group of associated minerals. Thus, where the undertaking of an Indian company which is entitled to deduction on account of prospecting of minerals, is transferred before the expiry of the period of ten years to another company in a scheme of demerger, such expenditure of prospecting, etc. which is not yet written off is allowed as a deduction to the resulting company in the same manner as would have been allowed to the demerged company. The demerged company will not be entitled to the deduction thereafter.

Resulting company as "successor in business": Clause (iv) of Explanation 2 to Sub-section (1) of Section 41 of the Income-tax Act, 1961 inserted by the Finance Act, 1999, with effect from 1st April, 2000, clarifies that where there has been a demerger, the resulting company is 'successor in business' for the purpose of Sub-section (1) of Section 41. According to Section 41(1), where an allowance or deduction has been made in the assessment for any year in respect of loss, expenditure or trading liability incurred by successor in business and he has obtained, whether in cash or in any manner whatsoever—

(a) any amount in respect of which loss or expenditure was incurred by the predecessor; or

(b) some benefit in respect of trading liability by way of remission or cessation thereof, the amount obtained by successor in business or the value of benefit occurring to him, shall be deemed to be income under the head 'profits and gains from business or profession' of the successor of that previous year.

Carry forward and set off of loss and unabsorbed depreciation allowance: The provisions relating to carrying forward and set off of accumulated loss and unabsorbed/depreciation allowance as provided under Section 72A are as under: Sub-section (4) lays down that notwithstanding anything contained in any other provisions of the Act, in the case of a demerger, the accumulated loss and the allowance for unabsorbed depreciation of the demerged company shall—

(a) where such loss or unabsorbed depreciation is directly relatable to the undertakings transferred to the resulting company, be allowed to be carried forward and set off in the hands of the resulting company;

(b) where such loss or unabsorbed depreciation is not directly relatable to the undertakings transferred to the resulting company, be apportioned between the demerged company and the resulting company in the same proportion in which the assets of the undertakings have been retained by the demerged and transferred to the resulting company, and be allowed to be carried forward and set off in the hands of the demerged company or the resulting company, as the case may be.

Sub-section (5) lays down that the Central Government may, for the purpose of this Act, by notification in the Official Gazette, specify such conditions as it considers necessary to ensure that the demerger is for genuine business purposes.

Sub-section (7) lays down that for the purposes of this section— (a) "accumulated loss" means so much of the loss of the demerged company under the head "Profits and gains of business or profession" (not being loss sustained in a speculation business) which such demerged company would have been entitled to carry forward and set off under the provisions of Section 72 if the demerger had not taken place.

Exemption from the provisions of Section 79: Sections 79 of the Income-tax Act, 1961 deals with the carry forward and set off of losses in case of certain companies. It provides that in case of a company, not being a company in which public are substantially interested, where a change in shareholding has taken place in a previous year, then no loss incurred in any year prior to the previous year's shall be carried forward and set off against the income of the previous year unless on the last day of that previous year and on the last day of the previous year in which the loss was incurred, the shares of the company carrying not less than 51% of the voting power were beneficially held by the same persons.

The second proviso to clause (a) of Section 79 of the Income-tax Act, 1961, inserted by the Finance Act, 1999, with effect from 1st April, 2000, lays down that nothing contained in Section 79 relating to carry forward and set off of losses in case of certain companies, shall apply to any change in the shareholding of an Indian company which is a subsidiary of a foreign company, as a result of demerger of a foreign company subject to the condition that fifty-one per cent

shareholders of the demerged foreign company continue to be the shareholders of the resulting foreign company.

Benefit of Depreciation: The fifth proviso to Sub-section (1) of Section 32 provides that benefit of depreciation on tangible and intangible assets available to the demerged company and the resulting company shall not exceed in the aggregate the amount of depreciation that would have been available if such a demerger had not taken place and such deduction shall be apportioned between the demerged company and the resulting company in the ratio of the number of days for which the assets were used by them.

Miscellaneous Issues: In respect of bad debts written off by the resulting company with respect to debts incurred by the demerged company, deduction will be allowed under Section 36(1)(vii). It was held in CIT v. T. Veerabhadra Rao, K. Koteshwar Rao & Co. (1985) 155 ITR 152 (SC) that the bad debts is a business relief and not a personal relief and the successor will be entitled to deduction. In terms of Section 41(4) which provides for taxing any sum recovered from a debtor which was earlier allowed as a bad debt, the resulting company may not be taxed if the debts that were written off by the demerged company are recovered by the resulting company. This is so because of the absence of any provision to tax the successor of business in case of recovery of bad debts.

10.6 REVERSE MERGER

It must be understood at the outset that amalgamation and merger are corporate restructuring methods. Both the terms are synonymous. The procedure to be adopted for both is the same and the consequences of both are also the same. For achieving amalgamation as well as merger, an existing company (which is referred to as the “amalgamating or merging or transferor company”), under a scheme of amalgamation or merger, loses its own legal identity and is dissolved without being wound up and its assets, properties and liabilities are transferred to another existing company (which is referred to as the “amalgamated or merged or transferee company”). Generally, a loss makes or less profit earning company merges with a company with track record, to obtain the benefits of economies of scale of production, marketing network, etc. This situation arises when the sick company’s survival becomes more important for strategic reasons and to conserve the interest of community.

In a reverse merger, a healthy company merges with a financially weak company. The main reason for this type of reverse merger is the tax savings under the Income-Tax Act, 1961. Section 72A ensures the tax relief, which becomes attractive for such reverse mergers, since the healthy and profitable company can take advantage of the carry forward losses/of the other company. The healthy units loses its name and surviving sick company retains its name. In the context of the Companies Act, 1956 there is no difference between a merger and a reverse merger. It is like any amalgamation. A reverse merger is carried out through the High Court route. However, where one of the merging companies is a sick industrial company in terms of the Sick Industrial Companies (Special Provisions) Act, 1985, such merger has necessarily to be through the Board for Industrial and Financial Reconstruction (BIFR). On the reverse merger becoming effective, the name and objects of the sick company (merged company) may be changed to that of the healthy company. To save the Government from social costs in terms of loss of production and employment and to relieve the Government of the uneconomical burden of taking over and running sick industrial units, Section 72A was introduced in Income Tax Act, 1961.

Salient features of reverse mergers under Section 72A

1. Amalgamation should be between the companies and none of them should be a firm of partners or sole-proprietor. In other words, partnership firm or sole proprietary concerns cannot get the benefit of tax relief under Section 72A merger.
2. The companies entering into amalgamation should be engaged in either industrial activity or shipping business or hotel with another company or banking business under Section 5(c) of the Banking Regulation Act, 1949 or Public Sector Companies engaged in the business of operation of aircraft. In other words, the tax relief under Section 72A would not be made available to companies engaged in trading activities or services.
3. After amalgamation, the "sick" or "financially unviable company" shall survive and the other income generating company shall extinct. In other words, essential condition to be fulfilled is that the acquiring company will be able to revive or rehabilitate having consumed the healthy company.
4. One of the merger partner should be financially unviable and have accumulated losses to qualify for the merger and the other merger partner should be profit earning so that tax relief to the maximum extent could be had. In other words, the company which is financially unviable should be technically sound and feasible, commercially and economically viable but financially weak because of financial stringency or lack of financial resources or its liabilities have exceeded

its assets and is on the brink of insolvency. The second requisite qualification associated with financial unviability is the accumulation of losses for past few years.

5. Amalgamation should be in the public interest i.e. it should not be against public policy, should not defeat the basic tenets of law, and must safeguard the interest of employees, consumers, customers, creditors and shareholders' apart from the promoters of the company through the revival of the company.

6. The merger should result into the following benefits to the amalgamated (acquired/target) company i.e. (a) carry forward of accumulated business losses of the amalgamating company; (b) carry forward of unabsorbed depreciation of the amalgamating company and (c) accumulated loss would be allowed to be carried forward and set of for eight subsequent years under Section 72A of the Income-tax Act, from the A.Y. 2009-10, the accumulated loss or the case may be, allowance for unabsorbed depreciation of amalgamating company shall be deemed to be the loss or as the case may be, allowance for unabsorbed depreciation of the amalgamated company for the previous year in which the amalgamation was effected and other provisions of the Income Tax Act relating to set off and carry forward of loss and allowance for depreciation.

7. Accumulated loss should arise from "Profits and Gains from business or profession" and not be loss under the head "Capital Gains" or "Speculation".

8. For qualifying carry forward loss, the provisions of Section 72 should not have been contravened.

9. Similarly for carry forward of unabsorbed depreciation the conditions of Section
32 should not have been violated.

10. Specified Authority has to be satisfied of the eligibility of the company for the relief under Section 72 of the Income-tax Act. It is only on the recommendation of the specified authority that Central Government may allow the relief.

11. The company should make an application to the "specified authority" for requisite recommendation of the case to the Central Government for granting or allowing the relief.

12. Procedure for merger or amalgamation to be followed in such cases is the same as discussed above. Specified Authority makes recommendation after taking into consideration the court's direction on scheme of amalgamation.

10.7 SUMMARY

Companies have to downsize or 'contract' their operation in certain circumstances such as when a division of the company is performing poorly or simply because it no longer fits into the

company's plans or to give effect to rationalization. Demerger is defined as division or separation of different undertakings of a business functioning hitherto under a common umbrella. Demerger may take the shape of spin off, split off or split up. Demerger may be partial or complete. Demerger may be by agreement between promoters or under scheme of arrangement with approval by the court under section 391 or under voluntary winding up. Chapter covers in detail the procedure for demerger of a company. There are various tax incentives to demerged company, to shareholders of demerged company and to resulting company. In a reverse merger, a healthy company merges with a financially weak company. The chapter provides for salient features of reverse merger and the provisions of Section 72A of Income-tax Act,1961.

10.8 KEY WORDS

1. BIFR: Board for Industrial and Financial Reconstruction
2. Reverse merger
3. Demerger
4. Reconstruction

10.9 SELF ASSESSMENT QUESTIONS

1. Briefly explain process of demergers
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…………………………………………………………………………………………
2. Explain the taxation aspects of merger
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3. What is demerger?

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10.10 REFERENCES

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BLOCK: III

UNIT-11 TAKEOVER OF UNLISTED AND CLOSELY HELD COMPANIES; TAKEOVER OF LISTED COMPANIES, LISTING AGREEMENT PROVISIONS RELATING TO TAKEOVER, SEBI GUIDELINES FOR TAKEOVER;

Structure

11.0 Objective
11.1 Introduction
11.2 Meaning and concept of takeover
11.3 Takeover of unlisted and closely held companies
11.4 Takeover of listed companies
11.5 SEBI guidelines for takeover
11.6 Summary
11.7 Key words
11.8 Self Assessment Questions
11.9 References

11.0 OBJECTIVES

1. To understand the meaning and concept of takeover
2. To analyse the legal aspects of takeover
3. To know the SEBI Regulations

11.1 INTRODUCTION

Takeovers are increasingly gaining importance and significance in Indian as well as global scenario. Takeover of a company attracts compliance of company law provisions as well as the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997. This chapter covers the meaning, concept, modes, objects, procedural and other aspects of takeovers. After going through this chapter, Students will be able to understand:

11.2 MEANING AND CONCEPT OF TAKEOVER

Takeover implies acquisition of control of a company, which is already registered, through the purchase or exchange of shares. Takeovers usually take place when shares are acquired or purchased from the shareholders of a company at a specified price to the extent of at least controlling interest in order to gain control of that company. Takeover of management and control of a business enterprise could take place in different modes. The management of a company may be acquired by acquiring the majority stake in the share capital of a company. The acquisition could take place through different methods. A person may acquire the voting shares of a listed company. A company may acquire shares of an unlisted company through what is called the acquisition under Section 395 of the Companies Act, 1956. Where the shares of the company are closely held by a small number of persons, a takeover may be effected by agreement with the holders of those shares. However, where the shares of a company are widely held by the general public, it involves the process as set out in the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997. Takeovers are taking place all over the world. Those companies whose shares are under quoted on the stock market are under a constant threat of takeover. In fact every company is vulnerable to a takeover threat. Takeover is a corporate device whereby one company acquires control over another company, usually by purchasing all or a majority of its shares. Ordinarily, a larger company takes over a smaller company. In a reverse takeover, a smaller company acquires control over a larger company. It must be noted that takeover of management is quite distinct from takeover of possession for the purpose of sale of establishment. In the former case, the underlying view is to rehabilitate the establishment by providing better management which is not so in the latter case. The takeover strategy has been

conceived to improve corporate value, achieve better productivity and profitability by making optimum use of the available resources in the form of men, materials and machines.

11.3 TAKEOVER OF UNLISTED AND CLOSELY HELD COMPANIES

The regulatory framework for controlling the takeover activities of a company consists of the Companies Act, 1956, Listing Agreement and SEBI's Takeover Code. As far as Companies Act is concerned, the provisions of Section 372A apply to the acquisition of shares through a Company. Also Section 395 of the Companies Act lays down legal requirements for purpose of take-over of an unlisted company through transfer of undertaking to another company. The takeover of a listed company is regulated by clause 40A and 40B of the Listing Agreement. These clauses in the Listing Agreement seek to regulate takeover activities independently and impose certain requirements of disclosure and transparency. The Securities and Exchange Board of India had earlier issued SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1994 which were repealed by SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 issued on 20.02.1997.

Takeover of Unlisted and Closely Held Companies

The following legal requirements are to be satisfied for the purpose of takeover of an unlisted company, which is exempt from the provisions of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997.

Transfer of undertaking to another company

It is well known that Sections 391 to 394 of the Companies Act, 1956 contains a complete code for mergers and amalgamations or arrangements or compromises. Section 395 of the Act on the other hand contains a compulsory acquisition mode for the transferee company to acquire the shares of minority shareholders of Transferor Company. Where the scheme has been approved by the holders of not less than nine tenth (90%) in value of the shares of the transferor company whose transfer is involved, the transferee company, may, give notice to any dissenting shareholders that transferee company desires to acquire their shares. The scheme shall be binding on all the shareholders of the transferor company (including dissenting shareholders), unless the Court Orders otherwise (i.e. that the scheme shall not be binding on all shareholders). Accordingly, the transferor company shall be entitled and bound to acquire these shares on the terms on which it acquires under the scheme (the binding provision). The advantage of going

through the route contained in Section 395 of the Act is the facility for acquisition of minority stake. The transferee company shall give notice to the minority dissenting shareholders and express its desire to acquire their shares within 2 months of the expiry of the period of 4 months envisaged under Section 395 of the Act. When a Company intends to take over another Company through acquisition of 90% or more in value of the shares of that Company, the procedure laid down under Section 395 of the Act could be beneficially utilized. When one Company has been able to acquire more than 90% control in another Company, the shareholders holding the remaining control in the other Company are reduced to a miserable minority. They do not even command a 10% stake so as to make any meaningful utilization of the power. Such minority cannot even call an extra-ordinary general meeting under Section 168 of the Act nor can they constitute a valid strength on the grounds of their proportion of issued capital for making an application to Company Law Board under Section 397 and 398 of the Act alleging acts of oppression and/or mismanagement. Hence the statute itself provides them a meaningful exit route. The advantage of going through the route is the facility for acquisition of minority stake. But even without going through this process, if an acquirer is confident of acquiring the entire control, there is no need to go through Section 395 of the Act. It is purely an option recognized by the statute. The merit of this scheme is that without resort to tedious court procedures the takeover is affected. Only in cases where any dissentient shareholder or shareholders exist, the procedures prescribed by this section will have to be followed. It provides machinery for adequately safeguarding the rights of the dissentient shareholders also. Section 395 lays down two safeguard in respect of expropriation of private property (by compulsory acquisition of majority shares). First the scheme requires approval of a large majority of shareholders. Second the Court's discretion to prevent compulsory acquisition. A greater weightage given to the first would negate the other. Section 395 requires mandatory compliance of certain formalities including registration of a scheme or contract for acquisition of shares of Transferor Company. The scheme or contract between the Transferee Company and Transferor Company is solemnized with blessings of the Board of Directors of both the companies.

The Companies Act, 1956 does not contain specific provision with respect to takeover offer within the framework of compromise / arrangement. Takeovers Regulations 2011 provides for takeover of substantial stake in listed companies. Under the new Companies Act facilitates takeover offer within the framework of compromise/ arrangement [section 230(11)] (Section yet to be notified).

Compliance of SEBI takeover code, Stock Exchange formalities have also to be borne in mind. After the takeover, the resulting entities will have the holding and subsidiary relationship with the Transferor Company becoming a wholly owned subsidiary of the transferee Company. When a holding company wants to sell immovable properties to the other, or the vice versa or when the sale is between two subsidiaries of the same holding company, there are certain advantages. The Stamp Act as in force in many states such as the State of Tamilnadu exempts such sale from payment of stamp duty. The Income Tax Act exempts such transfer from the purview of the capital gains tax. But the concession under the Income Tax Act is available only if the holding and subsidiary is maintained for a minimum period of 8 years. The takeover achieved in the above process through this Section 395 of the Act will not fall within the meaning of amalgamation under the Income Tax Act and as such benefits of amalgamation provided under the said Act will not be available to the acquisition under consideration. The takeover in the above process will not enable carrying forward of unabsorbed depreciation and accumulated losses of the transferor Company in the transferee Company for the reason that the takeover does not result in the transferor Company losing its identity.

11.4 TAKEOVER OF LISTED COMPANIES, LISTING AGREEMENT PROVISIONS RELATING TO TAKEOVER

Takeover of companies whose securities are listed on one or more recognized stock exchanges in India is regulated by the provisions of the Listing Agreements with various stock exchanges and the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 (the Regulations). Therefore, before planning a takeover of a listed company, any acquirer should understand the compliance requirements under the Regulations and also the requirements under the Listing Agreement and the Companies Act. There could also be some compliance requirements under the Foreign Exchange Management Act if acquirer were a person resident outside India.

1. Listing Agreement

The reporting format for shareholding pattern: It has been decided to revise the existing reporting format of shareholding pattern provided in Clause 35 of the Listing Agreement. The shareholding pattern will now be indicated under three categories, viz., "shares held by promoter and promoter group", "shares held by public" and "shares held by custodians and against which Depository Receipts have been issued,". Further, details such as number of shareholders, number

and percentage of shares held, number of shares held in dematerialized form, shareholding as percentage of total number of shares, shares pledged otherwise encumbered etc.

Conditions for continued listing:

Clauses 40A and 40B of the listing agreement were amended to bring them in consonance with the Regulations. These clauses are placed under the heading “Conditions for Continued Listing”.

Clause 40A – Minimum level of public shareholding

(i) The company agrees to maintain on a continuous basis, public shareholding of at least 25% of the total number of issued shares of a class or kind, for every such class or kind of its shares which are listed.

(ii) Where the company offers or has in the past offered a particular class or kind of its shares to the public to the extent of at least 10% of the issue size in terms of Rule 19(2)(b) of the Securities Contracts (Regulations) Rules, 1957, it agrees to maintain on a continuous basis, public shareholding of at least 10% of the total number of issued shares of such class or kind.

(iii) Where the number of outstanding listed shares of any class or kind of the company are two crore or more and the market capitalization of such company in respect of shares of such class or kind is Rs. 1000 crore or more, it agrees to maintain on a continuous basis, public shareholding of at least 10% of the total number of issued shares of such class or kind.

(iv) Where, as on May 1, 2006, the shares of a particular class or kind issued by the company are listed and the public shareholding in respect of shares of such class or kind is less than 25% or 10%, as the case may be, of the total number of issued shares of such class or kind, the company agrees to increase public shareholding in respect of shares of such class or kind to 25% or 10%, as the case may be, within such period as may be approved by the Specified Stock Exchange (SSE) but not exceeding two years from the said date.

Provided that the SSE may, on an application made by the company and after satisfying itself about the adequacy of steps taken by the company to increase its public shareholding and genuineness of the reasons submitted by the company for not reaching the minimum level of public shareholding and after recording reasons in writing, extend the time for compliance with the requirement of minimum level of public shareholding by a further period not exceeding one year.

(v) Where the public shareholding in a company in respect of shares of such class or kind is less than 25% or 10%, as the case may be, of the total number of issued shares of such class or kind, the company agrees not to dilute in any way its public shareholding, except for supervening extraordinary events, including, but not limited to events specified in sub-clause of Clause 40A, with the prior approval of the SSE.

(vi) The company agrees not to make any allotment of its shares to its promoters or entities belonging to its promoter group, except on account of supervening extraordinary events, including, but not limited to events specified in sub-clause (vii) of clause 40A, or make any offer to buy back its shares or buy its shares for the purpose of making sponsored issuance of depository receipts or take any other step, including issuance of depository receipts, if it results in reducing the public shareholding below the minimum level of 25% or 10%, as the case may be.

(vii) Where the public shareholding in any class or kind of shares of a company falls below the minimum level of public shareholding on account of supervening extraordinary events, including, but not limited to—

(a) issuance or transfer of shares in compliance with directions of a regulatory or statutory authority or court or tribunal;

(b) issuance or transfer of shares in compliance with the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997;

(c) re-organization of capital by way of a scheme of arrangement; and

(d) issuance or transfer of shares under a restructuring plan approved in compliance with the Corporate Debt Restructuring System laid down by the Reserve Bank of India,

the SSE may, after examining and satisfying itself about the circumstances of the case and after recording reasons in writing, extend the time for compliance with the requirement of minimum level of public shareholding by a further period not exceeding one year.

Provided that the SSE may, on an application made by the company and after satisfying itself about the adequacy of steps taken by the company to increase its public shareholding and genuineness of the reasons submitted by the company for not reaching the minimum level of public shareholding and after recording reasons in writing, extend the time for compliance with the requirement of minimum level of public shareholding by a further period not exceeding one year.

(viii) The company agrees that in the event of sub-clauses (iv) or (vii) becoming applicable, it shall forthwith adopt any of the following methods to raise the public shareholding to the minimum level:

(a) issuance of shares to public through prospectus;

(b) offer for sale of shares held by promoters to public through prospectus;

(c) sale of shares held by promoters through the secondary market; or

(d) any other method which does not adversely affect the interest of minority shareholders.

Provided that for the purpose of adopting methods specified at sub-clauses (c) and (d) above, the company agrees to take prior approval of the SSE which may impose such conditions as it deems fit.

(ix) Where a company fails to comply with this clause, its shares shall be liable to be delisted in terms of the Delisting Guidelines/Regulations, if any, prescribed by SEBI in this regard and the company shall be liable for penal actions under the Securities Contracts (Regulation) Act, 1956 and the Securities and Exchange Board of India Act, 1992.

(x) Nothing contained in sub-clauses (i) to (vii) shall apply to—

(a) a company in respect of which reference is or has been made to the Board for Industrial and Financial Reconstruction under the SickIndustrial Companies (Special Provisions) Act, 1985 or to the National Company Law Tribunal under Section 424A of the Companies Act, 1956 and such reference is pending or a company in respect of which any rehabilitation scheme is sanctioned by the Board for Industrial and Financial Reconstruction or the National Company Law Tribunal pursuant thereto and is pending full implementation or any appeal is pending regarding such reference or scheme before the Appellate Authority for Industrial and Financial Reconstruction or National Company Law Appellate Tribunal;

(b) a government company as defined under Section 617 of the Companies Act, 1956; or,

(c) an infrastructure company as defined in clause 1.2.1(xv) of the SEBI(Disclosure and Investor Protection) Guidelines, 2000.

Clause 40B – Take Over Offer

A company agrees that it is a condition for continued listing that whenever the take-over offer is made or there is any change in the control of the management of the company, the person who

secures the control of the management of the company and the company whose shares have been acquired shall comply with the relevant provisions of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997.

Under the above clause it could be seen that there is nothing except that for any purpose other than that for takeover or where the takeover results in change in the control of the management, the Regulations have to be complied with.

11.5 SEBI GUIDELINES FOR TAKEOVER

SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 are popularly known as Takeover Code. Basically these Regulations stipulate the need for certain disclosures to be made from time to time by those who acquire shares or voting rights of a listed company and also by those who are promoters or those who have control over the management of a listed company. The disclosures have to be understood in relation to each of the following questions:

— Who should disclose?

— When?

— What format?

— To whom?

The purpose of these disclosure requirements is to give the company, the public and the stock exchanges the information as soon as may be possible of acquisitions not only by acquirers but also by persons who join the main acquirer to acquire and thereby strengthen the hands of the acquirer.

Regulations 7 and 8 in Chapter II of the Regulations deal with the responsibility of acquirers and the company concerned to make disclosures at various stages.

These requirements are as follows:

Regulation 7: Acquisition of 5% or more shares or voting rights of a company:

Under Regulation 7(1), any acquirer who acquires shares or voting rights which(taken together with shares or voting rights, if any, held by him) would entitle him to more than five per cent or ten per cent or fourteen per cent or fifty four percent or seventy four percent shares or voting rights in a company, in any manner whatsoever, shall disclose at every stage the aggregate of his shareholding or voting rights in that company to the company and to the stock exchanges where shares of the target company are listed.

According to Regulation 7(1A), any acquirer who has acquired shares or voting rights of a company under Regulation 11(1), shall disclose purchase or sale aggregating two per cent or more of the share capital of the target company, to the target company and the stock exchanges where the shares of the target company are listed. The disclosure is to be made within two days of such purchase or sale along with the aggregate shareholding after such acquisition or sale.

The following are other connected requirements:

- The stock exchange concerned shall immediately display the information received from the acquirer on the trading screen, the notice board and also on its website.
- The disclosure required to be made in sub-regulation (1) and (1A) shall be made within two days of (a) the receipt of intimation of allotment of shares (b) the acquisition of shares or voting rights, as the case may be.
- Acquirer for the purpose of sub-regulations (1) and (1A) shall include a pledgee, other than a bank or a financial institution. Every company, whose shares are acquired in a manner, referred to above, shall disclose to all the stock exchanges on which the shares of the said company are listed, the aggregate number of shares held by each such person referred above, within seven days of receipt of aforesaid information.

Regulation 8: Continual Disclosure:

This regulation is very important and applies to two categories of persons. A person, who holds more than fifteen per cent shares or voting rights in any company falls under the first category. He is required to make yearly disclosure to the company, within 21 days from the financial year ending 31st March, in respect of his holdings as on 31st March. The promoter or every person having control over a company falls under the second category. He shall give his disclosure twice i.e. within 21 days from the financial year ending 31st March as well as within 21 days from the record date of the company for the purposes of declaration of dividend. He shall disclose the number and percentage of shares or voting rights held by him and by persons acting in concert with him in that company, to the company.

Every company, whose shares are listed on a stock exchange, shall likewise give its disclosure twice i.e. within 30 days from the financial year ending 31st March, as well as within 30 days from the record date of the company for the purposes of declaration of dividend. It shall make yearly disclosures to all the stock exchanges on which the shares of the company are listed.

The disclosures shall be made, of the changes, if any, in respect of the holdings of the persons and also holdings of promoters or person(s) having control over the company.

As per Regulation 8(4) every company, whose shares are listed on a stock exchange, is required to maintain a register in the specified format to record the specified information received by it from specified persons and promoters. A look at the format prescribed under this regulations would reveal that the format is meant for recording information disclosed by the respective persons in accordance with these regulations. The Secretarial Standard on Registers and Records (SS-4) issued by the Institute of Company Secretaries of India lays down standards in respect of maintenance, inspection and authentication of the register.

11.6 SUMMARY

Takeover is a corporate device whereby one company acquires control over another company, usually by purchasing all or a majority of its shares. Takeover bids may be mandatory, partial or competitive bids. When a company intends to take over another company through acquisition of 90% or more in value of the shares of that company, the procedure laid down under Section 395 of the Act could be beneficially utilized. Section 230 of the Companies Act, 2013 is prescribing about the provision of takeover. Transferor and transferee companies are required to take care of the check points as specified in the chapter. Takeover of companies whose securities are listed or one or more stock exchanges is regulated by the provisions of listed agreements and SEBI (Substantial Acquisition of Shares and Takeovers) Regulation, 1997.

11.7 KEY WORDS

1. SEBI: Securities Exchange Board of India
2. SAST: Substantial Acquisition of Shares and Takeovers
3. SSE: Specified Stock Exchange

11.8 SELF ASSESSMENT QUESTIONS

1. Can unlisted companies affect takeovers? If so, how?

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12 "SEBI has formulated a comprehensive code for takeover of listed companies" Do you agree?

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13 Briefly explain the responsibility of acquirers and the company concerned to make disclosures at various stages in takeover.

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UNIT-12 CONSIDERATION AND FUNDING FOR TAKEOVER; FINANCIAL AND ACCOUNTING, STAMP DUTY AND TAXATION IN CASE OF TAKEOVER

Structure

12.0 Objective

12.1 Introduction

12.2 Consideration and funding for takeover

12.3 Financial and Accounting in takeover

12.4 Stamp duty and taxation case to takeover

12.5 Summary

12.6 Key words

12.7 Self Assessment Questions

12.8 References

12.0 OBJECTIVES

1. To able to understand consideration of takeover
2. To analyse the economic aspects of takeover
3. To know the financial and accounting aspects of takeover
4. To analyse the taxation aspects of takeover

12.1 INTRODUCTION

In business, a **takeover** is the purchase of one company (the target) by another (the acquirer, or bidder). In UK, the term refers to the acquisition of a public company whose shares are listed on a stock exchange, in contrast to the acquisition of a private company. Often a company acquiring another pays a specified amount for it. This money can be raised in a number of ways. Although the company may have sufficient funds available in its account, remitting payment entirely from the acquiring company's cash on hand is unusual. More often, it will be borrowed from a bank, or raised by an issue of bonds. Acquisitions financed through debt are known as leveraged buyouts, and the debt will often be moved down onto the balance sheet of the acquired company. The acquired company then has to pay back the debt. This is a technique often used by private equity companies. The debt ratio of financing can go as high as 80% in some cases. In such a case, the acquiring company would only need to raise 20% of the purchase price.

12.2 CONSIDERATION AND FUNDING FOR TAKEOVER

Selection of the mode of payment of consideration for takeover should be made on the basis of information received about the target company and the means available with the acquirer.

(1) Consideration in the form of cash: Cash could be paid in exchange for the shares acquired. Shares could be acquired through a bid made directly to the equity holders or through the stock market. The offeror company may also consider issuing new shares for enabling the acquirer to get controlling stake such that the acquirer is able to place its nominees on the Board of the target company to control the affairs of the company.

(2) Consideration in the form of Shares: In this method, consideration is paid by issuing to the shareholders of the target company the shares of the acquirer company. In exchange for such shares the acquirer company will purchase the shares of the target company. Under this broad scheme, various courses of action are available:

(a) Share-for-share takeover bid in which the offeror company in exchange for shares of offeree provides fully paid up shares on a stated basis. Apart from this, share-plus-cash or share-plus-loan stock, convertible or non-convertible, shares or loan stock with a cash option could be a mode of consideration.

(b) Reverse bid wherein the offeree company makes share-for-share bid for the whole of the equity capital of the offeror company where the offeror company has a large capital base. This alternative is more suitable when the offeree company is listed, a growing concern and capable of acting as a better holding company by pursuing its policies etc. Also, this mode offers sufficient tax advantages.

(c)Combinations of various modes may be resorted to, for discharging the consideration. For instance, acquisition by private deal of a block of shares from the existing Board of Directors or larger controlling interest shareholders of the offeree company or acquisition of all or part of the assets of the offeree company for shares of offeror company or reverse acquisition with offeree company etc. Thus, the decision about the proper mix of alternatives should be taken through expert advice, having considered the relative quoted market prices of shares of offeror and offeree, their dividend yield, gearing level, security cover, voting strength, net assets value, etc.

(3) Acquisition through a new company: A new company may be formed by acquiring shares in target companies and the shares of the new company may be issued to the shareholders of both the target companies, inconsideration for acquisition of share capital or undertakings in whole or in part.

(4) Acquisition of Minority held shares of a company: The offeror, if already holds more than 50% of issued capital in the offeree company can plan to acquire the balance equity of the offeree subject to applicable legal compliances.

Payment of consideration

For amount of consideration payable in cash, the acquirer should, within 7 days from the closure of the offer, open a special account with a SEBI-registered banker to an issue and deposit therein, such sum as would, together with 90% of the amount lying in the Escrow Account, if any, make up the entire sum due and payable to the shareholders as consideration for acceptances received and accepted in terms of Regulations and for this purpose, transfer the funds from the Escrow Account. In respect of consideration payable by way of exchange of securities, the acquirer should ensure that the securities are actually issued and dispatched to the shareholders.

12.3 FINANCIAL AND ACCOUNTING IN TAKEOVER

Accounting considerations are vital in planning a takeover. While many such transactions are based upon industrial or other operation considerations, others depend upon the financial impact of transactions on the financial position of the parties. In a takeover, if the acquirer is an individual, he has to write in his personal books of account the amounts invested in the shares of the company, whose majority shares or control has been taken over by him. This investment in the shares of the target company shall be reflected in his personal Return of Income at the end of the financial year.

Where the acquirer is a company, on the registration of the acquired shares in the register of members of the target company, the acquirer company will become the holding company and the target company will become its subsidiary company by virtue of its holding more than half in nominal value of its equity share capital, as per provisions of Section 4 of the Companies Act, 1956.

Holding company's books of account:

The books of account of the holding company will be accordingly written asunder:

If consideration for the acquired shares has been paid in cash only, the Cash Account will be credited and the Investments Account will be debited. If only fully paid shares have been allotted by the acquiring company to the shareholders of the target company, whose shares have been acquired, in exchange for their shares, then the Share Capital Account will be credited and the Investments Account will be debited. If the consideration has been paid partly in cash and partly in the form of fully paid shares, then for the cash portion, Cash Account will be credited and the Investments Account will be debited and for the fully paid shares portion, Share Capital Account will be credited and the Investments Account will be debited. Besides, the books of account, the acquiring or the holding company shall also maintain a Register of Investments in accordance with the provisions of Section 372A(5) of the Companies Act, 1956.

Subsidiary companies books of account:

There will be no accounting entry in the books of account of the target company or the subsidiary company. However, in the register of members of the subsidiary company, the transfer of shares of the shareholders, whose shares have been acquired by the holding company, shall be registered as soon as the relevant instruments of transfer along with the relevant share certificates have been received and the registration of their transfer. The share certificates shall be sent to the holding company after making due endorsement of the transfer under the authentication of the authorized signatory of the subsidiary company.

Economic Aspects of Takeover:

As discussed earlier in this chapter, in a takeover, the management of the acquirer may maintain the legal identify of both the companies and operate them under the direction of separate Boards of Directors (having common directors) or the management may decide that both the companies should merge or amalgamate in a new company or one may amalgamate or merge with the other

so that there is only one company, either the new company or the merged or the amalgamated company functioning under a unified command of one Board of Directors. In either case, the object of a successful takeover should be the overall economic betterment of the shareholders, the management, staff and all other employees, suppliers of raw materials and other consumables, personnel engaged in the marketing network, the ultimate consumer, the public at large and the Government. By virtue of better management of the business and affairs of the company, with the active and dedicated association of qualified and experienced technical, managerial, financial and marketing personnel, the value of the shares should increase, employees feel assured of timely payment of their salaries and other dues, suppliers get timely payments for their supplies, end products of the company are freely available, Government dues are paid on time and the company contributes to the society in which it operates and the areas whereof it serves. Socially conscious management of such a unified company is supposed to look after the surroundings and the environment of the place where it works. Besides being beneficial to the concerned companies, takeovers are also beneficial to the economy in the following manner:

(i) Disciplining the capital market: Takeovers help in disciplining the market as inefficient and errant companies get taken over due to their low book value and share prices. This process also helps in discovering the potential of the acquired companies, if any.
(ii) Consolid1ation of Efforts and Capacities: In the yesteryears, Government authorities had issued licenses to units with capacities much below the minimum economic size. Due to increased competition in markets, many of these are either incurring losses or earning marginal profits. Also, in the light of stringent control standards and emergence of multinationals, small units have realized the importance of conservation of resources and reduction of costs. However due to lack of proper infrastructure and sufficient capacity they are unable to implement their schemes efficiently. In such circumstances, takeovers can be an effective mode of consolidating splintered capacities to reach the minimum economic size. This will be resulted into not only revival of sick units but also prevention of sickness. Consolidation of capacities enables the industries to gain competitive strength in domestic as well as international markets.
(iii) Concentrating on core competencies: Due to the restrictive licensing policies followed by the Government, in the past, large companies were not allowed to grow and diversify easily. Rigorous provisions of MRTP posed serious obstacles. The companies were required to

diversify into totally unrelated areas. However, due to recent developments like liberalisation and increasing pressure of competition, they are realising the need to focus on core competition, for which mergers and takeovers offer green pastures. This is because these strategies enable the companies to rationalize their portfolios, enhance entity value and increase leveraging capability. The unified command of the company in a takeover transaction should ensure creation of more wealth through optimum competence, improved productivity and higher profitability. All initiatives to enhance productivity, performance and market capitalisation should be supported. Thus, the takeover strategy has been conceived to improve general economic well-being of all those who are, directly or indirectly, connected with the corporate sector. It is adopted to increase the corporate value, achieve better productivity and profitability by making optimum use of the available resources in the form of men, materials and machines.

12.4STAMP DUTY AND TAXATION IN CASE OF TAKEOVER

Taxation Aspects of Takeover

Taxation aspect is not involved in a takeover at the time of acquisition of shares by the holding company in the company which becomes its subsidiary company by virtue of acquisition of majority of shares. However, if and when the holding company sells the shares, the sale would involve the payment of Capital Gains Tax (short-term or long-term) under the Income Tax Act, 1961 depending on the period for which the shares are held by the holding company.

Stamp Duty on Takeover Documents:

In a takeover the dutiable document is the Instruments of Transfer executed by and between the transferors of the shares and the transferee of the shares in the form prescribed in the Companies (Central Government's) General Rules and Forms, 1956. The duty on the Instruments of Transfer is paid in the form of Share Transfer Stamps. These are affixed and cancelled on each Instrument of Transfer at the rate of 0.50 P. per one hundred rupees or a fraction thereof of the sale value of the shares. No stamp duty is payable in case of transfer of shares through Depository.

12.5 SUMMARY

Takeover is a corporate device whereby one company acquires control over another company, usually by purchasing all or a majority of its shares. Consideration for takeover could be in the

form of cash or in the form of shares. Financial, accounting, taxation and legal aspects are vital in planning a takeover and hence covered in detail in the chapter.

12.6KEY WORDS

1. SEBI : Securities Exchange Board of India
2. MRTP : Monopolistic and Restrictive Trade Practices

12.7 SELF ASSESSMENT QUESTIONS

1. Explain the modes of payment of consideration in takeover

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2. Briefly explain stamp duty and taxation aspects of Take Over

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3. Explain economic aspects of takeover

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4. Briefly explain accounting aspects of takeover.

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UNIT-13 BAILOUT TAKEOVERS; OBJECT AND RATIONALE BEHIND BAILOUT TAKEOVERS; PROCEDURES AND DOCUMENTATION;

Structure

13.0 Objective
13.1 Introduction
13.2 Bailout Takeover
13.3 Objective and rational behind Bailout takeovers
13.4 Procures and Documentation in Bailout takeover
13.5 Summary
13.6 Key words
13.7 Self Assessment Questions
13.8 References

13.0 OBJECTIVES

- To know the meaning and object of Bailout takeover
- To understand the procedure of bailout takeover
- To analyse the documentation in case of Bailout takeover

13.1 INTRODUCTION

A scenario in which a government or profitable company acquires control of a financially unstable company with the goal of returning it to a position of financial strength. In a bailout takeover, the government or strong company takes over the weak company by purchasing its shares, exchanging shares or both. The acquiring entity develops a rehabilitation plan for the weak company, describing how it will be managed and by whom, how shareholders will be protected and how its financial position will be turned around.

Investopediaexplains'BailoutTakeover'

An example of a bailout takeover is NPNC Financial Services' 2008 takeover of National City Corp. National City experienced massive losses because of the subprime mortgage crisis, and PNC used TARP funds to bail it out. PNC purchased about $5.2 billion in National City's stock to acquire it; some people said the purchase price was less than National City's fair market value. PNC became the fifth-largest U.S. bank as a result of the bailout takeover, but numerous National City employees lost their jobs at the bank's headquarters. Another example of a bailout takeover is the U.S. government's takeover of Chrysler and General Motors in 2008 to prevent the companies' bankruptcy and the subsequent loss of approximately 1 million jobs in the industry. Under the takeover's terms, the government loaned the two companies $17.4 billion and required them to reduce their debt, decrease workers' wages and benefits, and create restructuring plans. The government retained the ability to call the loans if the companies didn't uphold their end of the bargain. The companies later received additional funds from the government, but they were forced through bankruptcy anyway, causing both stockholders and bondholders to lose everything. The bailout was criticized as primarily benefiting labor unions since workers kept their jobs but investors lost everything.

13.2 BAILOUT TAKEOVERS

Takeover of a financially sick company by a profit earning company to bail out the former is known as bail out takeover. There are several advantages for a profit making company to take over a sick company. The price would be very attractive as creditors, mostly banks and financial

institutions having a charge on the industrial assets, would like to recover to the extent possible. Banks and other lending financial institutions would evaluate various options and if there is no other go except to sell the property, they will invite bids. Such a sale could take place in the form by transfer of shares. While identifying a party (acquirer), lenders do evaluate the bids received, the purchase price, the track record of the acquirer and the overall financial position of the acquirer. Thus a bail out takeover takes place with the approval of the Financial Institutions and banks.

Regulation 30 of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 states that the provisions of Chapter IV of the Regulations is applicable to a substantial acquisition of shares in a financially weak company not being a sick industrial company, in pursuance to a scheme of rehabilitation approved by a public financial institution or a scheduled bank (hereinafter referred to as lead institution). The lead institution is responsible for ensuring compliance with the provisions of Chapter IV."Financially weak company" in this context means a company which has at the end of the previous financial year accumulated losses resulting in erosion of over 50% but below 100% of its net worth (total of the paid-up capital and free reserves)as at the beginning of the previous financial year. In a bail out takeover, the lead institution, which is a public financial institution or bank, appraises the financially weak company, which is not a sick industrial company, taking into account its financial viability, its requirement of funds for revival and draws up a rehabilitation package on the principle of protection of interests of minority shareholders, good management, effective revival and transparency. To facilitate the takeover of `financially weak company', the lead institution can invite offers for acquisition of the shares of the said company from at least three parties. The lead institution evaluates the bids received with respect to the purchase price or exchange of shares, track record, financial resources and reputation of the management of the person acquiring shares. The offers are listed in the order of preference and after consultation with existing management. The scheme should also specifically provide the details of any change in management. The scheme may provide for acquisition of shares in the financially weak company as:

(a) an outright purchase of shares, or
(b) exchange of shares, or
(c) a combination of both.

However, the scheme may ensure that after the proposed acquisition the erstwhile promoters do not own any shares in case such acquisition is made by the new promoters pursuant to such scheme. In other words, if the acquisition of shares is by new promoters then the old promoters have to give up their shareholding in the financially weak company in its entirely.

13.3 OBJECT AND RATIONALE BEHIND BAILOUT TAKEOVERS

The basic objective of this regulation is to protect the interest of minority shareholders for which the responsibility rests upon the lead institutions which shall take into consideration while drawing up rehabilitation programme or package the principles of good management, effective revival and transparency. Lead institutions/banks shall provide in the rehabilitation scheme the details of changes it seeks to make in the management and the payment of consideration whether outright purchase or shares or exchange of shares or a combination of both.

13.4 PROCEDURES AND DOCUMENTATION IN BAILOUT TAKEOVERS

Manner of acquisition of shares of financially weak company: Before giving effect to any scheme of rehabilitation the lead institution is required to invite offers for acquisition of shares from at least three parties. After receipt of the offers, the lead institution shall select one party having regard to the managerial competence, adequacy of financial resources and technical capability of the person acquiring shares to rehabilitate the financially weak company. The lead institution shall provide necessary information to any person, intending to make an offer to acquire shares, about the financially weak company, particularly regarding its present management, technology, range of products manufactured, shareholding pattern, financial holding and performance and assets and liabilities of the company for five years from the date of offer and also the minimum financial and other commitments expected of the person acquiring shares. (Regulation 31)

Manner of evaluation of bids: The lead institution shall evaluate the bids received in terms of purchase price or exchange of shares, track record, financial resources, reputation of the management of the person acquiring shares and ensure fairness and transparency in the process.

Acceptance of one bid: After evaluating the offers, the lead institution has to list them in order of preference, and in consultation with the persons concerned with the affairs of the management of the company, accept one of the bids. (Regulation 32)

Persons acquiring shares to make an offer: The person identified by the lead institution shall, on receipt of a communication in this behalf from the lead institution, make a formal offer to acquire shares from promoters etc. of the company, financial institutions and also other shareholders of a company, financial institutions and also other shareholders of a mutually determined price. The lead institution may also offer the shares held by it in the target company, as part of the package for its rehabilitation. (Regulation 33)

Person acquiring shares to make public announcement – Financially Weak Company: The person acquiring shares is required to make a public announcement of his intention to acquire shares from the other shareholders of the company. The public announcement shall contain relevant details about the offer including the information about the identity and background of the person acquiring shares, number and percentage of shares proposed to be acquired, offer price, the specified date, the date of opening of the offer and the period for which the offer shall be kept open and such other particulars as may be required by SEBI. The offer letter should be forwarded to each shareholder, other than the promoters or persons in charge of the management of the company and the financial institutions. If the offer results in the public shareholding being reduced to 10% or less of the voting capital of the company, the acquirer should either:

(a) within three months from the date of closure of the public offer, make an offer to buy out the outstanding shares remaining with the shareholders at the same offer price, which may have the effect of delisting the target company; or
(b) undertake to disinvest through an offer for sale or by a fresh issue of capital to the public which shall open within 6 months from the date of closure of public offer, such number of shares so as to satisfy the listing requirements. The letter of offer shall clearly specify the option available to the acquirer. In order to compute the percentage as specified above, the voting rights as at the expiration of thirty days after the closure of public offer shall be reckoned. The acquirer shall while accepting the offer from the shareholders other than promoters or persons in charge, offer to acquire from the individual shareholder, his entire shareholdings if such holding is up to hundred shares of face value of rupees ten or ten shares of the face value of rupees hundred each.

No competitive bid to be made: No person shall make a competitive bid for acquisition of shares of the financially weak company once the lead institution has evaluated the bids and

accepted the bidof the acquirer who has made the public announcement of offer for acquisition of\ shares of the company.

Responsibility of Lead Institution: Where proposal for acquisition of shares of a financially weak company is made by a state level public financial institution, the provisions of the regulations relating to\ rehabilitation scheme prepared by a public financial institution, shall apply. However, in such a case the Industrial Development Bank of India shall be the agency for ensuring compliance of the regulations in this respect.

Process of Bailout Takeover:

30. (1) The provisions of this Chapter shall apply to a substantial acquisition of shares in a financially weak company not being a sick industrial company, in pursuance of a scheme of rehabilitation approved by a public financial institution of a scheduled bank (herein-after referred to as “the lead institution”).

(2) The lead institution shall be responsible for ensuring compliance with the provisions of this Chapter.

(3) The lead institution shall appraise the financially weak company taking into account the financial viability, and assess the requirement of funds for revival and draw up the rehabilitation package on the principle of protection of interests of minority shareholders, good management, effective revival and transparency.

(4) The rehabilitation scheme shall also specifically provide the details of any change in management.

(5) The scheme may provide for acquisition of shares in the financially weak company in any of the following manner :

a. outright purchase of shares, or

b. exchange of shares, or

c. a combination of both :

Provided that the scheme as far as possible may ensure that after the proposed acquisition the erstwhile promoters do not own any shares in case such acquisition is made by the new promoters pursuant to such scheme.

Manner of acquisition of shares:

31. (1) Before giving effect to any scheme of rehabilitation the lead institution shall invite offers for acquisition of shares from at least three parties.

(2) After receipt of the offers under sub-regulation (1), the lead institution shall select one of the parties having regard to the managerial competence, adequacy of financial resources and technical capability of the person acquiring shares to rehabilitate the financially weak company.

(3) The lead institution shall provide necessary information to any person intending to make an offer to acquire shares about the financially weak company and particularly in relation to its present management technology, range of products manufactured, shareholding pattern, financial holding and performance and assets and liabilities of such company for a period covering five years from the date of the offer as also the minimum financial and other commitments expected of from the person acquiring shares for such rehabilitation.

Manner of evaluation of bids.

32. (1) The lead institution shall evaluate the bids received with respect to the purchase price or exchange of shares, track record, financial resources, reputation of the management of the person acquiring shares and ensure fairness and transparency in the process.

(2) After making evaluation as provided in sub-regulation (1), the offers received shall be listed in order of preference and after consultation with the persons in the affairs of the management of the financially weak company accept one of the bids.

Person acquiring shares to make an offer.

33. The person acquiring shares who has been identified by the lead institution under sub-regulation (2) of regulation 32, shall on receipt of a communication in this behalf from the lead institution make a formal offer to acquire shares from the promoters or persons in charge of the affairs of the management of the financially weak company, financial institutions and also other shareholders of the company at a price determined by mutual negotiation between the person acquiring the shares and the lead institution.

Explanation.—Nothing in this regulation shall prohibit the lead institution offering the shareholdings held by it in the financially weak company as part of the scheme of rehabilitation.

Person acquiring shares to make public announcement.

34. (1) The person acquiring shares from the promoters or the persons in charge of the management of the affairs of the financially weak company or the financial institution shall make a public announcement of his intention for acquisition of shares from the other shareholders of the company.

(2) Such public announcement shall contain relevant details about the offer including the information about the identity and background of the person acquiring shares, the number and percentage of shares proposed to be acquired, offer price, the specified date, the date of opening of the offer and the period for which the offer shall be kept open and such other particulars as may be required by the Board.

(3) The letter of offer shall be forwarded to each of the shareholders other than the promoters or the persons in charge of the management of the financially weak company and the financial institutions.

(4) If the offer referred to in sub-regulation (1) results in the public shareholding being reduced to 10 per cent or less of the voting capital of the company, the acquirer shall either—

a. within a period of three months from the date of closure of the public offer, make an offer to buy out the outstanding shares remaining with the shareholders at the same offer price, which may have the effect of delisting the target company; or

b. undertake to disinvest through an offer for sale or by a fresh issue of capital to the public which shall open within a period of six months from the date of closure of the public offer, such number of shares so as to satisfy the listing requirements.

(5) The letter of offer shall state clearly the option available to the acquirer under sub-regulation (4).

(6) For the purposes of computing the percentage referred to in sub-regulation (4), the voting rights as at the expiration of twenty days after the closure of the public offer shall be reckoned.

(7) While accepting the offer from the shareholders other than the promoters or persons in charge of the financially weak company or the financial institutions, the person acquiring shares shall offer to acquire from the individual shareholder his entire holdings if such holding is up to hundred shares of the face value of rupees ten each or ten shares of the face value of rupees hundred each.

Competitive bid

35. No person shall make a competitive bid for acquisition of shares of the financially weak company once the lead institution has evaluated the bid and accepted the bid of the acquirer who has made the public announcement of offer for acquisition of shares from the shareholders other than the promoters or the persons in charge of the management of the financially weak company.

Exemption from the operations of Chapter III.

36. (1) Every offer which has been made in pursuance of regulation 30 shall be accompanied with an application to the Board for exempting such acquisitions from the provisions of Chapter III of these regulations.

(2) For considering such request the Board may call for such information from the company as also from the lead institution, in relation to the manner of vetting the offers evaluation of such offers and similar other matters.

(3) Notwithstanding grant of exemption by the Board, the lead institution or the acquirer as far as may be possible, shall adhere to the time limits specified for various activities for public offer specified in Chapter III.

Acquisition of shares by a State level public financial institution.

37. Where a proposal for acquisition of shares in respect of a financially weak company is made by a State level public financial institution, the provisions of these regulations insofar as they relate to scheme of rehabilitation prepared by a public financial institution, shall apply except that in such a case the Industrial Development Bank of India, a corporation established under the Industrial Development Bank of India Act, 1964 (10 of 1964), shall be the agency for ensuring compliance with these regulations for acquisition of shares in the financially weak company.

13.5 SUMMARY

Takeover of a financially sick company by a profit earning company to bail out the former is known as bail out takeover. A bail out takeover takes place with the approval of the Financial Institutions and banks. SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 deals with the procedure for takeover of listed companies

13.6 KEY WORDS

1. SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997

2. SEBI: Securities Exchange Board of India

13.7 SELF ASSESSMENT QUESTIONS

1. Explain the bailout takeover and reasons for such takeover.

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2. Explain the procedure involved in Bail out takeover.

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UNIT-14 FINANCIAL RECONSTRUCTION; MEANING, RATIONALE AND METHODS OF FINANCIAL RECONSTRUCTION; REVALUATION OF ASSETS; ACCOUNTING PRINCIPLES OF REVALUATION; PROFIT ON REVALUATION AND UTILISATION THEREOF

Structure

14.0 Objectives
14.1 Introduction
14.2 Financial Reconstruction meaning and rationale
14.3 Methods of financial reconstruction
14.4 Revaluation of Assists
14.5 Accounting principles revaluation profit on Revaluation and utilization thereof
14.6 Summary
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14.0 OBJECTIVES

1. To able to understand need for financial restructuring
2. To understand reorganization of capital
3. Methods of financial restructuring
4. To analyse the revaluation of assets
5. To understand the reduction of share capital

14.1 INTRODUCTION

Reconstruction Finance Corporation (RFC), former U.S. government agency, created in 1932 by the administration of Herbert Hoover. Its purpose was to facilitate economic activity by lending money in the depression. At first it lent money only to financial, industrial, and agricultural institutions, but the scope of its operations was greatly widened by the New Deal administrations of Franklin Delano Roosevelt. It financed the construction and operation of war plants, made loans to foreign governments, provided protection against war and disaster damages, and engaged in numerous other activities. In 1939 the RFC merged with other agencies to form the Federal Loan Agency, and Jesse Jones , who had long headed the RFC, was appointed federal loan administrator. After Jones became (1940) Secretary of Commerce, Congress transferred (1942) the RFC to his department. When Henry Wallace succeeded (1945) Jones, Congress removed the agency from Dept. of Commerce control and returned it to the Federal Loan Agency. When the Federal Loan Agency was abolished (1947), the RFC assumed its many functions. After a Senate investigation (1951) and amid charges of political favoritism, the RFC was abolished as an independent agency by act of Congress (1953) and was transferred to the Dept. of the Treasury to wind up its affairs, effective June, 1954. It was totally disbanded in 1957. RFC had made loans of approximately $50 billion since its creation in 1932.

14.2 FINANCIAL RECONSTRUCTION; MEANING AND RATIONALE

Companies have access to a range of sources from which they finance business. These funds are called ‘capital’. The sources of capital can be divided into two categories; internally generated funds and funds provided by third parties. Whichever form of capital is used, it will fall into one of the two categories – debt or equity.

Determination of the proportion of own funds and borrowed funds:

Internally generated funds are an important component of a company’s capital structure but it would be unusual for a company to grow at a fast pace only through internal generation of funds.

The deficit between the funds which a company requires to fund its growth and the funds which are generated internally is funded by provision of capital from third parties.

Cost of various types of capital:

Equity capital is the permanent capital of the company, which does not require any servicing in the form of interest. However, the return to the equity capital is in the form of dividend paid to the equity shareholders out of the profits earned by the company. The ideal capital structure would be to raise money through the issue of equity capital. Debt is essentially an obligation, the terms of which are, inter alia, the repayment of the principal sum within a specific time together with periodic interest payments. Perhaps the easiest form of capital for a company to raise is, a loan from a bank. This form of loan capital may be comparatively expensive than equity. However, as regards servicing of capital there are advantages of issuing debt instruments. Dividend is not a deductible expense when calculating a company's taxable profit; it is on the contrary an appropriation of profits. On the other hand, interest paid by a company on debt finance is an allowable expense when calculating a company's tax, thereby reducing its taxable profit.

Need for Financial Restructuring

A company is required to balance between its debt and equity in its capital structure and the funding of the resulting deficit. The targets a company sets in striking this balance are influenced by business conditions, which seldom remain constant.

When, during the life time of a company, any of the following situations arise, the Board of Directors of a company is compelled to think and decide on the company's restructuring:

(i) necessity for injecting more working capital to meet the market demand for the company's products or services;

(ii) when the company is unable to meet its current commitments;

(iii) when the company is unable to obtain further credit from suppliers of raw materials, consumable stores, bought-out components etc. and from other parties like those doing job work for the company.

(iv) when the company is unable to utilise its full production capacity for lack of liquid funds.

Financial restructuring of a company involves rearrangement of its financial structure so as to make the company's finances more balanced.

Restructuring of under-capitalized Company

An under-capitalized company may restructure its capital by taking one or more of the following corrective steps:

(i) injecting more capital whenever required either by resorting to rights issue/preferential issue or additional public issue.

(ii) resorting to additional borrowings from financial institutions, banks, other companies etc.

(iii) issuing debentures, bonds, etc. or

(iv) inviting and accepting fixed deposits from directors, their relatives, business associates and public.

Restructuring of over-capitalized company

If a company is over-capitalized, its capital also requires restructuring by taking following corrective measures:

(i) Buy-back of own shares.

(ii) Paying back surplus share capital to shareholders.

(iii) Repaying loans to financial institutions, banks, etc.

(iv) Repaying fixed deposits to public, etc.

(v) Redeeming its debentures, bonds, etc.

14.3 METHODS OF FINANCIAL RECONSTRUCTION

Broadly speaking, the financial structure of a company comprises its—

(i) paid up equity and preference share capital;

(ii) various reserves;

(iii) all borrowings in the form of –

(a) long-term loans from financial institutions;
(b) working capital from banks including loans through commercial papers;
(c) debentures;
(d) bonds;
(e) credits from suppliers;
(f) trade deposits;
(g) public deposits;
(h) deposits/loans from directors, their relatives and business associates;
(i) deposits from shareholders;
(j) Global Depository Receipts, American Depository Receipts and Foreign

(k) Currency Convertible Bonds;
(l) funds raised through any other loan instrument.

A company may require any one or more of the above keeping in view its financial requirements at a particular point of time. A dynamic Board should constantly review the financial structure of the company and effect financial restructuring and reorganisation whenever the need arises. In accordance with Section 390(b), the expression "arrangement" includes a reorganization of the share capital of the Company by the consolidation of shares of different classes or by division of shares of one class into shares of different classes or by both these methods.

Accordingly, as per Section 390(b), the reorganization of share capital of a company may take place—
(1) by the consolidation of shares of different classes, or
(2) by the division of shares of one class into shares of different classes, or
(3) by both these methods [Section 390(b)].

Besides, a company may reorganize its capital in different ways, such as – (a) reduction of paid-up share capital; (b) conversion of one type of shares into another; (c) conversion of shares into debentures or other securities. But these are only illustrations, there may be other ways. Besides, a company may modify all or any of the rights attached to the shares of any class.

The reorganization of share capital of a company may be proposed—
(a) between a company and its creditors or any class of them; or
(b) between a company and its members or any class of them.

In such a case, the Company Law Board1 may, on the application of the company or of any creditor or member of the company, order a meeting of the creditors, or of the members, as the case may be. The meeting is to be called, held and conducted in such manner as the Company Law Board directs. A majority of 3/4th in value of the creditors or members present and voting either in person or by proxy at the meeting should agree to the reorganization of share capital. The reorganization should also be sanctioned by the Company Law Board. If these conditions are satisfied, the reorganization is binding on all the creditors or all the members, and also on the company or, in the case of a company which is being wound up, on the liquidator and contributories of the company. The order of the Company Law Board has no effect until a certified copy of the order in e-form 21 has been filed with the Registrar (Section 391).

Reduction of Share Capital

Reduction of capital means reduction of issued, subscribed and paid-up capital of the company. Section 100 provides for the reduction of share capital, if the articles of the company so

authorise. If there is no such clause in the articles, these must be altered by a special resolution giving the company the power to reduce its capital. The need for reduction of capital may arise in various circumstances for example trading losses, heavy capital expenses and assets of reduced or doubtful value. As a result, the original capital may either have become lost or a company may find that it has more resources than it can profitably employ. In either case, the need may arise to adjust the relation between capital and assets [Indian National Press (Indore) Ltd., In re. (1989) 66 Com Cases 387, 392 (MP)].

The mode of reduction, as laid down in Section 100 of the Companies Act, is as follows:

A company limited by shares or a company limited by guarantee and having a share capital may, if authorised by its articles, by special resolution, and subject to its confirmation by the Court on petition, reduce its share capital in any way and in particular:

(a) by reducing or extinguishing the liability of members in respect of uncalled or unpaid capital e.g., where the shares are of Rs. 100 each with Rs. 75 paidup, reduce them to Rs. 75 fully paid-up shares and thus relieve the shareholders from liability on the uncalled capital of Rs. 25 per share;
(b) by paying off or returning paid-up capital not wanted for the purposes of the company, e.g., where the shares are fully paid-up, reduce them to Rs. 75 each and pay back, Rs. 25 per share;
(c) by paying off the paid-up capital on the conditions that it may be called up again so that the liability is not extinguished;
(d) by following a combination of any of the preceding methods;
(e) by writing off or canceling the capital which has been lost or is under represented by the available assets e.g. a share of Rs. 100 fully paid-up is represented by Rs. 75 worth of assets. In such a situation reality can be reintroduced by writing off Rs. 25 per share. This is the most common method of reduction of capital. The assets side of the balance sheet may include useless assets which are cancelled. On the other side i.e. on the liability side share capital is reduced.

There is no limitation on the power of the Court to confirm the reduction except that it must first be satisfied that all the creditors entitled to object to the reduction have either consented or been paid or secured [British and American Trustee and Finance Corpn. v. Couper, (1894) AC 399, 403: (1991-4) All ER Rep 667].

When exercising its discretion, the Court must ensure that the reduction is fair and equitable. In short, the Court shall consider the following, while sanctioning the reduction:

(i) The interests of creditors are safeguarded;
(ii) The interests of shareholders are considered; and
(iii) Lastly, the public interest is taken care of.

Reduction of share capital without sanction of the Court

The following are cases which amount to reduction of share capital but where no confirmation by the Court is necessary:

(A)Surrender of shares – "Surrender of shares" means the surrender of shares already issued to the company by the registered holder of shares. Where shares are surrendered to the company, whether by way of settlement of a dispute or for any other reason, it will have the same effect as a transfer in favour of the company and amount to a reduction of capital. But if, under any arrangement, such shares, instead of being surrendered to the company, are transferred to a nominee of the company then there will be no reduction of capital [Collector of Moradabad v. Equity Insurance Co. Ltd., (1948) 18 Com Cases 309: AIR 1948 Oudh 197]. Surrender may be accepted by the company under the same circumstances where forfeiture is justified. It has the effect of releasing the shareholder whose surrender is accepted for further liability on shares.

The Companies Act contains no provision for surrender of shares. Thus surrender of shares is valid only when Articles of Association provide for the same and:

(i) where forfeiture of such shares is justified; or

(ii) when shares are surrendered in exchange for new shares of same nominal value.

Both forfeiture and surrender lead to termination of membership. However, in the case of forfeiture, it is at the initiative of company and in the case of surrender it is at the initiative of member or shareholder.

(B) **Forfeiture of shares** – A company may if authorised by its articles, forfeit shares for non-payment of calls and the same will not require confirmation of the Court. Where power is given in the articles, it must be exercised strictly in accordance with the regulations regarding notice, procedure and manner stated therein, otherwise the forfeiture will be void. Forfeiture will be effected by means of Board resolution. The power of forfeiture must be exercised bona fide and in the interest of the company.

(C) Diminution of capital – Where the company cancels shares which have not been taken or agreed to be taken by any person [Section 94(1)(3)].

(D) Redemption of redeemable preference shares.

(E) Purchase of shares of a member by the company under Section 402.

(F) Buy-back of its own shares under Section 77A.

Reduction of capital when company is defunct

The Registrar of Companies has been empowered under Section 560 to strike off the name of a company from its register on the ground of non-working company. Therefore, where the company has ceased to trade, and Registrar exercises his power under Section 560 a reduction of capital cannot be prevented. [Great Universal Stores Ltd., Re. (1960) 1 All ER 252: (1960)].

Reduction of capital of unlimited company

An unlimited company to which Section 100 does not apply, can reduce its capital in any manner that its Memorandum and Articles of Association allow. It is not governed by Sections 94 and 100 of the Act.

Equal Reduction of Shares of One Class

Where there is only one class of shares, prima facie, the same percentage should be paid off or cancelled or reduced in respect of each share, but where different amounts are paid-up on shares of the same class, the reduction can be effected by equalizing the amount so paid-up. [Marwari Stores Ltd. v. Gouri Shanker Goenka (1936) 6 Com Cases 285]. The same principle is to be followed where there are different classes of shares. It is, however, not necessary that extinguishment of shares in all cases should necessarily result in reduction of share capital. Accordingly, where reduction is not involved, Section 100 would not be attracted. [Asian Investment Ltd. Re. (1992) 73 Com Cases 517, 523 (Mad)].

Qualification shares of directors [Section 270]

Where the directors are required to hold qualification shares, care must be taken to ensure that the effect of a reduction does not disqualify any director.

Creditors' Right to Object to Reduction

After passing the special resolution for the reduction of capital, the company is required to apply to the Court by way of petition for the confirmation of the resolution under Section 101. Where the proposed reduction of share capital involves either (i) diminution of liability in respect of unpaid share capital, or (ii) the payment to any shareholder of any paid-up share capital, or (iii) in any other case, if the Court so directs, the following provisions shall have effect:

The creditors having a debt or claim admissible in winding up are entitled to object. To enable them to do so, the Court will settle a list of creditors entitled to object. If any creditor

objects, then either his consent to the proposed reduction should be obtained or he should be paid off or his payment be secured. The Court, in deciding whether or not to confirm the reduction will take into consideration the minority shareholders and creditors.

A Company might decide to return a part of its capital when its paid-up share capital is in excess of its needs. It is not simply handed over to shareholders in proportion to their holdings. Their class rights will be considered with the Court treating the reduction as though it was analogous to liquidation. Therefore, the preference shareholders who have priority to return of capital in liquidation will be the first to have their share capital returned to them in a share capital reduction, even if they prefer to remain members of the company.

Confirmation and Registration

Section 102 of the Act states that if the Court is satisfied that either the creditors entitled to object have consented to the reduction, or that their debts have been determined, discharged, paid or secured, it may confirm the reduction. The Court may also direct that the words "and reduced" be added to the company's name for a specified period, and that the company must publish the reasons for the reduction and the causes which led to it, with a view to giving proper information to the public. Section 103 states that the Court's order confirming the reduction together with the minutes giving the details of the company's share capital, as altered, should be delivered to the Registrar who will register them. The reduction takes effect only on registration of the order and minutes, and not before. The Registrar will then issue a certificate of registration which will be a conclusive evidence that the requirements of the Act have been complied with and that the share capital is now as set out in the minutes. The Memorandum has to be altered accordingly.

Conclusiveness of certificate for reduction of capital

Where the Registrar had issued his certificate confirming the reduction, the same was held to be conclusive although it was discovered later that the company had no authority under its articles to reduce capital [Re Walkar & Smith Ltd., (1903) 88 LT 792 (Ch D)]. Similarly, in a case where the special resolution for reduction was an invalid one, but the company had gone through with the reduction, the reduction was not allowed to be upset [Ladies's Dress Assn. v. Pulbrook, (1900) 2 QB 376].

Diminution of share capital is not a reduction of capital

In the following cases, the diminution of share capital is not to be treated as reduction of the capital:

(b) Where the company cancels shares which have not been taken or agreed to be taken by any person [Section 94(1)(e)];

(c) Where redeemable preference shares are redeemed in accordance with the provisions of Section 80;

(d) Where any shares are forfeited for non-payment of calls and such forfeiture amounts to reduction of capital;

(e) Where the company buys-back its own shares under Section 77A of the Act.

In all these cases, the procedure for reduction of capital as laid down in Section 100 is not attracted.

Liability of Members in respect of Reduced Share Capital

On the reduction of share capital, the extent of the liability of any past or present member or any call or contribution shall not exceed the difference between the amount already paid on the share, or the reduced amount, if any, which is deemed to have been paid thereon by the member, and the amount of the shares fixed by the scheme of the reduction.If, however any creditor entitled to object to the reduction of share capital is not entered in the list of creditors by reason of his ignorance of the proceedings for reduction and, after the reduction the company is unable to pay his debt or claim, then:

(a) every member at the time of registration of the Court's order for reduction is liable to contribute for the payment of the debt or claim, an amount not exceeding the amount which he would have contributed on the day before registration of the order and minutes; and

(b) if the company is wound up, the Court on the application by the creditor and on proof of his ignorance, may settle a list of contributories and make and enforce calls and orders on the contributories, settled on the list, as if they were ordinary contributories in a winding up.

It is further provided that, if any officer of the company knowingly conceals the name of any creditor entitled to object to the reduction; or knowingly misrepresents the name or amount of the debt or claim of any creditor; or abets or is privy to any such concealment or misrepresentation as aforesaid, he shall be liable to be punishable with imprisonment upto one year, or with fine or with both (Section 105).

14.4 REVALUATION OF ASSETS

In the preparation of the financial statements of a company, various fixed assets are stated on the basis of their historical cost. Sometimes, in order to bring into the Balance Sheet their replacement cost, a company revalues its fixed assets on the basis of a valuation made by competent valuers. When the value of fixed assets in written up in account books of a company on revaluation, a corresponding credit is given to the Revaluation Reserve. Such reserve represents the difference between the estimated present market values and the book values of the fixed assets. Generally, revaluation will be dome for reflecting the true value of asset.

Para 13 of Accounting Standard 10 contains provisions for Revaluation of Fixed Assets. It states three methods of revaluation:

1. Appraisal by competent valuers (Standard refers this as a common technique)
2. Indexation (Standard requires this method to be cross checked periodically by appraisal method)
3. Current market prices (Standard requires this method to be cross checked periodically by appraisal method)

Fixed assets should not be revalued selectively. Revaluation should be done for an entire class of fixed assets such as entire class of Plant and Machinery or Buildings etc. The revalued amount should not be greater than the net recoverable amount which is the higher of the assets net selling price and its value in use. This situation will arise only if the costs of disposal of the asset are significant.

14.5 ACCOUNTING PRINCIPLES OF REVALUATION; PROFIT ON REVALUATION AND UTILISATION THEREOF

AS 10 allows two methods of accounting for revaluation:

1. By restating both the gross book value and accumulated depreciation to give net book value; and
2. By restating the net book value by adding therein the net increase on account of revaluation.
   Initial Revaluation:

An increase in the net book value on revaluation should be credited directly to owners interests under the heading of revaluation reserve and the same is not available for distribution directly. AS 10 also envisages a situation where on initial revaluation there is a decrease in net book value. In such a case, the decrease is charged to Profit and Loss Account. This situation can arise where recoverable amount is based on value in use of the asset.

Subsequent revaluation:

a. If previous increase and subsequent increase
b. Credit Revaluation Reserve
c. If previous increase and subsequent decrease
d. Debit Revaluation Reserve and if still the carrying amount of the asset is higher than its revalued amount then charge to Profit and Loss Account.
e. If previous decrease and subsequent decrease
f. Charge to Profit and Loss Account
g. If previous decrease and subsequent increase
h. Credit Profit and Loss to the extent of previous decrease(s) and if still the carrying amount of the asset is lower than its revalued amount, credit the balance to revaluation surplus.

Provisions of Schedule VI to the Companies Act, 1956

Part I of Schedule VI requires that if there is a revaluation or reduction in value of assets, the balance sheet should show the increased or reduced figures in place of the original cost for at least five years. Thus, in accordance with Schedule VI, method 2 cannot be followed.

Disposal of Revalued Fixed Assets

If the asset has been sold at a loss, first the loss is charged to revaluation reserve and the balance to Profit & Loss Account. If revaluation reserve is not squared up, the balance is transferred to general reserve. If the asset has been sold at a profit, the profit is credited to Profit and Loss Account and the revaluation reserve balance is transferred to General Reserve Account.

Use of Revaluation Reserve:

A. Whether additional depreciation can be charged against revaluation reserve?

Revaluation Reserve is not a free reserve. No dividend can be declared out of such reserve. However, revaluation reserve can be used to nullify the effect of additional depreciation arising out of revaluation of fixed assets. AS 6 in para 26 states that "where the depreciable assets are revalued, the provision for depreciation should be based on the revalued amount and on the estimate of the remaining useful lives of such assets". Thus, there is an additional depreciation charge on account of revaluation. The issue here is whether this additional depreciation can be charged against revaluation reserve?

AS 10 and AS 6 are silent on the treatment of such additional depreciation. However, the ICAI has issued a Guidance Note on Treatment of Reserve created on Revaluation of Fixed Assets. The in few places of the guidance note suggests that "it will be prudent not to charge additional depreciation against revaluation reserve". However, in some other places,

the Guidance Note allows utilizing revaluation reserve to nullify the effect of additional depreciation. It is further suggested that company will have to provide for full depreciation in the profit and loss account and thereafter it can take transfer from revaluation reserve to adjust additional depreciation. Mostly, companies do not opt for the more prudent policy of not adjusting additional depreciation.

B. Whether such transfer can affect the profit attributable to equity shareholders?

The Guidance Note explains that the company should charge full depreciation to the Profit and Loss and thereafter it can take transfer from revaluation reserve to adjust additional depreciation. Thus, the Guidance Note vaguely explains that such transfer should not affect profit attributable to equity shareholders. However, companies use revaluation reserve to maintain bottom line by adjusting it directly in depreciation and thereby affecting net profit attributable to equity shareholders.

C. Whether bonus shares can be issued out of revaluation reserve?

SEBI guidelines for disclosure and investor protection do not allow issue of bonus shares out of revaluation reserve. This prohibition is applicable to listed companies. DCA vide its Circular No. 9/94 has also prohibited issue of bonus shares out of revaluation reserve by existing private / closely held and unlisted companies. Guidance note on availability of revaluation reserve for issue of bonus share issued by ICAI states that the excess of the revalued amount over the net book value of fixed assets, which is credited to revaluation reserve, is created as a result of book adjustment only. The revaluation reserve does not result from an arm’s length transaction; it represents an expert’s perception of value. The revaluation reserve, thus, does not represent realized gain. The Guidance Note also states that share capital represents money or moneys worth received from the owners and capitalization of earned profits or other gains arising out of arm’s length transaction. Only profits as are earned or the relevant capital receipts as are realized, can be capitalized. However, the Guidance Note on Treatment of Reserve created on Revaluation of Fixed Assets discussed above or the Exposure Draft on AS 10 (Revised) allows transfer from revaluation reserve to the extent of additional depreciation to the Profit and Loss Account. To that extent profit is inflated every year and the revaluation reserve is converted into so called "earned profit". As the entire revaluation reserve is converted into "earned profit", a

company can issue bonus shares. Thus, the prohibition on use of revaluation reserve for issue of bonus shares has been nullified.

14.6 SUMMARY

Financial restructuring of a company involves a rearrangement of its financial structure to make the company's finances more balanced. A company may reorganize its capital in different ways, such as reduction of paid up share capital; conversion of one type of shares into another; conversion of shares into debentures or other securities. Section 100 of the Companies Act deals with reduction of capital which means reduction of issued, subscribed and paid up capital of the company.

14.7 KEY WORDS

1. AS : Accounting Standard
2. DCA: Department of Company Affairs
3. ICAI: The Institute of Chartered Accountants of Inida

14.8 SELF ASSESSMENT QUESTIONS

1. Briefly explain the need of financial restructuring and highlight reasons in the context of over capitalised and under capitalised companies.
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   ……………………………………………………………………………………………
2. Briefly explain the process of reduction of Capital
   ……………………………………………………………………………………………
   ……………………………………………………………………………………………
3. What do you mean by revaluation of assets? Briefly explain the accounting aspects of revaluation of assets.
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UNIT-15 FINANCIAL RECONSTRUCTION - BUYBACK OF SHARES; FUNDING FOR BUY BACK OF SHARES AND CONDITIONS FOR BUY BACK OF SHARES; LEGAL PROVISIONS OF BUYBACK OF SHARES

Structure

15.0 Objectives
15.1 Introduction
15.2 Buyback of shares
15.3 Funding for buy back of shares
15.4 Conditions for buy back of shares
15.5 Legal provisions and procedures in buyback of shares
15.6 Summary
15.7 Key words
15.8 Self Assessment Questions
15.9 References

15.0 OBJECTIVES

1. To know the concept and objects Buyback of shares
2. To analyse the provisions of buy back under Companies Act, 1956
3. To know about SEBI (Buy back of Securities) Regulations, 1998

15.1 INTRODUCTION

Buyback of shares is a part of Financial restructuring of a company so as to make the company's finances more balanced. Both, an undercapitalized and an over-capitalised company may restructure their capital by taking certain corrective steps. If a company is over capitalized, one of the methods for its restructuring is to buy back of its own shares. The buy back of shares of unlisted companies is guided by Private Ltd. Company and Unlisted Public Ltd. Company (Buy back of Securities) Rules, 2013. For listed companies, SEBI (Buy back of Securities) Regulations, 1998 are required to be complied with. This chapter covers in detail the procedure for buy back of shares. After going through this chapter, students will be able to understand:

15.2BUYBACK OF SHARES

Not only statute, but also common law, has upheld the 'sanctity' of a company's capital. In 1887, in Trevor v. Whitworth (1887) 12 App Case 409, it was held that a company limited by shares may not purchase its own shares as this would amount to an unauthorized reduction of capital. The rationale for this decision is plain, namely, that the creditors of the company make decisions on its credit-worthiness on several grounds, but an important ground is the amount of its share capital. If the courts had not established at an early stage that capital was 'sacrosanct' and could not be returned to shareholders at their whim, then share capital would not have been protected. Without this protection, creditors could find shareholders depleting share capital, with creditors left to carry all the business risks.

In India, the rule in Trevor v. Whitworth was enshrined in Section 77 of the Companies Act, 1956 which prohibited a company from buying or cancelling its own shares, unless it complied with the provisions and followed the procedure for reduction of share capital under Sections 100 to 104 of the Companies Act, 1956 which involved confirmation by the Court. However, Section 77A of the Companies Act, 1956 which was inserted in the Companies Act, 1956 by the Companies (Amendment) Act, 1999 with retrospective effect from 31.10.1998 is an exception to the prohibition under Section 77 and Section 100. Section 77A allows companies to buy-back their own shares as well as 'other specified securities'.

Concept of Buy-Back of Shares

The concept of buy-back is a recent one so far as India is concerned. The Companies Amendment Act, 1999 introduced the concept of buy-back of shares. Buy-back of shares means the purchase by the company of its own shares. Buyback of equity shares is an important mode of capital restructuring. It is a corporate financial strategy which involves capital restructuring and is prevalent globally with the underlying objectives of increasing earnings per share, averting hostile takeovers, improving returns to the stakeholders and realigning the capital structure.In India, while buy-back of securities is not permitted as a treasury option under which the securities may be reissued later, a company can resort to buy-back to reduce the number of shares issued and return surplus cash to the shareholders.

Objectives of Buy-Back

Good corporate governance calls for maximizing the shareholder value. When a company has surplus funds for which it does not have good avenues for deployment assuring an average return on capital employed and earnings per share, the company's financial structure requires balancing. The reasons for buy-back may be one or more of the following:

(i) to improve earnings per share;
(ii) to improve return on capital, return on net worth and to enhance the long term shareholder value;
(iii) to provide an additional exit route to shareholders when shares are undervalued or are thinly traded;
(iv) to enhance consolidation of stake in the company;
(v) to prevent unwelcome takeover bids;
(vi) to return surplus cash to shareholders;
(vii) to achieve optimum capital structure;
(viii) to support share price during periods of sluggish market conditions;
(ix) to service the equity more efficiently.

The decision to buy-back is also influenced by various other factors relating to the company, such as growth opportunities, capital structure, sourcing of funds, cost of capital and optimum allocation of funds generated.

15.3FUNDING FOR BUY BACK OF SHARES

According to Section 77A(1) of the Companies Act, 1956 a company may purchase its own shares or other specified securities (hereinafter referred to as "buyback") out of:

(i) its free reserves; or

(ii) the securities premium account; or
(iii) the proceeds of any shares or other specified securities.
However, no buy-back of any kind of shares or other specified securities can be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities. Thus, the company must have at the time of buy-back, sufficient balance in any one or more of these accounts to accommodate the total value of the buy-back.

Free reserves and securities premium account

While the surplus in the profit and loss account can be used for buy-back of securities, in case the profit and loss account shows a debit balance, such debit balance should first be deducted from free reserves. Capital redemption reserve, revaluation reserve, investment allowance reserve, profit on re-issue of forfeited shares, profits earned prior to incorporation of the company and any other specific reserve are not available for distribution as dividend and hence do not form part of free reserves for the purpose of buy-back. Even though Section 77A(1) provides that a company may buy-back its securities out of securities premium account, Sub-section (2) of Section 78 does not mention buy-back of securities as one of the purposes for which the balance in the securities premium account may be utilised. However, by virtue of the non obstante clause in Section 77A, namely 'Notwithstanding anything contained in this Act….', Section 77A prevails over Section 78. Therefore, the securities premium account can be utilized for buy-back of securities.

Borrowings from banks/financial institutions

Where a company has borrowed any money from banks/ financial institutions for any purpose, it should not utilize such money for buy-back of securities. [Rule 8(e)]. Further, if any approval is required to be obtained from banks/financial institutions, such approval should be obtained before passing the Board resolution for buy-back of securities.

15.4CONDITIONS FOR BUY BACK OF SHARES

Authority in the Articles

Buy-back of securities should be authorised by the Articles of Association of the company. [Section 77A (2)(a)]. In case the Articles do not contain such a provision, they should be amended appropriately authorizing the buy-back of securities. Such an amendment should be made either at a meeting preceding the meeting wherein the resolution for buy-back is to be passed or at the same meeting wherein the resolution for buy-back is to be passed but the resolution for amendment of Articles should precede the resolution for buy-back of securities.

Board resolution and quantum of buy-back

By passing a resolution, the Board can authorize the buy-back of securities not exceeding 10% of the total paid-up equity capital and free reserves of the company.[Proviso to Section 77A(2)]. The aforesaid limit is to be applied not to the number of securities to be bought back but to the amount required for buy-back of such securities. The resolution authorizing buy-back should be passed at a meeting of the Board [Section 292(1)(as)]. Such a resolution should not be passed by circulation or at a meeting of a committee of the Board. However, the methodology, mode of buy-back and other procedural requirements for buy-back may be delegated by the Board.

Shareholders' resolution and quantum of buy-back

By passing a special resolution, the shareholders can authorize the buy-back of securities not exceeding 25% of the total paid-up capital and free reserves of the company in that financial year. [Section 77A(2)(b) and (c)]. Paid-up capital includes both equity and preference share capital. Whereas unlisted companies should obtain shareholders' approval by passing the special resolution only at a duly convened general meeting, listed companies should obtain such approval by postal ballot. The notice containing the special resolution proposed to be passed should be accompanied by an explanatory statement stating:

(a) all material facts, fully and completely disclosed;
(b) the necessity for buy-back;
(c) the class of security intended to be purchased under the buy-back;
(d) the amount to be invested under buy-back; and
(e) the time limit for completion of buy-back [Section 77A(3)].

The detailed requirements in this regard, as laid down in the Regulations and Rules respectively for listed and unlisted companies, are explained later.

Maximum quantum of buy-back

A company cannot buy-back more than 25% of its total paid-up capital and free reserves. [Section 77A(2)(c)]. The aforesaid limit is to be applied not to the number of securities to be bought back but to the amount required for buy-back of such securities. Buy-back of equity shares in any financial year should not exceed 25% of the total paid-up equity capital of the company. [Proviso to Section 77A(2)(c)]. A company may buy-back its entire (i.e. 100%) securities other than equity shares, viz. preference shares and any other securities as may be notified by the Central Government from time to time, in a financial year, subject to the overall limit of 25% of the total paid-up capital and free reserves of the company.

Given below are illustrations of the quantum that the Board/shareholders can buy-back in certain situations:

Illustration A: The capital structure of a company consists of:

(a) 10,00,000 equity shares of Rs. 10 each fully paid-up.

(b) Free reserves Rs. 7,50,00,000.

The Board can authorise buy-back up to 10% of the total paid-up equity share capital and free reserves, i.e.10% of Rs. [1,00,00,000 + 7,50,00,000] = Rs. 85,00,000 However, buy-back of equity shares in a financial year cannot exceed 25% of the paid-up equity capital in that year and hence the Board cannot authorize buy-back of equity shares in excess of 25% of Rs.1, 00,00,000 = Rs. 25,00,000. Shareholders can approve buy-back upto 25% of paid-up capital and free reserves, i.e. 25% of Rs. [1,00,00,000 + 7,50,00,000] = Rs. 2,12,50,000, but this is subject to the overall limit of 25% of Rs. 1,00,00,000 = Rs. 25,00,000.

Illustration B:

The capital structure of a company consists of:

(a) 10,00,000 equity shares of Rs. 10 each fully paid-up.

(b) 10,00,000 equity shares of Rs. 10 each on which Rs. 5 is paid-up.

(c) Free reserves Rs. 7,50,00,000.

The total paid-up equity share capital of the company is Rs. [1,00,00,000 + 50,00,000] = Rs.1,50,00,000. The Board can, within the overall limits, buy-back upto 10% of the total paid-up equity share capital and free reserves, i.e. 10% of Rs. [1,50,00,000 + 7,50,00,000]= Rs. 90,00,000. The shareholders can approve buy-back upto 25% of paid-up capital and free reserves, i.e.25% of Rs. [1,50,00,000 + 7,50,00,000] = Rs. 2,25,00,000.

However, the buy-back in the present case cannot exceed 25% of paid-up equity capital i.e. 25% of Rs. [1,00,00,000 + 50,00,000] = Rs. 37,50,000.

Illustration C:

The capital structure of a company consists of:

(a) 10,00,000 equity shares of Rs. 10 each fully paid-up.

(b) 10,00,000 equity shares of Rs. 10 each on which Rs. 5 is paid-up.

(c) 10,00,000 equity shares of Rs.10 each fully paid-up with differential rights as to voting.

(d) 1,00,000 preference shares of Rs. 100 each fully paid-up.

(e) Free reserves Rs. 7,50,00,000.

The total paid-up equity share capital of the company is Rs. [1,00,00,000 + 50,00,000 + 1,00,00,000] = Rs. 2,50,00,000.

The Board can draw upto 10% of the total paid-up equity share capital and free reserves, i.e. 10% of Rs. [2,50,00,000 + 7,50,00,000] = Rs. 1,00,00,000. The shareholders can approve buy-back up to 25% of paid-up capital and free reserves, i.e. 25% of Rs.[2,50,00,000 +1,00,00,000 + 7,50,00,000] = Rs.2,75,00,000.

However, the buy-back of equity shares should be limited to 25% of the total paid-up equity capital of Rs.2,50,00,000 = Rs. 62,50,000. In both the cases of approval by the Board or the shareholders, the buy-back of preference shares can be done upto 100% i.e. 1,00,000 preference shares of Rs. 100 each as it is within the overall limit of Rs. 1,00,00,000 or Rs. 2,75,00,000 respectively.

Further offer of buy-back

Once the buy-back has been made with the authorization of the Board and not that of the shareholders, no further offer for buy-back of any securities can be made without the consent of shareholders accorded by a special resolution within 365 days reckoned from the date of the offer. [Second Proviso to Section 77A(2)].

However, the shareholders can make further offer within a period of 365 days, provided the aggregate of authorization does not exceed the quantum specified in 1.3 and 1.4 above.

Illustration D:

Where an earlier offer up to 8% of the total paid-up equity capital and free reserves was made with the approval of the Board, no further offer can be made without the approval of shareholders within a period of 365 days reckoned from the date of offer, in spite of the fact that the Board is entitled to buy-back upto 10% of paid-up equity capital and free reserves but had drawn upon only 8% thereof.

Conditions to be Fulfilled and Obligations for Buy-back of Securities:

— Only fully paid-up securities qualify for buy-back. [Section 77A (2)(e)]. If some security holders have not made the payment of calls or any sums due on the securities, it would not disentitle the company from buy-back.

However, the securities on which the call money remains in arrears cannot be bought back. Fully paid-up securities, even if quoted below par on the stock exchanges, qualify for buy-back. If a

security has been issued at a discount, the payment of the total amount due thereon should be considered as a sufficient qualification for its buyback.

— After buy-back, the company should have a debt-equity ratio not exceeding 2:1, i.e. all secured and unsecured debts of the company should not be more than twice the aggregate of its capital and free reserves. However, the Central Government has the power to prescribe a higher debt-equity ratio for a class or classes of companies. [Section 77A(2)(d)]. For the purpose of computing debt-equity ratio, 'debt' includes:

(i) long-term loans/deposits (repayable after 12 months) including interest bearing unsecured loans from government;
(ii) debentures including convertible debentures (except the part of debentures which are compulsorily convertible into equity), until they are converted, irrespective of the maturity period;
(iii) deferred payments; redeemable preference shares due for redemption between 1 to 3 years. 'Equity' includes:
(iv) paid-up equity share capital;
(v) redeemable preference shares due for redemption after 3 years;
(vi) share premium;
(vii) free reserves less accumulated losses, arrears of unabsorbed depreciation, all items of assets which are of intangible nature or expenditure not written off;
(viii) Government subsidies.

— Where buy-back of shares is made out of free reserves, the company should transfer to the capital redemption reserve account referred to in clause (d) of the proviso to Sub-section (1) of Section 80, a sum equal to the nominal value of the shares so bought back and the details of such transfer should be disclosed in the balance sheet. [Section 77AA]. In any other case, the company is not required to transfer to the capital redemption reserve account a sum equal to the nominal value of the shares so bought back. Such transfer to capital redemption reserve account will also not be required when buy-back is of securities other than shares.

— No further issue of the same kind of securities should be made within a period of 6 months from the date of completion of buy-back of securities. [Section 77A(8)]. The date of further issue of securities, for this purpose, means the date of the resolution passed by the Board or shareholders, as the case may be. Hence, an issue of preference shares may be made by a company within a period of 6 months from the date of completion of buy-back of equity shares and vice versa. However, further issue of the same kind of securities is allowed by way of bonus issue or in discharge of subsisting obligations such as conversion of warrants, stock option schemes, sweat equity or conversion of preference shares or debentures into equity shares. [Section 77A(8)].

An issue of shares in pursuance of a scheme of amalgamation, being by virtue of a court order, is permissible. However, no buy-back of securities should be undertaken while a petition for amalgamation is pending.

— No issue of any security including bonus shares should be made till the closure of offer of buy-back. [Regulation 19(1)(b) & Rule 8(1)(b)].

— A company should not make any announcement in respect of buy-back of securities from the date of approval by the Board of any scheme of compromise or arrangement pursuant to the provisions of the Act, upto the date of filing of the court order with the Registrar. [Regulation 19(2)].

— No offer of buy-back of securities should be made if such offer would result in reducing the non-promoter holding below the limit of public shareholding specified under the SEBI (Disclosure and Investor Protection) Guidelines, 2000 as applicable at the time of initial listing. [Clause 40A (iii) of Listing Agreement of Mumbai Stock Exchange].

— Convertible debentures can be bought back before the date of their conversion but such a purchase would amount to the company purchasing its own shares and all the provisions relating to buy-back shall become applicable.

— Promoters or persons acting in concert should not deal in the securities of the company while the buy-back offer is open. [Regulation 19(1)(e)].

Restrictions on Buy-back of Securities in Certain Circumstances:

— A company should not buy-back its securities if default subsists in repayment of deposits or interest payable thereon, or in redemption of debentures or preference shares or repayment of any term loan or interest payable thereon to any financial institution or bank. [Section 77B(1)(c)]. Deposits for this purpose include deposits under Section 58A read with Rule 2(b) of the Companies (Acceptance of Deposits) Rules, 1975.

— Buy-back should not be made if a company has defaulted in relation to preparation and filing of its annual return. [Section 77B(2)]. However, such a company may buy-back its securities after the default has been rectified.

— Buy-back should not be made in the event of any default in relation to payment of dividend to any equity or preference shareholder. [Section 77B(2)]. Where a dividend has been declared by a company but has not been paid in accordance with the provisions of the Act, the company may buy-back its securities only after payment of dividend and interest thereon as per the provisions of the Act.

— Buy-back should not be made in the event of default in preparation of the annual accounts. [Section 77B(2)]. Where the report of the statutory auditors of the company contains a qualification that annual accounts are not prepared as per the accounting standards or otherwise are not in accordance with the provisions of Section 211, the company cannot proceed to buy-back its securities.

— However, compounding of the aforementioned defaults or subsequent curing of the default may qualify as an enabling provision for buy-back.

— Buy-back should not be made by a company:

(i) through any subsidiary company including its own subsidiary companies;

(ii) through any investment company or group of investment companies. [Section 77B(1)(a) and (b)].

15.5 LEGAL PROVISIONS OF BUYBACK OF SHARES

Declaration of Solvency:

As per section 77A(6) where the Board or the shareholders of a listed company pass a resolution to buy-back shares, the company should, before making such buyback, file with the Registrar and SEBI a declaration of solvency in the prescribed form.A private company and a public company whose shares are not listed on a stock exchange should file the declaration of solvency with the Registrar in the prescribed form.

Stamp Duty on Buy-back: Transfer of shares attracts stamp duty vide Schedule I, entry 62 to the Indian Stamp Act, 1899. For completion of transfer of shares, a company is required to register the shares in the name of the transferee. In the case of buy-back, the shares bought back have to be statutorily extinguished within 7 days from the last date of completion of buy-back. Hence, no registration of such shares takes place in the name of the company. The names of the members/holders of the shares have to be struck off from the register of members if the entire holding is bought back. Therefore, buy-back cannot be considered as transfer and stamp duty would not be payable in a case where buy-back of shares takes place in physical form even if the shares are accompanied by an application form for transfer of shares in favour of the company.

Further, buy-back of shares will not be construed as “release” falling under Article 55 of the Indian Stamp Act attracting stamp duty. Shares received by the company for buy-back in electronic mode do not attract stamp duty in terms of the provisions contained in the Depositories Act, 1996.

Income Tax Aspects: Section 46A has been inserted in the Income Tax Act, 1961 with effect from the assessment year 2000-01. The said section provides that any consideration received by a security holder from any company on buy back shall be chargeable to tax on the difference between the cost of acquisition and the value of consideration received by the security holder as capital gains. The computation of capital gains shall be in accordance with the provisions of Section 48 of the Income Tax Act, 1961.

(ii) Approval of Shareholders: In terms of Sub-section (2)(b) of Section 77A, a buy-back must be approved by a special resolution. However, a special resolution at a general meeting is not necessary where buy-back is or less than ten per cent of the total paid-up equity capital and free reserves of the company and such buy-back has been authorized by the Board of Directors of the company by means of a resolution passed at its meeting and not by way of a resolution of board of directors passed by circulation. In case of a listed company, the approval of shareholders should be taken only by way of postal ballot [Section 192A].

Also, a copy of the resolution, passed by the Board of Directors at its meeting, authorising buy back of its shares or other specified securities, shall be filed with the SEBI and the stock exchanges where the shares or other specified securities of the company are listed, within two days of the date of passing a special resolution. All the shares or other specified securities for buy-back must be fully paid-up [Section 77A(2)(e)].

(iii) Special Resolution and Explanatory statement to be annexed: Where buy-back of securities needs the approval of the company at a general meeting by special resolution, Sub-section (3) of Section 77A provides that the notice of the meeting at which the special resolution authorising the buy-back is proposed to be passed should be accompanied by an explanatory statement stating. An explanatory statement containing full and complete disclosure of all the material facts and the disclosures prescribed in Schedule I of the Regulations should be annexed to the notice where the buy-back is pursuant to shareholders' approval.

(viii) Time limit for completion of buy-back: Every buy-back must be completed within twelve months from the date of passing of the special resolution or the resolution of the Board of Directors (i.e. in case of buy-back is or less than ten per cent of the total paid-up equity capital and free reserves of the company), as the case may be. [Section 77A(4)].

(vii) Return to be filed with Registrar: After completion of the buy-back, the company should file with the Registrar of Companies, a return in the prescribed Form specified in Annexure 'A' of the Rules [Rule 9].

(viii) Extinguishment of certificates: Rule 10 lays down that the company should extinguish and physically destroy the share certificates so bought back in the presence of a company secretary in whole time practice within seven days from the date of acceptance of the shares. The company should furnish a certificate to the Registrar of Companies duly verified by (a) two whole-time directors including the managing director and (b) company secretary in whole-time practice, certifying compliance of these rules including those specified in sub-rule (1) above within seven days of the extinguishment and destruction of the certificates. The company should maintain a record of share certificates which have been cancelled and destroyed within seven days of the buy-back of the shares.

(ix) Register of shares: The company should maintain a register of shares bought back by it, which should be in the prescribed format specified in Annexure 'B' of the Rules [Rule 11].

68. (4) <u>Time Limit</u>: Every buy-back shall be completed within a period of one year from the date of passing of the special resolution, or as the case may be, the resolution passed by the Board.

68. (6) <u>Solvency Declaration</u>: Before making such buy-back, file with the Registrar, a declaration of solvency signed by at least two directors of the company, one of whom shall be the managing director, if any, Form No. SH.9 may be prescribed and verified by an affidavit to the effect that the Board of Directors of the company has made a full inquiry into the affairs of the company as a result of which they have formed an opinion that it is capable of meeting its liabilities and will not be rendered insolvent within a period of one year from the date of declaration adopted by the Board.

68. (7) <u>Extinguishment of Certificate</u>: Company shall extinguish and physically destroy the shares or securities so bought back within seven days of the last date of completion of buy-back.

68. (8) <u>No further issue till 6 months</u>: Where a company completes a buy-back of its shares or other specified securities, it shall not make a further issue of the same kind of shares or other

securities including allotment of new shares or other specified securities within a period of **six** months except by way of:

a) a bonus issue or

b) in the discharge of subsisting obligations such as conversion of warrants, stock option schemes, sweat equity or conversion of preference shares or debentures into equity shares.

68. (11) Punishment for any Default: If a company makes any default in complying with the provisions of this section, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to three years or with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees, or with both.

69. (1) Capital Redemption Reserves: Where a company purchases its own shares out of free reserves or securities premium account, a sum equal to the nominal value of the shares so purchased shall be transferred to the capital redemption reserve account and details of such transfer shall be disclosed in the balance sheet.

69. (2) Utilization of Capital Redemption Reserves: The capital redemption reserve account may be applied by the company, in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.

70. (1) Restriction on Buy Back: No company shall directly or indirectly purchase its own shares or other specified securities—

a) through any subsidiary company including its own subsidiary companies;

b) through any investment company or group of investment companies; or

b) if a default, is made by the company, in the repayment of deposits accepted either before or after the commencement of this Act, interest payment thereon, redemption of debentures or preference shares or payment of dividend to any shareholder, or repayment of any term loan or interest payable thereon to any financial institution or banking company. Provided that the buy-back is not prohibited, if the default is remedied and a period of three years has lapsed after such default ceased to subsist.

70. (2) **No Buy Back if:** No company shall, directly or indirectly, purchase its own shares or other specified securities in case such company has not complied with the provisions of:

a) Sections 92: Annual Return
b) Section 123: Declaration and Payment of Dividend
c) Section 127: Failure to pay Dividend
d) Section 129: Failure to give True and Fair Statement

15.6 SUMMARY

Section 77A of the Companies Act is an exception to the prohibition under Section 77 as it allows companies to buy-back their own shares as well as 'other specified securities', subject to the conditions specified therein. Under Section 77A, any company limited by shares or company Ltd. by guarantee and having a share capital can buy-back its own securities, whether it is a private, public, listed or unlisted company. The buyback of securities of listed companies are guided by SEBI (Buy-back of Securities) Regulations, 1998. The buy-back in respect of securities which are not listed on any recognized stock exchange must be in accordance with Private Limited Company and Unlisted Public Limited Company (Buy-back of Securities) Rules,1999.

15.7 KEY WORDS

1. DCA: Department of Company Affairs
2. CLB: Company Law Board
3. SEBI: Securities Exchange Board of India

15.8 SELF ASSESSMENT QUESTIONS

1. What do you mean by 'buy-back' of shares or specified securities as under the Companies Act, 1956. Explain the relevant provisions.
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2. What are the different alternatives available to a public company for 'buyback'?
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   ……………………………………………………………………………………………
3. Briefly explain the procedure for buyback of unlisted and private companies
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   ……………………………………………………………………………………………

15.9REFERENCES

1. A.Ramaiya : Guide Companies Act, Wadhwa & Company, Nagpur
2. Corporate Laws, Bare Act : Taxmann's Publications
3. Dr. K.R. Chandratre: Corporate Restructuring

BLOCK: IV

UNIT-16 INTRODUCTION AND MEANING; KINDS OF WINDING UP

Structure

16.0 Objective
16.1 Introduction
16.2 Meaning of Winding up
16.3 Kinds of Winding up
16.4 Summary
16.5 Key Words
16.6 Self Assessment Questions
16.7 References

16.0 OBJECTIVES

•To able know the meaning of winding up

•To analyse Winding up and dissolution of a company

• To understand the kinds of winding up

16.1 INTRODUCTION

In law, **liquidation** is the process by which a company (or part of a company) is brought to an end, and the assets and property of the company are redistributed. Liquidation is also sometimes referred to as **winding-up** or **dissolution**, although dissolution technically refers to the last stage of liquidation. The process of liquidation also arises when customs, an authority or agency in a country responsible for collecting and safeguarding customs duties, determines the final computation or ascertainment of the duties or drawback accruing on an entry. Liquidation may either be compulsory (sometimes referred to as a creditors' liquidation) or voluntary (sometimes referred to as a shareholders' liquidation, although some voluntary liquidations are controlled by the creditors, see below). An Insolvency Practitioner has to be appointed Liquidator

16.2MEANING OF WINDINGUP

Corporate Collapse is inevitable in any economy particularly in market-oriented economy. It implies business failure of the company, which may occur due to inadequate capital, fraudulent business practices, management inexperience and incompetence, failure to respond to change, recession, obsolescence, excessive gearing etc. The Companies Act, 1956, provides various remedies to deal with such business failures such as arrangement, reconstruction, amalgamation, winding-up. Winding-up of a company is a process of putting an end to the life of a company. It is a proceeding by means of which a company is dissolved and in the course of such dissolution its assets are collected, its debts are paid off out of the assets of the company or from contributions by its members, if necessary. If any surplus is left, it is distributed among the members in accordance with their rights. In the words of Prof. L.C.B. Gower, Winding-up of a company is the process whereby its life is ended and its property administered for the benefit of its creditors and members. An administrator called liquidator is appointed and he takes control of the company, collects its debts and finally distributes any surplus among the members in accordance with their rights. Thus Winding-up is the process by which management of a company's affairs is taken out of its directors' hands, its assets are realized by a liquidator and its debts are realized and liabilities are discharged out of proceeds of realization and any surplus of

assets remaining is returned to its members or shareholders. At the end of the winding up the company will have no assets or liabilities and it will, therefore, be simply a formal step for it to be dissolved, that is, for its legal personality as a corporation to be brought to an end. The main purpose of winding up of a company is to realize the assets and pay the debts of the company expeditiously and fairly in accordance with the law. However, the purpose must not be exploited for the benefit or advantage of any class or person entitled to submit petition for winding up of a company. It may be noted that on winding up, the company does not cease to exist as such except when it is dissolved. The administrative machinery of the company gets changed as the administration is transferred in the hands of the liquidator. Even after commencement of the winding-up, the property and assets of the company belong to the company until dissolution takes place. On dissolution the company ceases to exist as a separate entity and becomes incapable of keeping property, suing or being sued. Thus in between the winding up and dissolution, the legal status of the company continues and it can be sued in the court of law.

Company Cannot be Adjudged Insolvent

The winding up of a company is not the same thing as the insolvency of a company, for the general rule in regard to winding up is that if the members of a company desire that the company should be dissolved or if it becomes insolvent or is otherwise unable to pay its debts, or if for any reason it seems desirable that it should cease to exist, it is wound up. It is obvious that a company may be wound up even when it is perfectly solvent, e.g. for purpose of reconstruction. Furthermore, a company can never be declared bankrupt although it is unable to pay its debts. It can only be wound up, of course, some provisions of insolvency laws are made applicable to companies in liquidation (See Sections 442, 446, 477, 528 to 531 and 534 to 537 of the Companies Act). Thus, we may put the proposition that in so far as inability to pay debts is concerned, a bankruptcy of an individual under the insolvency law is the same thing as a winding up of a company under the company law but a company can also be wound up for reasons other than mere inability to pay its debts.

Winding up and Dissolution

The terms “Winding up” and “Dissolution” are sometimes erroneously used to mean the same thing. But according to the Companies Act, 1956, the legal implications of these two terms are quite different and there are fundamental differences between them as regards the legal procedure involved. The main points of distinction are given below:

1. The entire procedure for bringing about a lawful end to the life of a company is divided into two stages – 'winding up' and 'dissolution'. Winding up is the first stage in the process whereby assets are realised, liabilities are paid off and the surplus, if any, distributed among its members. Dissolution is the final stage whereby the existence of the company is withdrawn by the law.
2. The liquidator appointed by the company or the Court carries out the winding up proceedings but the order for dissolution can be passed by the Court only.
3. According to the Companies Act the liquidator can represent the company in the process of winding up. This can be done till the order of dissolution is passed by the Court. Once the Court passes dissolution orders the liquidator can no longer represent the company.
4. Creditors can prove their debts in the winding up but not on the dissolution of the company.
5. Winding up in all cases does not culminate in dissolution. Even after paying all the creditors there may still be a surplus; company may earn profits during the course of beneficial winding up; there may be a scheme of compromise with creditors while company is in winding up and in all such events the company will in all probability come out of winding up and hand over back to shareholders/old management. Dissolution is an act which puts an end to the life of the company. As such winding up is only a process while the dissolution puts an end to the existence of the company. Unless and until it has been set aside under Section 559 of the Act, it prevents any proceedings being taken against promoters, directors or officers of the company to recover money or property due or belonging to the company or to prove a debt due from the company. When the company is dissolved, the statutory duty of the liquidator towards the creditors and contributories is gone, but if he has committed without complying with the requirements of the Act, he is liable to damages to the creditors.

16.3 KINDS OF WINDING UP

A company registered under the Companies Act, 1956 may be wound up in any of the following modes:

1. **By the Court** i.e. compulsory winding up;
2. **Voluntary winding up**, which may be either: (a) Members' voluntary winding up; or (b) Creditor's voluntary winding up;
3. **Winding up subject to the supervision of the Court**.2 Section 425 of the Companies Act, 1956 lays down the above two modes of winding up and provides that the provisions of the Act with respect to winding up shall apply, unless the contrary appears, to the winding up of a company in any of these two modes. In every winding up, a liquidator or

liquidators is or are appointed to administer the property of the company and he or they must apply the assets of the company, first, in the payment of the creditors in their proper order, and then, in distributing the among the members according to their rights.

Provisions of Winding-up under the Companies Act, 2013:

Chapter XX of the Companies Act, 2013 deals winding up. Provisions of Section 270 to 358 of the Companies Act, 2013 provides for various compliances and procedures to be followed in case of winding up. Section 359 to 365 speaks about the official liquidators. These sections are yet to be notified in the Official Gazette and Students are required to refer the Bare Act for provisions.

16.4 SUMMARY

There are fundamental differences between winding up and dissolution as regards the legal procedure is involved. A company may be wound up by the Court i.e. compulsory winding up; By voluntary winding up (members' voluntary winding up or creditors' voluntary winding up) or winding up subject to the supervision of the Court.

16.5KEY WORDS

1. Winding up by Court
2. Members Voluntary Winding up
3. Creditors Voluntary Winding up
4. Winding up subject to the supervision of the Court

16.6 SELF ASSESSMENT QUESTIONS

1. Winding up and Dissolution are two different stages in bringing about a lawful end to the life of a company. In this context, explain the differences between Winding up and Dissolution.

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2. The company incorporated under the law and end of the company also by the process of law only. Substantiate this statement with meaning of winding up.

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3. What are the modes of winding up?

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16.7 REFERENCES

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UNIT-17 WINDING UP THROUGH COURT; GROUNDS FOR WINDING UP BY THE COURT; RIGHTS OF FILING PETITION FOR WINDING UP BEFORE THE COURT; PROVISIONS AND PROCEDURES

Structure

17.0 Objective

17.1 Introduction

17.2 Winding up through court; grounds for winding up by the court

17.3 Right of filing petition for winding up before the court

17.4 Provisions and procedures of winding up through court

17.5 Summary

17.6 Keywords

17.7 Self Assessment Questions

17.8 References

17.0 OBJECTIVES

To able to know the grounds on which a company may be wound up by the court

1. To know who may petition for the winding up
2. To understand the procedure for compulsory winding up by the court

17.1INTRODUCTION

A company can be wound up by the Court at the instigation principally of any member or creditor of the company or the Minister in appropriate circumstances. The Court appoints the liquidator and he/she becomes an officer of the Court and works under its supervision. The Court, used in relation to a company, means the High Court

17.2 WINDING UP THROUGH COURT; GROUNDS FOR WINDING UP BY THE COURT

Winding up by the Court or compulsory winding up is initiated by an application by way of petition to the appropriate Court for a winding up order. A winding up petition has to be resorted to only when other means of healing an ailing company are of absolutely no avail. Remedies are provided by the statute on matters concerning the management and running of company. The extreme and irretrievable step of winding up must be resorted to only in very compelling circumstances. [Daulat MakanmalLuthridv. Solatire Hotels (1993) 76 Comp. Case. 215 (Bom. HCD)]. It is primarily the High Court which has the jurisdiction to wind up companies under Section 10 of the Companies Act, 1956 in relation to the place at which registered office of the company concerned is situated except to the extent to which jurisdiction has been conferred on any District or District Courts subordinate to the High Court. The Central Government may empower any District Court to exercise that jurisdiction, presumably to reduce the burden of the High Court, only in respect of small companies with the paid-up capital of not more than one lakh of rupees and having their registered office within the District, with a view to achieving expeditious and efficient disposal of winding up proceedings. The Act, therefore, under Sections 435 to 438, confers wide powers upon the High Court to regulate the conduct of such proceedings. Accordingly the High Court which is the winding up Court may direct a District Court to retain and continue winding up proceedings which should not really have been commenced in that Court (Section 437). It may also withdraw any winding up which is in progress in a District Court from that Court and proceed with the winding up itself, or transfer it

to another District Court (Section 436), and with respect to all proceedings subsequent to its own order of winding up, direct them to be had in a District Court or with the consent of any other High Court, in such High Court or in a District Court subordinate to that High Court, whereupon the Court in respect of which such direction is given shall be deemed tom be the Court with all powers and jurisdiction of the High Court under the Act (Section 435). Lastly, the High Court can pass orders under any of the foregoing sections at any time and at any stage, whether or not an application in that behalf is made by any of the parties to the proceedings (Section 438). There must be strong reasons to order winding up as it is a last resort to be adopted. Temporary difficulty cannot be ground for liquidating company when company is on path of revival. D. Ashokanv. S.T. Reddiar & Sons (2002) 40 SCL (Ker. HC DB).

Grounds on which a Company may be Wound up by the Court

A company under Section 433 may be wound up by the Court if (a) the company has passed a special resolution of its being wound up by the Court; or (b) default is made in delivering the statutory report to the Registrar or in holding the statutory meeting; or (c) it does not commence business within a year from its incorporation or suspends business for a whole year; or (d) the number of its members in the case of a public company is reduced below seven and in the case of a private company, below two; or (e) it is unable to pay its debts; or (f) the Court is of the opinion that it is just and equitable that it should be wound up; or (g) if the company has made a default filing with the Registrar its balance sheet and profit and loss account or annual return for any five consecutive financial years; or (h) if the company has acted against the interests of the sovereignty and integrity of India, the security of the state, friendly relations with foreign states, public order, decency or morality; or (i) If the tribunal is of opinion that the company should be wound up under the circumstances specified in Section 424G:

Provided that the tribunal shall make an order for winding up of a company under clause (h) on application made by the Central Government or a State Government.

(a) Special Resolution:

A company may be wound up for any cause whatever if it passes a special resolution to that effect. The Court is, however, not bound to order winding up simply because the company has so resolved. The power may not be exercised if the winding up is opposed to the public or company's interest. The power of the Court in such a case is discretionary and should be exercised only where a bona fide case is made out. Winding up order on this ground is not a common feature because if such a large number of shareholders want the company to be wound

up they would prefer the mode of voluntary winding up, which involves less time and is cheaper than winding up by order of the Court. It may be mentioned here that without the authority of the general meeting the directors are not entitled to present a winding up petition in the name of the company. But where the directors have presented such a petition, it is open to general meeting of shareholders to ratify their action.

(b) Default in filing statutory report or holding statutory meeting:

A petition for winding up of a company on this ground can only be made either by the Registrar with the previous sanction of the Central Government or by a contributory on or after the expiration of 14 days after the last day on which the statutory meeting ought to have been held. The power of the Court is discretionary. Instead of making an order for winding up, the Court may direct that the statutory report shall be filed or a meeting should be held, as the nature of the default may be. The Court may order the costs to be paid by any persons who, in its opinion, are responsible for the default [Section 443(3)].

(c) Non-Commencement or Suspension of Business:

If a company does not commence its business within a year from its incorporation or has suspended business for a whole year, it may be ordered to be wound up. Here again the power of the Court is discretionary and will be exercised only when there is a fair indication that there is no intention to carry on business or where the delay has been sufficiently accounted for and there is no evidence or any probability of its commencing its business within a reasonable time (See The Malabar Iron and Steel Works Ltd. v. The Registrar of Companies, AIR 1965 Ker. 35). Similarly, when the delay appears to be due to temporary or unavoidable causes, the Court will not order a winding up. In Re. Capital Fire Insurance Association, (1883) 24 Ch.D. 408. Also see Aluminium Corporation of India Ltd. v. Lakshmi Rattan Cotton Mills Co. Ltd. AIR 1970 All 452]. For instance, where, at the instance of the shareholders, a company's business was suspended due to recession, and a petition for winding up made by a shareholder after a year of suspension, was opposed by four-fifths in value of shareholders, the order for winding up was refused. In Re. Middlesborough Assembly Rooms Co., (1880) 14 Ch.D. 104]. Where a company ceases to operate in the field of its activities but becomes a holding company in relation to other companies which are engaged in pursuit of objects for which it was incorporated, such company cannot be said to have suspended its business for a whole year so as to justify an order for its winding up. In Re. Eastern Telegraph Co. Ltd., (1947) 2 All ER 104]. The suspension must be of entire business and not a part of it. Where a company having many businesses discontinues one

of them, it cannot be said to have suspended its business [ParamjitLalBadhwarv. PremSpg. and Weaving Mills Ltd. (1983) Tax. L.R. 2506 (All)]. In Registrar of Companies v. Bihar Wire (1975) 45 Comp. Cas. 194 (P&HHC) it was held that mere fact that business has not been commenced within a year or has been suspended for a year or more is not a ground for a Court to order winding up of a company. It has to be found out whether the non-commencement or suspension of business is for good reason. The decisive question is whether there is reasonable hope of the company commencing or resuming business and doing it at profit and whether substratum of the company has disappeared. Another consideration is taking into account the wishes of majority of shareholders about continuing the business. Further, a company will not be wound up because it has ceased to carry on one of its several businesses unless that business is the main object of the company. In Re. Amalgamated Syndicate [(1897) 2 Ch. D. 600], nor can a company which has amalgamated with another company be wound up on the ground that it has ceased to carry on business as a separate company. If the company has made all possible efforts to proceed with business but due to unforeseen circumstances beyond its control, company could not proceed, company cannot be ordered to be wound up under Section 433(c). [Bikkim Gopalakrishna Rao v. Seavally Resorts (2000) 27 SCL 242]. In Surendra Kumar Pareekv. Shree Guru Nanak Oils (P) Ltd. (1995) 82 Comp. Cases 642 (Raj.), the business of the company was suspended for over a year, the number of members was reduced to less than two, all directors but one were absconding and the assets were taken over by the lending institutions, the winding up was admitted despite objection from the lending institution that the winding up was being resorted to, to stable the remaining liability to the Institution.

(d) Reduction of members below minimum:

If the number of members is reduced, in the case of a public company, below seven, and in case of a private company, below two, the company may be ordered to be wound up. The word “member” in clause (d) of Section 433 means actual members and does not include past members or representatives of the deceased members, or trustees or assignees of bankrupt members [See Bowling and Welby’s Contract, (1895) I Ch.D. 663]. The Court usually in such a case does not order winding up, but leaves it to the company to go into voluntary liquidation. This ground for winding up is meant to enable a member to escape personal liability for the company’s debts which he will incur under Section 45 of the Act.

(e) Inability to pay debts:

Section 434 of the Companies Act lays down the specific circumstances when the company shall be deemed to be unable to pay its debts. These are:

(i) If a creditor to whom the company owes more than Rs. 500/- then due, has served on the company a demand in writing for payment of the debt and the company has within three weeks thereafter, neglected to pay or secure or compound for it to the reasonable satisfaction of the Court. The debt must be really due and not under dispute. Where the object of the petition to wind up a company really is to bring pressure upon the company in order to make it pay the debt cheaply and expeditiously when the company desires to dispute the debt in the Civil Court, the petition was held to be abuse of the process of the Court and liable to be dismissed. [P. Satya Raju v. Guntur Cotton, Jute and Paper Mills AIR 1955 (Mad.) 199].

(ii) If an execution or other process has not been satisfied by the company. The decree or order contemplated by this clause is confined not to money decreeonly but is of a general nature. [Seethal Mills Ltd. v. N. Perumalswamy, (1980) 50 Comp. Cas. 422 Mad.].

(iii) If it is proved to the satisfaction of the Court that the company cannot pay its debts including the contingent and prospective liabilities, it may be ordered to be wound up. In this case, it is the commercial insolvency of the company which is important rather than the difference between the assets and liabilities.

The company is liable to be wound up if it is unable to pay its current demands even though the assets, when realised, would exceed its liabilities or where its assets are locked up and it is running at a loss. The important aspect to be examined in this situation is whether in a commercial sense the company is in a position to pay its existing liabilities while it continues to carry on its business. A debt must be a definite sum of money payable immediately or at a future date. A contingent or conditional liability is not a debt unless the contingency or condition has already happened [Registrar of Companies v. Kavita Benefit Pvt. Ltd. (1978) 48 Comp. Cas. 231]. If the Court is satisfied that the company cannot pay its admitted or undisputed debts, it may order the company to be wound up, however small such debts may be. It is not necessary that demand should have been made or the execution levied. In Re. Globe Steel & Co. (7 Eq. 337), the company accepted a bill of exchange in part payment for goods bought. No demand had been made nor execution levied. This bill was dishonored. It was held that it was sufficient proof of the company's inability to pay its debts. The Central Government is entitled to apply

and obtain an order, for the compulsory winding up of a company if the company is unable to pay a large sum lawfully due to it as income-tax [Coimbatore Transport Co. Ltd. v. Governor General in Council (1948) 1 M.L.J. 407]. Where a debt is bona fide disputed by the company and the Court is satisfied with the company's defense, there is no 'neglect to pay' and therefore a winding up order will not be made [Piara Singh (S) v. S.H.R. Properties Pvt. Ltd. (1993) 10 CLA 83]. Bona fide dispute implies the existence of a substantial ground for the dispute raised. In other words, where there is scope for honest differences of opinion and disputes in respect of the claim made, the Court will not entertain a winding up petition. [Bhabesh Chandra Guha Roy v. Bisserwarlal Sharma, 1973 Tax LR 2331 (Cal)]. The Court may however at its discretion direct the company to furnish security. While hearing a winding up petition, the court decides only whether the company is liable to be wound up or not. A winding up application cannot be used for obtaining decision for recovery of debts due to any banks or financial institution. The Tribunals constituted under the Recovery of Debts due to Banks and Financial Institutions Act, 1993, does not have the jurisdiction to entertain an application for winding up of a company. Such an application can be made only under the Companies Act, 1956 [Andhra Steel Corpn. Ltd. v. Bank of Baroda (1996) 1 Comp. LJ 313]. A notice under Section 434 is a serious matter. If the notice is validly given, its effect would be to raise a presumption as to the inability of the company to pay the debt and as to its insolvency rendering it liable to be wound up by the Court. Such a notice must comply with the requirements of the statute. All that is required by a statute is that the notice must be in respect of an existing and presently payable debt exceeding Rs. 500/-. The notice will not be invalid merely because sum demanded ismore than the sum actually due. In such a case the sum due remains included in the demand (Ofu Lynx Ltd. v. Simon Carves India Ltd., AIR 1970 Cal 418). The expression three weeks means three clear weeks from the date of the demand. The date on which the demand is made is excluded. [In Re. Lympane Investments Ltd., (1972) 2 All. E.R. 385]. As for the second proposition it is sufficient if the company has informed a judgment-creditor that it has no assets on which to levy execution or the payment was demanded from it by the petition or without any success. [In Re. Flag Staff Co. of Utah, (1875) R. 20 Eq. 268]. If company persistently fails to honour its commitment made at various stages to discharge its financial obligations, it has to held that it was unable to pay its debts and is therefore liable to be wound up. [Bharwan Bros. v. Motorola (India) Ltd. (2000) 25 SCL 517 (Guj HC)]. It is not the requirement of Section 434 that the creditor in his notice must mention that in the event of non-compliance, the creditor will apply for winding up. No form has

been prescribed for the notice. [Color Coats v. Venkataramanas Hotels Ltd. AIR 1999 AP 16]. Notice is valid even in absence of stipulation of period of three weeks notice and expression 'winding up proceedings', if the notice specifically states that in the event of default in payment of debt due, appropriate legal proceedings will be taken. [J.G. Finance v. HansaflonPlastochem(2001) 30 SCL 430].

(f) Just and Equitable:

If the Court is of opinion that it is just and equitable that the company should be wound up, it may be ordered to be wound up. In this case, the Court has wide powers and has a complete discretion to decide when it is just and equitable that the company should be wound up. The word "just and equitable" are not confined to matters ejusdem generis as the preceding clauses of the section, nor to prove cases of mala fides. They are general words which must not be reduced to the sum of particular instances, nor confined to circumstances affecting the petitioner in his capacity as shareholder. They enable the Court to subject the exercise of legal rights to equitable considerations through thewords themselves, and not because the company's structure is in any way analogous to a partnership. [Ebrahimiv. Westbourne Galleries Ltd. & Others (1972) 2 W.L.R. 1289]. Lord Wilberforce observed in Ebrahimiv. B. Westbourne Galleries Ltd.: "the tendency to create categories or headings is wrong: the general words of the subsection should remain general and not be reduced to the sum of particular instances." The discretion of the Court under this clause is very wide and the courts have exercised this discretion on a variety of grounds. Some of the cases by way of illustration are given here in which, the Court ordered winding up of the company under 'just and equitable' clause to indicate the general categories:

(i) Where the whole object of the company was fradulent [In Re. German Date Coffee Co., (1882) 20 Ch.D. 169].

(ii) Where the substratum of the company is gone. The substratum of a company is deemed to have gone where (a) the subject matter of the company is gone, or (b) the object for which it was formed has substantially failed, or (c) it is impossible to carry on the business of the company except at a loss, or (d) the existing and possible assets are insufficient to meet the existing liabilities of the company (Seth Mohan Lalv. Grain Chambers Ltd.,AIR 1968 S.C. 772).

(iii) Where the main object of the company for which it was incorporated has been completely achieved.

(iv) Where there is a complete deadlock in the management of the company e.g., where two shareholders, who were also directors of private company, were not on speaking term [In Re. Yenidjye Tobacco (1916) 2 Ch. 426]. Fractions among shareholders is, however, not a sufficient ground.

(v) Where the company is a "bubble" and has no business to carry on e.g. where the main business of the company has been taken over by the Government and there is no prospect of the company doing any other business mentioned in the objects clause of the Memorandum of Association.

(vi) Where the company is insolvent and its business is being carried on for the benefit of the debenture holders.

(vii) Where there has been mismanagement and misapplication of funds by the directors of private company [Lock v. John Blackwood Ltd., (1924) A.C. 73].

(viii) Where the petitioner was excluded from all participation in the business of a private company.

(ix) If the company has committed default in making payment to various investors, allegations that directors have cheated several thousand investors, banks and FIs, company has not filed balance sheet for two years and no reply from company to advertisement under Rule 24, the company is liable to be wound up [ROC v. Country Informtech Services P. Ltd. (2002) 39 SCL 504 (All HC)].

The following are some of the cases in which winding up was not ordered under just and equitable clause:

(i) Where the company was under a loss but there was a chance of its making profit and the majority of shareholders were against winding up.

(ii) Where the directors in the exercise of their powers to do so, refused to register the executors of the deceased shareholder even when this caused hardship to the shareholders.

(iii) Where there is honest difference between the petitioner, a director and the other directors and he has been outvoted.

(iv) Where the business of the company was temporarily suspended owing to trade depression and was intended to be continued when conditions improved.

(v) Where there was a deadlock in management of a public company.

(vi) If the 'just and equitable' ground does not exist at the time of hearing the petition though it might have existed at the time of presenting the petition.

17.3 RIGHTS OF FILING PETITION FOR WINDING UP BEFORE THE COURT

Who may Petition for the Winding up:

An application for the winding up of a company has to be made by way of petition to the Court. A petition may be presented under Section 439 by any of the following persons:

(i) the company; or

(ii) any creditor or creditors, including any contingent or prospective creditor or creditors; or

(iii) any contributory or contributories; or

(iv) all or any of the parties specified above in clauses (a), (b), (c) whether together or separately; or

(v) the Registrar; or

(vi) any person authorised by the Central Government in the case falling under Section 243, i.e. following upon a report of inspectors; or

(vii) in case falling under clause (h) of Section 433, by the Central Government or State Government.

The Official Liquidator or any of the persons mentioned above as being entitled to present a petition under Section 439, will have a right to present a winding-up petition when a company is already being wound up voluntarily or subject to the supervision of the Court, and such voluntary winding up cannot be continued with due regard to the interests of the creditors or contributories or both (Section 440). In Mumbai Labour Union v. Indo French Time Industries (2002) 38 SCL 924, it was held that a trade union can not file winding up petition for unpaid wages of workmen/employees. They are disentitled as other legitimate and efficacious remedy under labour laws is available. In such case, filing winding up petition is abuse of law.

Petition by the Company

The company may make a petition through its directors with the authority of a special resolution passed at a general meeting. It may also, apply to liquidator if it is being wound up voluntarily. The directors may, on their authority present a petition on behalf of the company. However, when the ground for winding up is that the company has passed special resolution, the petition must be presented by the company itself.

Petition by Creditor

A creditor or creditors (including any contingent or prospective creditor) may make petition, and the Court would make a winding up order on such petition if the creditor proves that the claims

are undisputed debt and any of the contingencies stated in Section 433 (grounds of winding up) had arisen to justify the order. The expression "creditors" includes the assignee of debt, a decree holder, a secured creditor, a debenture holder or the trustee for debenture holders. But a creditor whose debt is unliquidated cannot apply for winding up order. A contingent or prospective creditor can present petition on giving security for costs and showing that a prima facie case has arisen. A petition by a secured creditor for winding up may not be allowed by the Court where the security is ample and the petition is not supported by the other creditors. In Gramercy Emerging Market Fund v. Essar Steels (2002) 39 SCL 435 (Guj. HC). It was held that debenture holder can file application for winding up. However trustee is a necessary party if there is no direct covenant between the company and debenture holder, but the covenant is between company and trustee. This principle is not applicable where there is a direct covenant between company and debenture holder. Moreover trustee can sue the company in its own right as a covenanting party. Although an unpaid creditor, as between himself and the company, is prima facie entitled to a winding up order, ex debitojustitiae (i.e., as a matter of right), he is not so entitled as between himself and others creditors of the same class, for the Court may have regard to the wishes of creditors in all matters relating to the winding up, and may refuse to make a winding up order if a majority in value of the creditors oppose the petition. For instance, if a creditor to whom the company owes Rs. 10,000, petitions for winding up of the company and other creditors to whom the company owes Rs. 10 lakhs oppose the petition, the Court would obviously refuse to order winding up of the company (Ram Kumar v. Busar Oil and Rice Mills, AIR 1960 Cal. 764). The term creditor includes the Central Government or any State Government or municipal or local authority to whom any tax or other public charge is due. A foreign creditor and a guarantor who is a prospective creditor has a right to apply for winding up. In Padam Team Tea Co. Ltd. v. Darjeeling Commercial Co. Ltd., (1977) 47 Comp. Cas. 15, it was held that on the basis of an admission by the company of its indebtedness to a creditor, the creditor is entitled to petition for the winding up of the company, even if he has given full details of his petition as required under Section 434.

Petition by Workers not maintainable: Section 439 of the Companies Act, 1956 confers right upon certain persons to file a petition for winding up. The said section does not authorize the workers to make a winding up petition. Accordingly, the workers can not make a winding up petition. [National Textile Workers' Union v. P.R. Ramakrishnan (1983) 53 Comp. Cas. 184].

Appeal by workers against winding up order maintainable: There is nothing in the Act which prohibits workers from being heard in a winding up petition. Accordingly, the workers would be entitled to be heard though as interveners and not as parties. Further after the winding up order is made, the workers may appeal against it. But once the order becomes final, the workers shall not participate in any further proceedings [National Textile Workers' Union v. P.R. Ramakrishnan(1983) 53 Comp. Cas. 184].

Contributory's Petition: Section 428 of the Companies Act defines a 'contributory' as "every person liable to contribute to the assets of a company in the event of its being wound up, and includes holders of any shares which are fully paid-up and for the purposes of all proceedings for determining, and all proceedings prior to the final determination of, the persons who are deemed to be contributories, includes any person alleged to bea 'contributory'. In terms of the provisions of this section, the holder of fully paid-up share is also a contributory though he has no further liability to contribute to the assets of the company in winding up. The holder of a fully paid-up shares is included in the list of contributories for distribution of the residuary assets of the company after satisfying the claims of the creditors. He is also entitled to file a winding up petition. While every member of a company becomes a contributory on the company going into liquidation, every contributory need not be a member. Besides, the members presently borne on the register, the past members of a company, who ceased to be members within one year of the commencement of the winding up, are also liable as contributories by virtue of Section 426. By virtue of Section 439(1)(c), a contributory has a statutory right to present a petition for the winding up of the company, which right cannot be excluded or limited by the articles, but is subject to certain conditions as laid down in the section [Subsection (4)]. Accordingly, a contributory is entitled to present a winding up petition in case where:

(a) the number of members of the company is reduced below the statutory minimum of 7, in the case of a public company and below 2 in the case of private company; or

(b) the shares in respect of which he is a contributory or some of them: (i) were originally allotted to him; or (ii) have been held by him and registered in his name for at least six months during the 18 months before the commencement of the winding up; or (iii) have devolved upon him through the death of a former holder.

The object of making these provisions is to prevent a person buying a share or two in order to qualify himself as a contributory to wreck the company. In Re. Gattapardo Ltd. (1969) 2 All. ER

344, a transfer of shares had been executed, stamped and dated in June, 1967. The company did not register it until October, 1968. The shareholder presented a petition for the winding up of the company in December, 1968. It was held that the petition did not lie, as the petitioner shareholder did not hold her shares for six months as required by the Act. However, where the company has been ordered by the Court to allot shares and had failed to do so, the person in whose favour the order had been made was qualified to apply [In Re. Petent Steam Engines Co. (1878) 8 Ch.D. 464]. A petition for the winding up of a company can be presented by a contributory notwithstanding the fact that he may be holder of fully paid-up shares or the company may have no assets at all or may have no surplus assets at all or may have no surplus assets left for distribution amongst the shareholders after satisfaction of its liabilities towards creditors. A contributory is, thus, entitled to present a winding up petition even when the company is insolvent and is not in a position to satisfy even the creditors and the contributory have no tangible interest is as much as nothing is left back for distribution amongst the shareholders. It may be noted that an insolvent shareholder whose name still appears on the register of members as holder of the shares may present petition as a contributory at the instance of the Official Assignee or Receiver, but the Official Assignee or Receiver himself cannot petition as he is not a contributory. Again, a legal representative of a deceased shareholder can present petition for a winding up order.

Petition by Registrar: The Registrar may, with the previous sanction of the Central Government present a petition for winding up of a company but only on the following grounds, namely:

(i) if default is made by the company in delivering the statutory report to him or in holding a statutory meeting. It may be reiterated that on this ground no one except the Registrar or a contributory can petition:

(ii) if the company does not commence its business within one year from its incorporation or suspends its business for a whole year;

(iii) if it appears to him either from the financial condition of the company as disclosed in the balance sheet or from the report of a special auditor or an inspector that the company is unable to pay its debts;

(iv) where the Registrar is authorized by the Central Government under Section 243 to present a petition for winding up;

(v) where the number of members of the company has fallen below the statutory minimum; i.e., below seven in case of public company and below two in case of private company.
(vi) where it is just and equitable that the company be wound up. In all these cases the Registrar has to obtain previous sanction of the Central Government to the presentation of a petition. With regard to previous sanction, the Central Government will not grant it to the Registrar to present petition for the winding up of a company without first giving the company an opportunity to make its representation, if any.

Petition by persons authorised by Central Government1: By virtue of Section 243, if any report of an inspector appointed under Section 235 or 237 to investigate affairs of a company discloses:
(i) that the business of the company is being conducted to defraud its creditors or members or any other person otherwise for a fraudulent or unlawful purpose or in a manner oppressive of any of its members or that the company was formed for any fraudulent or unlawful purposes or
(ii) that the persons concerned in the formation of the company or management have been guilty of fraud, misfeasance or misconduct towards the company or towards any of its members; and it appears to the Central Government from such report that it is expedient so to do, then the Central Government may, unless the company or body corporate is already being wound up by the court, authorise any person (including the Registrar) to petition for the winding up of the company on the ground that it is just and equitable that the company should be wound up.

Jurisdiction of Court for entertaining Winding up Petition: In terms of the provisions of Section 10 of the Companies Act, 1956, the jurisdiction for entertaining winding up petition vests either in the High Court having jurisdiction in relation to the place where the registered office of the company is situate or the District Court of the area subordinate to the High Court, in which the jurisdiction has been vested either by the Act or by the Central Government by notification in the Official Gazette. In GTC Industries Ltd. v. Parasrampuria Trading (1999) 34 CLA 380 (All HC), it was held that only High Court where the registered office is situated has jurisdiction in winding up, even if there was agreement between parties that dispute between parties will be resolved before High Court where registered office is not situated. Regardless of where agreement is executed, Company Court having jurisdiction over the place where the registered office is situated, will have the jurisdiction to entertain a petition for winding up. LKP Merchant Financing v. Arwin Liquid Gases (2001) 103 Comp. Cas. 211 (Guj.). For the purposes

of jurisdiction to wind up companies, the expression ‘Registered Office’ means the place which has longest been the registered office of the company during the six months immediately preceeding the presentation of the petition for winding up. In Kalpana Trading v. N.C.L. Industries Ltd. [(1996) 1 Comp. LJ 152], the Orissa High Court refused to entertain the petition for winding up as the Company had its place of Registered Office at Hyderabad.

17.4 PROVISIONS AND PROCEDURES OF WINDING UP THROUGH COURT

Procedure for Compulsory Winding up by the Court

(i) A winding up of a company by the Court shall be deemed to commence at the time of the presentation of the petition for winding up [Section 441(2)].

(ii) As per rules of the High Court, every petition shall be advertised 14 days before the hearing, stating the date on which the petition was presented and names and addresses of petitioners. The petition has to be verified by an affidavit. The petition must contain the allegations and true facts together with the date of incorporation of the company, the situation of its registered office, the amounts of its paid-up capital a prayer that the company be wound up in the end. A copy of such petition must be served at the registered office of the company.

(iii) An order for winding up a company shall operate in favour of all the creditors and of all the contributories of the company as if it had been made on the joint petition of a creditor and of a contributory (Section 447).

(iv) At any time after the presentation of a winding up petition and before a winding up order had been made, the company or any creditor or contributory may apply to the High Court or supreme Court, in which the suit or proceeding is pending against the company in any other Court, such an application may be made to the Court having jurisdiction to wind up the company, to stay or restrain further proceeding in the suit or proceeding. The Court to which application is so made may stay or restrain the proceedings accordingly on such terms as it thinsk fit (Section 442): [See also Governor General-in Council v. Shiromani Sugar Mills, AIR (1946) FC 16].

(v) Two companies cannot be wound up by the same order.

(vi) The persons to be heard at the time of hearing of the petition are the company, its creditors and contributories. As per a 3 to 2 majority view the SupremeCourt has decided [National

Textile Workers' Union v. P.R. Ramkrishnan, (1983) 53 Comp. Cas. 184 (S.C.)] that workers are also entitled to be heard as interveners and not as parties.

(vii) In case several petitions are presented; they rank according to the date of presentation.

(viii) On hearing the petition, the Court may either

- (a) dismiss it, with or without costs, or
- (b) adjourn the hearing conditionally or unconditionally, or
- (c) make any interim order that it thinks fit, or
- (d) make a compulsory order for winding up the company with or without costs, or any other order that it may deem fit [Section 443(1)].

(ix) Where the petition is presented on the ground that it is just and equitable that the company should be wound up, the Court may refuse to make an order of winding up if it is of opinion that some other remedy is available to the petitioners and that they are acting unreasonably in seeking to have the company wound up instead of pursuing that other remedy [Section 443(2)].

(x) Further, where the petition is presented on the ground of default in delivering the statutory report to the Registrar, or in holding the statutory meeting, the Court may instead of making a winding up order, direct that the statutory report may be delivered to the Registrar or that a meeting may be held, and order the cost to be paid by any persons who are responsible for the default [Section 443(3)].

(xi) As soon as the Court makes an order for the winding up of a company, the court shall forthwith cause intimation thereof to be sent to the Official Liquidator and the Registrar. This is necessary so that Official Liquidator can take up the administration of the Company in winding up immediately [Section 444]

(xii) On the making of a winding up order, it is the duty of the petitioner in the winding up proceedings and of the company to file with the Registrar a certified copy of the order in e-form 21, within 30 days from the date of making of the order. The Registrar shall thereupon make a minute thereof in his books relating to the company and shall notify in the Official Gazette that such an order has been made. Such order shall be deemed to be the notice of discharge to the officers and employees of the company, except when the business of the company is continued. In computing the period of 30 days from the date of the making of a winding up order under this section, the time requisite for obtaining certified copy of the order shall be excluded [Section 445].

(xiii) When a winding up order has been made or the Official Liquidator has been appointed as Provisional Liquidator, no suit or other legal proceedings shall be commenced, or if pending at the date of the winding order, shall be proceeded with, against the company, except by leave of the Court and subject to such terms as the Court may impose [Section 446].

(xiv) As per Section 449 of the Companies Act, 1956, on the issue of the winding up order, the Official Liquidator becomes the liquidator of the company by virtue of his office. In Mafatbhai V. Shah v. Secretary (2000) 27 SCL 361, it was held that if Official Liquidator does not have adequate staff and is not in a position to look after properties of the company which are wound up under orders of the Court, he can get Receiver appointed with the leave of the Court. The Court can pass appropriate orders.

(xv) The Court shall also settle the list of contributories, make calls and determine any other question arising in winding up on the application of the liquidator (Section 467).

(xvi) Where the Court has made the order or appointed the Official Liquidator, the directors, secretary, manager or chief officer of the company shall make out and submit to the Official Liquidator, a statement as to the affairs of the company in the prescribed form, verified by an affidavit, containing the following particulars:

(a) the assets of the company stating separately the balance in hand and at the bank and the negotiable securities, if any, held by the company;

(b) its debts and liabilities;

(c) the names, residences and occupations of its creditors, stating separately the amount of secured and unsecured debts; and in the case of secured debts particulars of securities, their values and their dates;

(d) the debts due to the company and the names and addresses of the debtors and the amount likely to be realised thereupon [Section 454(1)];

(e) such further or other information as may be prescribed, or as the official liquidator may require.

This statement has to be submitted within 21 days from the date of the appointment of provisional liquidator or if no such appointment is made, the date of winding up order. The Official Liquidator or the Court, for special reasons, may extend this time up to three months. The persons making the statement and affidavit are to be paid by the Official Liquidator or Provisional Liquidator out of the assets of the company, such costs and

expenses incurred as the Official Liquidator mayconsider reasonable subject to an appeal to the Court. If any person without reasonable excuse makes a default in complying with any requirements of this section, he is liable to be punished with imprisonment for a term which may extend to two years or to a fine not exceeding Rs. 1,000 for every day during which the default continues. This is a criminal liability triable by the winding up Court, which is a High Court itself. For speedy administration of liquidation proceedings it is necessary that Official Liquidator should know all the assets and liabilities with necessary details at an early date. If directors and officers commit default, without reasonable excuse then they are criminally liable to severe punishment.

In Official Liquidator v. P.R. Mehta (2000) 36 CLA 210, it was held that the prosecution has to prove that the person has failed to submit the statement without reasonable cause. If a person was not director on relevant date or if there was reasonable cause for non-filing for statement, liability under this provision would notbe there. In Indla Satya Raju v. Sramika Agro Farm (2002) 39 SCL 940, it was held that a person cannot be prosecuted and convicted order Section 454 merely for reason that he committed default in complying with any requirements of Section 454. In addition to establishing default, prosecution is also required to establish that the said person, without reasonable excuse, committed such fault.

(xvii) After the receipt of the above statement the Official Liquidator prepares and submits a preliminary report to the winding up Court within six months or such extended period as may be allowed by the Court stating the amount of capital issued, subscribed and paid-up and the estimated amount of assets and liabilities of the company in liquidation giving separately, under the heading of assets, particulars of:

1. Cash and negotiable securities;
2. Debts due from contributories;
3. Debts due to the company and security, if any, available in respect thereof;
4. Moveable and immovable properties belonging to the company; and
5. Unpaid calls (Section 455).

If the liquidator is of the opinion that a fraud has been played in relation to the company and if he thinks fit he may submit a further report to the Court in this regard [Section 455(2)]. This report of the Official Liquidator is absolutely privileged. The preliminary report of the Official Liquidator shall be heard by the judge in Chambers. The Judge can

give such directions as he may consider necessary. On further report there can be a direction about the public examination of the directors (Section 478).

(xviii) The Official Liquidator shall take into his custody or control all the property, effects an actionable claims to which the company is or appears to be entitled. For this purpose, he can take help of the Chief Presidency Magistrate or District Magistrate (Section 456). The Official Liquidator then acts as a custodian. His position is that of a receiver and an officer of the Court. The liquidator has to realize all the assets. For that he may institute various legal proceedings, sell the immovable and movable property and actionable claims of the company and distribute these assets (Section 457). For this purpose he has to invite claims from creditors, settle them and make payments to creditors as per their respective rights (Sections 528 to 530). A Liquidator is an agent employed for the purpose of winding up of the company. In some respects he is a trustee, but he is not a trustee for each individual creditor. His principal duties are to take possession of assets, to make out the requisite list of contributories and of creditors, to have disputed cases adjudicated upon, to realize the assets subject to the control of the Court in certain matters and to apply the proceeds in payment of the company's debts and liabilities in due course of administration and having done that, to divide the surplus amongst the contributories and to adjust their rights [Discount Bank of India Ltd. (in liquidation) v. TrilokNath (1952) 54 Punj LR 335]. In Remu Pipes v. IFCI (2002) 35 SCL 358, it was held that ownership of assets of company in liquidation remains with the company but by a legal fiction the properties are taken to be vested in the Court. The Official Liquidator takes properties under his control and custody with the permission of Court and under its superintendence. The Official Liquidator is custodian of property and statutory trustee. Assets of company inliquidation vest in Court and not in Official Liquidator. Official Liquidator cannot sell property without sanction of Court. He has no absolute say in the matter of disposal of the company's property. While granting sanction, the Court can issue suitable directions as it may think fit and proper.

(xix) When the affairs of a company have been completely wound up or when the Court is of the opinion that the liquidator cannot proceed with the winding up of a company for want of funds and assets or for any other reason whatsoever and it is just and reasonable in the circumstances of the case that an order of dissolution of the company should be made, the Court will make an order that the company be dissolved from the date of the order and the company shall be dissolved accordingly.

The liquidator has to forward within 30 days from the date thereof a copy of the order to the Registrar who will register it and the company will then cease to exist but within two years of dissolution, the Court may, on the application of the liquidator or any other interested person, declare the dissolution to have been void (Sections 481 and 559). By virtue of Section 482, any order made by a Court for, or in the course of, winding up a company is enforceable at any place in India other than that over which such Court has jurisdiction, by the Court which would have jurisdiction if the registered office of the company had been situated at such place, and in the same manner in all respects as if the order had been made by that Court. The section may be illustrated by a decision of the Andhra Pradesh High Court in Tulasammav. Subhadaya Publications Ltd., AIR 1969 AP 207 that the District Court in Andhra Pradesh has jurisdiction to execute the order of the Madras High Court calling upon a judgment-debtor to pay call money which was sent to the Andhra Pradesh High Court for enforcement.

The expression 'in the course of winding up' as used in the section is not limited to what happens after a winding up order is made. As was pointed out by Sir George Jessel, M.R. in [In Re. International Pulp and Paper Co. (1876) 3 Ch.D. 594], "it would defeat the object of enabling the Court, once a winding up petition is presented, to see that the creditors of the company share rateably in the assets and that one particular creditor is not enabled 'to jump the gun' by taking an enforcement proceeding to any part of the country". The words have accordingly been widely interpreted to mean that once a winding up petition has been presented, everything thereafter is 'in the course of winding up a company', although it does not necessarily follow that a winding up order will eventually be made [In Re. Dynamics Corporation of America, (1976) 2 All ER 669].

Appeals from Orders or Decisions in the Matter of Winding Up

Section 483 of the Act provides that appeals from any order made, or decision given, in the matter of the winding up of a company by the Court shall lie to the same Court to which, in the same manner in which, and subject to the same conditions, under which, appeals lie from any order or decision of the Court in cases within its ordinary jurisdiction. Such order or decision, however, must be a judicial and not an administrative or a procedural one. An administrative order would be an order which is directed to the regulation or supervision of matters as distinguished from an order which decides the rights of parties or confers or refuses to confer

rights to property which are the subject of adjudication before the Court. Thus, where the Court confirms the winding up sale after hearing the two contending parties and the order vitally affects the rights of such parties, the Court in making the order acts in a judicial way, and the order is a judicial way, and not a procedural or administrative one so as to be inherently incable of being brought up in appeal [Shankarlalv. Shankarlal, AIR 1965 SC 507]. On the same principle, an order refusing stay of the winding up proceedings is a judicial order in the matter of winding up and is appealable (Jagannath Gupta & Co. v. Mulchand Gupta, AIR 1969 Cal 363). The stay order made in this case was set aside by the Supreme Court. On the other hand, no appeal would lie against an order removing a liquidator since such order cannot be said to be an order determining or affecting any rights of the parties in the winding up (Gordhan Das v. ShilwateDeve, AIR 1963 All. 606). Similarly, an order dropping the misfeasance proceedings under Section 543 against some of the directors at an initial stage on the ground that there is no prima facie case against them directing them to continue against the other is not appealable since it cannot be said to decide finally the rights and liabilities even in respect of the former and the Court can reopen the inquiry in respect of them on the basis of fresh materials or otherwise according to law (D.C. Mehta v. Lakshmipat, AIR 1968 Pat. 280). The expression 'in the matter of the winding up of a company' as used in the Section would include the case of an application made under Section 446 of the Act for leave to file a suit against the company, and the order made on such application would be appealable under the Section (BalkrishnaMahadeoVertakv. Indian Associate Chemical Industries Ltd., 60 Bom. LR 30). The expression also includes an order directing advertisement of the winding up petition and an appeal would lie against such order (Western India Theatres Ltd. v. IshwarbhaiSomabhai Patel, AIR 1959 Bom. 386); [Golcha Investment (P) Ltd., v. S.C.Bafna, AIR 1970 SC 1850]. In the latter case, the Supreme Court further held that, by virtue of Rule 966-A in Chapter XII of the Bombay High Court Rules, such an appeal was entitled to be\ admitted as a matter of course and could not be summarily dismissed as was done by the High Court treating the order appealed against as interlocutory order. The second part of the section which refers to 'the manner' in which and 'the conditions' subject to which appeals may lie must be construed as merely regulating the procedure to be followed in the presentation of the appeal and of hearing them, the period of limitation within which the appeal is to be presented and the forum to which the appeal would lie, and not as restricting or impairing the substantial right of appeal which has been conferred by the opening words of the section. It must be noted, however, that though the rights of appeal under the

section is a substantive right, since the procedure applicable to regular appeals under the Civil Procedure Code is applicable to the appeals under the section, the right to file a cross-appeal or a cross-objection to any such appeal is a matter of procedure as comprised in Order 41, Rule 22 of that Code. Consequently, the respondent to any such appeal is entitled to file a cross objection under that provision of the Code [The Central Provinces Syndicate (Private) Ltd. v. Sita Devi, AIR 1973 MP 134].

Dissolution of Company in Compulsory Liquidation

Winding up of a company ultimately results in its dissolution and its corporate existence comes to an end. When the affairs of a company are completely wound up as a result of the Court's order for winding up, or when the Court is of opinion that the liquidator cannot proceed with the winding up for want of funds or assets or for any other reason whatsoever, and that it is just and reasonable in the circumstances of the case that an order for the dissolution of the company should be made, the Court makes an order that the company be dissolved from the date of the order, and the company is accordingly dissolved. A copy of this order has to be forwarded by the liquidator to the Registrar within 30 days in e-form 21 and the Registrar is required to make a minute of the dissolution of the company in his books relating to such company. In case of default, the liquidator is liable to be fined to the extent of Rs. 500 a day [Section 481]. In Rishabh Agro Industries Ltd. v. PNB Capital Services Ltd. (2000) AIR SCW, it was observed that winding up order passed under the Companies Act is not the culmination of proceedings pending before company Judge but is in effect the commencement of the process. The ultimate order to be passed in such a petition is the dissolution under Section 481.

Court's Power to declare Dissolution Void

The Court has also got the power to declare the dissolution of a company void in appropriate cases under Section 559 of the Act. Where a company has been dissolved as a result of the Court's order as aforesaid, or under Section 394 or otherwise, the Court, by that section, may at any time within two years of the date of dissolution, make an order, on the application of the liquidator or of any other person interested and upon such terms as it thinks fit, declaring the dissolution to have been void. The effect of an order under Section 559 is that it makes the dissolution void ab initio and all consequences resulting from the dissolution are avoided, including proceedings taken during the interval between the date of dissolution and the date of declaration of dissolution as void. [Morris v. Harris, 1927 AC 252]. The person who obtains the

order avoiding the dissolution must file a certified copy thereof with the Registrar within thirty days or such further time as the Court may allow. In case of default, he will be punishable with fine to the extent of Rs. 500 for every day during which the default continues.

17.5 SUMMARY

A company under Section 433 may be wound up by the Court if (a) the company has passed a special resolution of its being wound up by the Court; or (b) default is made in delivering the statutory report to the Registrar or in holding the statutory meeting; or (c) it does not commence business within a year from its incorporation or suspends business for a whole year; or (d) the number of its members in the case of a public company is reduced below seven and in the case of a private company, below two; or (e) it is unable to pay its debts; or (f) the Court is of the opinion that it is just and equitable that it should be wound up; or (g) if the company has made a default filing with the Registrar its balance sheet and profit and loss account or annual return for any five consecutive financial years; or (h) if the company has acted against the interests of the sovereignty and integrity of India, the security of the state, friendly relations with foreign states, public order, decency or morality; or (i) If the tribunal is of opinion that the company should be wound up under the circumstances specified in Section 424G

17.6KEY WORDS

1. CLB: Company Law Board
2. Official Liquidator
3. Contributory's Petition

17.7 SELF ASSESSMENT QUESTIONS

1. Briefly explain the grounds for winding up by the Court

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2. Write a note on procedure for winding up by court

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3. Explain Jurisdiction of Court for entertaining Winding up Petition

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4. Who may file Petition for the Winding up?

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17.8REFERENCES

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UNIT-18 VOLUNTARY WINDING UP AND WINDING UP UNDER THE SUPERVISION OF COURT; KINDS OF VOLUNTARY WINDING UP; PROVISIONS AND PROCEDURE

STRUCTURE

18.0 Objective

18.1 Introduction

18.2 Voluntary winding up and winding up under the supervision of court

18.3 Kinds of voluntary winding up

18.4 Provisions and procedure

18.5 Summary

18.6 Key words

18.7 Self Assessment Questions

18.8 References

18.0 OBJECTIVES

This chapter covers the Voluntary winding up and winding up under the supervision of Court. After going through this chapter, students will be able to understand:

1. Meaning of and kinds of voluntary winding up
2. Winding up and under the supervision of court
3. Procedure involved in winding up

18.1 INTRODUCTION

A company may, voluntary wind up its affairs, if it is unable to carry on its business, or if it was formed only for a limited purpose, or if it is unable to meet its financial obligation, and etc. A company may voluntary wind up itself, under any of the two modes:

Members voluntarily winding up.

Creditors voluntarily winding up.

(1) Members voluntary winding up: under which the directors make a statutory declaration of the firm's solvency within the five weeks preceding the adoption of resolution. This declaration must state that, upon an inquiry into the firm's financial affairs, directors are of the opinion that the firm can pay off its debts in full within a specified period not exceeding 12 months after commencement of winding up. A statement of the firm's assets and liabilities (as on the latest practicable date) must also accompany the declaration and, thereafter, the shareholders (members) of the firm must appoint one or more liquidators in a general meeting. (2) Creditor's voluntary winding up: under which no declaration of the firm's solvency is made but the firm must hold a meeting of creditors and submit to them the statement of its assets and liabilities as on the latest practicable date. The right to appoint liquidator(s) accrues to the creditors. In both types, the powers of directors cease upon the appointment of the liquidator(s). Also called voluntary liquidation.

18.2 VOLUNTARY WINDING UP AND WINDING UP UNDER THE SUPERVISION OF COURT

The companies are usually wound up voluntarily as it is an easier process of winding up. It is altogether different from a compulsory winding up. In voluntary winding up the company and its creditors are left to settle their affairs without going to a Court, although they may apply to the Court for directions or orders, as and when necessary. One or more liquidators are to be

appointed by the company in general meeting for the purpose of winding up the affairs and distributing the assets of the company. The remuneration of the liquidators is also required to be fixed by the company in general meeting. Unless the remuneration as aforesaid is fixed the liquidators shall not take charge of his/their offices (Section 490). The circumstances in which a company may be wound up voluntarily are:

(a) when the period fixed for the duration of the company as mentioned in its articles has expired; or
(b) the event, on the happening of which the articles provide that the company is to be dissolved has occurred; and
(c) the company passes a special resolution that the company be wound up voluntarily [Section 484 (1)].

Thus, a company may be wound up voluntarily on the expiry of the term fixed for duration of the company or on the occurrence of the event as provided in its articles. In these two cases only an ordinary resolution may be passed in the general meeting of the company. Apart from these two cases, a company may be voluntarily wound up for any other reason as well for which a company has to pass a special resolution. A proper notice required for the respective meetings must be given to all the members and in the latter case the text of the special resolution to be passed together with the reason to wind up voluntarily must be mentioned therein. The resolution (whether ordinary or special), when passed, must be advertised within 14 days of the passing of the resolution in the Official Gazette and also in some newspaper circulating in the district where the registered office of the company is situated. A default in complying with the above requirements renders the company and every officer of the company, who is in default, liable to a penalty which may extend to five hundred rupees for every day during which the default continues. A liquidator of the company is deemed to an officer of the company for the purposes of the above requirements (Section 485). A voluntary winding up commences from the date of the passing of the resolution for voluntary winding up. This is so even when after passing a resolution for voluntary winding up, a petition is presented for winding up by the Court. The effect of the voluntary winding up is that the company ceases to carry on its business except so for as may be required for the beneficial winding up thereof. The corporate status and the powers of the company, however, continue until it is dissolved [Section 487].

Winding up Subject to the Supervision of Court

When a company has by special or ordinary resolution resolved to wind up voluntarily, the Court may make an order that the voluntary winding up shall continue, but subject to such supervision of the Court and with such liberty for creditors, contributories or others to apply to the Court and generally on such terms and conditions, as the Court thinks just (Section 522). The application for such intervention of the Court is made by a creditor, contributory or the voluntary liquidator, when there are irregularities or frauds in the voluntary winding up. The Court may have regard to the wishes of creditors and contributories, while making such an order. A petition for the continuance of a voluntary winding up subject to the supervision of the Court shall, for the purpose of giving jurisdiction to the Court over suits and legal proceedings, be deemed to be a petition for winding up by the Court (Section 523). The object of the supervision order is to safeguard the interest of the company, shareholders and creditors. When an order is made for a winding up subject to supervision, the Court may, by that or any subsequent order, appoint an additional liquidator or liquidators. Generally, the old liquidator is permitted to continue by the Court if there is no complaint against him. The Court is also empowered to remove any liquidator so appointed or any liquidator continued by the removal or by death or resignation of the liquidator. The Court has also been empowered under the Companies (Amendment) Act, 1960 to appoint Official Liquidator as a Liquidator or to fill any vacancy caused by the removal, death or resignation of the previously appointed liquidator. The Court may also appoint or remove a liquidator on an application of the Registrar in this behalf (Section 524).

Effect of Supervision Order

(i) In supervisory winding up, the liquidator may, subject to any restrictions imposed by the Court, exercise all his powers, without the sanction or intervention of the Court, in the same manner as if the company were being wound up altogether voluntarily [Section 526(1)].

(ii) The effect of a petition for winding up subject to supervision is, that the Court Implications obtains jurisdiction over suits and legal proceedings as in the case of a petition for compulsory winding up [Section 526(2)].

(iii) The supervision order also confers full authority on the Court to make calls or to enforce calls made by the liquidators, and to exercise all other powers which it might have

exercised if an order had been made for winding up the company altogether by the Court [Section 526(2)].

(iv) When an order has been made for winding up a company subject to supervision, and an order is afterwards made for winding up by the Court, the Court has power to appoint any person or persons who are then liquidators either provisionally or permanently, to be liquidator or liquidators in the winding up by the Court in addition to, and subject to the control of the Official Liquidator [Section 527].

(v) Since the supervision order has the same effect as an order for compulsory winding up, the company cannot be dissolved except by the order of the Court as in the case of compulsory winding up.

Distinction between Voluntary Winding up and Winding up under the supervision of the Court

The points of distinction between the two modes are summarised below, as brought out by Section 524 of the Act:

1. In pure voluntary winding up, the liquidator is appointed by the members in general meeting in the case of members' voluntary winding up and by the creditors in the case of creditors' voluntary winding up. In a voluntary winding up subject to supervision, the Court may appoint an additional liquidator, or liquidators who may be the Official Liquidator. The Court may remove the liquidator appointed by it or any liquidator continued under supervision order and fill any vacancy caused by such removal, death or resignations.
2. By virtue of Section 536, transfers of shares or any alteration in the status of the Members of the Company or any disposition of property (including actionable claim) of the company made after the commencement of winding up are void unless the Court orders otherwise in a winding up under the supervision of the Court. In a pure voluntary winding up such transfers can be agreed to by the voluntary liquidator.
3. Any attachment, distress or execution against the company after the commencement of winding up subject to supervision, without the leave of the Court, is void. The provisions of Section 527 does not apply to pure voluntary winding up.
4. By virtue of Section 545, if it appears to the Court either in compulsory winding up or subject to Court's supervision, that any past or present officer, or any member, of the

company has been guilty of any offence in relation to the company the Court may, either on the application of any person interested in the winding up or of its own motion direct the liquidator to prosecute the offender or to refer the matter to the Registrar. But in the case of a pure voluntary winding up, the liquidator only makes a report to the Court in this regard, as stated in Section 519.

5. For exercising certain powers conferred by Section 546, the liquidator has to get the sanction of the Court in a winding up subject to supervision whereas in a pure voluntary winding up the liquidator gets the sanction by special resolution passed in a general meeting of the company.

Advantages of Supervision Order

The practical advantage of a supervision order are as follows:

1. The supervision order operates automatically as a stay or suits and other proceedings against the company in the same way as the winding up order does in the case of a compulsory winding up.
2. The Court controls the appointment or removal of liquidators. This is an important advantage, because the Court is usually asked for a supervision order in cases where the contributories or creditors are not satisfied with the appointment or conduct of the voluntary liquidator. Accordingly, the Court is likely to exercise supervision effectively in the best interests of the creditors and contributories.
3. The Court may, and usually does, require the liquidator to file with the Registrar a quarterly report as to the progress made with the winding up.
4. The Court may, and will, issue such directions as it considers necessary to control the course of winding up, if the minority interests are at stake or if they have been coerced or overridden by a fraudulent or aggressive majority.
5. No proceedings can be started or continued against the company without the leave of the Court.
6. The Court can make calls or enforce calls made by the liquidators.
7. The Court can exercise all other powers which it might have exercised if the order had been for the winding up of the company compulsorily.

18.3 KINDS OF VOLUNTARY WINDING UP

Kinds of Voluntary Winding Up

Section 488(5) divides voluntary winding up into two kinds:

(i) Members' voluntary winding up; and (ii) Creditors' voluntary winding up.

A. Members' Voluntary Winding Up

When the company is solvent and is able to pay its liabilities in full, it need not consult the creditors or call their meeting. Its directors, or where they are more than two, the majority of its directors may, at a meeting of the Board, make a declaration of solvency verified by an affidavit stating that they have made full enquiry into the affairs of the company and that having done so they have formed an opinion that the company has no debts or that it will be able to pay its debts in full within such period not exceeding three years from the commencement of the winding up as may be specified in the declaration. In Shri Raja Mohan Manuchav. LakshminathSaigal (1963) 33 Comp. Cas. 719, it was held that where the declaration of solvency is not made in accordance with the law, the resolution for winding up and all subsequent proceedings will be null and void. Such a declaration must be made within five weeks immediately preceding the date of the passing of the resolution for winding up the company and be delivered to the Registrar for registration before that date. The declaration must embody a statement of the company's assets and liabilities as at the latest practicable date before the making of the declaration. Any director making a declaration without having reasonable grounds for the aforesaid opinion, shall be punishable with imprisonment extending up to six months or with fine extending up to Rs. 50,000 or with both [Section 488]. A winding up in the case of which such a declaration has been made and delivered in accordance with Section 488 is referred to as "a member's voluntary winding up". A winding up in the case of which such a declaration has not been so made and delivered is referred to as a "creditors' voluntary winding up" [Section 488(5)].

Specimen of Declaration of Solvency (under Section 488)

We .... of .... of .... being all the/majority of Directors of .... Company Limited declare that we have made a full enquiry into the affairs of this company; and that having so done, we have formed the opinion that this company has no debt or will be able to pay its debts in full within a period, not exceeding three years from the commencement of the winding up.

Signature of Directors

1……………………….

2……………………….

3……………………….

Sworn/solemnly affirmed by the above named directors at………this……….day of ……..20……..before me. ....Commissioner of Oaths.

B. Creditors' Voluntary Winding Up

As discussed earlier, where a declaration of solvency of the company is not made and delivered to the Registrar in a voluntary winding up it is a case of creditor's voluntary winding up. The following provisions as contained in Sections 500 to 509 of the Companies Act, 1956 apply to a creditors' voluntary winding up:

(i) In this case the company must call a meeting of its creditors for the day or the day next following the day on which there is to be held the general meeting of the company at which the resolution for voluntary winding up is to be proposed and notices of the meeting of creditors be sent by post to the creditors simultaneously with the notices of the general meeting of the company. The notice of the meeting must also be advertised once at least in the Official Gazette and once at least in two newspapers circulating in the district where the registered office or principal place of business of the company is situate [Section 500(1) and (2)].

(ii) The directors of the company shall prepare a full statement of the position of the company's affairs together with a list of the creditors of the company and an estimated amount of their claims to be laid before the meeting of the creditors to be held as aforesaid. They must also appoint one of their number to preside at the said meeting. It shall be the duty of the director appointed to preside at the meeting of the creditors to attend the meeting and preside thereat [Section 500(3) and (4)].

(iii) If the meeting of the company at which the resolution for voluntary winding up is to be proposed is adjourned owing to some reason and the resolution is passed at an adjourned meeting, any resolution passed at the meeting of the creditors held in pursuance of Sub-section (1) of Section 500 shall have effect as if it had been passed immediately after the passing of the resolution for winding up the company [Section 500(5)]. Default in complying with Section 500 will render the company, the directors and officers liable to a fine up to Rs.10,000.

(iv) Notice of any resolution passed at a creditors meeting must be given by the company to the Registrar within ten days of the passing thereof. In case of default, the company and every officer of the company who is in default is liable to a fine which may extend to Rs. 500 for every day till the default continues. For this purpose, a liquidator of the company shall be deemed to be an officer of the company [Section 501].

(v) The creditors and the company at their respective meetings mentioned in Section 500 may nominate a person to be liquidator, but the person nominated by the creditors shall become the liquidator subject to an application to the Court. If no person is nominated by the creditors, the person nominated by the company shall be liquidator. Further if no person is nominated by the company, the person nominated by the creditors shall be liquidator. (Section 502).

(vi) The creditors may at the same or subsequent meeting appoint a Committee of Inspection consisting of not more than five members. If such a committee is appointed, the company may also at the same or any subsequent general meeting appoint such number of persons not exceeding five as they think fit to act as members of the committee. In any case, the creditors may resolve that all or any of the persons so appointed by the company ought not to be members of the committee of Inspection, whereupon the persons mentioned in the company's resolution shall not be qualified to act as members of the committee unless the Court otherwise directs. The Act provides that the powers and proceedings of such Committee of Inspection are the same as those of a Committee of Inspection appointed in a winding up by Court (compulsory winding up) and as provided in Section 465 (Section 503).

(vii) The remuneration to be paid to the liquidator in creditors voluntary winding up is to be fixed either by the Committee of Inspection or by creditors. Where the remuneration is not so fixed, it shall be determined by the Court. Any remuneration fixed by the Committee or creditors cannot be increased in any circumstances whatsoever whether with or without the sanction of the Court (Section 504).

(viii) On the appointment of a liquidator, all the powers of the Board of directors shall cease, except in so far as the Committee of Inspection, or if there is no such committee, the creditors in general meeting may sanction the continuance thereof (Section 505).

(ix) If a vacancy in the office of Liquidator occurs by death, resignation or otherwise (other than a liquidator appointed by or by the direction of the Court) the creditors in general meeting may fill the vacancy. (Section 506)

Distinction between Members' and Creditors' Voluntary Winding Up

The main differences between the two are as follows:

1. A member's voluntary winding up results where, before convening the general meeting of the company at which the resolution of winding up is to be passed, the majority of the directors file with the Registrar a statutory declaration of solvency. A creditors' voluntary winding up is one where no such declaration is filed.
1. In a member's voluntary winding up, the creditors do not participate directly in the control of the liquidation, as the company is deemed to be solvent; but in a creditors' voluntary winding up, the company is deemed to be insolvent and, therefore, the control of liquidation remains in the hands of the creditors.
2. There is no meeting of creditors in a members' voluntary winding up and the liquidator appointed by the company acts in the liquidation of its affairs; whereas in a creditors' voluntary winding up, meetings of creditors have to be called at the beginning and subsequently the liquidator is appointed by the creditors.
3. In a members' voluntary winding up the liquidator can exercise some of his powers with the sanction of a special resolution of the company; but in a creditors' voluntary winding up he can do so with the sanction of the Court or the Committee of Inspection or of a meeting of creditors.
4. In a winding up where the creditors are interested and the directors are not able to guarantee the company's solvency, the creditors are entitled to secure control of the winding up, so that their interests may be safeguarded. (Section 495)

Powers of the Court to Intervene in Voluntary Winding Up

In voluntary winding up it is left to the company, the contributories and the creditors to settle their affairs without intervention of the Court as far as possible. However, the Companies Act, 1956, contains certain provisions which provide a means of acces to the Court with a view to speed up the liquidation proceedings and to overcome the difficulties that may arise in the course of liquidation. The Court will intervene in the voluntary winding up whenever it is satisfied that such an intervention will be just and beneficial. In appropriate cases the Court can be approached

for compulsory winding up (Section 440) or winding up being conducted under the supervision of the Court (Section 522). The Court is vested with the following powers in voluntary winding up:

(i) To appoint the Official Liquidator or any other person as liquidator where no liquidator is acting [Section 515(1)].

(ii) To remove the liquidator and appoint the Official Liquidator or any other person as liquidator on justifiable cause being shown [Section 515(2)].

(iii) To determine the remunerations of liquidator when the Official Liquidator is appointed as a liquidator [Section 515(3)].

(iv) To amend, vary, confirm or set aside the arrangement entered into between a company and its creditors on an appeal being made by any creditor or contributory within 3 weeks of the completion of the arrangement (Section 517).

(v) On an application of the Liquidator or contributory or creditor: (a) to determine any question arising in the winding up of a company [Section 518(1)(a)]; (b) to exercise, as respects the enforcing of calls, the staying of suits or other legal proceedings or any other matter, all or any of the powers which the Court might exercise if the company were being wound up by the Court [Section 518(1)(b)].

(vi) To set aside any attachment, distress or execution started against the estate or effects of the company after the commencement of the winding up on such terms as it thinks fit on an application made by the liquidator, creditor or contributory if the Court is satisfied that it is just and beneficial to do so [Section 518(3) and (4)].

(vii) To order public examination of any person connected with promotion or formation of a company or any officer connected with the affairs of the company in regard to matters of promotion or formation or conduct of the business of the company or as to his conduct or dealing as officer thereof. Such an examination can be ordered on a report of the liquidator where he is of the opinion that a fraud has been committed by the persons aforesaid in the formation or promotion of the company or in the conduct of its affairs [Section 519(1)].

18.4 PROCEDURE FOR MEMBERS' VOLUNTARY WINDING UP

(i) When declaration of solvency is made and filed with the Registrar in e-form 62, the directors arrange to convene a meeting of the members of the company and pass the necessary resolution of winding up (Section 484).

(ii) The company shall appoint in general meeting one or more liquidators for the purpose of winding up the affairs and distributing the assets of the company and fix the remuneration to be paid. Any remuneration so fixed shall not be increased in any circumstances. The liquidators shall not take charge of his office unless the remuneration is fixed (Section 490).

The resolution passed may be in the following form:

"Resolved that the company be wound up voluntarily and that Mr.____ and Mr.____ be and are hereby appointed liquidators of the company on Rs.10,000 per month with all the powers under Section 457 for the purpose of such winding up and with power to each of them to act alone."

(iii) On the appointment of liquidator, all the powers of the Board of directors, managing directors, or whole time directors, and managers (if any) of the company cease except for the purpose of giving notice of the appointment of liquidator to the Registrar or so far as the company in general meeting or the liquidator may sanction their continuance (Section 491).

(iv) If any vacancy occurs by death, resignation or otherwise in the office of any liquidator appointed by the company, the company in general meeting, subject to any arrangement with its creditors, can fill the vacancy. The general meeting for this purpose may be convened by the continuing liquidator or by any contributory and must be held in the manner provided by the article or in any manner prescribed by the Court (Section 492).

(v) The company has to give notice to the Registrar relating to the appointment of liquidator or liquidators made by it under Section 490, of every vacancy occurring in the office of the liquidator, and of the name of the liquidator or liquidators appointed to fill every such vacancy under Section 492. The notice aforesaid shall be given by the company in within 10 days of the event to which it relates. In case of default, the company and every officer of the company (including every liquidator or continuing liquidator) who is in default, shall be punishable with fine extending up to Rs. 1,000 for every day till the default continues [Section 493]. The liquidator must also inform the Registrar of his appointment within thirty days thereof and publish the notice in the Official Gazette (Section 516). He is also required to file Form No. 152 of the Companies (Court) Rules, 1959 with Registrar. He is also required to notify his appointment to the Income-tax Officer who is entitled to assess

the income of the company. He must also comply with the other provisions of the Section 178 of the Income Tax Act.

(vi) The liquidator (under members' voluntary winding up) may transfer the whole or any part of the company's business or property to another company (called the transferee company) and receive, with the sanction of the special resolution of the transferor company by way of compensation for the transfer or sale, shares, policies or other like interests in the transferee company, for distribution among the members of the transferor company or may enter into any other arrangement whereby the members of the transferor company may in lieu of receiving cash, shares, policies, or other like interests participate in the profits or receive any benefit from the transferee company. Any sale or arrangement made by the liquidator shall be binding on the members of the transferor company [Section 494(1) and (2)]. If any member of the transferor company, who did not vote in favour of the special resolution, objects to the arrangement entered into by the liquidator, he may express his dissent in writing addressed to the liquidator and leave it at the registered office of the company within seven days after the passing of the resolution and he may also require the liquidator either to abstain from carrying the resolution into effect or to purchase his interest at a price to be determined by arrangement or by arbitration. If the liquidator decides to purchase the dissenting member's interest, the purchase money shall be paid before the company is dissolved [Section 494(3) and (4)].

(vii) In the event of the winding up continuing for more than one year, the liquidator is required to call general meeting of the company at the end of the first year from the commencement of the winding up, and at the end of the each succeeding year, or as soon thereafter as may be convenient within three months from the end of the year or such longer period as the Central Government1 may allow, and must lay before the meeting an account of his acts and dealings and of the conduct of the winding up during the preceding year, together with a statement in the prescribed form containing the prescribed particulars with respect to the proceedings and position of liquidation. In case of default, the liquidator is liable to a fine not exceeding Rs. 1,000 (Section 496).

(viii) As soon as the affairs of the company are fully wound up, the liquidator has to make an account of the winding up showing how the winding up has been conducted and the property of the company has been disposed of and is required to summon a general meeting of the company for the purpose of laying the account before it and giving any

explanation thereof. The meeting must be called by giving a month's notice specifying the time, place and object of the meeting and the notice must appear in the Official Gazette and also in some newspaper circulating in the district where the registered office of the company is situate. Within one week after the meeting, the liquidator must send to the Registrar and the Official Liquidator a copy of the account and shall make a return to each of them of the date and holding of the meeting. If a quorum is not present at this meeting, the liquidator shall make a return that the meeting was duly called but the quorum was not present [Section 497(1) to (4)].

(ix) The Registrar, on receiving account and the return shall forthwith register them. The Official Liquidator, on receiving the account and the return shall, as soon as may be, make and the liquidator and all officers, past or present, of the company shall give the official liquidator all reasonable facilities to make a scrutiny of books and papers of the company and if on such scrutiny the official liquidator makes a report to the Court that the affairs of the company have not been conducted in a manner prejudicial to the interest of its members or to public interest then from the date of submission of such report the company shall be deemed to be dissolved. The Official Liquidator scrutinize the accounts of pre-liquidation as well as of post liquidation period and for discharging this duty the Voluntary Liquidator and all past and present Officers of the company shall give to the Official Liquidator all reasonable facilities. If on such scrutiny the Official Liquidator makes a report to the Court that the affairs of the company have been conducted in a manner prejudicial to the interest of its members or to public interest, the Court shall by order direct the Official Liquidator to make a further investigation of the affairs of the company and for that purpose shall invest him with all such powers as the Court may deem fit. On the receipt of the report of the Official Liquidator on such further investigation, the Court may either make an order that the company shall stand dissolved with effect from the date to be specified by the Court therein or make such other order as the circumstances of the case brought out in the report permit. If the liquidator fails to call a general meeting of the company, he is also liable to fine extending up to Rs.5,000 [Section 497(5) to (7)].

18.5SUMMARY

Kinds of Voluntary Winding Up: (1) Members' voluntary winding up; and (2) Creditors' voluntary winding up. In voluntary winding up it is left to the company, the contributories and

the creditors to settle their affairs without intervention of the Court as far as possible. Sections 511 to 521 of the Act prescribe the procedure for all types of voluntary winding up.

18.6 KEY WORDS

1. Official Liquidator
2. Members Voluntary Winding up
3. Creditor's Voluntary winding up

18.7 SELF ASSESSMENT QUESTIONS

1. Explain the kinds of voluntary winding up

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2. Briefly explain the procedure for voluntary winding up

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3. Compare Voluntary winding up and winding up under the supervision of Court

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UNIT-19 CONSEQUENCES OF WINDING UP; APPOINTMENT OF LIQUIDATORS, POWERS AND DUTIES OF LIQUIDATORS; PROCESS OF WINDING UP;

Structure

19.0 Objectives

19.1 Introduction

19.2 Consequences of winding up

19.3 Appointment of liquidators

19.4 Powers and duties of liquidators

19.5 Process of winding up

19.6 Summary

19.7 Key words

19.8 Self Assessment Questions

19.9 References

19.0 OBJECTIVES

1. To able to understand Consequences of winding up
2. To know the appointment, powers and duties of liquidator
3. To analyse the procedure involved in winding up

19.1 INTRODUCTION

Winding up or liquidation of a company represents the last stage in its life. It means a proceeding by which a company is dissolved. The assets of the company are disposed of, the debts are paid off out of the realized assets (or from contributions from its members), and the surplus, if any, is then distributed among the members in proportion to their holdings in the company. The two terms winding up and liquidation used interchangeably. An administrator, called liquidator is appointed and he collects its assets, pays its debts and finally distributes any surplus among the members in accordance with their rights.

19.2 CONSEQUENCES OF WINDING UP

The order of winding up by the Court is made when all the available remedies are exhausted to keep the company going. An administrator called the liquidator, takes control of the company, collects its assets, pays its debts and finally distributes any surplus among the members in accordance with their rights. Winding up commences not from the date of the order, but it shall be deemed to commence from the time of presentation of the petition [Section 441(2)]. But where, before the presentation of the petition, a resolution has been passed by the company for voluntary winding up, the winding up shall be deemed to have commenced at the time of the passing of the resolution [Section 441(1)]. The process of winding up has important consequences for different parties - contributories, creditors, officers of the company and so on. Firstly, we shall deal with the consequences of winding up as to different parties and other aspects of the administration of company law subsequently.

Consequences of Winding Up Order

(i) Where the Court makes an order for winding up of a company the Court shall forthwith cause intimation thereof to be sent to the Official Liquidator and the Registrar (Section 444).

(ii) On the making of a winding up order it shall be the duty of the petitioner in the winding up proceedings and of the company to file with the Registrar a certified copy of the order of the Court within 30 days from the date of making of the order [Section 445(1)].

(iii) The winding up order is deemed to be notice of discharge to the officers and employees of the company except when the business of the company is continued [Section 445(3)].

(iv) When a winding up order has been made, no suit or other legal proceeding shall be commenced against the company except with the leave of the Court [Section 446]. Suits pending at the date of winding up order shall not be further proceeded without the leave of the Court [Section 446].

(v) An order for winding up shall operate in favour of all the creditors and of all the contributories of the company as if it had been made on the joint petition of a creditor and of a contributory [Section 447].

(vi) According to Section 536, any disposition of the property (including actionable claims) of the company, any transfer of shares in the company or alteration in the status of its members, made after the commencement of the winding up shall be void, unless the court otherwise orders. Thus, the court can direct that any such disposition of property or actionable claims or transfer of shares or alteration of status of members will be valid. But unless the Court so directs, such disposition, transfer or alteration will be void.

(vii) Section 537 declares that any attachment and sale of the estate properties or effects of the company, after the commencement of the winding up will be void. In the case of winding up by the Court any attachment, distress or execution put in force, without leave of the Court against the estate or effects of the company after the commencement of the winding up will be void. Similarly any sale held, without leave of the Court, of any of the properties or effects of the company after the commencement of the winding up will be void. But with leave of the Court, attachment and sale of the properties of the company will be valid even if such attachment and sale are made after the commencement of the winding up of the company. Besides, this section does not apply to any proceedings for the recovery of any tax or impost or any dues payable to the Government. In Titan Industries v. Punwire Mobile Communications (2002) 40 SCL 117, it was held that Section 537 being a central legislation prevails over state law in case of conflict/overlapping and Registrar of Cooperative Societies cannot attach property of company under liquidation.

(viii) It may be noted that winding up order does not bring the business of the company to an end. The corporate existence of the company continues through winding up till the company is dissolved. Thus, the company continues to have corporate personality during winding up till the company is dissolved.

(ix) On a winding up order being made in respect of a company, the Official Liquidator, by virtue of his office, becomes the liquidator of company (Section 449).

(x) On commencement of winding up, the limitation ceases to run in favour of the company. The period from the date of commencement of winding to update of the making of the winding up order (both inclusive) and a period of one year from the date of winding up order is excluded for computing the period of limitation for any suit or application in the name and on behalf of the company, notwithstanding the provisions of the Limitation Act, 1963 or any other law for the time being in force. The suit or application must satisfy both the conditions, i.e., it must be in the name and on behalf of the company [Section 458(A)]. This relaxation and extension is only in favour of the company i.e. it is only in respect of suit or application in the name and on behalf of the company. It is not applicable to suits filed against the company. However, if the debt was time barred on date of winding up (i.e. when application for winding up was made) and was not enforceable, it does not get revived on filing of winding up application and passing of winding up order. [Karnataka Steel v. Kohinoor Rolling Shutters (2002) AIR SCW 4613].

(xi) Any fraudulent preference of company's creditors within six months before the commencement of winding up is invalid (Section 531).

(xii) Any transfer of property, movable or immovable, or any delivery of goods, except in the ordinary course of business in favour of a person in good faith and for valuable consideration, made within one year before the commencement of winding up, shall be void against the liquidator (Section 531 A).

(xiii) Similarly, any transfer or assignment by a company of all its property to trustees for the benefit of all its creditors shall be void (Section 532).

(xiv) On the commencement of winding up any floating charge created within the preceding 12 months becomes invalid except as to any cash advanced at the time of or subsequent to the creation of the charge, together with interest on that amount at the rate of 5 per cent per annum or at such other rate as from time to time be notified by the Central Government in the Official gazette (Section 534).

Consequences as to Shareholders described as Contributories

A shareholder in a company limited by shares is liable to pay full amount on the shares held by him but nothing more. This liability of his continues after winding up, but then a shareholder or

member is described by the Companies Act, 1956 as a "Contributory", and the nature of his liability changes.

Nature of Contributory's Liability

According to Section 428, a "Contributory" means every person liable to contribute to the assets of a company in the event of its being wound up, and includes the holder of fully paid-up shares. In the case of a deceased member, his legal representatives will be liable in due course of administration to contribute to the assets of the company in discharge of his liability and will be contributories accordingly [Section 430]. Thus, in the case of a deceased member his legal representatives will be liable for the debts of the deceased contributory but their liabilities will be limited to the extent of the assets of the deceased coming in their hands [see Bayswater Trading Co. Ltd., (1970) I all ER 608]. If the legal representatives make default in paying the money demanded to be paid by them, proceedings may be taken for administering the estate left by the deceased contributory and compelling payment there out of the money due (Section 430). In the case of an insolvent member his assignees in insolvency represent him for all the purposes of the winding up as contributories and will be liable to the debts of the insolvent contributory out of the assets that have come into their hands (Section 431). If a contributory happens to be a body corporate which has been ordered to be wound up, the liquidator of the body corporate will be treated as contributory and may be called on to admit to proof against the assets of the body corporate or otherwise to allow to be paid out of its assets any money due from the body corporate in respect of its liability to contribute to the assets of the company (Section 432). But the term "Contributory" does not include ordinary debtor of the company. It, however, comprises present and past members of the company who are liable to the company in their capacity as members. A present member is one whose name appears on the register of members at the commencement of the winding up, and his name is put on the list of contributories, known as "A List". A past member is one who ceased to be a member of the company within a year before the commencement of winding up, and his name is put by the Liquidator on the list of contributories known as "B List". With regard to liability, before winding up, the liability of a member is contractual obligation arising out of membership. But winding up creates a new liability and the liquidator can call upon him to pay the unpaid calls even if they had become time barred before liquidation. [In Re East Bengal Sugar Mills Ltd. I.L.R. (1940) 2 Cal. 175 (AIR 1941 Cal 143). The liability arises from the fact that his name appears on the register of members [Goenkav. Majumdar, (1958) 28 Comp. Cas. 536]. The members of a company in liquidation are liable in

respect of unpaid calls even though the calls were made by the company before it went into liquidation and suit of the company for its realisation had become time barred. Thus, on the commencement of winding up, a new liability is cast on the members in respect of unpaid calls. The liquidator gets a fresh right to enforce the payment of unpaid calls. His rights are independence of the rights which the company had before winding up. [Pokhar Mal v. Flour and Oil Mills Co. Ltd. AIR (1934) Lah. 1015]. Section 429 expressly defines the liability of contributory, and states that the liability of a contributory shall create a debt accruing due from him at the time when his liability commenced, but payable at the time specified in the calls made on him for enforcing the liability (by the liquidator). This means that the liability of a member arises as soon as he makes a contract with the company under which he becomes a member and during winding up it is only contingent until a call is made by the liquidator. It has been held in numerous cases that after winding up the liability of a contributory is ex lege (legal) and not ex contract (contractual) and is the direct result of his being a member of the company with his name appearing on the register of members [Lakshmi Narasa Reddy v. O.L. Shree films Ltd., AIR (1951) Mad. 890]. As the liability of a contributory is legal and statutory because his name appears on the register of members, he will not be allowed to say that, although his name is on the register of members, he is not liable because the allotment of shares to him was void. The Court has power to rectify the register of members, if required (Section 467). Unless the Court orders the rectification of register of members, the liability of a contributory is absolute. [Mohd. Akbar v. Official Liquidator, AIR 1950 Bom. 386]. In Re. Whitehouse & Co., (1878) 9 ch. D. 595, Jessel M.R. said: "After winding up the liability is a 'new liability': the contributory is to contribute, it is a new contribution; it is a liability to be enforced by the liquidator". Thus, the time will not run as against the liquidator as soon as the company goes into liquidation, for the liability to contribute does not arise unless and until a call is made by the liquidator (L.Guptav. Vishnu Sarvate, AIR 1956 Nag. 204). In the absence of a proceeding for rectification of the register of members before winding up, the contributory has been held out of the public as a member of the company. Whatever may have been the rights and liabilities of the shareholders before the winding up, the position is altered by the happening of that event. His name appears on the register of members at the commencement of the winding up with his full knowledge and assent. On the winding up, his liability under Section 426 in respect of shares held by him is statutory and absolute and flows from the fact of his being on the register of members in respect of those shares. Hence, his liability in respect of unpaid calls is absolute even though the calls

were made by the company for their realisation had become barred by time under Article 112 of the Schedule to the Limitation Act, 1963. The estate of the deceased contributory is liable to the same extent as it would have been if he had been alive. The legal representatives of a deceased contributory are liable to contribute to the assets of the company in discharge of the liability. If a contributory becomes insolvent after the commencement of winding up, he becomes a stranger to the company, and his assignee in insolvency (Official Assignee or Official Receiver) represents him for all purposes and is deemed to be a contributory.

List of Contributories

On winding up a list called the list of contributories is prepared by the liquidator and settled by the Court in a compulsory winding up. In a voluntary winding up the list is both prepared as well as settled by the liquidator. The list consists of two parts, namely:

(a) the list of present members, i.e. those whose names appear on the register of members at the commencement of winding up, called the "A" List, and

(b) the list of past members, i.e. those who ceased to be members of the company within one year before the commencement of winding up, called the "B" List. Past members, therefore, include persons whose shares have been forfeited, surrendered or transferred within twelve months before the commencement of winding up, but not a person who has died.

Extent of Liability

By virtue of Section 426, in the event of the company being wound up every present and past member is liable to contribute to the assets of the company to an amount sufficient for payment of its debts and liabilities and the costs, charges and expenses of winding up, and for the adjustment to the rights of the contributories among themselves. Subject to the provisions of Section 427 and subject also to the following qualifications, namely:

(a) a past member shall not be liable to contribute if he has ceased to be a member for one year or more before the commencement of the winding up;

(b) a past member shall not be liable to contribute in respect of any debt or liability contracted by the company after he ceased to be a member;

(c) a past member shall not be liable to contribute unless it appears to the court that the present members are unable to satisfy the contribution required to be made by them in pursuance of the Act;

(d) In the case of a company limited by shares, the present and past members shall not be liable to contribute more than the unpaid amount, if any, in respect of his shares.

(e) In the case of a company limited by guarantee, the present and the past members shall not be liable to contribute more than the amount, undertaken to be contributed by them in the event of the company being wound up;

(f) Any sum due to the present or past member by way of dividend, profits or otherwise shall not be deemed to be a debt payable by the company in case of competition between himself and the creditors but any such amount shall be taken into consideration for the purpose of final adjustment of the rights of the contributories among themselves. The relation of present and past members is one of primary and secondary liability, and they do not in any way, stand to each other in the relation of principal and surety. The liquidator cannot call upon the past members to contribute before the present ones. The measure of liability of "A" List contributory is the full amount unpaid on his shares. He is primarily liable and must be tried first. The liability of "B" List contributory is equated by the Act and arises only:

   (i) if it appears to the Court that the present members are unable to satisfy the contribution required to be made by them, within a reasonable time;

   (ii) the debt or liability was incurred while he was a member; and

   (iii) he had not ceased to be a member for one year or upward before the commencement of the winding up, i.e., to be liable he must have ceased to be a member within 12 months immediately before the commencement of the winding up. It is to be noted that "B" List can be resorted to only when the "A" List has been exhausted and part of the debts have been paid. Even when he resorts to "B" List, he can only claim from a "B" List member when the corresponding "A" List member has been unable to pay. Let us suppose that there is a debt of Rs. 50,000 contracted before six "B" List contributories had transferred their shares. There are many debts amounting to Rs. 50,000 in all contracted after all the "B" List members had transferred their shares. The total liability on shares of the six "B" List members is Rs. 10,000. In such case the liquidator can demand from them only Rs. 5,000, and he must apply this Rs. 5,000 paripassu towards all the debts. It is clear that if he has Rs. 5,000 to apply towards debts of Rs. 50,000 + Rs. 5,000 = Rs. 55,000, each creditor will receive one eleventh (Rs.55,000 : 5,000) of the amount which he is owned. The

single "B" List creditor will, therefore, receive one-eleventh of Rs.5,000, yet there is still a liability on the "B" List shares of Rs. 5,000. As per Section 427, in the winding up of a limited company, any director, or manager whether past or present, whose liability is unlimited (under the provisions of the Act) shall be liable to contribute to the assets of the company to an unlimited extent, over and above his ordinary liability to contribute as an ordinary member. There are three exceptions to the rule contained in Section 427 of the Companies Act, 1956 Firstly, past director or manager shall not be liable to make such further contribution if he has ceased to hold office for a year or more before the commencement of winding up. Secondly, past director or manager shall not be liable to make such further contribution in respect of any debt or liability of the company contracted after he ceased to hold office. Subject to the articles of the company, a director or manager shall not be liable to make such further contribution, unless the Court deems it necessary to require the contribution in order to satisfy the debts and liabilities of the company and the costs, charges and expenses of the winding up.

Enforcement of Liability of Contributory

The liability of the contributories is enforced by means of calls. In the case of winding up by the Court the call is made by the liquidator with the sanction or order of the Court. In the case of a voluntary winding up, the call may be made by the liquidator without the sanction of the Court.

Set Off

A person, as observed earlier, who is both a contributory and a creditor of the company (in respect of dividends, profits or otherwise) cannot set off his debts against his liability for calls even if there is an express agreement to do so whether the call was made before or after winding up [Rameshwar Prasad v. Simla Banking & Industrial Co. etc. Ltd., (1955) 25 Comp. Cas. 475]. The principle underlying denial of right of set off is that where a person entitled to participate in a fund is also bound to make a contribution in aid of that fund, he cannot be allowed to participate until he has discharged his obligation [Re. Peruvian Railway Constructions Co. (1915) 2 Ch. 442]. When all the creditors have been paid in full, the debts due from the company to the contributory in respect of independent dealing or contracts may be set off against debts due to the company in the case of an unlimited company. Such an allowance may be made, in the case of a limited company, to any director or manager whose liability is unlimited. A creditor to

whom money is due from the company, other than in his capacity as a member of the company, may claim set off against the money owed by him to the company. In Official Liquidator, High Court of Karnataka v. Smt. V. Lakshmi Kutty, (1981) - 51 Comp. Cas. 566 (SC), it has been held by the Supreme Court that Sections 529 and 530 of the Companies Act should be read together whenever any creditor seeks to prove his debt against the company in liquidation, the rule enacted in Section 46 of the Provincial Insolvency Act, 1920, should apply and only that amount which is found due from him at the foot of the account in respect of the mutual dealings should be recoverable from him and not that the amount due from the company in liquidation should rank in payment after the preferential claims prescribed under Section 530 have been paid. The set off is allowed where the dealings are mutual. In the case of chit fund transactions the subscribers can set off the debts owing to them by chit fund company against the debts due by them to the chit fund company. The cutoff date for the purpose of set off is the date of commencement of the winding up. Therefore, any claim arising after the commencement of the winding up cannot be set off.

Consequences as a Creditor

A company, as observed earlier, cannot be adjudged an insolvent, although it may become insolvent in the sense that it is unable to pay its debts. As to the rights of the creditors in winding up, a distinction between solvent and insolvent companies has to be made. Where a solvent company is being wound up, all debts payable on a contingency, and all claims against the company, present or future, certain or contingent, are admissible to proof against the company, a just estimate being made as far as possible, of the value of such debts or claims as may be subject to any contingency or for some other reason do not bear a certain value (Section 528). No difficulty arises in the case of an insolvent company, as when the claims are proved they are paid off according to the availability of the assets. In the winding up of an insolvent company, the same rules shall prevail as in the case of insolvency law, in respect of:

(i) debts provable,

(ii) the valuation of annuities and future and contingent liabilities, and

(iii) the respective rights of secured and unsecured creditors [Section 529].

Secured Creditors

A secured creditor is defined in the Insolvency Act to mean "a person who holds a mortgage, charge or lien on the company's property or any part of it as security for any debt due to him

from the company." The effect of the provisions of Section 529 is that the secured creditor may either:

(i) rely on the security and ignore the liquidation altogether;

(ii) value his security and prove for the balance of his debt; or

(iii) give up his security and prove for the whole amount as an unsecured creditor.

The secured creditor can, on his option, stand wholly outside the winding up proceedings. He need not prove his debts out of that security with the leave of the winding up Court. If the security is insufficient to pay his debt fully, he may exhaust the security and prove for the deficiency in the winding up. Alternatively, he can assess the value of his security and prove for the balance. The liquidator can redeem the security from the secured creditors at the value assessed by him. With the amendment of Section 529 by the Companies (Amendment) Act, 1985 the law about realisation of dues by the secured creditors has now been amended w.e.f. 1st May, 1985. Now Section 529 has been amended by making wide amendments and also by inserting a new Section 529A. Henceforth the security of other secured creditors shall be deemed to be subject to a paripassu charge in favour of the workmen to the extent of their dues. The Official Liquidator has been given the duty of representing the workmen to enforce their charge over the property. The dues of the workmen are to be paid in full but if the assets are insufficient to meet them, then, in such a case the dues of the workmen shall abate in equal proportions along with the secured creditors. A secured creditor who realises his security is liable to reimburse the liquidator for all expenses incurred by the latter for the preservation of the security before the realisation. The secured creditor is liable to pay the whole of the expenses but if workmen are participating in the security, then such expenses should be apportioned between the secured creditors and workers in the proportion of the amount to be distributed to them.

Secured creditors can apply for Winding Up

A Secured Creditor can apply for winding up if the adequacy of security is open to grave doubt. Banaras Beads v. Shrishti Carriers (2000) 38 CLA 352. The secured creditor can file winding up petition. He is not required to relinquish his security at the time of filing a company petition for winding up. He can realize his security and prove for balance due to him. However, if the secured creditor seeks to prove whole of his debt in winding up proceedings, he must relinquish his security for benefit of general body of creditors, before proving his debt. [Canfin Homes v. Lloyds Steel Industries Ltd. (2001) 32 SCL 283 (Bom. HC).]

Position of State Financial Corporation

Section 29 of State Financial Corporation Act empowers State Financial Corporation to take over management and/or possession of property of industrial concern. However once winding up order is issued, these powers can be exercised only with permission of Court. In A.P. State Financial Corporation v. Official Liquidator 2000 (5) Scale 486, it was held that the provisions of Section 529A of the Act prevail over provisions of Section 29 of SFC Act.

Unsecured Creditors

Unsecured creditors of an insolvent company are paid in the following order:

(i) Over-riding preferential payments under Section 529A.

(ii) Preferential payments under Section 530;

(iii) Other debts paripassu.

Order of Priority of Debts

(a) Secured creditors subject to a paripassu charge in favour of the workmen to the extent of workmen's portion therein;

(b) Workmen's dues; and debts due to secured creditors to the extent such debts rank under clause (c) of the proviso to Sub-section (1) of Section 529 paripassuwith such dues;

(c) Costs and charges of winding up. In a voluntary winding up this item is a priority automatically but in compulsory winding up, the court has, to give priority by order under Section 476;

(d) Preferential debts – Section 530;

(e) Floating charges – Section 530(5)(b); and

(f) Unsecured creditors.

If there is any surplus (as it may happen in the case of a solvent company), capital is returned to preference shareholders, and then equity shareholders are returned their capital, if assets are still available. If there is still some more surplus, it depends on the articles as to whether preference shares are participating or not. In the case of a solvent company, interest can be claimed subsequent to winding up order, if there is agreement to pay interest.

Overriding Preferential Payments (Section 529A)

According to Section 529A, notwithstanding anything contained in any other provision of this Act or any other law for the time being in force in the winding up of the company–(a)

workmen's dues; (b) debts due to secured creditors to the extent such debts rank under clause (c) of the proviso to Sub-section (1) of Section 529 pari passuwith such dues shall be paid in priority to all other debts. In the case of Allahabad Bank v. Canara Bank [2000 (101) Comp. Cas. 64 (SC)] the Supreme Court held that when the secured creditors stand outside the winding up and realise their security on the assets of the company sold in pursuance of the order of Debt Recovery Tribunal, dues of workers, if any, are to be satisfied first before the sale proceeds are appropriated by the secured creditors. The impact is that Section 529A of the Companies Act has overriding effect on the provisions of Recovery debts due to Banks and Financial Institutions Act, 1993. Section 529(2) provides that the debts payable under clause (a) and clause (b) of Sub-section (1) shall be paid in full, unless the assets are insufficient to meet them, in which case they shall abate in equal proportions. The statutory charge under Section 529 acquires the status of paripassu charge for labour dues along with secured creditor.

Preferential Payments

Section 530 provides that in winding up subject to the provisions of Section 529A, the following debts shall be paid in priority to all other debts:

(a) all revenues, taxes, cesses and rates due from the company to the Central or State Government or to a local authority. The amount should have become due and payable within twelve months before the date of commencement of winding up. The amount imposed and demanded as advance-tax under Section 207 of the Income-tax Act, 1961, is a tax within the meaning of this clause but any amount due to the Government in relation to commercial transactions does not enjoy preferential right, as it is not tax or cess.

(b) all wages or salary of any employee in respect of services rendered to the company and due for a period not exceeding four months within twelve months before the relevant date. The amount to be paid as preferential payment must not exceed Rs. 20,000 in the case of each employee or workmen.

(c) all accrued holiday remuneration becoming payable to any employee or in the case of his death to any other person in his right on termination of his employment before or by the effect of the winding up order or resolution.

(d) unless the company is being wound up voluntarily only for the purpose of reconstruction or of amalgamation with another company in respect of all contributions payable during 12 months next before the relevant date, by the company as the employer of any persons, under the Employees State

(e) Insurance Act, 1948, or any other law for the time being in force.

(f) unless as in (d) above or unless workmen's compensation insurance policy is taken, all sums due as compensation under the Workmen's Compensation Act, 1923.

(g) all sums due to any employee from a provident fund, a pension fund, a gratuity fund or any other fund for the welfare of the employees, maintained by the company.

(h) the expenses of any investigation held under Section 235 or Section 237 in so far as they are payable by the company. Where any payment has been made to an employee of a company (i) on account of wages and salary, or (ii) to him or in case of his death, to any other person in his right, on account of accrued holiday remuneration, out of money advanced by some person for that purpose, the person by whom the money was advanced, shall in a winding up, have a right of priority in respect of the money so advanced and paid-up to the amount by which the employee would have been entitled to priority. All the preferential debts rank equally among themselves and are to be paid in full unless the assets are insufficient, in which case they will abate in equal proportion. After retaining sufficient sum for costs charges and expenses of winding up, preferential debts must be paid forthwith so far as assets are sufficient to meet them.

Proof of Debts

Persons who claim to be creditors must prove their debts within the time fixed by the Court, or in voluntary winding up, by the liquidator. If a creditor does not prove within the time fixed, he may still prove. In a winding up by the Court, if a creditor fails to file his proof of debt within time then he should apply to the Court for relief, i.e., condonation of delay under rule 177 of the Companies (Court) Rules, 1959. The creditor may then be paid out of any assets remaining in the hands of the liquidator but he cannot upset any dividend which has already been paid. Even where no claim is made by a creditor, the liquidator must pay him after all the other creditors have been paid and assets available, provided he is satisfied that the debt is due to the creditor. But the liquidator must not pay a statute barred debt if the shareholders object.

Consequences as to Disposition of Property by the Company

The following safeguards have been provided by the Act with regard to antecedent and other transactions in relation to company's property:

(a) Fraudulent Preference:

The insolvency rules as to fraudulent preference apply to companies. The object of the Act being a paripassu distribution, Section 531 provides that every transfer of property, movable or immovable, delivery of goods, payment, execution or other act relating to property made, taken or done by or against the company within six months before the commencement of its winding up shall be deemed, in the event of its being wound up, a fraudulent preference of its creditors and, therefore, invalid. It will amount to a fraudulent preference if it is shown that-

(i) the company was at the date of transfer unable to pay its debts as they became due;

(ii) the transaction took place within six months of the presentation of the petition to the Court and in case of voluntary winding up, within six months from the date of the resolution for winding up;

(iii) the dominant motive of the company, acting by its directors was to prefer one creditor to another;

(iv) the transaction was made in favour of a creditor.

There is no fraudulent preference when a debtor's dominant intention is to benefit himself rather than to confer an advantage on his creditor. Thus where a company created a legal mortgage in favour of a bank in the hope that by keeping good faith with the bank it could get further advance from the bank which could be utilized torevive the company, the mortgage was held not to be a fraudulent preference even though the mortgage was ceased after it was fairly clear that the company had become insolvent. [Re. F.L.E. Holdings Ltd. (1967) 3 ALL ER 353.] The essence of fraudulent preference is the giving of an improper benefit to a few creditors leading to inequality between them and the generality of the creditors. In order to establish fraudulent preference it is not enough only to show that the preference was to a particular creditor, it must also be proved that it was done with a view to giving him a "favoured treatment". The dominant motive attending transfer has to be ascertained and if it is tainted with an element of dishonesty, the question of fraud arises. The probe into the debtors' mind and an assessment of the various motives that animate his conduct is thus involved. There must be solid grounds for drawing an inference of dishonesty. Mere suspicion, however strong, is not sufficient. There is no fraudulent preference if the transfer is not voluntary. [Official Liquidator, Kerala High Court v. Victory Hire Purchasing Co. (P) Ltd., (1982) 52 Comp. Cas. 88 (Ker)].

(b) Avoidance of Voluntary Transfer:

Any voluntary transfer of property of any kind by a company, otherwise than in the ordinary course of business for valuable consideration, made within a period of one year before the commencement of winding up, shall be void against liquidator [Section 531A]. The purpose of the provision is to be preserve the assets of the Company and to enable the company to carry out transactions that might be for the benefit of those interested in the assets of the company. Sugar Properties (Derisley Wood) Ltd., 1988 BCLC 146 (Ch. D).

(c) Transfer for benefit of all Creditors:

Any transfer or assignment by a company of all its property to trustees for the benefit of all its creditors is void [Section 532]. The words 'any transfer of all its property' includes the transfer of an interest in all its property. Accordingly, a floating charge or a debenture upon the whole of a company's property for the benefit of all its creditors comes within this section. London Joint City and Midland Bank v. Dickinson (H.) 1922 WN 13.

(d) Effect of Floating Charge:

According to Section 534, a floating charge on the undertaking or property of a company, created within twelve months before the commencement of the winding up, is void (except as to the amount of any cash paid to the company upon or after the creation of the charge and consideration thereof, together with 5 per cent per annum interest on such amount), unless the company was solvent immediately after the creation of the charge. The object is to prevent insolvent companies from creating any floating charges on their assets with a view to securing past liabilities.

(e) Avoidance of Transfer of Shares in Voluntary Winding Up:

Section 536 provides that any transfer of shares in the company not being atransfer made to or with the sanction of the liquidator and any alteration in the status of the members of the company made after the commencement of the winding up shall be void. In the case of winding up by, or subject to the supervision of the Court, any disposal of property (including actionable claims) of the company and any transfer of shares in the company or alteration in the status of its members made after the commencement of the winding up is void unless Court otherwise orders.

(f) Avoidance of Attachment, Execution, etc.:

In terms of Section 537 of the Act, where the company is being wound up by or subject to the supervision of the Court, the following transactions are void:

(a) any attachment, distress or execution put in force, without leave of the Court, against the estate or effects of the company after the commencement of the winding up; or

(b) any sale held without leave of the Court, of any of the properties or effects of the company after such commencement; Any proceedings initiated in respect of any recovery of tax or in respect of any dues payable to the Government is not, however, affected by the above provisions.

Disclaimer of Onerous Property

Section 535 states that the liquidator may disclaim onerous properties belonging to the company. Following types of properties are regarded as onerous for purposes of this section:

(a) land of any tenure, burdened with onerous covenants; or

(b) shares or stock in companies; or

(c) any other property which is unsaleable or is not readily saleable by reason of the fact that it requires the possessor to perform certain acts or pay a sum of money.

(d) unprofitable contracts; or

The liquidator may, with the leave of the Court, disclaim any such property. The Court will assist the liquidator to get rid of "onerous and burdensome contracts" whenever it is necessary to safeguard in full the interests of the body of creditors and the shareholders of the company. The right of disclaimer can be exercised in relation only to property which in effect has ceased to be an asset and has become a liability. The disclaimer should be made in writing signed by the liquidator within 12 months after the commencement of the winding up or such extended period as the Court may allow. If the liquidator does not come to know of the existence of an onerous property within one month of the commencement of the winding up, the period of 12 months begins from the date of his knowledge. The disclaimer shall operate to determine, as from the date of disclaimer, the rights, interests and liabilities of the company. It release the company and the property from liability. However, it does not affect the rights and liabilities of any other person in respect of the property. Any person injured by the operation of a disclaimer is deemed to be a creditor of the company to the amount of the compensation or damages payable in respect

of the injury, and may accordingly prove the amount asa debt in the winding up. The Court may, require notices to be given to persons interested in the property before granting the disclaimer. Where a person interested in the property has required the liquidator to decide whether he will or will not disclaim the property, the liquidator should, within 28 days, give notice to the applicant that he intends to apply to the Court for leave to disclaim. If he fails to do so, he shall not be entitled to disclaim the property and where the property is a contract which he has not disclaimed within the aforesaid time, he shall be deemed to have adopted it.

Consequences as to Servants and Officers

A winding up order operates as a notice of discharge to the employees and officers of the company, except when the business of the company is to be continued after winding up [Section 445(3)]. A voluntary winding up which involves a discontinuance of the business also operates as notice of discharge, and may also give rise to a claim for damages where there is an agreement for employment for a\ fixed time Fowler v. Commercial Trading Co. (1930)2 K.B.I. We have already seen that on the winding up of a company, the powers of directors, etc., cease. In a winding up by the Court, on an application of the Official Liquidator, the Court may summon and examine personally any person known or suspected to have in his possession any property, books, or papers of the company or to be indebted to company, or who can give any information as to the affairs of the company, and order him to deliver any property or books with him and papers relating to the company only persons who are individuals can be examined under this section (Section 477). The Court can also order public examination of any promoter, director or any officer of the company, if the Official Liquidator suspects that a fraud has been committed and informs the Court of the same (Section 478).

Suits or Legal Proceedings Stayed on Winding Up

It has already been observed that after winding up petition is presented, the Court may stay all proceedings against the company (Section 442). But once a winding up Order is passed no suit or legal proceedings against the company can continue or be freshly commenced except by leave of the winding up Court (Section 446).

19.3 APPOINTMENT OF LIQUIDATORS

The Official Liquidator is appointed by the Central Government under section 448 of the Companies Act, 1956 attached to High Court of the State for the purpose of conducting

liquidation proceedings of those companies which are ordered to be wound up by the High Court. Functionally the Official Liquidator is under the supervision and control of the High Court but administratively is under the control of the Central Government through the Regional Director.

The Primary function of the Official liquidator is to administrate the assets of companies under liquidation, sale of the assets and realization of all debts of companies in liquidation for the purpose of distributing the same among the various creditors and other shareholders of the companies and to finally dissolve such companies after the affairs are completely concluded. When a company is put to winding up by an order of the High Court, the Official Liquidator attached to the said High Court takes possession of the company's assets, books of accounts, etc. and liquidates the company as per the further orders of the High Court. The procedure of liquidation is prescribed under the Companies (Court) Rules, 1959. These rules are approved by the Honorable Supreme Court of India and notified by the Central Government. The duties and powers of the Official Liquidator as laid down in section 457 of the Companies Act, 1956 are mainly of, filing of claims against, the debtors for realization of the debts due to the company, sale of movable and immovable assets of the company taken possession by the Official Liquidator, institute criminal complaints and misfeasance proceedings against the former Directors of the company for their acts and omissions, breach of trust etc., invitation of claims from the creditors, adjudication of claims and settlement of list of creditors, payment to creditors by way of dividend and settlement of list of contributories wherever necessary, and payment of return of capital where the company's assets exceeded its liability and finally dissolve the company under section 481 of the Companies Act,1956.

19.4 POWERS AND DUTIES OF LIQUIDATORS

Powers and duties of the Liquidators in Compulsory winding up of a Company

Section 456 of the Act requires the liquidator to take into the custody or under the control, all the property, effects and actionable claims to which the company is or appears to be entitled. After this, all the property and effects of the company shall be deemed to be in the custody of the court as from the date of the order for the winding up of the company.

Liquidator is not employer

When Official Liquidator is merely directed to wind up the affairs of company in liquidation, he is not 'employer' liable to make contribution of provident fund of ESIC contribution [Rohtas Industries Ltd. (In liquidation) - In re. (2000) 99 Comp. Cas. 503(Pat HC)]. Section 457 confers on the liquidator in a winding up by the Court, certain specific powers necessary for the performance of his duties in relation to winding up. Under Sub-section (1) of Section 457, the liquidator has following powers with the sanction of the Court:

(a) to institute or defend any suit, prosecution or other legal proceeding, civil or criminal, in the name and on behalf of the company;

(b) to carry on the business of the company so far as may be necessary for the beneficial winding up of the company;

(c) to sell the immovable and movable property and actionable claims of the company by public auction or private contract, with power, to transfer the whole thereof to any person or body corporate or the sell the same in parcels;

(d) to raise on the security of the assets of the company any money requisite;

(e) to do all such other things as may be necessary for winding up the affairs of the company and distributing its assets;

As per Section 459, the liquidator may, with the sanction of Court, appoint an advocate, attorney or pleader entitled to appear before the Court to assist him in the performance of his duties.

Under Section 546, the liquidator may exercise the following powers with the sanction of the Court in winding up by or under the supervision of the Court, and with the sanction of the special resolution of the company in voluntary winding up:

(i) to pay any classes of creditors in full:

(ii) to make any compromise or arrangement with creditors or persons claiming to be creditors or having or alleging themselves to have any claim, present or future, certain or contingent, ascertained or sounding only in damages, against the company or whereby the company may be rendered liable; or

(iii) to compromise any call or liability to call, debt and liability capable of resulting in a debt, and any claim, present or future, certain or contingent, ascertained or sounding only in damages, subsisting or alleged to subsist between the company and a contributory or alleged contributory or other debtor or person apprehending liability to

the company, and all questions in any way relating to or affecting the assets or liabilities or the winding up of the company, on such terms as may be agreed, and take any security for the discharge of any such call, debt, liability or claim, and give a complete discharge in respect thereof.

The exercise of aforesaid powers by the liquidator in the case of voluntary winding up is subject to the control of the Court. Under Sub-section (2) of Section 457, the liquidator has following powers without obtaining any sanction of the Court:

(a) to do all acts and to execute in the name and on behalf of the company and to execute all deeds, receipts and other documents and for that purpose to use, when necessary the company's seal;

(b) to inspect the records and returns of the company on the files of the Registrar without payment of any fee;

(c) to prove, rank and claim in the insolvency of any contributory for any balance against his estate and to receive dividends in the insolvency in respect of that balance as a separate debt due from the insolvent, and rateably with other separate creditors;

(d) to draw, accept, make and endorse any negotiable instruments in the name and on behalf of the company in the course of its business;

(e) to take out, in his official name, letters of administration to any deceased contributory and to do in his official name any other act necessary for obtaining payment of any money due from a contributory or his estate;

(f) to appoint an agent to do any business which the liquidator is unable to do himself.

"(2A) The liquidator shall —

(a) appoint security guards to protect the property of the company taken into his custody and to make out an inventory of the assets in consultation with secured creditors after giving them notice;

(b) appoint, as the case may be, valuer, chartered surveyors or chartered accountant to assess the value of the company's assets within fifteen days after taking into custody of property, assets referred to in sub clause and effects or actionable claims subject to such terms and conditions as may be specified by the Tribunal;

(c) give an advertisement, inviting bids for sale of the assets of the company, within fifteen days from the date of receiving valuation report from the valuer, chartered surveyors or chartered accountants referred to in clause (b), as the case may be.

(2B) The liquidator shall, immediately after the order for winding up or appointing the liquidator as provisional liquidator is made, issue a notice requiring any of the persons mentioned in Sub-section (2) of Section 454, to submit and verify a statement of the affairs of the company and such notice shall be served by the liquidator.

(2C) The liquidator may apply to the Tribunal for an order directing any person who, in his opinion, is competent to furnish a statement of the affairs under Sections 439A and 454 and such person shall for the said purpose be served a notice by the liquidator in the manner as may be prescribed.

(2D) The liquidator may, from time to time, call any person for recording any statement for the purpose of investigating the affairs of the company which is being wound up and it shall be the duty of every such person to attend to the liquidator at such time and place as the liquidator may appoint and give the liquidator all information which he may require and answer all such questions relating to winding up of company as may be put to him by the liquidator.

(2E) Every bidder shall, in response to the advertisement referred to in clause (c) of Sub-section (2A), deposit, his offer in the manner as may be prescribed, with liquidator or provisional liquidator, as the case may be, within forty-five days from the date of the advertisement and the liquidator or provisional liquidator shall permit inspection of property and assets in respect of which bids were invited: Provided that such bid may be withdrawn within three days before the last day of closing of the bid: Provided further that the inspection of property shall be open for not more than five days before closing of the bid.

(2F) The advertisement inviting bids shall contain the following details, namely:—

(a) name, address of registered office of the company and its branch offices factories and plants and the place where assets of the company are kept and available for sale;

(b) last date for submitting bids which shall not exceed ninety days from the date of advertisement;

(c) time during which the premises of the company shall remain open for inspection;

(d) the last date for withdrawing the bid;

(e) financial guarantee which shall not be less than one-half of the value of the bid;

(f) validity period of the bids;

(g) place and date of opening of the bids in public;

(h) reserve price and earnest money to be deposited along with the bid;

(i) any other terms and conditions of sale which may be prescribed.

(2G) The liquidator appointed shall—

(a) maintain a separate bank account for each company under his charge for depositing the sale proceeds of the assets and recovery of debts of each company;

(b) maintain proper books of account in respect of all receipts and payments made by him in respect of each company and submit half yearly return of receipts and payments to the Tribunal."

Although the liquidator is not required to obtain sanction of the Court before exercising any of the foregoing powers yet he is subject to the control of the Court, and any contributory or creditor may apply to the Court with respect to any exercise of any such powers. He should have regard to any directions which may be given by resolutions of creditors or contributories in their respective meetings, called by the liquidator. The liquidator may summon general meetings of creditors and contributories, whenever he thinks fit, to ascertain their wishes. He is bound to call such meetings at such times as the creditors or contributories may by resolutions direct or whenever requested in writing to do so by not less than 1/10th in value of creditors or contributories (Sections 458 and 460). The liquidator is required to present to the Court twice a year an account of his receipts and payments as liquidator. The Court gets the accounts audited; and the liquidator has to send a copy of the printed accounts to every creditor and contributory. A copy is also filed with the Registrar.

The Central Government is conferred with the power to take cognizance of the conduct of liquidators of companies which are being wound up by the Court. If it appears that a liquidator is not faithfully performing his duties or is not observing the requirements of the Act or if any complaint is made by a creditor or a contributory, the Central Government shall inquire into the matter and take necessary action (Section 463).

Powers of the Liquidator in Voluntary Winding Up of a Company

The powers of the liquidator in voluntary winding up are just the same as those of an Official Liquidator in a winding up by the Court. However, in cases where the Official Liquidator has to obtain the sanction of the Court before acting, the voluntary liquidator shall have to obtain the sanction of the company, and in case of creditors' voluntary winding up, he shall have to obtain the sanction of the Court, or of the Committee of Inspection or, in its absence, of the creditors. However, for the convenience of the students, the powers of a voluntary liquidator are detailed below. Thus, the voluntary liquidator may exercise the following powers, in the case of a members' voluntary winding up with the sanction of a special resolution of the company, and in the case of a creditors' voluntary winding up, with the sanction of the Court or the Committee of Inspection or, if there is no Committee of Inspection, with the sanction of the creditors:

(a) to institute or defend any suit, prosecution or other legal proceedings, civil or criminal, in the name and on behalf of the company;
(b) to carry on the business of the company so far as may be necessary for the beneficial winding up of the company;
(c) to sell immovable or movable property and actionable claims of the company; and
(d) to raise on the security of the assets of the company any money requisite.

The following powers can be exercised by voluntary liquidator without any sanction:

(i) to do all acts and to execute, in the name and on behalf of the company all deeds, receipts and other documents, and for that purpose to use, when necessary, the company's seal.
(ii) to inspect the records and returns of the company on the files of the Registrar without payment of any fee.
(iii) to prove, rank and claim in the insolvency of any contributory.
(iv) to draw, accept, make and endorse any bill of exchange, hundi or promissory note in the name and on behalf of the company.
(v) to take out, in his official name, letters of administration to any deceased contributory, and to do in his official name any other act necessary for obtaining payment of any money due from a contributory or his estate.
(vi) to appoint an agent to do any business which the liquidator is unable to do himself.
(vii) to exercise the power of the Court of setting the list of contributories (which shall be prima facie evidence of the liability) of the persons named therein to be contributories.
(viii) to exercise the power of the court of making calls.
(ix) to call general meetings of the company for the purpose of obtaining the sanction of the company by ordinary resolution or special resolution, as the case may require, or for any other purpose he may think fit.
(x) to pay the debts of the company and adjust the rights of the contributories among themselves.

Although the foregoing powers can be exercised by the voluntary liquidator without any sanction, they are, nevertheless, subject to the control of the Court inasmuch as any creditor or contributory may apply to the Court with respect to any exercise or proposed exercise of any of these powers. For example, a contributory, whose name has been settled on the list of contributories by the voluntary liquidator, may apply to the Court with the prayer that his name ought not to have been so settled on the list as he is not a member or had ceased to be a member more than 12 months before the commencement of winding up. Or a creditor may apply to the Court against the decision of the voluntary liquidator to admit his claim. When more than one liquidators are appointed, the manner and extent of their powers are determined at the time of their appointment by the authority appointing them. If the powers of the liquidators are not so determined on their appointment, then any of the aforesaid powers is exercisable only jointly by all or by not less than 2 of them.

Duties and Functions of Voluntary Liquidator

The function and duties of a voluntary liquidator may be summarised as follows:

1. To satisfy himself that the resolution for voluntary winding up was validly passed and that a copy of the resolution was duly filed with the Registrar.
2. To file with the Registrar a notice of his appointment.
3. To advertise in the Official Gazette and in a local newspaper asking the creditors to meet at a certain specified place and time within 21 days of his appointment, and also to send notice to each creditor.
4. To take possession of the companies assets and see that they are intact.
5. To call by advertisement for the claims of creditors by a certain specified date, and to admit the claims.
6. To prepare a list of debts and claims and send notices to contributories for the settlement of list of contributories.
7. To settle the list of contributories on the date fixed for the purpose.
8. To look into payment made during six months immediately preceding the winding up and satisfy himself that there has been no fraudulent preference.
9. To avoid voluntary transfers.
10. To disclaim onerous property.
11. To dispose of the assets of the company to the best advantage and collect so far as practicable all outstanding debts due to the company.
12. To apply the proceeds of realisation in the prescribed manner.
13. To make calls on unpaid shares, if necessary.
14. To file returns at the end of the first year and then every six months during the continuation of the winding up.
15. To convene annual general meetings of the company and of creditors during liquidation and present the annual accounts thereat.

16. At the end of winding up, to call a general meeting and lay before it the account of the winding up. For this to make publication in the Official Gazette and in newspapers.
17. To file within one week of this meeting a return with the Registrar and the Official Liquidator.
18. To give information, papers, books and documents to the Official Liquidator for his scrutiny and submission of report to the Court.

Status of Liquidator

The liquidator in a winding up by the Court or under the supervision of the Court, is an officer of the Court, and as such is required to exercise a high degree of honesty and fairness towards the creditors and the members of the company. He is also the agent of the company and incurs no personal liability when he enters into any contracts as a liquidator. In a voluntary winding up, the liquidator is more rightly described as the agent of the company. He is not an officer of the Court. As a paid agent of the company he has statutory duties towards the creditors and contributories including the administration of the assets of the company. Both in a compulsory winding up and voluntary winding up, a liquidator as an agent of the company, must exercise a high degree of care and diligence in discharging his statutory duties. He may be liable in damage to a creditor or contributory for injury caused to him as a result of his breach of statutory duties. A liquidator is not a trustee. The property of the company is not vested in him. But he is in a fiduciary position in relation to any property of the company and is in the position of a trustee, or what is sometimes stated, he is a "statutory trustee". Accordingly, if he pays an invalid claim, even without willful default, he is liable to misfeasance proceedings. He is not a trustee for individual creditors or contributories.

19.5 PROCESS OF WINDING UP

Conduct of Compulsory Winding Up of a Company - Winding Up Petition and Procedure

A winding up petition is quite different from a plaint in an ordinary suit. The Companies (Court) Rules, 1959 contain the procedure for hearing of the winding up\ petitions. Rules 103 and 104 of Companies (Court) Rules, 1959 provide for affidavits in opposition and affidavits in reply. Though there is a fundamental procedural difference between these two kinds of actions, the Civil Procedure Code, 1908 empowers the Court to apply procedure provided in the Code in regard to suits in all proceedings in any Court of civil jurisdiction. Similar provisions have also been made in Rule 9 of the Companies (Court) Rules, 1959 which empowers the Court to invoke

the inherent powers with regard to directions or passing such orders as it may deem necessary for the ends of justice or to prevent abuse of the process of the Court. Both these provisions may be utilised by the Court for expeditiously and effectively deciding winding up petitions; and no party in such cases can claim as a matter of right of the application of the provisions of the Code of Civil Procedure, 1908, Rules 6 and 7 of Order 11 of the Code can also be used to object interrogatories application. Grounds and particulars relating to winding up of a company must be set out in the petition itself and not in the affidavit in reply. The petitioner must confine himself to the grounds set out in the petition. Where an application is not in proper form, the Court may exclude the defect. The application for amendment of the petition for winding up of a company will be governed by Order 6, Rule 17, Code of Civil Procedure, for Section 141, the Code of Civil Procedure is made applicable to proceedings under the companies Act, 1956.

Persons entitled to be Heard

The persons entitled to be heard by the Court in a winding up petition are the company, the creditors, the contributories, the Registrar and the Central Government. The Court may, however, in its discretion hear any other person who may be interested in the winding up. Rule 34 of the Companies (Court) Rules, 1959, provides that any person who intends to appear at the hearing of the petition must give notice in Form No. 9 to the petitioner indicating the grounds of opposition, if he wishes to oppose the petition. The question whether the workmen of a company have a right to appear and contend the winding up petition came up for consideration by the Supreme Court in National Textiles Corporation Workers' Union v. P.R. Rama Krishnan, (1983) (I) Comp. L.J. 1 (SC). In that case the court held that workers are entitled to appear at the hearing of the winding up petition whether to support or to oppose it so long as no winding up order is made by the Court. The workers have locus standi to appear and be heard before winding up order is made. Even where a winding up order is made and the workers are aggrieved by it, they would also be entitled to prefer an appeal contending that no winding up order should have been made. But when a winding up order is made and it has become final, the workers ordinarily would not have any right to participate in any proceedings in the course of winding up of the company. It was further held that since there was nothing in the Companies Act expressly prohibiting the workers from being heard in a winding up proceedings, the workers would be entitled to be heard as interveners. The Court observed that the law cannot stand still; it must change with the changing social concepts and values. Under Section 445(3), the winding up order has the effect of terminating the services of workers except where the business of the

company is continued. The workers have, therefore, vital interest in the continuance or dissolution of the company.

Powers of the Court on hearing Petition (Section 443)

On hearing a petition for winding up of a company, the Court may:

(a) dismiss it, with or without costs; or

(b) adjourn the hearing conditionally or unconditionally; or

(c) make any interim order that it thinks fit; or

(d) make an order for the winding up of the company with or without costs or any other order as it thinks fit.

Provided that the Tribunal shall not refuse to make a winding up order on the ground only that the assets of the company have been mortgaged to an account equal to or in excess of those assets, or that the company has no assets.\ Where the petition is presented on the ground that it is just and equitable that the company should be wound up, the Court may refuse to make an order of winding up, if it is of opinion that some other remedy is available to the petitioners and that they are acting unreasonably in seeking to have the company wound up instead of pursuing that other remedy. Where the petition is presented on the ground of default in delivering the statutory report to the Registrar or in holding the statutory meeting, the Court may:-

(a) instead of making a winding up order, direct that the statutory report shall be delivered or that a meeting shall be held; and

(b) order the costs to be paid by any persons who, in the opinion of the Court, are responsible for the default.

Before making the winding up order, the Court notifies all the creditors and contributories of the company intimating that a petition for winding up has been filed and would be heard by the Court on a specified day. The Court also invites all concerned to be present at the hearing. If the Court is of the opinion that the company should be wound up, it makes an order for winding up. By virtue of Section 449 on a winding up order being made in respect of the Company the Official Liquidator shall, by virtue of his office, become the liquidator of the company. As per Section 451(1), the liquidator, shall conduct the proceedings in winding up the company and perform such duties as may be imposed by Court. If Official Liquidator becomes liquidator, there shall be paid to the Central Government out of the assets of the company such fees as may be prescribed. Upon making the winding up order, the Court shall forthwith send intimation of the same to the Official Liquidator and the Registrar. A certified copy of the winding up order must

be filed with the Registrar within thirty days from the date of the order. On receipt of the certified copy of the order, the Registrar shall record it in his books and notify in the Official Gazette that such an order has been made. The Court has enormous discretionary power to order or not to order winding up of a company. It has been held in Re. Suleka works Ltd. AIR 1965 Cal. 98 that "the Court has also inherent power to prevent a petitioner from proceeding further with his petition when the Court is satisfied that the object of the petitioner is mischievous and malicious and the petition is based on reckless and frivolous charges of mismanagement, mis-application of funds and irregularities in the company's administration". The Court in the same case has further held "Where the winding up petition is moved with the primary object of putting pressure on the company by threats of advertisement, the Court will stop or stay the winding up proceeding and the advertisement ought not to be allowed to be published."

Stay of Proceedings against the Company

The Court has powers to stay or restrain any proceedings against the company in respect of which the petition for winding up has been presented. Section 442 provides that at any time after the presentation of a petition for winding up and before winding up order has been made, the company, or any creditor or contributory, may: (a) where any suit or proceeding against the company is pending in the Supreme Court or in any High Court, apply to the Court in which the suit or proceeding is pending for stay of proceedings therein; and (b) where any suit or proceeding is pending against the company in another Court, apply to the Court having jurisdiction to wind up the company, to restrain further proceedings in the suit or proceedings; and the Court to which the application is made may stay or restrain the proceedings, on such terms as it thinks fit.

Stay of Suits and Proceedings on Winding Up

Section 446 of the Act provides that on the making of winding up order or on the appointment of Official Liquidator as provisional liquidator, no suit or legal proceedings shall be proceeded with, except with the leave of the Court. The Court may grant leave to commence or proceed with the pending suits or proceedings subject to such terms and conditions as it may impose. The Court has jurisdiction to grant such leave to proceed with a suit or other legal proceedings pending against a company in liquidation even if such leave had not been obtained earlier before the commencement of the proceedings. The Court which is winding up the company has jurisdiction to entertain or dispose of:

(a) any suit or proceedings by or against the company;

(b) any claim made by or against the company (including claims by or against any of its branches in India):

(c) any application made under Section 391 by or in respect of the company.

(d) any question of priorities or any other question whatsoever whether of law or fact which may relate to or arise in the course of winding up of the company.

The Court has further powers to transfer to itself and dispose of any similar proceedings by or against the company pending in any other Court. These powers of the winding up Court do not, however, extend to any proceedings pending before the Supreme Court or the High Court. In Fakir Chand v. Tanvar Finance Pvt. Ltd.. (1981) 51 Comp. Cas. 60 (Del,), it was held that the Company Court has jurisdiction to determine whether the sale of company's property after the commencement of the winding up is in accordance with the provisions of the Act or not and in the latter case it has powers to set aside the sale. It was further held in this case that the order of the Executing Court is not binding upon the Company Court. Order passed by the Company Court is on the other hand binding on the Executing Court.

Procedure after the Winding Up Order

(1) For the purpose of winding up of companies by the Court, an Official Liquidator may be appointed either from a panel of professional firms of chartered accountants, advocates, company secretaries, costs and works accountants or firms having a combination of these professionals, which the Central Government shall constitute for the Tribunal, or may be a body corporate consisting of such professionals as may be approved by the Central Government from time to time, or may be a whole-time or a part-time officers appointed by the Central Government. Before appointing the Official Liquidator, the Tribunal may give due regard to the views or opinion of the secured creditors and workmen. Provided that before appointing the Official Liquidator, the Tribunal may give due regard to the views or Opinion of the secured creditors and workmen.

(2) The terms and conditions for the appointment of Official Liquidators appointed by Tribunal shall be approved by the Tribunal and remuneration shall be subject to a maximum remuneration of five per cent of the value of debt record and realization of sale of assets. The terms and conditions of the Official Liquidator appointed from the Officers appointed by the Central Government shall be approved by the Central Government in accordance with the rules made by it in this behalf.

(3) Where the Official Liquidator is an officer appointed by the Central Government under clause (c) of Sub-section (1), the Central Government may also appoint, if considered necessary, one or more Deputy Official Liquidators or Assistant Official Liquidators to assist the Official Liquidator in the discharge of his functions, and the terms and conditions for the appointment of such Official Liquidators and the remuneration payable to them shall also be in accordance with the rules made by the Central Government.

(4) All references to the "Official Liquidator" in this Act shall be construed as reference to the Official Liquidator specified in Sub-section (1), or to the Deputy Official Liquidator or Assistant Official Liquidator referred to in Sub-section (3), as the case may be.

(5) The amount of the remuneration payable shall—
   (a) form part of the winding up order made by the Tribunal;
   (b) be treated as first charge on the realisation of the assets and be paid to the Official Liquidator or to the Central Government, as the case may be.

(6) The Official Liquidator shall conduct proceedings in the winding up of a company and perform such duties in reference thereto as the Tribunal may specify in this behalf: Provided that the Tribunal may—
   (a) transfer the work assigned from one Official Liquidator to another Official Liquidator for the reasons to be recorded in writing;
   (b) remove the Official Liquidator on sufficient cause being shown;
   (c) proceed against the Official Liquidator for professional misconduct. The Official Liquidator is required to conduct the proceedings in winding up of the company and perform such duties as the Court may impose.

Statement of Affairs by Directors

Section 454 provides that within twenty-one days of the date of winding up order a statement as to the affairs of the company has to be submitted to the Official Liquidator. This time may be extended up to three months either by the Official Liquidator or by the Court. The statement has to be submitted and verified by a director, manager, secretary or other chief officer of the company or such other persons as the Official Liquidator may, subject to the direction of the Court, require. The statement should be verified by an affidavit by any of the aforementioned officers of the company and should contain the following particulars:

(a) assets of the company, showing separately cash in hand and at the bank and negotiable securities if any held by the company;

(b) its liabilities and debts;

(c) names, residences and occupation of the company's creditors indicating the amount of secured or unsecured debts and in the case of secured debts, the particulars of the securities given, whether by the company or an officer thereof, their value and dates on which they were given;

(d) the debts due to the company and the names, residences and occupation of the persons from whom they are due, and the amount likely to be realized on account thereof; and

(e) such other information as may be required.

As per Sub-section (5) of said section, if any person, without reasonable excuse, makes default in complying with any of the requirements of this Section, he shall be punishable with imprisonment for a term which may extend to two years or with fine which may extend to one thousand rupees for every day during which the default continues or with both. In Official Liquidator v. P.R. Mehta (2000) 36 CLA 210, it was held that the prosecution has to prove that the person has failed to submit the statement without reasonable cause. If a person was not director on relevant date or if there was reasonable cause for non-filing for statement, liability under this provision would not be there. In Indla Satya Raju v. Sramika Agro Farm (2002) 39 SCL 940, it was held that a person cannot be prosecuted and convicted under Section 454(5) merely for reason that he committed default in complying with any requirements of Section 454. In addition to establishing default, prosecution is also required to establish that the said person, without reasonable excuse, committed such fault.

Report by the Official Liquidator

Section 455 provides that, in case where a winding up order is made, the Official Liquidator shall, as soon as practicable after receipt of the above mentioned statement of affairs submitted to him under Section 454 but not later than 6 months of the date of winding up order or such time as extended by the Court submit a preliminary report to the Court showing:

(a) the amount of issued, subscribed and paid-up share capital and the estimated amount of assets and liabilities;

(b) if the company has failed, the causes of the failure; and

(c) whether, in his opinion, further inquiry is desirable as to any matter relating to the promotion, formation or failure of the company or the conduct of its business. If the Official Liquidator is of the view that there has been a fraud about formation of the company then he may submit a further report or reports. This can be the basis of public examination of the directors of the company under Section 478.

Committee of Inspection (Sections 464 and 465)

The Court may, at the time of making an order for the winding up or at any time thereafter, direct that there shall be appointed a Committee of Inspection to act with the liquidator. Where such a direction is given by the Court, the liquidator is required to convene, within two months from the date of direction, a meeting of the creditors for the purpose of determining who are to be members of the committee, the liquidator must call a meeting of the contributories within fourteen days from the date of creditor's meeting, to consider the creditors meetings' decision with respect to the membership of the Committee. Contributories may accept the decision of the creditors with or without modification or reject it. If the contributories at their meeting do not accept the creditors' decision in its entirety, the liquidator shall apply to the for directions as to what the composition of the committee shall be and who shall be its members (Section 464). The committee of inspection shall consist of not more than twelve members, being creditors and contributories of the company or persons holding general or special power of attorney from creditors or contributories, in such proportion as may be agreed upon by the meetings of the creditors and contributories and in case of difference of opinion between the meetings, as may be determined by the Court [Section 465(1)]. The committee of inspection may inspect the accounts of the liquidator at all reasonable times [Section 465(2)]. The committee of inspection will meet at such times as it may from time to time appoint and the liquidator or any member of the committee may also call a meeting of the committee as and when he thinks necessary. The quorum for a meeting of the committee shall be one-third of the total number of the members or two whichever is higher. The committee may act by a majority of its members present at a meeting but shall not act unless a quorum is present. A member of the committee may resign by notice in writing signed by him and delivered to the liquidator. If a member is adjudged an insolvent or compounds or arranges with his creditors or is absent from five consecutive meetings of the committee without leave of those members who, together with himself, represent the creditors or contributories, his office shall become vacant. A member of the Committee of Inspection may be removed at a meeting of the creditors, if he represents creditors, or at a

meeting of contributories if he represents contributories, by an ordinary resolution of which seven days notice has been given stating the object of the meeting. When any vacancy has occurred in the committee the liquidator shall call a meeting of the creditors or contributories, as the case may be, and the meeting may re-appoint the same person or appoint some other person to fill the vacancy. However, the liquidator may apply to the Court that in the circumstances of the case the vacancy need not be filled. The Court may make an order accordingly.

General Powers of the Court

The Court has the power to cause the assets of the company to be collected and applied in discharge of its liabilities. For this purpose, the Court will settle a list of contributories. The Court may, after ascertaining the adequacy of the company's assets, proceed to make calls on all or any of the contributories requiring them, within the extent of their liability, to pay any money which the Court considers necessary to satisfy the debts and liabilities of the company, and the expenses of winding up and for the adjustment of the rights of the contributories. Where the contributory owes money on calls on his shares and the company owes him some money, he cannot set off one against the other except:

(1) in the case of unlimited company;

(2) in the case of limited company with directors having un-limited liability in respect of such directors;

(3) in the case of any company after the creditors are paid in full;

He must first pay what is due by him on the shares and then claim payment of his debt along with other creditors. Where any contributory, trustee, receiver, banker, agent, officer or other employee of the company is in possession of any money, property, books or papers of the company, the Court may require him to deliver the same to the liquidator. The Court can also summon before it any officer of the company or person known or suspected to have in his possession any such property of the company, orany person whom the Court deems capable of giving information concerning the promotion, formation, trade, property or other affairs of the company. Such person may be examined on oath which is called "private examination". The examination may be ordered by the Court ex-parte or on an application by the liquidator or any other person including a creditor or contributory. A person failing to respond to the order to appear before the Court may be caused to be apprehended and brought before the Court. The

Court may require him to produce any books and papers in his custody relating to the company. It may be remembered that the auditor is also an officer of the company for this purpose.

Dissolution of the Company in Winding Up by Court (Section 481)

The Court may make an order for dissolution of a company in the following conditions:

(a) when the affairs of the company have been completely wound up; or

(b) when the Court is of the opinion that the liquidator cannot proceed with the winding up of a company for want of funds and assets or for any other reason and it is just and equitable in the circumstances of the case that an order of dissolution of the company should be made. Where an order in the above circumstances is made by the Court, the company will be dissolved from the date of the order of the Court. Within 30 days from the date of the order, the liquidator must send a copy of the order to the Registrar. On the dissolution, the corporate existence of the company comes to an end.

After order of dissolution, the company has no legal existence. Thus no suit can lie by or against the company after order of dissolution. In NarendraBahadurTandon v. ShankerLalAIR (1980) SC 575, it was held that after company is dissolved, liquidator can not represent company and execute a deed of sale. Once company is dissolved, it ceases to exist and official liquidator can not represent a non-existent company. The property of dissolved company vest in Government and not in the trustee. Hence shareholders or creditors of dissolved company cannot be regarded as heirs and successors. They cannot maintain any action for recovery of assets. The Court may at any time declare the dissolution void within two years from the date of dissolution on application by the liquidator of the company or by any other person who appears to the Court to be interested. Thereupon such proceedings may be taken as might have been taken if the company had not been dissolved (Section 559).

19.6 SUMMARY

Powers of the Court on hearing a petition for winding up of a company: (i) dismiss it, with or without costs; or (ii) adjourn the hearing conditionally or unconditionally; or (iii) make any interim order that it thinks fit; or (iv) make an order for the winding up of the company with or without costs or any other order as it thinks fit. The order of winding up by the Court is made when all the available remedies are exhausted to keep the company going. An administrator called the liquidator, takes control of the company, collects its assets, pays its debts and finally

distributes any surplus among the members in accordance with their rights. Winding up commences not from the date of the order The Court may make an order for dissolution of a company in the following conditions: when the affairs of the company have been completely wound up; or (ii) when the Court is of the opinion that the liquidator cannot proceed with the winding up of a company for want of funds and assets or for any other reason and it is just and equitable in the circumstances of the case that an order of dissolution of the company should be made.

19.7 KEY WORDS

1. Official Liquidators
2. Contributories
3. Set off

19.8 SELF ASSESSMENT QUESTIONS

1. Explain the consequences of winding up

   …………………………………………………………………………………………………

   ………………………………………………………………………………………………

2. Write a brief note on appointment, powers and duties of liquidator.
   …………………………………………………………………………………………………
   …………………………………………………………………………………………………
3. Explain the procedure of winding up
   …………………………………………………………………………………………………
   ………………………………………………………………………………………………..

19.9 REFERENCES

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UNIT-20 OFFENCES AND PENALTIES FOR DEFAULTS; OFFICERS IN DEFAULTS; RECOVERY OF DAMAGES; COMPOUNDING OF OFFENCES, PROVISIONS AND PROCEDURES;

Structure

20.0 Objectives
20.1 Introduction
20.2 Officers and penalties for defaults
20.3 Officers in Defaults
20.4 Recovery of damages
20.5 Compounding of offences provisions and procedures
20.6 Summary
20.7 Key words
20.8 Self Assessment Questions
20.9 References

20.0 OBJECTIVES

1. To able to understand the offences and penalties for defaults
2. To know officers in defaults
3. To understand the compounding of offences, provisions and procedures

20.1 INTRODUCTION

The Ministry of Company Affairs (“MCA”), Government of India vide Order No. 3/39/2005/CLII dated 4th May, 2005 constituted an Expert Group (the “Group”) to examine issues relating to the streamlining of the prosecution mechanism under the Companies Act, 1956 (the “Act”) to make it more effective and to advise on the following:

1. Identification of broad categories of offences for which cases filed for violations of the Companies Act, 1956 are pending and the period of pendency thereof;
2. Investigating reasons for excessive pendency, where relevant;
3. Review of steps taken in the past to expedite disposal of these cases, their outcome and limitations;
4. Suggesting ways and means of expeditious disposal of these cases;
5. Outlining a workable mechanism for expeditious disposal of cases of purely technical nature within a reasonable time frame.

20.2 OFFENCES AND PENALTIES FOR DEFAULTS

Section 3(38) of General Clauses Act 1897 defines ‘offence’ as ‘any act or omission made punishable by any law for the time being in force’. Section 2(n) of Criminal Procedure Code 1973 (‘CrPC’) also defines ‘offence’ similarly. An accused committing an offence is liable to be prosecuted as per relevant provisions of law. Compounding is a settlement process by which the accused pays compounding charges in lieu of undergoing consequences of lengthy prosecution.

Offences which can be compounded under Companies Act 1956: Offences under various Sections of Companies Act 1956 (‘the Act’) can be classified into following five categories:

a) Offences punishable with fine only;

b) Offences punishable with fine or imprisonment;

c) Offences punishable with fine or imprisonment or both;

d) Offences punishable with imprisonment only;

e) Offences punishable with imprisonment and also with fine.

As per Section 621A of the Act, offences committed by a company or any officer thereof under the above first three categories are compoundable whereas offences under remaining two categories are not compoundable.

Further, offences under other Acts like Employees' Provident Funds & Misc. Provisions Act 1952 or Employees' State Insurance Act 1948 cannot be compounded under Section 621A of Companies Act.

Offences committed by persons other than a company or its officers (like trustees, liquidators, contributories etc.) cannot be compounded under the Act.

Indian Companies Act 1956 provides a range of obligations to be discharged by every company registered under this Act and also on the part of its Directors / Managers / Secretaries, etc. The law relating to penalties arising from non-compliance of various legalities is provided in tabulated format here in below. The basic knowledge of the Company Law is essential for every company director to avoid superfluous annoyance arising from lack of knowledge of the law.

Sr. No	**Section**	**Nature of Default**	**Penalty**	**Persons to be held responsible for offence**
1	168	Failing to hold AGM in accordance with section 166	50,000/- +2,500 per day.	The company and every officer of the company who is in default.
2	220(3)	Failure to file Annual Accounts with MCA	Rs.500/- per day	The company and every officer of the company who is in default.
3	210(5) (6)	Default in laying Accounts at the AGM	Imprisonment up to 6 months or fine up to 10,000 or both.	Any person, not being a director of the company.
4	218	Improper issue, circulation or publication of Balance sheet or Profit and Loss Account	Fine up to Rs 5,000/-	The company and every officer of the company who is in default.
5	219(3)	Failure to sent members Annual Accounts / Auditors Report 21 days before meeting.	Fine up to Rs.5,000/-	The company and every officer of the company who is in default.
6	219(4)	Default in complying with certain demands for copies of Annual Accounts within 7 days	Fine up to Rs.5,000/-	The company and every officer of the company who is in default.

7	162(1)	Non compliance with the provisions of section 150, 160 or 161 wrt Annual Return.	Fine up to Rs.500/- Per day.	The company and every officer of the company who is in default.
8		Failure to file with MCA certain Resolutions or Agreements entered in accordance with section 192 (1)	Fine up to Rs.200/- Per day.	
9	217(5) (6)	Default in complying with the provisions of subsection (1) to (3) regarding Boards report.	Imprisonment up to 6 months or fine up to Rs.20,000/-or with both	
10	171(1) (2)	Contents & manner of service of notice in contravention of the provisions of the Act.	Fine up to 5,000/-& further 500 for each day or default.	
11	193(6)	Noncompliance with provisions of 193 regarding minutes of proceedings of General Meeting.	Fine up to Rs.500/-	The company and every officer of the company who is in default.
12	176(2)	Omitting to state in notice that a member is entitled Appoint a proxy and that the proxy need not be a member.	Fine up to Rs.5,000/-	Every officer of the company who is in default.
13	211(7) (8)	Failure to prepare Annual Accounts in he form & contents specified in the section.	Imprisonment up to 6 months or Rs.10, 000 or both.	
14	142	Non-Filing of registration of any charge created by the company, the payment or satisfaction of a debt in respect of which a charge has been registered under this part, or of the issue of debentures of a series.	Fine upto Rs. 5,000/- for every day during which the default continues.	The company and every officer of the company who is in default.
15	143	Wilfully omission of any entry in the Registrer of charges.	Fine upto Rs. 5,000/-	Any officer of the company
16	144	Refusal for inspection of Register of Charge.	Fine upto Rs. 500 which amy extend to Rs. 200 for every day during which the refusal continues.	The company and every officer of the company who is in default.
17	146	Failure to intimate Registrar about change of Registered Office.	Fine upto Rs. 500/- for every day during which the default continues.	The company and every officer of the company who is in

				default.
18	147(1) (a)	Failure to paint or affix the name and the address of the company or to keep the same painted or affixed outside the office	Fine upto Rs. 500/- for every day during which its name not so kept painted or affixed.	The company and every officer of the company who is in default.
19	147(1) (b)&(c)	Failure to print its name on the seal or on letter heads, notices, hundies, promissory notes, cheques etc.	Fine upto Rs. 5,000/-	The company
20	148	Failure to publish Authorised, Subscribed and Paid – up Capital simultaneously.	Fine upto Rs. 10,000/-	The company and every officer of the company who is in default.
21	150	Failure to maintain Register of members	Fine upto Rs. 500/- for every day during which the default continues	The company and every officer of the company who is in default.
22	151	Failure to maintain Index of members.	Fine upto Rs. 500/-	The company and every officer of the company who is in default.
23	152	Failure to maintain Index of Debenture holders.	Fine upto Rs. 500/-	The company and every officer of the company who is in default.
24	25	Failure to renew the license of maintaining the words “Chambers of Commerce” in its name.	Fine upto Rs. 5000/- for every day during which the default continues.	
25	44(3)	Failure to intimate the Registrar about any alteration in Article	Fine upto Rs. 5000/- for every day during which the default continues.	The company and every officer of the company who is in default.
26	44(4)	Untrue statement filed in any prospectus or statement in lieu of prospectus filed	Fine upto Rs. 50,000/- and imprisonment upto 2 years.	Any person who authorized the filing of such prospectus.
27	40	Default in alteration is made in memorandum or articles in each copy after the alteration in MOA and AOA	Rs. 100/- for each copy so issued.	The company and every officer of the company who is in default.
28	49	Investments of company to be held in its own name.	Fine upto Rs. 50,000/-	
29	153B(3)(a)	Non-declaration by trustee of shares and debentures held in trust.	Fine upto Rs. 5,000/- which may extend to a further fine of Rs. 100 for	Trustee

			every day during which the default continues.	
30	153B(3)(b)	False declaration by trustee.	Imprisonment for a term which may extend to two years and also with fine.	Trustee
31	154	If the register of members and debenture holders is closed without giving notice or giving a notice of less than 7 days.	Fine upto Rs. 5,000/- for every day during which the register is so closed.	The company and every officer of the company who is in default.
32	162(1)	Failure in complying with the provisions of section – 159, 160 and 161 (regarding filing of Annual Return)	Fine upto Rs. 500/- for every day during which the default continues.	Every officer of the company who is in default.
33	163	If any inspection, or the making of any extract u/s 163 is not sent.	Fine upto Rs. 500/- for every day during which the refusal or default continues.	The company and every officer of the company who is in default.
34	165	If default is made in complying with section 165 (holding of Statutory Meeting and preparation of Statutory Report)	Fine upto Rs. 5,000/-	Every Director or other officer of the Company who is in default.
35	168	If default is made in holding an AGM (Sec 166) or in complying with any directions of the CG (Sec 167).	Fine upto Rs. 50,000/- + Rs. 2,500 for every day after the first during which such default continues.	The company and every officer of the company who is in default.
36	176(2)	Default in giving the Proxy Form at the end of Notice for meeting.	Fine upto Rs. 5,000/-	Every officer of the company who is in default.
37	188	Default in complying with section 188 (regarding circulation of member's resolution)	Fine upto Rs. 50,000/-	Every officer of the company who is in default.
38	192A(5)	If a shareholder sends his assent or dissent under Sec-192A(2) in writing on a postal ballot and thereafter any person fraudulently defaces or destroys the ballot paper or declaration of identity of the shareholder.	Imprisonment for a term which may extend to six months or with fine or both.	
39	192A(6)	Default in complying with sec- 192A(1) to 192A(4) (Regarding passing of	Fine upto Rs. 50,000/- in respect of each such default.	The company and every officer of the company who is in

		resolutions by postal ballot)		default.
40	193(6)	Default in complying with the provisions of sec-193 in respect of any meeting (Minutes of proceedings of General Meeting and of Board and other meetings).	Fine upto Rs. 5,000/-	The Company and every officer of the company who is in default.
41	196(4)	If inspection of minute books is refused or any copy of minutes, if demanded, is not furnished.	Fine upto Rs. 5,000/- in respect of each offence.	The Company and every officer of the company who is in default.
42	202	If an undischarged insolvent discharges any of the functions of a Director.	Imprisonment for a term which may extend to two years or with fine of upto Rs. 50,000/- or with both.	
43	203(7)	If any person acts in contravention of an order made under sec-203.	Imprisonment for a term which may extend to 2 years or with fine upto Rs. 50,000/- or with both.	
44	58A(5)	Default in repayment of amount of deposit.	Fine not less than twice the amount in relation to which the repayment of deposit has not been made and imprisonment for a term which may extend to 5 years.	The company and every officer of the company who is in default.
45	58A(6) (a)(i)	If a company accepts any deposit in excess of the limits prescribed.	Fine which shall not be less than an amount equal to the amount of deposit so accepted and imprisonment for a term which may extend to 5 years?	The company and every officer of the company who is in default.
46	58A(6) (a)(ii)	If a company invites any deposit in excess of the limits prescribed.	Fine which may extend to Rs. 10,00,000/- but shall not be less than Rs. 50,000/- and imprisonment for a term which may extend to 5 years.	The company and every officer of the company who is in default.
47	58A(10)	Failure in compliance with the order of Company Law Board passed under Sec-58A(9) regarding repayment of deposit.	Imprisonment which may extend to 3 years and fine of not less than Rs. 500 for every day during which such non-compliance continues.	Whoever fails to comply with the order.

48	58AA (9)	Failure in compliance with the order of Company Law Board passed under Sec- 58AA(9).	Imprisonment which may extend to 3 years and fine of not less than Rs. 500 for every day during which such non-compliance continues.	Whoever fails to comply with the order.
49	59	If any prospectus is issued in contravention of sec- 57 & 58.	Fine which may extend to Rs. 50,000	Any person who is knowingly a party of the issue.
50	60(5)	If a prospectus is issued without a copy being delivered to the Registrar or without the copy so delivered having endorsed thereon and attached thereto the required consent or documents.	Fine which may extend to Rs. 50,000/-	The company and every person who is knowingly the party of the issue.
51	63	Mis-statement or untrue statement in prospectus.	Imprisonment for a term which may extend to 2 years or wit fine which may extend to Rs. 50,000/- or with both.	Every person who authorized the issue of prospectus.
52	68	Any person who knowingly or recklessly makes any statement, promise or forecast which is false, deceptive or misleading.	Imprisonment for a term which may extend to 5 years or with fine which may extend to Rs. 1,00,000/-or with both.	Any person.
53	68A	Any person who makes application in a fictitious name for acquiring shares, etc.	Imprisonment for a term which may extend to 5 years.	Any person.
54	69(4)	Contravention of the provisions of sec-69(4) regarding deposit and refund of application money received.	Fine which may extend to Rs. 50,000/-	Every Promoter, Director or other person who knowingly responsible for such contravention.
55	70(5)	Where a statement in lieu of prospectus delivered to the Registrar includes any untrue statement.	Imprisonment for a term which may extend to 2 years or with fine which may extend to Rs. 50,000/- or with both.	Every person who authorized the delivery of statement in lieu of prospectus for registration.
56	73(2B)	If default is made in complying with the provisions of Sec -73(2A) which states that where permission has been granted by the Recognised Stock Exchange for dealing in	Fine which may extend to Rs. 50,000 and where repayment is not made within 6 months from the expiry of eighth day, also with imprisonment which may extend to one year.	The company and every officer of the company who is in default.

		shares or debentures in such stock exchange and the moneys received from the applicants for shares or debentures are in excess of the aggregate of the application moneys relating to the shares or debentures in respect of which allotments have been made, the company shall repay the moneys to the extent of such excess forthwith without interest, and if such money is not repaid within eight days, from the days company liable to pay it.		
57	73(3)	Failure in keeping the money received in a separate bank account maintained with a schedule bank.	Fine which may extend to Rs. 50,000/-	The company and every officer of the company who is in default.
58	79(4)	Every prospectus relating to the issue of the shares shall contain particulars of the discount allowed on the issue of the shares or of so much of that discount as has not been written off at the date of the issue of the prospectus.	Fine which may extend to Rs. 500/-.	The company and every officer of the company who is in default.
59	207	Failure to distribute dividends within thirty days.	Simple imprisonment for a term which may extend to three years and shall also be liable to fine of Rs. 1000/- for every day during which the default continues and the company shall also be liable to pay simple interest at the rate of 18% p.a. during the period for which such default continues.	Every Director of the Company, if he is knowingly a party to the default.
60	218	Improper issue, circulation or publication of Balance Sheet or Profit and Loss A/c.	Fine which may extend to Rs. 5000/-	The Company and every officer of the company, who is in default.

61	232	Default in complying with the provisions of Sec-225 to 231.	Fine which may extend to Rs. 5000/-	The company and every officer of the company who is in default.
62	233	Non-compliance by auditors with the provisions of Sec 227 and 229	Fine which may extend to Rs. 10,000/-	The Auditor concerned, and the person, if any, other than the auditor who signs the report or signs or authenticates the document.
63	272	If, after the expiry of the said period of two months, any person acts as a director of the company when he does not hold the qualification shares (as referred in sec-270)	Fine this may extend to Rs. 500 for every day between such expiry and the last day on which he acted as a director.	Any person who acts as a Director.
64	279	If any person who holds office, or acts, as a Director of more than 15 companies in contravention of the provisions.	Fine this may extend to Rs. 50,000/- in respect of each of those companies after the first 20.	Any person who holds office or acts as a Director.
65	302(5)	Failure in disclosing to members of Director's interest in contract appointing manager, managing director.	Fine this may extend to Rs. 10,000.	The company and every officer of the company who is in default.
66	303(3)	Failure in maintaining the Register of director.	Fine which may extend to Rs. 500/- for every day during which the default continues.	The company and every officer of the company who is in default.
67	304(2)	Refusal for inspection of Register of director.	Fine which may extend to Rs. 500/-	The company and every officer of the company who is in default.
68	308	Duty of directors and persons deemed to be directors to make disclosure of shareholdings.	Imprisonment for a term which may extend to 2 years, or with fine which may extend to Rs. 50,000 or with both.	Any person who fails to comply.
69	322	If any director, manager or proposer makes default in adding a statement that the liability of the person holding the office will be unlimited.	Fine which may extend to Rs. 10,000/- and shall also be liable for any damage which the person so appointed may sustain from the default but the liability of the person	Any director, manager or proposer.

			appointed shall not be affected by the default.	
70	371	Contravention to the provisions of sec – 370 or 370A including in particular any person to whom the loan is made, or in whose interest the guarantee is given or the security is provided.	Fine which may extend to Rs. 50,000/- or with simple imprisonment for a term which may extend to 6 months.	Every person who is a party to any contravention.
71	374	Contravention with the provisions of Sec – 372 or 373.	Fine which may extend to Rs. 50,000/-	Every officer of the company who is in default.
72	383A	Failure in having a whole time secretary.	Fine which may extend to Rs. 500/- for every day during which the default continues.	The company and every officer of the company who is in default.
73	404(4)	Failure in filing copy of every order altering, or giving leave to alter, a company's memorandum or articles, within 30 days.	Fine which may extend to Rs. 50,000/-.	The company and every officer of the company who is in default.
74	420	Contravention of the provisions of Section – 417, 418 and 419. (Regarding provident fund of employees)	Imprisonment for a term which may extend to 6 months or with fine which may extend to Rs. 10,000/-.	Any officer of the company, or any such trustee of a provident fund
75	423	Non compliance with sections 421 and 422. (Regarding filing of accounts of receivers and Invoices, etc. to refer to receiver where there is one)	Fine which may extend to Rs. 2000/-	The company and every officer of the company who is in default.
76	485	Failure in publication of resolution of winding up in the official gazette and also in newspaper circulating in the district.	Fine which may extend to Rs. 500/- for every day during which the default continues.	The company and every officer of the company who is in default.
77	493	Failure in giving the notice of appointment of liquidator to the registrar.	Fine which may extend to Rs. 1000/- for every day during which the default continues.	The company and every officer of the company who is in default. (including every liquidator or continuing liquidator)
78	496	Duty of liquidator to call general meeting at end of each year, in the event of the	Fine which may extend to Rs. 1000/-	Liquidator

		winding up continuing for more than 1 year.		
79	497	Failure in sending a copy of account and return to the registrar and official liquidator.	Fine which may extend to Rs. 500- for every day during which the default continues.	Liquidator
80	501	Failure in submitting with the registrar copy of resolution passed at a creditor's meeting.	Fine which may extend to Rs. 500/- for every day during which the default continues.	The company and every officer of the company who is in default.
81	508	Duty of liquidator to call meetings of company and of creditors at the end of each year.	Fine which may extend to Rs. 1000/-	Liquidator
82	513	If a body corporate is appointed as a liquidator.	Fine which may extend to Rs. 10,000/-	Every director or manager
83	514	Corrupt inducement affecting appointment as a liquidator.	Fine which may extend to Rs. 10,000/-	Any person.
84	516	Failure in giving the notice of appointment of liquidator by the liquidator.	Fine which may extend to Rs. 500/- for every day during which the default continues.	Liquidator
85	539	Falsification of books.	Imprisonment for a term which may extend to 7 years and shall also be liable to fine.	Any person, any officer or contributory of a company.
86	541	Default in keeping proper accounts.	Imprisonment for a term which may extend to 1 year.	Every officer of the company who is in default.
87	542	Fraudulent conduct of business with intent to defraud creditors or any person or for any fraudulent purpose.	Imprisonment for a term which may extend to 2 years or with fine which may extend to Rs. 50,000 or with both.	Every person who was knowingly a party to the carrying of the business.
88	551	Failure in filing of information as to pending liquidations.	Imprisonment for a term which may extend to 6 months or with fine which may extend to Rs. 10,000 or with both.	Liquidator
89	598	If any foreign company fails to comply with the provisions of companies act.	Fine which may extend to Rs. 10,000/- and in case of continuing offence, with an additional fine which may extend to Rs. 1000/- for every day during which the default	Any foreign company.

			continues.	
90	606	Any person who is knowingly responsible for the issue, circulation or distribution of a prospectus for the issue of a form of application for shares, debentures or Indian Depository Receipts in contravention with the provisions of Sec-603, 604, 605 and 605A.	Imprisonment for a term which may extend to 6 months or with fine which may extend to Rs. 50,000/- or with both.	Any person.
91	615	Failure in complying with the order of the Central Government to furnish information or statistics or knowingly furnishing any information or statistics which is incorrect or incomplete.	Imprisonment which may extend to 3 months or with fine which may extend to Rs. 10,000/- or with both.	The company and every officer of the company who is in default.
92	621A (6)	Non-compliance with order made by CLB or the RD to file or register with, or deliver or send to, the Registrar any return, account or other document.	Imprisonment for a term which may extend to 6 months or with fine not exceeding Rs. 50,000/- or with both.	Any officer or other employee of the company.
93	628	Making a statement which is false in any material particular or which omits any material fact.	Imprisonment for a term which may extend to 2 years and shall also be liable to fine.	Any person
94	629	Giving false evidence.	Imprisonment for a term which may extend to 7 years, and shall also be liable to fine.	Any person
95	629A	Penalty where no specific penalty is provided elsewhere in the Act.	Fine which may extend to Rs. 5000/- and where the contravention is a continuing one, further fine which may extend to Rs. 500/- for every day after the first day during which the contravention continues.	Every officer of the company who is in default or such other person.
96	630	Penalty for wrongful withholding of property.	Fine which may extend to Rs. 10,000/-	Any officer or employee of the company.
97	631	Improper use of words “Limited” and “Private	Fine which may extend to Rs. 500/- for every day	Any person

		Limited”	upon which that name or title has been used.	

20.3 OFFICERS IN DEFAULTS

Meaning of 'officer'

Section 2(30) of the Companies Act, 1956, provides that officer includes any director, manager, secretary or any person in accordance with whose directions or instructions the Board of directors or any one or more of the director is or are accustomed to act. Therefore, it refers only to the officers of the company and not subordinate staff.

Definition of the term 'officer' is to be read in the context provided and not independently thereof. [Haryana Seeds Development Corpn. Ltd. v Aggarwal (J.K.) (1989) 65 Comp Cas 95 (P&H)].

The definition of 'officer' cannot be taken as exhaustive or conclusive and, therefore, Secretary, Assistant Secretary, accountant and cashier of a bank are all officers of bank. [Hanuman Bank Ltd., In re (1964) 34 Comp Cas 640 (Mad); Official Liquidator, Golcha Properties (P.) Ltd. v Dhadda (P.C.) (1980) 50 Comp Cas 175 (Raj)]

Meaning of 'officer who is in default': The Companies Act, 1956 in number of sections uses the term 'officer in default' when affixing a person with liability for offences, i.e. if default is made in complying with a section, the company and every officer of the company who is in default shall be guilty of an offence under that section. This is followed by the specified penalty consisting of fine or fine and imprisonment in certain cases.

Section 5 of the Companies Act, provides that, for the purpose of any provisions in this Act which enacts that an officer of the company who is in default shall be liable to any punishment or penalty, whether by way of imprisonment, fine or otherwise, the expression 'officer who is in default' means all the following officer of the company, namely:—

(a) the managing director or managing directors;

(b) the whole-time director or whole-time directors;

(c) the manager;

(d) the secretary;

(e) any person in accordance with whose directions or instructions the Board of directors of the company are accustomed to act;

(f) any person charged by the Board with the responsibility of complying with that provisions:

(g) Provided that the person so charged has given his consent in this behalf to the Board;

(h) where any company does not have any of the officers specified in clauses (a) to (c), any director or directors who may be specified by the Board in this behalf or where no director is so specified, all the directors:

Provided that where the Board exercises any power under clause (f) or clause (g), it shall within 30 days of the exercise of such powers, file with the Registrar a return in the prescribed form. Therefore, all the above said seven specified categories of officers of the company would be deemed to be an officer who is in default irrespective of whether they were party to the default or not. It would be enough to show that a statutory provision has not been complied with in order to bring them under the mischief of the section. However, section 5 applies only to those provisions of the Act, which uses the expression 'officer who is in default.

A close analysis of section 5 reveals the following:—

(a) Liability as officer in default is fastened on all the officers specified in clauses (a) to (g) collectively.

(b) If a person is shown as director in return, he is officer of the company. [Marthanda Varma (H.H.) v Registrar of Companies (1988) 64 Comp Cas 125 (Kar)]

(c) Liquidator is an officer of the company. [Official Liquidators, Baroda Batteries Ltd. v Registrar of Companies (1978) 48 Comp Cas 120 (Guj); Prahallad Bai Lath v Registrar of Companies (1979) 49 Comp Cas 317 (Ori)]

(d) If company have any of the officers specified in clauses (a) to (c), the other directors will not be held as officers in default.

(e) A company which does not have any of the officers, specified in clauses (a) to (c), any director or directors specified by the Board will be held as officers in default.

(f) If there is no officer as mentioned in clauses (a) to (c) and also the Board has not specified any of them, then all the directors will be held as officer in default, it may include employee directors, part-time directors and nominee directors as in default. Nominee directors of creditors, institutions, government, joint venture partners etc, generally, do not enjoy any special immunity. Financial institution nominee directors, however, get immunity under the State Financial Corporation Act but it has to be established that the accused person has acted in good faith. [Geethanjali Mills Ltd. v Thiruvengadathan (1989) 1 Comp LJ]

(g) When the directors on the Board of a company are in fact dummy persons and other person who remain behind the scene control the act of directors, such a person may perhaps include a company or firm, in which case the directors of that company or partners of that firm would be treated as persons in accordance with whose directions or instructions the Board of directors of the other company are accustomed to act.

(h) The expression 'any person charged by the Board' refers only to officers of the company and not to sub-ordinate staff. Further, the Board should charge a person with the responsibility of complying with any specific responsibility by passing a resolution (see Appendix 1) and the person so charged is required to give consent in Form 1AB. Thus, where a company has not obtained consent of the person as prescribed, he cannot be charged by the Board.

(i) The consent of the person as mentioned in clause (f) shall be filed electronically with the Registrar within 30 days in an e-Form 1AA with the filing fee enclosed with Form 1AB.

Interpretation of "person in accordance with whose directions or instructions directors are accustomed to Act": Section 7 provides that except, where the Companies Act expressly provides otherwise, a person shall not be deemed to be, within the meaning of any provisions in this Act, a person in accordance with whose directions or instructions the Board of directors of a company is accustomed to act, by reason only that the Board acts on the advice given by him in a professional capacity.

Therefore, the professional advisors, auditors, debenture trustees, bankers, are not covered under the officers who are in default.

The directors who are in the Board by virtue of their technical skill and professional competence are no different from other directors. [Madan Gopal Dey v State (1969) 39 Comp Cas 119 (Cal)]

Liability of all the directors' under section 5(g): Section 5 of the Companies Act 1956, provides an exhaustive list of officers who are in default. In one of the landmark case of Ravinder Narayan v Registrar of Companies (1994) 81 Comp Cas 925, the Rajasthan High Court construed the interpretation of section 5 of the Companies Act that the definition of the 'officer in default' makes it clear that a director(s) of the company fall within the said definition if the company does not have any of the officers specified in clause (a) to (c) i.e. Managing Director(s), the whole time director(s) and manager and held that the accusation made against the

directors of the company is liable to be quashed since at the time of offence Mr. X was the managing director therefore directors would not fall within the definition of officer in default.
All the Directors of the company will be officers in default within the meaning of section 5 only when there is no Managing Director, Whole Time Director, Manager, Secretary, a person, charged by the Board with the responsibility of complying with the provisions of the Act and the director/directors specified by the Board under clause (g) of section 5. [Vijay Kumar Gupta v Registrar of Companies (2004) 118 Comp Cas 604 (HP): (2003) CLC 777 (HP)]

JUDICIAL INTERPRETATION:

Directors where held as officer in default: The combined effect of clause (30) of section 2 and section 5 is that all the directors of the company cannot at all be construed as 'officers in default', unless each of the directors is an 'officer in default' within the meaning of section 5. Service of notice is a crucial factor for determining the question as to whether an accused could be construed as an 'officer in default'. [Sivandhi Adityan v Additional Registrar of Companies (1995) 83 Comp Cas 616 (Mad)] In case of an offence under Minimum Wages Act, each director is liable. [Hari Charan Singh Dugal v State of Bihar (1989) 66 Comp Cas 449 (Pat)]

Prosecution may be launched against all the directors by RoC: Where Registrar has issued notice to all directors in respect of default committed by a company under sections 161 and 220, but gets no response from any of them, prosecution may be launched against all of them as 'officers' in default. [Asstt. Registrar of Companies v Southern Machinery Works Ltd. (1986) 59 Comp Cas 670 (Mad)]

Punishment may be on such directors who are guilty of offence: Only those officers who are knowingly and intentionally guilty of the offence can be punished. [Consolidated Pneumatic Tool Co. (I) Ltd. v Addl. Registrar of Companies (1989) 65 Comp Cas 259 (Bom)].
It was held by the Supreme Court in the case of K.K. Ahuja v V.K. Vora (2009) 152 Comp Cas 520 (SC) that the liability arises from being in charge of and responsible for the conduct of business of the company at the relevant time when the offence was committed and not because on the basis of merely holding designation or office in a company.

If the Company is having managing director or whole-time directors, other directors are not as officer in default: Where the company had accepted excess deposits in contravention of

section 58A, the director, who was neither a managing or whole- time director, not even a shareholder nor was he involved in day-to-day affairs of the company could not be said to be 'an officer in default'. [Nanjundiah (H.) v Govindan, Registrar of Companies (1986) 59 Comp Cas 356 (Bom)]

The Madras High Court in Madhavan Nambiar v Registrar of Companies (2002) 108 Comp Cas 1 (Mad) held that in the matter of proceedings for negligence, default, breach of duty, misfeasance or breach of trust or violation of the statutory provisions of the Act and the Rules, there is no difference or distinction between the whole time or part time director or nominated or co-opted director and the liability for such acts, commission or omission is equal. So also the treatment for such violations as stipulated in the Companies Act, 1956.

Allegation must be made on a particular director for a default: Where the managing director of a company was prosecuted for an offence under the Payment of Bonus Act, but there was no allegation in the complaint filed by the Labour Officer that the managing director was responsible for the conduct of the company's business, it was held that without an allegation that the person was in charge of and was responsible for the conduct of the company's business, the complaint could not be maintained. [Sivalingam Chettiar (V.B.) v Labour Officer (1986) 59 Comp Cas 701 (AP)].

When in complaint, accused were not shown as 'officer in default' they could not be held responsible merely because they were directors. [Rameshchandra Manilal Kotla v State of Gujarat (1998) 30 CLA 313 (Guj)]

Director is not responsible for an offence committed before his appointment: For offences committed prior to appointment of petitioner as managing director, he cannot be held as officer in default u/s 5. [Siva Prasad (C.V.) v Registrar of Companies (1997) 88 Comp Cas 420 (AP)]

Whether officer in default can be prosecuted as 'officer in default' where the Company has a managing director?: Section 5 make it clear that criminal liability of ordinary directors would arise only in respect of a company which has no managing director or whole-time director or manager and where particular directors are not specified by the company to be liable. [Vijayalakshmi (G.) v SEBI (2000) 100 Comp Cas 726 (AP): (2000) 25 SCJ 183 (AP)]

Ordinary directors are not liable, unless no managing director or whole-time director or manager has been appointed: Ordinary directors, i.e. directors simpliciter are not liable, unless no managing director or whole-time director or manager has been appointed by the company. [see G. Vijayalakshmi v SEBI (2000) 100 Comp Cas 726 (AP); Ravindra Narayan v Registrar of Companies (1994) 81 Comp Cas 925 (Raj)]

Managing Director is prima facie deemed to be officer in default: In case of Managing Director, courts have usually held that he is, prima facie, deemed to be in charge and responsible for the conduct of business and management of the company and therefore liable for defaults. [Garda Chemical Pvt Ltd v Parthasarthy (R.), Asst. Collector Central Excise (1984) 2 ECC 384 (Bom)]

Officer in Default under the Companies Act, 2013: There is a broad classification of managerial personnel who are liable for penalty or punishment by way of imprisonment, fine or otherwise. They are (i) whole-time directors,(ii) key managerial personnel(KMP),that is, the CEO, or the managing director or the manager, the Company Secretary, the Chief Financial officer and such other directors as specified by the board in the absence of KMP and charged with the responsibility of having to comply with the legal requirement, deemed director, that is, any person whose advise is acted upon by the board, every director who is aware of contravention of law by virtue of receipt of board proceedings or participation therein without raising any objection or where contravention has taken place with his consent or connivance and in respect of issue or transfer of shares of a company, share transfer agents, registrars and merchant bankers to the issue or transfer. There are a number of provisions in the new Act which specify the "officer who is in default" as persons responsible for non compliance of law, whether they are privy to the offence or not. These offences are decided either by the adjudicating officer by imposing fine and where penalty involves imprisonment and fine, it will be decided by the Special Court.

20.4 RECOVERY OF DAMAGES

Section 224 of the Companies Act, 1956 deals with Companies Act, 1956. The provisions of Section 244 reads as follows:

Sec 244 - Proceedings for recovery of damages or property.

(1) If from any such report as aforesaid, it appears to the Central Government that proceedings ought, in the public interest, to be brought by the company or any body corporate whose affairs have been investigated in pursuance of clause (a), (b) or (c) of section 239,

(a) for the recovery of damages in respect of any fraud, misfeasance or other misconduct in connection with the promotion or formation, or the management of the affairs, of such company or body corporate ; or

(b) for the recovery of any property of such company, or body corporate, which has been misapplied or wrongfully retained ;

the Central Government may itself bring proceedings for that purpose in the name of such company or body corporate.

(2) The Central Government shall indemnify such company or body corporate against any costs or expenses incurred by it in, or in connection with, any proceedings brought by virtue of sub-section (1).

20.5 COMPOUNDING OF OFFENCES, PROVISIONS AND PROCEDURES

Who can make an application for compounding?

Section 621A(1) of the Act provides that a company or an officer thereof who has committed or who is alleged to have committed an offence can apply for compounding the offence. Section 5 of the Act defines the term 'officer who is in default'. It has been held that a compounding application by persons who were not officers in default was to be rejected. Amadhi Investments Ltd., re. (2009) 95 SCL 255:2009) 149 Com Cases 617 (CLB).

Application for compounding of offence can be made before or after institution of any prosecution. Default should be made good before filing application. In case prosecution is instituted, the case can be compounded before the sentence is pronounced.

Authority having power to compound an offence: The offence can be compounded by the Regional Director (RD) where the maximum amount of fine is upto Rs.50,000/- and by the Company Law Board (CLB) where the maximum amount of fine exceeds Rs.50,000/-.

Fee payable for compounding the offence:

The amount that may be specified by the authority to be paid for compounding of offence cannot exceed maximum amount of fine that may be imposed for the offence under the relevant provisions of the Act. Further, the sum, if any, paid by way of additional fee under Section 611(2) shall be deducted from the amount specified for compounding of the offence. The amount

should be decided keeping in view factors like the nature of the offence, financial position of the company, continuation of the default, intention etc.

Procedure for making an application for compounding of an offence under the Act: The company or the officers thereof can file online application for compounding of an offence to the Registrar of Companies in e-Form 61 who will forward the same to the RD/CLB togetherwith his comments thereon. The application should state the circumstances leading to the alleged offence and whether the default was made good before or at the time of making the application. Separate application should be filed by each officer even for the same offence. The application should be accompanied by Power of attorney for memorandum of appearance in Form 5 of CLB Regulations, affidavit verifying the content, detailed application as per the Regulations, copy of Memorandum & Articles of Association, copy of Balance Sheet and Statement of Profit & Loss etc. As per general circular No.14/2012 dated 21-6-2012 issued by MCA, filing fee should be paid as per Companies (Fees on Application) Rules 1999.

An opportunity of oral hearing is provided to the company, its officers in default, the Registrar or any other complainant by the compounding authority keeping in view principles of natural justice. After hearing all concerned, the authority shall pass an order specifying the amount to be credited to the Central Government account for compounding the offence which should be paid together with e-Form 21. Section 621A(3) of the Act provides that where an offence is compounded before or after the institution of any prosecution, intimation thereof should be given to the Registrar within 7 days from the date on which the offence is so compounded in e-Form 21 alongwith copy of order and resolution passed by Board of Directors of the company. If the order is made after institution of any prosecution, Registrar should bring the same in writing to the notice of the court where the prosecution is pending, and on such notice the company or its officers in default shall be discharged by the court.

Can directors of a company under liquidation make compounding application?: The DCA vide circular dated 6-3-2002 has clarified that in view of the provisions of Section 446 read with Section 621A of the Act, there is no legal bar for composition of offence under Section 621A. Section 446 does not bar criminal proceedings against the directors of the company for any offence under the Act and the offences are compoundable. Where the penal provisions provide for proceedings against the companies also and if the offences are compoundable, compounding will not be permissible against the company in view of provisions of Section 446 of the Act.

Powers of the authority in compounding of offences: The power to compound an offence under Section 621A of the Act is discretionary one and the authority can reject the application if the default is not made good [General Produce Company Ltd. Re (1994) 81 Comp Cas 570 CLB: (1994) 4 Comp LJ 99]. The authority can also issue directions for filing any document, return etc. with the Registrar within the period specified in the order along with the filing fee and the additional fee payable under Section 611. Failure to comply with such directions is punishable and is compoundable only with the permission of the court. Any officer or other employee of the company who fails to comply with any such order shall be punishable with imprisonment for a term which may extend to 6 months, or with fine not exceeding Rs.50,000/- or with both.

Effects of Compounding: If the offence is compounded before institution of prosecution, it would act as a bar to institution of any prosecution against the offender by the Registrar or by a shareholder or by any person authorised by the Government in relation to that offence. However, mere submission of the application for compounding does not operate as a bar for launching prosecution. If the offence is compounded after institution of prosecution and such composition is brought to the notice of the court by the Registrar in writing, the company or its officer in default shall be discharged. Where the offence falls within the purview of Section 621A(6)(a), i.e. offence which can be compounded only with the permission of the court, the composition thereof shall have the effect of an acquittal of the accused as per Section 320B(8) of CrPC. In S. Viswanathan v. State of Kerala [1999] 113 STC 182 (Ker.) it was held that the department cannot reopen the matter on the ground that the actual suppression was much higher.

Cases in which court's permission is required for compounding of offences:: Section 621A(6)(a) of the Act provides that offence which is punishable under the Act with imprisonment or fine, or with both, shall be compoundable with the permission of the Court in accordance with the procedure laid down in the Cr.P.C for compounding of offences. Sub-section (7) provides that no offence specified in the Section shall be compounded except under and in accordance with the provisions of the Section. In the case of VLS Finance Ltd. v. Union of India & Ors. Decided on 10th May 2013 the Supreme Court has held that powers of the Central Government to compound offence under sub-section (1) and sub-section (7) of Section 621A are parallel powers and permission of court is not required when compounding is done by Company Law Board.

Procedure for compounding under Cr.P.C: In case a prosecution is pending before the Trial Court, procedure under CrPC needs to be followed. Section 320 of Cr.P.C deals with compounding of offences. The complainant or the injured person can make application to the Trial Court. Parties themselves agree on the composition amount without any say of the court. The accused should appear before the Trial Court and may engage an advocate. Trial court's permission is required for compounding and on compounding the accused gets acquitted.

20.6 SUMMARY

Compounding is a settlement process by which the accused pays compounding charges in lieu of undergoing consequences of lengthy prosecution. Section 621A(1) of the Act provides that a company or an officer thereof who has committed or who is alleged to have committed an offence can apply for compounding the offence. The Regional Director (RD) having power to compound the offence where the maximum amount of fine is upto Rs.50,000/- and the Company Law Board (CLB) have power to compound the offence where the maximum amount of fine exceeds Rs.50,000/-.

20.7 KEY WORDS

1. DCA: Department of Corporate Affairs
2. CLB: Company Law Board
3. RD: Regional Director
4. CEO: Chief Executive Officer

20.8QUESTIONS FOR SELF STUDY

1. Which Offences can be compounded under Companies Act 1956?

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2. Who is officer in default? Compare the definition under the Companies Act, 1956 and the Companies Act, 2013.

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3. Briefly explain the procedure of compounding of offence.

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20.9REFERENCES

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