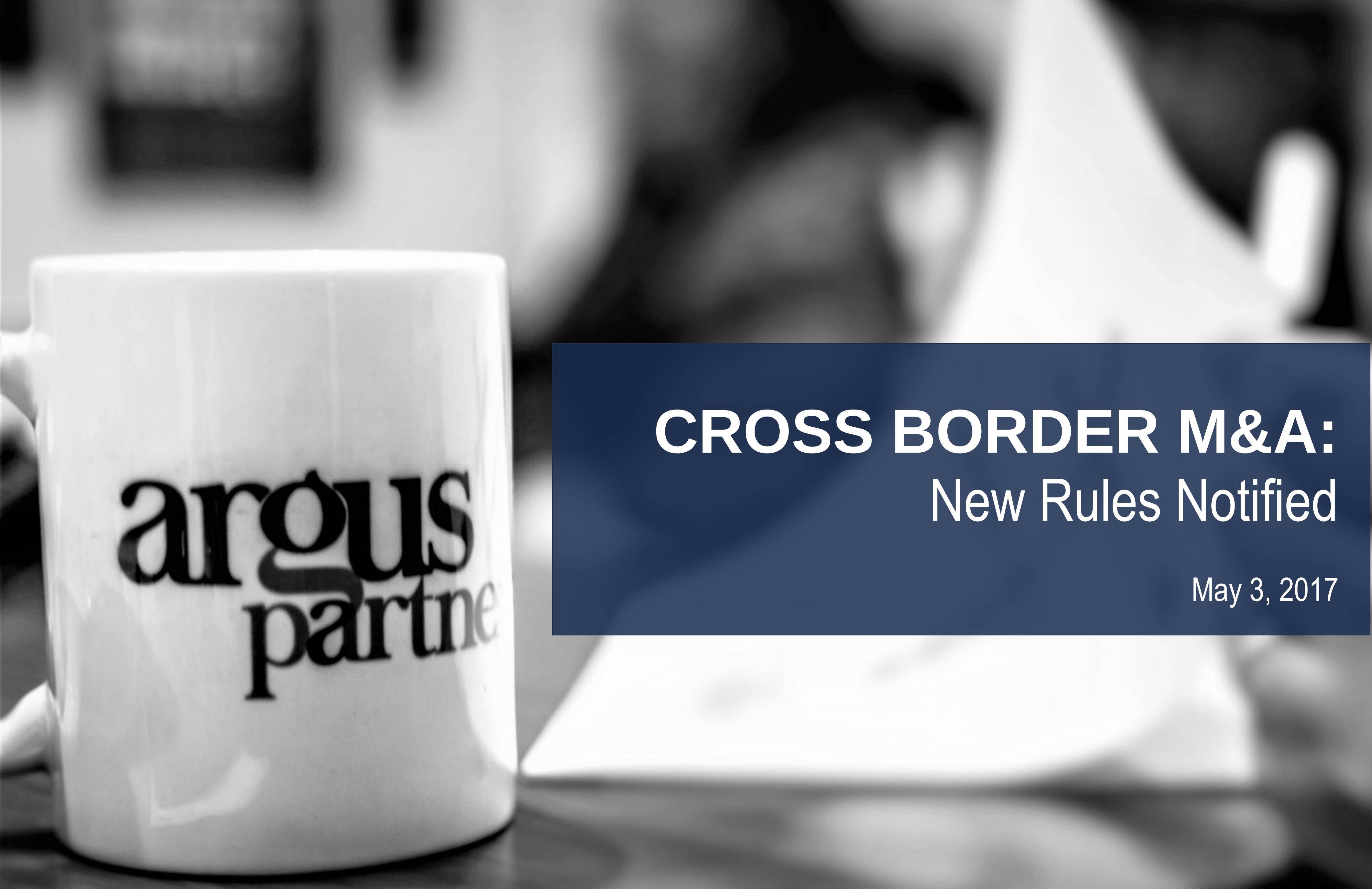

CROSS BORDER M&A:
New Rules Notified

May 3, 2017

Background

While cross border mergers and acquisitions by way of acquisition of shares are permitted in India, a merger of an Indian company with a foreign company pursuant to a Court sanctioned scheme, where the Indian company ceases to exist, was hitherto not permitted. In a significant move, the Government of India recently notified section 234[1] Companies Act, 2013 ("**Act**") permitting cross border mergers through a scheme sanctioned by the National Company Law Tribunal ("**NCLT**") in accordance with Chapter XV of the Act. The said chapter is a comprehensive code in itself providing the manner in which compromises, arrangements and amalgamations are to take place involving members or creditors. Prior to this notification, a merger or an amalgamation of an Indian company with a foreign company was not permitted through a scheme.

Alongwith section 234 of the Act ("**Section 234**"), the Government also amended the Companies (Compromises, Arrangements and Amalgamations) Rules, 2017 ("**Rules**") by inserting a new rule 25A ("**Rule 25A**") to operationalise such cross-border mergers.

The Reserve Bank of India ("**RBI**") has also issued a draft of the Foreign Exchange Management (Cross border Merger) Regulations, 2017 ("**RBI Draft Regulations**") in order to address the issues that may arise when an Indian company and a foreign company enter into scheme of merger, demerger, amalgamation, or rearrangement.

This paper provides a brief overview and implications of the new provisions on cross-border mergers.

[1] Section 234 of the Act has come into force from April 13, 2017 *vide* notification S.O. 1182(E) dated April 13, 2017 issued by the Ministry of Corporate Affairs, Government of India.

Introduction to the new law

Prior to discussing the new provisions on cross border mergers which have been introduced, it is pertinent to mention the provisions which held fort hitherto. The Act, which seeks to replace the Companies Act, 1956, is a relatively new legislation which was passed by both Houses of Parliament and received the assent of the President of India in 2013. However, the different provisions of the Act have been brought into force gradually.

While the earlier Companies Act, 1956 provided for a merger, amalgamation or a demerger between two Indian companies pursuant to a Court sanctioned scheme, it did not permit a merger or amalgamation of an Indian company with a foreign company i.e. where the *transferee company* is a foreign company. However, the *transferor company* could be a foreign body corporate.

With the coming into force of Section 234, an Indian company can now merge into a foreign company or vice-versa pursuant to a scheme sanctioned by the NCLT ("**Cross Border Mergers**"). The terms and conditions of such scheme may provide, among other things, for the payment of consideration to the shareholders of the merging company in cash, or in depository receipts, or partly in cash and partly in depository receipts. Such mergers are subject to various conditions as stipulated in Section 234 and the Rules. Further, such mergers will be subject to the regulations framed by RBI in this regard. As mentioned above, RBI has issued the RBI Draft Regulations.

Key Features

Approval of the RBI

Rule 25A requires RBI's prior approval for any Cross Border Merger. As per the RBI Draft Regulations, any transaction undertaken in accordance with the RBI Draft Regulations shall be deemed to be approved by RBI as required under Rule 25A.

Recognised Jurisdictions

When an Indian company merges with a foreign company such foreign company must be in a jurisdiction:

a. whose securities market regulator is a signatory to the International Organization of Securities Commission's Multilateral Memorandum of Understanding (appendix A signatories) or a signatory to the bilateral memorandum of understanding with the Securities and Exchange Board of India; or

b. whose central bank is a member of Bank for International Settlements; or

c. a jurisdiction, which is not identified in the public statement of Financial Action Task Force (FATF) as:

    i. a jurisdiction having a strategic anti-money laundering or combating the financing of terrorism deficiencies to which counter measures apply; or

    ii. a jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the Financial Action Task Force to address the deficiencies.

Compliance with sections 230 to 232 of the Act

Provisions of sections 230 to 232 of the Act have to be complied with for Cross Border Mergers. The said provisions were notified recently on December 7, 2016.

Section 230 of the Act provides that if a compromise or arrangement is proposed between a company and its creditors or any class of them, or between a company and its members or any class of them, then an application can be made to NCLT in accordance with section 230 of the Act for sanctioning the same. NCLT, may, on such an application, order the holding of a meeting of the creditors or class of creditors or members or class of members, as the case may be ("**Meeting**"). If, at such a Meeting, majority of persons representing three-fourths in value of the creditors, or class of creditors or members or class of members, as the case may be, voting in person or by proxy or by postal ballot, agree to the compromise or arrangement, and if the compromise or arrangement is sanctioned by NCLT by an order, then the same is binding on the company, all the creditors or class of creditors or members or class of members, as the case may be, or, in case of a company being wound up, on the liquidator and the contributories of the company.

Section 232 of the Act provides for schemes of reconstruction, mergers, amalgamations and demergers. If an application for sanctioning a compromise or arrangement is made to the NCLT under section 230 of the Act as mentioned above, and such a compromise or arrangement relates to a scheme of reconstruction, merger, amalgamation or demerger, then NCLT, may, order a meeting of the creditors or members, as the case may be, to be held as per the procedure in section 230 of the Act. If the requisite majority of persons agree to the scheme, and if the procedure specified in sub-sections (1) and (2) of section 232 of the Act is complied with, then NCLT may pass an order sanctioning the same.

For further details of the sections 230 to 232, please refer to our M&A Update dated December 12, 2016.

Valuation

Rule 25A provides that in case of a merger of an Indian company with a foreign company, the transferee company shall ensure that valuation is conducted by valuers who are members of a recognised professional body in the jurisdiction of the transferee company and such valuation should be in accordance with internationally accepted principles on accounting and valuation. The RBI Draft Regulations also provide that the valuation of the Indian company and the foreign company for the purpose of cross border merger should be done as per internationally accepted pricing methodology for valuation of shares on arm's length basis which should be duly certified by a chartered accountant/public accountant/merchant banker authorized to do so in either jurisdiction.

Regulations on foreign investments into India

In case of a merger of a foreign company with an Indian company, the RBI Draft Regulations provide that any issue or transfer of security by the resultant company to a person resident outside India has to be in accordance with the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000 ("**FEMA 20**").

FEMA 20 governs foreign investment into India. Broadly, FEMA 20 lays down the rules for investments into India under the following routes:

a. Foreign direct investment (FDI) route;
b. Foreign investment under the portfolio investment scheme (PIS);
c. Foreign venture capital investments;
d. Acquisitions by non-resident Indians (NRIs);
e. Investments by foreign portfolio investors, foreign institutional investors, qualified foreign investors and certain other investors into Government securities/ treasury bills, non-convertible debentures/bonds, commercial papers, units of domestic mutual fund, security receipts issued by asset reconstruction companies amongst others;
f. Investments into investment vehicles such as alternative investment funds, real estate investment trusts and infrastructure investment trusts; and
g. Investments into depository receipts.

Under the FDI route, FEMA 20, *inter alia*, prescribes pricing guidelines and sectoral caps. In case of a fresh issuance of shares of a listed company, the pricing has to be determined on the basis of guidelines issued by the Securities and Exchange Board of India ("**SEBI**") and in case of unlisted companies, the price cannot be less than the fair value of shares determined by a SEBI registered merchant banker or a chartered accountant as per any internationally accepted pricing methodology on arm's length basis. Pertinently, regulation 7 of FEMA 20 specifically permits issuance of shares by an Indian company to the shareholders of the transferor company in case of a Court approved scheme of merger or amalgamation of two or more Indian companies or a reconstruction by way of de-merger or otherwise of an Indian company, subject to 3 (three) conditions[2].

Regulations on overseas investments

In case of a merger of an Indian company with a foreign company where the resultant company is a foreign company, the RBI Draft Regulations provide that the Foreign Exchange Management (Transfer or issue of any Foreign Security) Regulations, 2000 ("**FEMA 120**")[3] or the provisions of the Liberalized Remittance Scheme, as applicable, have to be complied with.

FEMA 120:

FEMA 120 regulates investments or financial commitments by an Indian party (defined as a company or a body created under an Act of Parliament

[2] Under regulation 7 of FEMA 20, the 3 (three) conditions prescribed are as follows:

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 RBI, or specified in FEMA 20;
b. the transferor company or the transferee or new company cannot be engaged in agriculture, plantation or real estate business or trading in TDRs; and
c. the transferee company or the new company has to comply with certain reporting requirement.

[3] It may be noted that the Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004 were notified on July 7, 2004 in supersession of the Foreign Exchange Management (Transfer or issue of any Foreign Security) Regulations, 2000 issued *vide* Notification No. FEMA19/ RB 2000 dated May 3, 2000. The said notification is available at: https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=2126&Mode=0.

or a partnership firm or a limited liability partnership) in shares and securities issued outside India.

Indian parties are prohibited from making an investment (or financial commitment) in a foreign entity engaged in real estate (i.e. buying and selling of real estate or trading in transferable development rights ("**TDRs**") but not including development of townships, construction of residential/commercial premises, roads or bridges) or banking business, without the prior approval of RBI.

The total financial commitment of an Indian Party in joint ventures/wholly owned subsidiaries cannot exceed the ceiling prescribed by RBI from time to time[4]. However, any financial commitment exceeding USD 1,000,000,000,000 (United States Dollar one billion) (or its equivalent) in a financial year would require prior approval of RBI even when the total financial commitment of the Indian Party is within the eligible limit under the automatic route (i.e., within 400% (four hundred percent) of the net worth as per the last audited balance sheet).

Liberalized Remittance Scheme:

Under the Liberalised Remittance Scheme, all resident individuals, including minors, are allowed to freely remit up to USD 250,000 (United States Dollar two hundred fifty thousand) per financial year (April – March) for any permissible current or capital account transaction or a combination of both. However, a resident individual who has made overseas direct investment in the equity shares and compulsorily convertible preference shares of a joint venture or wholly owned subsidiary outside India, within the Liberalised Remittance Scheme limit, then he/she shall have to comply with the terms and conditions as prescribed under FEMA 120.

[4] Pursuant to A.P. (DIR Series) Circular No.1 dated July 3, 2014, the limit of overseas direct investment / financial commitment to be undertaken by an Indian Party under the automatic route has been restored to the limit prevailing prior to August 14, 2013 i.e. 400% (four hundred per cent) of the net worth of the Indian Party as on the date of the last audited balance sheet.

Borrowings

In case of a merger of a foreign company with an Indian company, the RBI Draft Regulations provide that any borrowing or impending borrowing of the foreign company from overseas sources which becomes the borrowing of the resultant company or any borrowing from overseas sources entering into the books of resultant company arising has to comply with the extant exchange control regulations in India on borrowings such as the guidelines for external commercial borrowing, trade credit and other foreign borrowing norms, as laid down under Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000 or Foreign Exchange Management (Guarantee) Regulations, 2000.

In case of a merger of an Indian company with a foreign company, the RBI Draft Regulations provide that the resultant company shall be liable to repay outstanding borrowings or impending borrowings as per the scheme sanctioned by the NCLT.

Holding of assets

In case of a merger of a foreign company with an Indian company, the RBI Draft Regulations provide that the resultant company may acquire and hold any asset outside India which an Indian company is permitted to acquire under the extant foreign exchange regulations. Under the Foreign Exchange Management (Acquisition and transfer of immovable property outside India) Regulations, 2015, a company incorporated in India having an overseas office, can acquire immovable property outside India for its business and for residential purposes of its staff, in accordance with the directions issued by RBI from time to time.

In case of a merger of an Indian company with a foreign company, the RBI Draft Regulations provide that the resultant company may acquire and hold any asset in India which a foreign company is permitted to acquire under the extant foreign exchange regulations. Under the Foreign Exchange Management (Acquisition and transfer of immovable property in India) Regulations, 2000 there are restrictions on a person resident outside India acquiring property in India. A person resident outside India who is a citizen of India or a person of Indian origin resident outside India can acquire immovable property in India other than an agricultural property, plantation, or a farm house. However, other persons resident outside India (such as foreign companies) can acquire any immovable property in India only if such persons have established in India a branch, office or other place of business for carrying on in India any activity, excluding a liaison office, and the property is necessary for or incidental to carrying on such activity.

Where the asset or security is not permitted to be acquired or held by the resultant company under the extant foreign exchange regulations, the resultant company is required sell such asset or security within a period of 180 (one hundred and eighty) days from the date of sanction of the scheme of cross border merger and the sale proceeds have to be repatriated to India or outside India, as the case may be, immediately through banking channels.

Some observations

The notification of Section 234 is indeed a welcome move by the Government and adds another structuring option available for cross-border transactions. However, there are several issues which are required to be ironed out and clarified before such transactions can be implemented. Specifically, the new provisions can be operationalized only once RBI notifies the final regulations for cross border mergers.

Tax treatment

Section 47(vi) of the Income Tax Act, 1961 ("**IT Act**") exempts from the payment of capital gains tax, a transfer, in a scheme of amalgamation, of a capital asset by the amalgamating company to the amalgamated company if the amalgamated company is an Indian company. Further, under section 47(vii) of the IT Act, a transfer of shares in the amalgamating company by a shareholder in consideration of the shares of the Indian amalgamated company (resultant company) is exempted from the payment of capital gains tax. However, a similar exemption is not provided where the resultant company is a foreign company i.e. in case of a merger of an Indian company with a foreign company.

In any event, in order to avail the benefit under section 47 of the IT Act, the amalgamation has to satisfy the definition of 'amalgamation' in section 2(1B) of the IT Act. As per the said definition, the following 3 (three) conditions have to be satisfied:

a. all the property of the amalgamating company or companies immediately before the amalgamation should become 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 should become the liabilities of the amalgamated company by virtue of the amalgamation;

c. shareholders holding not less than three-fourths in value of the shares in the amalgamating company or companies (other than shares already held therein immediately before the amalgamation by, or by a nominee for, the amalgamated company or its subsidiary) should become shareholders of the amalgamated company by virtue of the amalgamation.

Where the consideration for a merger is paid entirely in cash, the same may not be tax neutral under section 47 of the IT Act.

Sectoral regulators

Approval of sectoral regulators will be required in certain sectors such as insurance and telecom. Further, if certain thresholds are met then approval of the Competition Commission of India will be required.

Listed companies

In case of a listed company, the draft scheme has to be submitted with the relevant stock exchanges for obtaining an observation letter/ no-objection letter before filing such scheme with NCLT. In case of a merger of a wholly owned subsidiary with the parent company, the draft scheme has to be filed only for the purposes of disclosure.

Applicability to demergers

Section 234 states that the provisions of Chapter XV of the Act will apply to schemes of mergers and amalgamations between Indian and foreign companies. Rule 25A also refers only to a merger. However, the RBI Draft Regulations defines a 'cross border merger' as any merger, demerger, amalgamation or arrangement between Indian company(ies) and foreign company(ies) in accordance with the Rules and the Act. An issue may arise as to whether demergers involving a foreign company and an Indian company is allowed under the Act.

Jurisdiction of NCLT

Application for sanctioning a scheme of amalgamation is filed with the NCLT within whose jurisdiction, the registered office of the applicant is situated. In case of a merger between a foreign company and an Indian company, an issue may arise as to whether the foreign company is at all required to file an application before the NCLT. Under the Companies Act, 1956, in case of a merger of a foreign company (i.e. a transferor company) with an Indian company (i.e. a transferee company), there have been instances when the High Courts sanctioned the scheme on a petition filed only by the Indian company[5]. Hence, in the absence of any specific direction, it may be argued that the petition seeking the necessary sanction of NCLT may be filed by the Indian company.

This update has been contributed by Adity Chaudhury who is a Partner in our M&A Practice Team. For any query please write to us at argusknowledgecentre@argus-p.com.

[5] *In Re Moschip Semiconductor Technology Limited,* (2004)120 CompCas 108 (Andhra Pradesh High Court); and *In Re Essar Shipping Ports and Logistics Limited,* (2009)149 CompCas417 (Gujarat High Court).

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