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Inbound and outbound demerger dilemma: Loophole still persist in cross border merger legislations

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Abstract
There has been an unprecedented surge of overseas mergers and acquisitions in India since the mid-1990s. The overseas investments through FDI inflows have increased by 6 % in India to $42 billion as a result of mergers and acquisitions in services including retail, e-commerce, and telecommunication. The overseas mergers & acquisitions in India have gained popularity since the enactment of Foreign Exchange Management (Cross Border) Regulations, 2018 and other allied legislations for smoothening the procedure of cross border mergers deals in India. Literature in the past debated that the overseas foreign direct investment from emerging markets has grown massively and has become a vital part of global economic growth. The majority of overseas investments are due to cross border mergers and acquisitions. According to the World Investment Report 2019, Asia retained its position to be World's largest FDI recipient region whereby the FDI inflows in South Asia increased by 4 percent. FDI inflows increased by 6% in India due to cross border M&A in telecommunications, e-commerce, and retail services. The majority of overseas investment is due to cross-border M&A with a fast track growth strategy. Meanwhile, an ambiguity arises under section 234 of Companies Act, 2013 whether cross border demergers to be treated at par with cross-border mergers or not because of two conflicting NCLT orders of cross border inbounds demerger order and cross border outbound demerger order. This research paper will critically examine the situations of cross border demerger under Companies Act, 1956 and Companies Act, 2013.

Keywords: cross border mergers, demergers, FDI

Introduction

The enormity of overseas investment through cross border M&A helps entities consolidate instead of establishing new companies [1]. Globalizations and technological development have contributed majorly to cross border mergers and acquisitions. The emerging markets like India have witnessed a dramatic rise in overseas investments through cross border mergers and acquisitions. The liberalization of FDI policy regime began in early 1990. India experienced rapid growth in between 2000 and 2007 due to major financial reforms. Due to relaxation in the FDI norms, Foreign Direct Investments equity from March 2009 to September 2019 stands at USD 475 billion [2]. The total FDI has been highest in 2018-2019 amounting to USD 63.47 billion. Moreover, India has leaped to 63rd position as per World Bank's Ease of Doing Business Ranking in 2020 report in comparison to 77th position among 190 countries in the previous ranking of the World Bank report. India is among 10 top improvers as per Doing Business 2020 for implementing 59 regulatory reforms out of 1/5th of all reforms worldwide records [3]. But it has unfortunately left some gaps with respect to cross border demergers in India. According to the Department for Promotion of Industry and Internal Trade foreign companies have been extremely impressed with India's improvement in ease of doing business. FDI provisions have been amended progressively to make India an attractive investment destination. The cross-border mergers and acquisitions help Indian companies accessing high technology, process, expertise, supply and distribution chains. For global competitiveness cross border merger and acquisitions is the mantra for Indian companies. It encourages Indian companies to search for competitive advantages by spreading their wings across continents. Cross Border merger is the merger or amalgamation of an Indian company with foreign company. The cross-border merger is treated differently from local mergers as they are governed by different set of regulations. In cross border mergers Indian companies establish their presence in a new country to grab new business or clients.

Regulatory Framework of Cross Border Merger/ Demerger in India

The erstwhile Companies Act, 1956 permitted inbound merger only. The new Companies Act, 2013 allowed both outbound and inbound mergers. The enabling provision regulating cross border mergers are laid down in Section 234 of the Companies act, 2013 and Rule 25A of the Companies (Compromise, Arrangement and Amalgamations) Rules, 2016 Section 234 of Companies Act, 2013 required prior sanction of RBI which could lengthen the process of cross border mergers and acquisitions in India. But simultaneously FEM (Cross Border) Regulations, 2018 was enacted to smoothen the process of cross border brownfield investments in India as compliance of the regulations was considered to be deemed approval from RBI. Cross Border mergers are permitted in limited jurisdiction whose securities market regulator is a signatory to International Organization of Securities Commissions or one that is signatory to a bilateral memorandum of understanding with the SEBI or whose central bank is a member of Bank for International Settlements. But such jurisdictions should not have been identified in any public statement of the Financial Action Task Force due to lack of anti-money laundering or lack of prevention of financing of terrorism

legislations. Unfortunately, the regulations missed out to in regulating cross border demergers in India. The ambiguity arises under provision 234 of Companies Act, 2013 whether cross border demergers to be treated at par with cross border mergers or not because of two conflicting NCLT orders of cross border inbound demerger order [4] and cross border outbound demerger order [5]. According to JJ Irani Committee Report [6] demergers are treated equivalent to mergers and acquisitions.

The cross border merger regulations has laid down exhaustive regulations for inbound and outbound mergers. In case of inbound mergers, the Indian company need to comply Foreign Exchange Management (Non-debt Instruments) Rules, 2019 for issuance of securities by the Resultant Company to a person resident outside India in accordance with the pricing guidelines, entry routes, sectoral caps, attendant conditions, and reporting requirements for foreign investment. It also needs to comply Foreign Exchange Management (Transfer or issue of any foreign security) Regulations, 2004 where the foreign company is a wholly owned subsidiary or joint venture of the Indian company. In case of inbound merger of the joint venture or wholly owned subsidiary results into acquisition of the Step-down subsidiary of joint venture or wholly owned subsidiary of the Indian resultant company, then such acquisition needs compliance with Regulation 6 and 7 of Foreign Exchange Management (Transfer or issue of any foreign security) Regulations, 2004. An office outside India of the foreign company, pursuant to the cross-border merger shall be deemed to be the branch or office outside of the resultant company in accordance with the Foreign Exchange Management (Foreign Currency Account by a person resident in India) Regulations, 2015. The resultant company may acquire and hold any asset outside India which an Indian company is permitted to acquire framed thereunder FEMA (Acquisition and Transfer of Immovable Property), 1999.

Demergers means division of a company into two or more companies. The companies keep on diversifying to have more market presence thereby increasing their profit margins. But some of the companies diversify in unrelated businesses as results of which they face problems in maintain such entities. In such cases companies to reduce their profitability demerge such existing undertakings or business units to other entities. In India, family settlements are one of the major causes of demerger due to concentrated family-owned entities [7]. The demerger of Reliance group into Reliance Industries Limited and Anil Ambani Group is one of the largest demergers due to family settlements. Apart from these companies also indulge in demerges for maintaining more efficiency or specializations [8] and end up with an inefficient structure, dissension among operating managers and capital allocation system [9].

Position of Cross Border Demerger under Erstwhile Companies Act, 1956 v. New Companies Act, 2013

In the erstwhile Companies Act, 1956 there was no specific mention of the word demerger or division of companies. But the cross border inbound demergers were allowed under the erstwhile law by interpreting the arrangement [10] to include demergers. Justice NV Balasubramaniam in Re TVS Limited [11], interpreted demerger to be a scheme of business reorganizations whereby a company transfers its undertaking to a new company. But section 394 [12] of the Companies Act, 1956 permitted cross border inbound mergers but prohibited cross border outbound mergers as Transferee Company ought to be an Indian Company. As a result of which only inbound cross border demergers were allowed under the Companies Act, 1956. The JJ Irani Committee [13] had recommended allowing cross border outbound demergers whereby the foreign company is the transferee company. The Companies Act, 2013 has permitted both outbound as well as inbound mergers of companies in limited jurisdictions as prescribed under section 234 of Companies Act, 2013 read along with Rule 25 A of the Companies (CAA) Rules, 2016 and along with the deemed approval of Reserve Bank of India by the compliance of Foreign Exchange (Cross Border Merger Regulations), 2018. Unlike under section 232, there has been no mention of the word demerger or division of companies under section 234 of the Companies Act, 2013. But section 234 deals about the applicability of other provisions of Chapter XV mutatis mutandis. The word mutatis mutandis confines the applicability of other provisions restricting to any alterations in the parent provision. Let's now examine the interpretation of section 234 adopted by NCLT Ahmedabad in two different orders.

Sun Pharma Inbound Cross Border Demerger Deal

On October, 2018 the NCLT Ahmadabad [14] sanctioned an application of cross border inbound demerger involving the transfer of specified undertaking dealing with non-branded generic pharmaceutical of Sun-Pharma Global FZE situated in UAE to Sun Pharmaceutical Industries Limited. The Sun-Pharma Global FZE (Transferee Company) is an indirect wholly-owned subsidiary of Sun Pharmaceutical Industries Limited (Transferee Company). The objective of the demerger scheme is to integrate and consolidate business activities in relation to generic pharmaceutical products. The NCLT observed that section 234 of Companies Act, 2013 states that section 230-232 shall be applicable mutatis mutandis. Section 232 mentions about demerger i.e transfer of an undertaking from one entity to another entity. So, cross border demerger is also covered under section 234 of Companies Act, 2013. NCLT further interpreted with help of Regulation 9 of Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2017 "merger or demerger or amalgamations of Indian Companies" stating that if demerger was not covered then the Regulations would not have provided for the same.

Sun Pharma Outbound Cross Border Demerger Deal

On 19th December, 2019 NCLT Ahmadabad [15] rejected the scheme of cross border outbound demerger under section 234 of Companies act, 2013 filed by Sun Pharmaceutical Industries Limited. The cross border demerger scheme involved the transfer of two specified undertakings of Sun Pharmaceuticals Industries Limited to two overseas Companies i.e Sun Pharma Netherlands B.V and Sun Pharmaceutical Holdings USA Inc. Both the overseas companies are directly or indirectly held by Sun Pharmaceutical Industries Limited. NCLT interpreted that applicability of section 230-232 is limited to Indian Companies and not foreign companies under section 234 of Companies Act, 2013. The NCLT further stated that Section 234 prescribes about merger or amalgamations of foreign with Indian companies or vice versa and does not prescribe about demerger. Hence, it may be construed that section 234 of Companies Act, 2013 and Rule 25A of Companies (Compromise, Arrangement and Amalgamations) Rules, 2016 is limited to cross border merger or

amalgamations and it does not permit demerger or arrangement of Indian companies with foreign companies and vice versa. NCLT also referred to the principle of intentional omission whereby the definition of cross border merger in Draft Regulation of Cross border Mergers included demerger but which was subsequently removed in the enacted legislation of Foreign Exchange Management (Cross Border) Regulations, 2018.

Critical Analysis of Cross Border Demerger: Applications of Appropriate Statutory Interpretation

According to Franscis Bennion "*Interpreter's duty is to arrive at the legal meaning of the enactment which is not necessarily the same as its grammatical meaning. This must be done in accordance with the rules, principles, presumptions and canons which govern statutory interpretation*" [16]. The judges' or enforcement agencies like NCLT's role in interpretation is to arrive at the intention of the Law as expressed and implied in the relevant Act or any delegated legislations. They cannot modify the law which would supersede the existing enforcement procedures. By application of the literal rule of interpretation of sections 232 its clear that it is applicability is confined to cross border mergers or amalgamations as it does not mentions about demerger. Moreover the use of the words "mutatis mutandis" in section 234 pertains to applicability of section 230-232 without any alteration or modification to the parent provision i.e. section 234 of Companies Act, 2013. Thus, mere inclusion of demerger within section 232 of the Companies Act, 2013 cannot be assumed to be included within the parent provision of section 234 of the Companies Act, 2013. It was held in Crawford v. Spooner [17] "*We cannot aid the legislature's defective phrasing of an Act, we cannot add or mend and by construction make up deficiencies which are left there*." The Court or enforcement agencies cannot make changes in the law as it has no power to legislate [18].

In my viewpoint the NCLT Ahmedabad in outbound demerger deal has correctly interpreted section 234 of the Companies Act, 2013 by applying the principle of intentional omission whereby the definition of cross border merger in Draft Regulation of Cross Border Mergers Regulations, 2017 included demerger but which was subsequently removed in the enacted legislation of Foreign Exchange Management (Cross Border) Regulations, 2018. and NCLT Ahmedabad in inbound demerger deal has incorrectly interpreted section 234 of the Companies Act, 2013 by referring to terms of mutatis and mutandis in section 234 and Regulation 9 of Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2017 "Merger or Demerger or Amalgamations of Indian Companies". Regulation 9 of the above-mentioned regulation is applicable to Indian companies and not to outbound or inbound demergers. Moreover if any subordinate legislations goes beyond the totality of the legislative power which is conferred on the delegate by the enabling Principal Act i.e Section 234 of Companies Act, 2013. Such subordinate regulations can be declared ultra vires. But there is no conflict between the parent provision and subordinate provision. As Regulation 9 pertains procedures prescribed for demerger of Indian companies only. Presently Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2017 has been repealed by Foreign Exchange Management (*Non-Debt Instruments*) Rules, 2019. Even the new enactment nowhere mentions about outbound or inbound demerger. The Supreme Court while interpreting section 621-A(1) of the Companies Act, 1956 held in VLS Fiance Limited v. Union of India [19] " *the Court must avoid rejection or addition of the words and resort to that that only in exceptional circumstances to achieve the purpose of the legislation*."

Ideally, the literal rule of interpretation should be adopted while interpreting statutory provisions. The departure from literal rule of interpretation may be made to avoid absurdity. The court can adopt Golden Rule of Interpretation whereby the court can add or omit words. Before applying the golden rule of interpretation the Court must keep in mind three following matters: "*a. the intended purpose of the statute or provision in question, b. that by inadvertence that draftsman and Parliament failed to give effect to the purpose in the provision in question and substance of the provision Parliament would have used had the error in the Bill been noticed*." [20] The purposive or golden rule of interpretation is applied when the literal meaning of the words in a statutory provision defeats its intention by making it ineffective or meaningless or in cases of accidental omission. The demerger can be included within section 234 of the Companies Act, 2013 as it has been accidentally omitted. The cross border inbound demergers were allowed under the earlier Companies Act, 1956 by interpreting the word arrangement [21] to include demergers. The word arrangement has a very wider connotation in comparison to the words "merger" or "amalgamation" to include various corporate restructuring (merger, amalgamation or demerger). But the new provision section 234 does not mention the word arrangement. The application of casus omissus in a matter which should have been but has not been provided for in a statute cannot be supplied by courts as to do so will be legislation and not construction [22]. It has been by Supreme Court in Padmasudandara Rao v. State of Tamil Nadu [23] "*casus omissus cannot be supplied by the court except in the case of clear necessity and when reason for it is found in the four corners of the statute itself but at the same time a casus omissus should not be readily interfered*." In *Union of India Vs Rajiv Kumar* [24] held "*subsidiary rules of interpretation-Casus Omissus when can be supplied by the Court. At the same time a casus omissus should not be readily inferred and for that purpose all the parts of a statute or section must be construed together and every clause of a section should be construed with reference to the context and other clauses thereof so that the construction to be put on a particular provision makes a consistent enactment of the whole statute. This would be more so if literal construction of a particular clause leads to manifestly absurd or anomalous results which could not have been intended by the legislature*."

If we read the statute as whole the word arrangement mentioned in Section 230 "*includes a re organization of the company's share capital by the consolidation of shares of different classes or by the division of shares into shares of different classes, or by both of those methods" is only confined to internal restructuring*" and in section 232 dealing with external restructuring. In addition to this, there is specific mention of the word division i.e demerger in section 232(2) of Companies Act, 2013 and Explanation (iii) of section 232 of Companies Act, 2013 [25]. Even the word demerger has been substantially omitted in the final Foreign Exchange Management (Cross Border Merger) Regulations, 2018 which was there in the draft regulations of FEM (CBM) Regulation, 2017. There is no possible way of inclusion of demerger within section 234 of Companies Act, 2013.

Recently the even NLCAT also rejected the principle of casus omissus in *Regional Director v. Real Image LLP. & Qube Cinemas Private Limited* [26] held "*the provisions of Companies Act, 2013 as a whole in reference of conversion of Indian LLP into an Indian company there is no ambiguity or absurdity or anomalous results which could not have been intended by the legislature. The principal of casus omissus cannot be supplied by the Court except in the case of clear necessity and when the reason for it is found in the four corners of the statute itself. The legislature has enacted a provision in the Companies Act, 2013 for conversion of Indian LLP into Indian Company and vice versa in the Limited Liability Partnership Act, 2008."*

Conclusion

Ideally the literal rule of interpretation should be adopted while interpreting statutory provisions. But departure from literal rule of interpretation may be made to avoid absurdity. The sole objective in principles of interpretation is to arrive at the legislative intention. But when the purpose of an enactment is clear there cannot be any interpretation extending beyond its natural meaning. According to JJ Irani Committee Report [27] demergers are treated equivalent to mergers and acquisitions. The real intention is the intention of the draftsman of the bill that gives rise to an Act through the agreement of the Parliament. But the 21st Report of Standing Committee on Finance on Companies Bill, 2009 [28] paragraph 15.41 recommended for modification of the definition of Transferee Company to include foreign company for permitting foreign companies, which do not have a place of business in India to be the transferee company in a merger with an Indian company. This recommendation was simultaneously incorporated [29] in 57th Report [30] on Standing Committee Companies Bill, 2011 for Clause 234 of Companies Bill, 2011 dealing with cross border mergers. The recommendations of Clause 234 of Companies Bill, 2011 (it's now section 234 of Companies Act, 2013) i.e. both the Standing Committee Reports on Companies Bill clarifies the legislative intent of Section 234 of the Companies Act, 2013. The legislative intent of section 234 is to help foreign companies who do not have a place of business in India to be merged with Indian Company and vice versa. It does not mention about demerger of foreign company with Indian Company or vice versa. It's a clear lack of legislative intent as the erstwhile Companies Act, 1956 allowed inbound demergers there is no reason why the new enactment with objective of ease of doing business would lack legislative intent to allow cross border demergers within section 234 of the Companies Act, 2013. But the Indian Companies Board of Directors' can still sell of their undertaking to foreign company by virtue of Section 180 of the Companies Act, 2013 by a special resolution. For ease of doing business there is a requirement of amendment of section 234 to have seamless cross border mergers and demergers in India.

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