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DEMERGES UNDER COMPANY LAW

INTRODUCTION

Sometimes when two separate companies come together, they create more value compared to being on an individual stand. With the target of riches amplification, organizations continue assessing various open doors through the course of merger or obtaining. These corporate tie ups may or may not work out in the favour of the companies, and there are examples when the corporate has to restructure in which a business is broken down into various components. This form of corporate restructuring is known as 'Demerger'.

It allows large companies to split into various brands or business units or sometimes create separate legal entities to handle different operations. At times it is done with the intent to form a new company that operates on its own or sell or dissolve the unit so separated. The new company so formed need not be the subsidiaries of the parent companies undergone such split or division. The New Oxford dictionary defines the term "demerger" as "*the separation of a bigger company into two or additional smaller organizations.*"

Though the term 'Demerger' is not specifically defined anywhere in the companies act, however it can be derived from:

- a) The articulation, "arrangement" incorporate "a rearrangement of the offer capital of the organization by the union of offers of various classes, or by the division of offers into offers of various classes or by both those techniques".
- b) Deal, rent or generally transfer of the entire or the generously entire of the endeavour or where the organization claims more than one endeavour of the entire or considerably entire of any such endeavour.
- c) The plan of trade off, course of action or remaking under section 391 to 394 of the Companies Act, 1956.

The word 'Demerger' has been defined under Section 2 (19AA) of the Income Tax Act, 1961 as "Demerger, in relation to companies means the transfer, pursuant to a scheme of arrangement under section 391 to 394 of the Companies Act, 1956, by a demerged company of its one or more undertakings to any resulting company"

The idea of demerger underneath the income tax Act 1961 is the image of that under section 293(1) (a) of the companies Act, 1956.

REASONS FOR DEMERGES

When in a corporate house that has various departments and divisions, a specific department is growing at a remarkable rate and earning huge turn over showing huge potential, the said company chooses to demerge that particular department. Through this form of restructuring, the shareholders tend to have more direct ownership. Aside from that, where an organization chooses to demerge, with a point of corporate rebuilding, the endeavors tried to be demerged are exchanged from the transferor organization to a current transferee organization.

Demerger is undertaken basically for two reasons. The first one as an exercise in company restructuring and therefore the other is to provide result to a sort of family partitions within the case of family owned/controlled companies basically to provide impact to informal family partitions.

Where demerger is an activity of corporate rebuilding the endeavor tried to be demerged is moved from a transferor organization to a current transferee organization. But wherever demerger is an exercise in family partition the various 'undertakings' of an organization is transferred to a freshly incorporated transferee corporations to facilitate family partitions.

In a plan of course of action two bunches in a family will be appointed explicit advantages for their individual transferee enterprises from the parent transferor organization wherever they're investors. Ordinarily all the shareholders of the transferor company receive shares in one or the other of the two transferee companies. As this mode of effecting transfer isn't objected to by the Central Government and no provision of law that it may be aforementioned to violate has been brought to the notice of the Court it may be sanctioned. After the dispersion of the benefits inside

the way gave inside the subject, no advantages will be left with the transferor organization and it is subsequently tried to be disintegrated, the equivalent shaping piece of the plan.

Apart from these, they can be various other reasons due to which a company opts for demerger. In short they can be termed as follows:

- It offers the speculators a reasonable decision between various business types;
- It permits autonomous money related technique;
- Expands the value acquiring of the organizations;
- It builds the general market valuation of an organization, despite the fact that a demerger does not expand the estimation of the advantages of the organization.

MODES OF DEMERGERS

- **DEMERGER BY AGREEMENT-**
It might be affected by understanding where under the demerged organization turns off its particular endeavor to a subsequent organization, framed with another names in such a way, that all the property and all the liabilities of the endeavor, being moved by the demerged organization preceding the demerger, turns into the property and liabilities of the subsequent organization by temperance of demerger. The ensuing company problems, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis.
- **DEMERGER UNDER THE SCHEME OF ARRANGEMENT-**
On the idea of the powers a corporation has in its note, it can carry out division or split of its entity in the same manner as it could accomplish amalgamation through a theme of arrangement below the provisions of the Businesses Act, 1991. The procedure arranged down in Chapter-V below the Businesses Act, 1991 concerning Arbitration, Compromises, Arrangements and Reconstruction would be followed in the case of division of the company. It needs the approval by court u/s 391 of the Businesses Act, 1991.
- **DEMERGER UNDER VOLUNTARY WINDING UP-**

A Company, which has part into a few organizations after division, can be twisted up deliberately compliant with Section 484 to 498 of the Companies Act, 2013. Where a the transferor organization is proposed to be, or is in course of being wrapped up inside and out intentionally the outlet of the transferor organization may, with the assent of a unique goals of that organization conferring on the liquidator either a general authority or an authority in respect of any particular arrangement receive, by way of compensation or part compensation for the transfer or sale, shares, policies, or other like interest in the transferee company, for distribution among the members of the transferor company or enter into any other arrangement whereby the members of the transferor organization may, in lieu of getting money, offers, strategies, or other like premiums or furthermore thereto, take an interest in the benefits of, or get some other profit by, the transferee organization.

TYPES OF DEMERGERS

PARTIAL V/s COMPLETE DEMERGER

- **Partial Demerger** is when a department/division/part of a company is transferred to/separated to one or new company/companies formed with the same shareholders who are allotted the same number of shares and in the same proportion which they held in the demerged company. **Complete Demerger** is when whole of the undertaking/business of the existing company is transferred to the new company/companies formed and the shareholders by passing a special resolution dissolve the demerged company. Such shareholders are issued/allotted shares in the new company/companies in accordance with the share exchange ratio as sanctioned under the demerged scheme.
- Motive behind a **Partial Demerger** is to actually force the market to value the business of the demerged company separately whereas behind a **Complete Demerger** is to wind up the company voluntarily which my subsequently disappear.

SPIN-OFF V/s SPLIT UP

- **Spin-Off**, kind of divestiture strategy in which the division/undertaking of a company is separated from the parent company whereas the **Split up** is a kind of business strategy when a parent company splits into one or more independent companies.
- In a Spin-Off, both the parent and the subsequent organization go about as independent corporate substances though in a Split Up the parent organization stops to exist.
- **Spin-Off** is regarded as creation of an independent company by the way of sale distribution of new shares of a business which is already in existence; it may also be a division of the parent company. In **Split Up** the shares which are held by the parent company are exchanged for the shares in the new company so formed, such shares are distributed in same proportion as were held before splitting up.
- Reason behind **Spin-Off** type of divestiture is to attract more investments from outside which can be done efficiently when there is independent management also adopted when company wants to dispose of its non-core assets whereas reason behind adopting **Split Up** as a business strategy to curb the monopoly practices, when the government mandates and also if the company has several business lines then to focus on its core-activity.



STATUTORY FRAMEWORK

- The term is nowhere defined under the **Companies Act, 2013**; however explanation under Section 230(1)¹, prescribes arrangement as including a reorganization of the company's shares capital by the consolidation of shares of different classes or by division of shares of different classes or by both of these methods.
- Demerger has been defined in Sub Section 19AA of Section 2 of the Income Tax Act 1961, in relation to companies, as a scheme of arrangement under Sections 391-394 of the Companies Act, 1956.

¹Section 230, The Companies Act, 2013

- Provisions of Sections 230-232 of the Companies Act, 2013 read with the Companies (Compromises, Arrangements and Amalgamations) Rules, 2016, dealing with 'arrangement' enable a company to undertake a demerger vide a scheme of arrangement.
- In case of a demerger of a listed company, the resulting company, this may be an existing company or a new company to whom certain undertaking(s) is transferred, may or may not seek listing. If the resulting company seeks listing, the said company must comply with **Regulation 37 of the LODR²** prescribed by the Securities Exchange and Board of India.
- In a scheme of demerger under Companies Act, 2013, (Sections 230–232), if the consideration payable is in the form of shares issued by the transferee company or the resulting company, the ratio of the number of shares held by the shareholders of the transferor company/demerged company to the number of shares issued as consideration by the transferee company/resulting company is known as 'swap ratio'.³
- "A scheme of arrangement, falls within the meaning of the term 'combination' as per section 5 of the Competition Act, 2002 and accordingly, where the value of the deal falls within the prescribed thresholds as set out thereunder, a notice of the same is to be given to the concerned regulatory authority in terms of Section 6 of the Competition Act, 2002."⁴

PROCEDURE OF DEMERGER UNDER LAW

The process of demerger under the Companies Act, 2013 is as follows:

Step-1: Preparation of the Scheme of Arrangement- In demergers process this is the most essential document through which the company binds all related stakeholders on the terms of

²Regulation 37, Listing Obligations and Disclosure Regulations, 2015

³J Sagar Associates, LEGAL AND COMMERCIAL CONSIDERATIONS FOR DEMERGERS—OVERVIEW(2016), https://www.lexisnexis.com/ap/pg/indiamergersacquisitions/document/429520/5K3N-8061-DY1H-R3N1-00000-00/Legal_and_commercial_considerations_for_demergers_overview (Last visited on Mar 27, 2019)

⁴*Ibid.*

demerger. This plan can propose by the liquidators of the company of the directors of the company and it would have to be accepted by employees, creditor, shareholders and all related stakeholders.

Step-2: Application in the court (Section 391(1) of Companies Act⁵)-Both the demerged company and the resulting company needs to make an application⁶ to the High Court in Form 33 along with the affidavits of the promoters to obtain an order for holding meetings of members/creditors;

Step-3: Issue of Notice-Once the Court gives the order notice of the meeting needs to be served to the members/creditors or interested parties by the authorized person 21 days prior to the date of the meeting along with the proposed scheme of arrangement and proxy forms.⁷

Step-4: Holding of Meeting- Once the notice is served the company according to the guidelines of the court shall hold meeting(s) of the creditors/members.

Step-5: Reporting of result- Result of such meeting should be recorded along with votes in support or against the motion and must be submitted in the form of report in form 39⁸ by chairperson.

Step-6: Petition and Sanction of the Court (Section 394⁹) a petition needs to be filed to the Court for sanctioning the scheme of demerger, three-fourths of members/creditors must sanction it so that an appeal could be file. Once the Court gives an order sanctioning the scheme certified copy of the Courts order needs to be communicated to the Office of the Registrar of Joint Stock Companies and Firms (RJSC)¹⁰ and also in the newspaper in which notice of the meeting was advertised.

⁵The Companies Act, 2013

⁶Demerger - Companies Act - IndiaFilings, IndiaFilings - Learning Centre (2019), <https://www.indiafilings.com/learn/demerger-companies-act/> (Last visited on Mar 23, 2019)

⁷*Ibid.*

⁸*Ibid.*

⁹ The Companies Act, 2013

¹⁰Law Rights & Sayed Hossain, *Methods of Demerger*, The Daily Star (2019), <https://www.thedailystar.net/law-our-rights/methods-demerger-1386148> (Last visited on Mar 23, 2019)

BENEFITS OF DEMERGERS

Focus on Core Competency: Conglomerate companies are known for not have centered business operations. These companies endeavor to deal with a great deal of assorted tasks which require distinctive capabilities. In a many cases, these organizations lose to contenders who have a single-minded focus on any one particular line of business. The modern business environment is more about specialization. Generalists don't make due for exceptionally long. It is consequently that it is essential that companies need to focus on their core competencies. This thinking has driven numerous conglomerates to streamline their operations and demerger has been a noteworthy instrument utilized amid the procedure.

Management Accountability: Usually the management of each company has its own balance sheet, when they are split off. The management of each company becomes accountable for its own financial outcome. Likewise, the board will in general have more command over their activities. They have the right to make their own investments and even raise funds from the market on their own account.¹¹

Increase in Market Capitalization: In many cases, demergers are used to create stock market value. Investors have more visibility over the operations and cash flow of a firm that has been spun off. This empowers them to settle on better investing decisions. Investors are eager to pay a premium for this better data. Accordingly, spinning off units to form separate legal entities does result in increased market capitalization for the group as a whole.¹²

LIMITATION OF LAWS ON DEMERGER IN INDIA

The laws in this aspect in our country aren't very comprehensive as compared to the developed countries. Following are the limitations which are evident in context to Indian Statutory Framework:

- Indian Corporate Governance Framework and laws do not provide any clear and specific definition on the demerger form of restructuring.

¹¹What are Demergers: Its Pros and Cons, Management Study Guild (MGS), 2019, <https://www.managementstudyguide.com/what-is-demergers.htm> (Last visited on Mar 23, 2019)

¹²*Ibid*

- There exists a whole lot of ambiguity and also absence of clarity over the terms like split-offs, split up, divestitures etc.
- Our country doesn't have its own act which solely deals with Corporate Restructuring and all such transactions are governed through the Companies Act, 2013.
- Laws such as Income Tax Act, 1961 and SEBI LODR, 2015 face issues like that of cross jurisdictions apart from Companies Act, 2013 which acts as a hinder during litigation.

THE RECENT DEMERGERS APPROVED BY THE COURTS

After the enactment of comprehensive provisions under the Income Tax Act, 1961 dealing with demerger, many corporate embarked on more focused business plans by shedding off unrelated businesses through a scheme of Arrangement approved by the Courts. In some rare instances, there are also other reasons witnessed for embarking on demerger like the family split which occurred in Reliance Industries etc. Many of the companies of the DCM Group which sprung into life from the original demerger carried out more mergers & demergers in the later years and there are many Court approvals which are available in public domain through case laws reported in various magazines like in the case of *in re, SIEL Limited*¹³ or consider the case of *in re, DCM Limited*¹⁴.

Another biggest demerger that arose recently is the separation of Tata Consultancy Division from Tata Sons Ltd. resulting in the huge appearance before the public eyes, a new hitherto hidden organization known as Tata Consultancy Services Ltd. Many of these instances are of very same nature and these are not elaborated here excepting that one could easily scan the literatures which are available in great detail in the case laws, the schemes circulated to shareholders and the balance sheet of the demerged and resulting companies.¹⁵

CONCLUSION

Keeping all discussions aside, we can finally state that there is no bar on companies willing to break down into smaller units if they are unable to function together, on the believe that their net

¹³In Re, SIEL Limited (2005) 1 Comp LJ 369 (Del)

¹⁴In Re, DCM Limited 50 SCL 585 (Del)

¹⁵*Ibid.*

worth would sum up to be more being separate individual corporation than being a whole entity. Even after some companies merge with each other and finds out that they are unable to work as a single unit they may reverse the process of merger and get separated by various means under the company law. Though the Companies Act, 2013 governs the process of demergers, recently even the judiciary has acknowledged the term and process of demerger and supports the same.

