# Demerger – An Indian Legal Perspective

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Demerger is the converse of a merger or acquisition. It describes a form of restructure in which shareholders or unit holders in the parent company gain direct ownership in a subsidiary (the 'demerged entity'). Underlying ownership of the companies and/or trusts that formed part of the group does not change. The company or trust that ceases to own the entity is known as the 'demerging entity'. If the parent company holds a majority stake in the demerged entity , the resulting company is referred to as the subsidiary.[1]

Mergers, Amalgamations and De-mergers are strategies for corporate growth and expansion. Sections 391 to 394 of the Companies Act, 1956 deal, inter alia with the reconstruction and amalgamation of companies or what is commonly referred to as "mergers". The procedures contemplate an application by the company to the concerned High Court by way of a scheme of compromise or arrangement with its creditors or members or any class of its members. Such a Scheme is a viable option for the amalgamation of two or more Indian companies. Moreover, sections 391 to 394 of the Act envisage a "single window clearance" by providing a composite code for facilitating mergers and amalgamations which obviates the need for making multiple applications under the Act and ensures that the interested entities are not put through unnecessary and cumbersome procedures involving protracted consequences for implementing such Schemes.[2]

To enable Indian industry become globally competitive, tax concessions were brought in by the Finance Act, 1999, to take care of the entire gamut of business reorganization. Existing provisions relating to amalgamations of companies were rationalized and new ones relating to demerger of companies, or sale/transfer of business as a going concern through slump sales were introduced.

[1] Demerger: From Wikipedia, the free encyclopedia, http://en.wikipedia.org/wiki/Demerger

[2] Procedural Compliances Relating to De-merger/ Reconstruction of Companies in India- S. Dhanapal, Partner, Damodaran & Dhanapal Associates, Company Secretaries, Chennai.

The Companies Act had no specific provision governing demergers. Recourse to Sections 391 and 394 of the Companies Act had to be made through schemes of compromise or arrangement. With growing liberalization of the economy a need has arisen for industrial restructuring so that companies can focus better on their core activities.

The expression 'Demerger' is not expressly defined in the Companies Act, 1956 but, it is covered under the term "arrangement", defined in clause (b) of Section 390 of Companies Act. However, it has been defined in Sub-section (19AA) of Section 2 of the Income-tax Act, 1961.

*According to the said Subsection, "de-merger" in relation to companies, means transfer, pursuant to a scheme of arrangement under Sections 391 to 394 of the Companies Act, 1956, by a de-merged 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 de-merged company, immediately before the demerger, becomes the property of the resulting company by virtue of the de-merger ;*
ii. *All the liabilities related to the undertaking, being transferred by the de-merged company, immediately before the de-merger, become the liabilities of resulting company by virtue of the de-merger ;*
iii. *The property and the liabilities of the undertaking, being transferred by the de-merged company are transferred at values appearing in its books of account immediately before the de-merger ;*
iv. *The resulting company issues, in consideration of the demerger, its shares to the shareholders of the de-merged company on a proportionate basis ;*
v. *The shareholders holding not less than three fourths in value of the share in the de-merged 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 de-merger ;*
vi. *The transfer of the undertaking is on a going concern basis;*
vii. *The de-merger is in accordance with the conditions, if any, notified under Sub section (5) of Section 72A of the Income Tax Act 1961 by the Central Government in this behalf.*

***Explanation 1***

*For the purposes of this clause, "undertaking" shall include any part of an undertaking, or a unit or division of an undertaking or a business activity taken as a whole, but does not include individual assets or liabilities or any combination thereof not constituting a business activity.*

***Explanation 2***

*For the purposes of this clause, the liabilities referred to in sub clause (ii), shall include : (a) the liabilities which arise out of the activities or operations of the undertaking; (b) the specific loans or borrowings (including debentures) raised, incurred and utilized solely for the activities or operations of the undertaking; and (c) in cases, other than those referred to in clause (a) or clause (b), so much of the amounts of general or multipurpose borrowings, if any, of the de-merged company as stand in the same* *proportion which the value of the assets transferred in a de-merger bears to the total value of the assets of such de-merged company immediately before the de-merger.*

***Explanation 3***

*For determining the value of the property referred to in sub clause (iii), any change in the value of assets consequent to their revaluation shall be ignored.*

***Explanation 4***

*For the purposes of this clause, the splitting up or the reconstruction of any authority or a body constituted or established under a Central, State or Provincial Act, or a local authority or a public sector company, into separate authorities or bodies or local authorities or companies, as the case may be, shall be deemed to be a de-merger if such split up or reconstruction fulfills such conditions as may be notified in the Official Gazette, by the Central Government.*

Demerger of a company takes place when[3]

1. De-merger is essentially a scheme of arrangement under Section 391 to 394 of the Companies Act, 1956 requiring approval by:
   i. majority of shareholders holding shares representing three-fourths value in meeting convened for the purpose; and
   ii. sanction of High Court.
2. De-merger involves 'transfer' of one or more 'undertakings'.
3. The transfer of 'undertakings' is by the de-merged 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'.

A demerger is a form of restructure in which owners of interests in the head entity (for example, shareholders or unit-holders) gain direct ownership in an entity that they formerly owned indirectly (the 'demerged entity'). Underlying ownership of the companies and/or trusts that formed part of the group does not change. The company or trust that ceases to own the entity is known as the 'demerging entity'.

The entity that emerge have its own board of directors and, if listed on a stock exchange, have separate listings. The purpose of demerger is to revive a company's flagging commercial fortunes, or simply to lift its share price.

**Demerged Company and Resulting Company**

[3] Corporate Restructuring through De-merger of Undertakings – A study of Recent Cases in India by Dr. J. K. Singh, FCS, Senior Faculty Member, Department of Commerce, RLA College, University of Delhi.

According to Sub-section (19AAA) of Section 2 of the Income-tax Act, 1961, "de-merged company" means the company whose undertaking is transferred, pursuant to a de-merger, to a resulting company.

According to Sub-section (41A) of Section 2 of the Income-tax Act, 1961 "resulting company" means one or more companies (including a wholly owned subsidiary thereof) to which the undertaking of the de-merged company is transferred in a demerger and, the resulting company in consideration of such transfer of undertaking, issues shares to the shareholders of the de-merged company and includes any authority or body or local authority or public sector company or a company established, constituted or formed as a result of de-merger.

The definition of 'resulting company' has clearly brought out three important requirements while establishing its relationship with de-merging company. They are –

1. Consideration for transfer of undertaking would be by issue of shares only by resulting company.
2. Such consideration would be paid only to the shareholders of de-merged company.
3. Resulting company can also be a subsidiary company of a de-merged company.

**Activity List For De-Merger/Reconstruction Of A Listed Company**

| Serial No. | Nature of Activity |
|---|---|
| **Activities from board meeting for approval of demerger scheme to court order** | |
| 1. | Intimation in Stock Exchange of Board Meeting date for considering Demerger |
| 2. | Board Approval for the Scheme |
| 3. | Informing Stock Exchange of Board's decision |
| 4. | Consent from shareholders to the Scheme for Resulting Companies (in case of Closely held unlisted Companies) |
| 5. | Filing scheme with the Stock Exchanges |
| 6. | NOC/ Approval from Stock Exchanges (BSE/NSE) |
| 7. | Filing of application under section 391(1) with High Court (along with Judge's summons, affidavit in support of summons and draft minutes of order) |
| 8. | Finalizing the Notice/Explanatory Statement for Meeting of the Shareholders/Secured and unsecured Creditors |
| 9. | Hearing of company's application |
| 10. | Hearing of Resulting Companies application |
| 11. | Receiving authenticated copy of order for holding/ dispensing with the Meeting of Shareholders/ Secured and unsecured Creditors |
| 12. | Obtaining certified copy of order of High court for court Convened Meeting |

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| 13. | Commencement of Printing of Notice for court convened meetings |
| 14. | Completion of dispatch of notices for meeting under UCP |
| 15. | Advertisement of notice of meetings |
| 16. | Filing of Notice – Advertisement of meeting with stock Exchange(s) |
| 17. | Filing of advertisement of meeting with court |
| 18. | Filing of Affidavit signed by Chairman of the meeting or other person directed by the court verifying that the directions regarding the issue of notices and the advertisements have been duly complied with |
| 19. | Meeting of Creditors and Members |
| 20. | Reporting the decision of the poll to the High Court |
| 21. | Filing of petition with the Court along with relevant documents |
| 22. | Admission of the petition |
| 23. | Minutes of order by judge fixing the date of hearing of petition and advertisement of notice of hearing |
| 24. | Advertising the notice of hearing in news paper |
| 25. | Obtaining certified copy of order on admission of petition |
| 26. | Filing of copy of petition with annexures with RD / ROC through FORM 61 (eform) |
| 27. | Filing of affidavit confirming service of notice of petition and publication in newspaper |
| 28. | Follow up with RD/ ROC |
| 29. | Receipt of letter, queries etc., from RD and ROC |
| 30. | Follow – up with RD/ROC/ Legal Counsel to resolve issues, if any |
| 31. | Initial date of hearing of petition |
| 32. | Adjoined hearing if any |
| 33. | Filing of amended petition if any |
| 34. | Final date of hearing of petition |
| 35. | Obtaining certified copy of order on petition |
| 36. | Payment of Stamp duty, if required |
| 37. | Filing of certified order with RD / ROC along with Form 21 |
| **Activities from court order till Record Date** | |
| 38. | Acknowledgement of receipt from ROC and certified true copy of court order to be filed with the Stock Exchange. |

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| 39. | Notice to Stock Exchange for Record Date to determine eligibility to receive shares of the Resulting Companies and voluntarily give advertisement of the Record Date in National Dailies ( 30 day notice) |
| 40. | Agreement with CDSL and NSDL for admitting its securities |
| 41. | Printing of stationery – Allotment Advice, Share Certificate, Envelopes |
| 42. | Application seeking exemption for relaxation of Rule 19(2)(b) from SEBI through the designated Stock Exchange |
| 43. | Application to Stock exchange for in – principle approval for listing of shares |
| 44. | Designated Stock exchange to forward the application to SEBI for approval under Rule 19 (2)(b) of SCRA Rules |
| 45. | Prepare Information Memorandum (IM) |
| 46. | Compliance with clause 49 – prerequisite For Listing |
| 47. | File Information Memorandum with BSE and NSE |
| 48. | Stock Exchange to receive SEBI Approval and give In-Principle approval for listing of shares of the resulting companies. |
| 49. | Keep share certificates, covering letter, envelop of the resulting companies ready for over printing. |
| 50. | Keep text and stationery ready for intimation of corporate actions for the Resulting Companies |
| 51. | Letter relating to cost of Acquisition to be sent to Shareholders |
| 52. | Ex Date for Stock Exchange for F & O |
| 53. | Record Date |
| **Activities from Record date till listing** | |
| 54. | Procure details of Register of Members from R&T agent as on Record Date |
| 55. | Prepare list of eligible shareholders of the resulting companies, including details of the shareholding |
| 56. | Hold Board Meeting of Resulting Companies for allotment of shares |
| 57. | File Form 2 with ROC |
| 58. | Resulting Companies to submit the Corporate Action Forms to depositories and pay fee for the same |
| 59. | Over Printing of share certificates, cover letter, envelops and Despatch of Share certificates or demat credit of equity shares of the resulting companies. |
| 60. | Dispatching share certificate |
| 61. | Send intimation to the shareholders of each of the resulting companies regarding the corporate Action |

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| 62. | Application to Stock exchange, attaching dispatch certificate/demat credit certificate and copy of advertisement, for trading permission |
| 63. | Publication of the Advertisement (as per Schedule 28 of SEBI DIP Guidelines) in one English daily, Hindi Daily, and Regional Daily |
| 64. | Trading of shares at Stock Exchange |

**Documents To Be Filed Along With Company Application With The High Court**

Application is to be filed with the High Court where the Registered Office is situated for directions to convene a meeting for considering the draft Scheme of Demerger or for dispensing with the meeting. The following documents are necessary at this stage :

a) Judge's Summons under Order XIV read with Rule 67 (or Rule 9, 11(b) & 19) read with Sections 391 to 393 and 394 of the Companies Act (to be filed in Form No. 33 of the Companies (Court) Rules, 1959).
b) An affidavit in support of summons in Form No. 34 of the Companies (Court) Rules, 1959.
c) Memorandum and Articles of Association of the company.
d) Latest Audited Balance Sheet.
e) List of Shareholders (if meetings are to be dispensed with).
f) List of Secured Creditors.
g) Scheme of Amalgamation/Demerger.
h) Consent affidavits from all shareholders (if meetings are to be dispensed with).
i) Consent letters from secured creditors.
j) If the company does not have any secured creditor, a certificate to that effect from the statutory auditor must be obtained.
k) Valuation Report regarding share exchange ratio.
l) Vakalath.
m) Extract of the Board Resolution approving the draft Scheme of Demerger.
n) Draft notice of meeting, Explanatory Statement pursuant to Section 393 of the Companies Act, form of proxy (In case meetings are convened)

**Court Procedure Time Frame**

Submission of application under section 391 along with affidavit (F-34) in terms of Companies (Court) Rules, 1959 :

1) Notice and the explanatory statement under section 393
2) Obtain summon for direction in F-35 in terms of Companies (Court) Rules, 1959
3) Settlement of notice convening shareholders meeting
4) Despatch of notice to the shareholders

5) Publication of notice convening shareholders meeting
6) Submission of 3 copies of the published notice to stock exchange
7) Filing of affidavit of service regarding dispatch of individual notice with court.
8) Appointment of scrutinizers at the meeting
9) Requisite resolution to be passed at shareholders meeting
10) Publication of result of the poll
11) Intimation to stock exchange regarding approval
12) Filing of report along with affidavit
13) Forward minutes of the meeting of the shareholders to the stock exchange
14) Filing of petition for confirmation of the scheme in F-40 with court.
15) Servicing of notice of hearing of petition on central government.
16) Filing of Affidavit with Court regarding service of notice of hearing of petition on CG
17) Filing of Form-23 with ROC.
18) Publication of Notice of hearing of petition
19) Filing of affidavit with court regarding servicing of notice to Central Government and publication.
20) Hearing of petition, in case of objections if any
21) Obtaining no objection of Central Govt.
22) Obtaining sanction of the respective courts to the scheme.
23) Obtaining certified copies of court order approving Demerger scheme.
24) Court Order Copies to be filed with Stock exchanges
25) Court Order Copies to be filed with Registrar of Companies.

**Conclusion**[4]

Company demergers are a very common feature nowadays. This helps companies to create individual profit-centers and investors in the company also benefit from the process, as there is a fresh valuation of the demerged entity. However, the formation of a new entity also requires astute decision-making on the part of the investor because it has strong financial implications. Investors also will have to take a call themselves on how to react to such situations. The factors that should be considered include:

**Extent of separation**

First, the activities separated at the time of demerger is a critical factor. It is important to remember that the overall size of the business entity and the extent of the profits that it makes is one important factor that determines the pricing of the newly-listed shares. Also, the future potential will determine the price impact after the demerger. This distinction is crucial because there could be basic arbitrage opportunities, immediately after listing. This is because the extent

[4] Demergers: A great way to get richer by Arnav Pandya in New Delhi - http://in.rediff.com/money/2008/mar/10demerge.htm

separation will give some idea about the listing of the new company. For instance, when a company with a pre demerger price of Rs 250 separates an entity (Ratio 1:1) that trades at a price of Rs 55 and the original comes down to Rs 200 then it represents a 10 per cent gain for the investor immediately.

**Identifying benefits**

The key role for the investor is to identify an entity where the strong or profitable business remains. And then, look for the company which has a future potential. An example of this is say, a company is split into two additional companies, which are loss-making. This leads to a drop in the valuation of around 13 per cent. Also, if the profitability is only going to come after several years, a selling decision might be considered.

**Trading price**

One of the easiest give-aways when considering an investment opportunity is the price at which the various entities are being traded. Based on these workings, there is a certain valuation given by the markets. This can lead to some immediate gains for the investors where the price of the separate entities shoots up. Take for instance a company, which is trading at Rs 1,500 now. And after a demerger into two additional companies, it has a valuation that is 30 per cent higher. This means good gains for the investor. Too high a rise and you should immediately opt for the sell option. It is not uncommon to find valuations touch dizzying heights after a demerger and the benefits have to be booked.

**Investor interest**

In many cases, it is just the investor interest in a particular counter that leads to a situation where the price of the share presents a selling opportunity for the investor. There is often high interest on a particular scrip, immediately after the demerger leading to a shooting up of the scrip. Of course, such calls become difficult in a very depressed or buoyant market. However, following a thumb rule where the price of the scrip vis-a-vis actual valuation would give anyone a fair idea about the extent of overvaluation or undervaluation taking place.

**Financials**

It is best if one does not get swayed by the short-term disruptions. It is important to keep an eye on the financials to spot an opportunity. It is only a matter or time before valuations catch up with the prices in the market.