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Research Paper Law

# Demerger and its Aspects

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**ABSTRACT**

*Merger and Demerger are like two sides of the same coin. Mergers offer various benefits as the joining of two corporate houses brings profitable results to the new entity formed. Thus, the question that arises is; what is the need for a demerger? The concept of demerger has gained much importance in the corporate world owing to the added advantages that it offers. The word 'Demerger' denotes the act of disjoining a part or a unit of a company in order to incorporate a brand new company completely separate from the original company. A demerger aims at a more specific and a smoother functioning of the units. This paper commences by defining demerger under the Income Tax Act, 1961 and goes on to discuss the ways by which a demerger can be affected and its procedural aspects, it concludes by citing the relevant case law on the topic and laying down the benefits that a demerger offers.*

**KEYWORDS : Merger, Demerger**

**Introduction**

Demerger is defined under section 2 (19AA) of Income Tax Act, 1961 , which implies transfer, pursuant to a scheme of arrangement under section 391 to 394 of the Companies Act, 1956, by **Demerged Company** of its one or more undertaking to a new company formed for the purpose, known as **Resulting Company.**

The transfer takes place in such a manner that all the property, along with the liability of the Demerged Company becomes the property of the Resulting Company. The property is transferred **at a value that is appearing in the books of accounts** of the Demerged Company. The Resulting Company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis. The shareholders holding **not less than three-fourths** in value of the shares in the demerged company become shareholders of the resulting company. The transfer of the undertaking is on a **Going Concern basis**.

**Ways of Demerger**

Demerger can be affected by any of the following three ways:

(i) Demerger by agreement between promoters ; or
(ii) Demerger under the a scheme of arrangement with approval by the Court under section 391;
(iii) Demerger under voluntary winding up and power of liquidator.

In this information, we shall concentrate on Demerger done pursuant to **Scheme of Arrangement.**

The law w.r.t. a scheme of demerger or division is the same as it is with respect to a scheme for reconstruction, amalgamation or merger. A company can be demerged or split into, through scheme with the sanction of respective high court under the provisions of Companies Act, 1956**. The Memorandum of Association must contain provisions of demerger**. The scheme of arrangement has to be filed before the High Court where the registered office of the Demerged Company and Resulting Company is located. In case, the registered office of Demerged Company and Resulting Company are located in different states, **the scheme would be filed before their respective High Court and shall have to be approved by both the High Courts.**

**Procedural Aspects of Demerger**

The procedure for convening, holding and conducting class meeting for affecting demerger is laid down in Rules 67-87 of the **Companies (Court) Rules, 1959**. The steps to be taken for a demerger have been explained in detail as follows:

**(i) Preparation of Scheme of Arrangement:**

Prepare a scheme of demerger in consultation with all the interested parties and have the same **approved in principle by the Board of Directors** of the Company at a meeting. The Chartered Accountant/ Valuerbe appointed for valuation of shares to determine the share exchange ratio.

**(ii) Application to Court for direction to hold meetings of Members/Creditors:**

Both the companies should make an application under section 391 (1) to respective high courts for an order to convene and hold meeting of members/creditors by a Judge's summons supported by an affidavit. A copy of the proposed scheme should be annexed to the affidavit. The summons should be in Form 33 and affidavit in support in Form 34. Additional documents that are to be filed before the High Court are:

a) Memorandum and articles of association of the Company;
b) Latest Audited Balance Sheets ;
c) List of Shareholders and Creditors;
d) Extract of Board Resolution approving the Scheme, and
e) Draft notice of Meeting, Explanatory Statements and Proxy.

Both Transferor and Transferee companies have to file the aforementioned documents duly signed by a Director.

Further, **a creditor or a member may move an application u/s 391 (1**) of the act, yet, such an application may not accepted by Court because the scheme **shall not have the approval of the Board of Directors** or of the Company in general meeting. However, the Court has the discretion to give whatever direction it may deem fit and proper.

**(iii) Obtaining Court's order for holding meeting of Members/Creditors.**

On receiving a petition, the Court shall look into the fairness of the scheme before ordering meeting (s) because it would be of no use putting before the meeting, a scheme which is not capable of being implemented. The Court shall also ensure that the circular that is sent to all members/creditors shows a fair picture of the scheme. After the court is satisfied, it shall pass an order to convene the meeting (s). Such order should be in Form 35 of the Court rules.

**(iv) Notice of meeting of members/creditors**

After obtaining the Court's order, the Company should sent notice in Form-36 to the members/creditors and must be sent by the persons authorized by the Court in this behalf. The notice should be sent by post **at least Twenty One (21) days** before the date on which the meeting has been fixed. The notice must ne accompanied by the proposed scheme and proxy forms. The notice of the meeting **shall also be advertised in such newspapers** and in such manner as the judge may direct not less than twenty one (21) days from the date fixed for meeting. (Advertisement shall be in Form 38).

**(v) Holding meeting(s) of members/creditors.**

Pursuant to the directions, he meeting (s) should be held. The result of the meeting must be decided only by taking poll and by separately counting the votes in favour and against the resolutions. **The Chairman of each meeting shall submit a report** on the result thereof within the time fixed by the Court (**where no time has been fixed, within seven days after the conclusion of the meeting**) in prescribed Form 39 to the Court.

**(vi) Petition to the Court for sanctioning the scheme of Demerger.**

When the scheme of demerger has been approved by the required majority i.e. three-fourths of members/creditors, a petition must be made to the court for sanctioning the scheme of demerger. The petition is required to be made in Form 40, along-with the following documents that are necessary to enable the court to sanction the scheme.

a) An affidavit verifying the petition in form 3
b) Scheme of Demerger
c) Memorandum and Articles of Association
d) Audited accounts
e) Independent valuer's report
f) Copy of Chairman Report in form 39
g) Six copies of form no 5 being the advertisement of petition and form 6 being notice of petition to be issued to Regional Director, and Registrar of Companies.

The Court shall fix a date of hearing of the petition and notice of hearing shall be advertised in the same newspapers in which the notice of meeting was advertised. In this hearing, the court shall hear the objections (if any) raised by the Regional Director, Department of Company Affairs and Registrar of Companies.

**(vii) Court's order on petition sanctioning the scheme of Demerger.**

After hearing the objections, the Court may pass an order approving the scheme of demerger with or without modifications. A certified copy of the order shall be filed with the registrar of companies within fourteen days from the date of order in **E- Form 21** and **shall be binding on all creditors/members.**

**Relevant case laws on Demerger**

In "**In Re: Advance Plastics P. Ltd",** the Regional Director filed an affidavit that the scheme did not contain a valuation report on the shares which were to be transferred**.** The Bombay High Court in this case held that**, "*The shares are the properties of the shareholders and they are the ultimate and the best judge of the value they would put on their charges.*** *There is no requirement in the Companies Act, 1956 that in such a case the ratio of exchange has to be determined on a valuation made by a chartered accountant and the auditor. In the present case, no shareholder has challenged the amalgamation. In the circumstances, valuation report is not necessary.*"

In "**Vodafone Essar Ltd. and Ors vs. Vodafone Essar Infrastructure Ltd**." a Scheme of Arrangement involving demerger of Passive Infrastructure Assets into a group company was taking place. However, no consideration was to be paid nor were any shares to be issued by the transferee company to the transferor company, was sanctioned or mentioned. The Income Tax Department raised an objection; the transfer of assets by way of "gift" is impermissible, because a scheme of arrangement under Section 391-394, does not and cannot include a gift, as understood in law, and that the, "arrangement", contemplated by Section 391 can only be a transaction in the nature of a contractual arrangement for consideration. The Delhi High Court in this case opined that, since not even a single shareholder had objected to the scheme, the Income Tax Department cannot raise an objection w.r.t. the interest of the shareholders. It held that, "*And, to my mind, **the Income Tax Department is also not in any sort of loco parentis to the shareholders of the transferor companies who have unanimously agreed to transfer their assts without recompense**, nor are they the guardians of their interests, and therefore, the Income Tax Department cannot be heard to plead that the scheme must be thrown out because, in its opinion, the Scheme operates as a confiscation of the transferor shareholder's rights. The essence of the idea of confiscation is the taking away or abstraction of something from someone without his consent. Once there is consent, there can be no confiscation*."

In "**In Re: M/S. Indo Rama Textile Ltd.",**the Transferor Company transferred some of its assets to the Transferee Company. The Income Tax Department was of the view, that since a part of the assets was being transferred and the rest were being made available to the resulting company as resource under a contract. Therefore, it amounted to a Slump Sale and not a Demerger under the Companies Act, 1956. The Delhi high Court in this case held that, "*However, this Court is not in agreement with the Applicant's submissions that in a Scheme of Demerger by virtue of Section 2(19AA) of the Act, 1961, **all the properties of the undertaking become the property of the resulting company**. This Court is of the view that non-transfer of some of the pervious common assets being used by the transferee undertaking will not affect IRTL status as a going concern……. while framing a scheme of demerger, the existing and **the resulting companies after ensuring that both of them are a going concern, are free to negotiate which common asset/liability would be transferred to which undertaking**. After all, it is on this asset/liability transfer basis that share swap ratio are assessed, determined and allotted.*

**Conclusion**

In the era of globalization, the companies have to downsize their operations, since it no longer fits into the company plans. Thus, this type of restructuring helps the company in its growth. In a Demerger, the employees of the Demerged Company are reinstated in the resulting company, the interest of employees is also considered in this scheme. Further, a Demerger is also financially beneficial, owing to the fact that Capital Gains Tax is not attracted and the shareholders of the demerged company can also avail tax concessions. Similarly, Resulting Company also avails the tax concessions on acquisitions of Patents Rights, Know-How or any Licenses acquired under the Scheme of Demerger.

## REFERENCES

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