Corporate Reconstruction: Amalgamation, Merger and Acquisition

PRACTICE AREAS
- Banking & Finance
- Capital Markets
- Competition / Anti-trust
- Corporate & Commercial
- Dispute Resolution
- Mergers & Acquisitions
- Privatisation
- Projects & Infrastructure

INDUSTRIES
- Aviation
- Electronic Commerce
- Energy
- Healthcare & Pharmaceuticals
- Manufacturing
- Natural Resources
- Philanthropy & Not for Profit
- Property & Real Estate
- Technology, Media & Telecomm
A. **INTRODUCTION:** The subject assigned to me is very vast, interesting and timely and perhaps not susceptible to any precise definition.

The Companies Ordinance, among other things, provides for compromise, arrangements, amalgamations and reconstruction. None of these terms have been statutorily defined. In this paper, I will be concentrating on amalgamation and, to a lesser extent, on takeovers. Even though it may be obvious, it is probably prudent to let you know my understanding of what an amalgamation is. An amalgamation would include mergers and consolidations. A merger is a combination of two or more companies into a single company where one survives and the other loses its corporate existence. The survivor acquires the assets as well as the liabilities of the merged company. Generally, the company that survives is a purchaser while the seller is a company extinguished. A consolidation, on the other hand, is an amalgamation whereby two existing companies are fused into a new company in which both the existing companies extinguish. None of the consolidating companies legally survive. Consequently, in a consolidation, there is technically no purchaser or seller.

As the term “reconstruction” appears to be fashionable, let me digress somewhat and state the meaning assigned to reconstructions by Indian and English courts, which have given the term a rather narrow meaning. Reconstruction, as case law seems to suggest, would imply that the shareholders and the business remain substantially the same. This may be the case where it may not be desirable to kill an undertaking but to retain it in some altered form without selling it to an outsider. I am not going to deal with such reconstructions at any length in this paper.

B. **LAWS GOVERNING AMALGAMATION:** Having unavoidably dealt with certain definitional matters, I will now briefly touch upon the laws governing amalgamation and the entities they cover. As most of you know, the two primary laws in this regard are the Banking Companies Ordinance and the Companies Ordinance. Sections 284 to 287 of the Companies Ordinance deal with amalgamations. It would instinctively follow that the Companies Ordinance applies to amalgamations amongst companies, but this is not entirely correct. Its scope is wider. The transferee company or, in other words, the acquiring company needs to be a company incorporated under the Companies Ordinance. However, the transferor company or the acquired company need only a body corporate regardless of whether the same is incorporated under the Companies Ordinance. Consequently, though I am not presently aware of any such amalgamation, the provisions of the Companies Ordinance may be available in respect of amalgamation whereby a company absorbs anybody corporate, which are generally statutorily constituted.

The Banking Companies Ordinance covers amalgamation only among banking companies. Though various provisions of the Banking Companies Ordinance have been made applicable to Non-Banking Financial Institutions, such as leasing companies, DFIs and modarabas, the provisions of the Banking Companies Ordinance in relation to amalgamation do not extend to the amalgamation of Non-Banking Financial Institutions.

Another point worth mentioning in this regard is that the provisions of the Companies Ordinance relating to amalgamations will not apply to banking companies even if such banking companies are
incorporated under the Companies Ordinance. The logic behind this is that the Banking Companies Ordinance is a specific statute relating to banking companies and must take precedence over the general statute relating to companies.

There are various procedural dissimilarities between the amalgamation provisions under the two ordinances. One of the most significant being that a scheme of amalgamation under the Companies Ordinance can be sanctioned by the High Court whereas, under the Banking Companies Ordinance, the same can be sanctioned by the State Bank of Pakistan. I will deal with some of the statutory nuts and bolts of effecting an amalgamation later on.

C. **AMALGAMATION OF SICK UNITS**: Let me now highlight certain issues that are relevant in our present economic environment. Assuming that amalgamating sick units with each other or with healthy units is a commercially viable alternative, let me make a couple of suggestions which may facilitate such amalgamations. Though I am not a tax expert, my understanding is that where sick units are amalgamated into a healthy unit, the carry forwarding of losses (though I am aware of views to the contrary). In other words, the losses of the sick units cannot be set off against the profits of the healthy unit. The law, however, needs to be amended to permit such set off. Thus, various healthy companies may find an amalgamation an attractive proposition while at the same time prevent the sick units from being wound up and/or defaulting on its loan and other obligations. The Income Tax Act in India has been amended to provide for such set off in circumstances my find an amalgamation unit can be declared a sick unit under a specified criterion and is approved by the Government. To be effective in Pakistan, I submit that the law needs to be more liberal with respect to providing such set off as compared to India. Appropriate amendments in the law for the purpose of permitting carry forward and set off of accumulated losses and unabsorbed depreciation in the context of amalgamations may subsequently help in reviving the business of an undertaking which is financially non-viable.

Another way to deal with sick units, that is frequently mentioned, are debt equity swaps. I will go into this a little bit further as it is also indirectly related to amalgamations. The debt equity swap here refers to the lender exchanging the debt owned by the company (which is invariably in default) with such company’s equity. Such a swap may not be sufficient to compensate the lender. However, two or more companies subjected to such debt/equity swaps can be amalgamated and then sold which Kamran informs me could be sold for a significantly higher price. There are various units that intrinsically sound but have been financially mismanaged, resulting in heavy losses. The economics of scale resulting from such an amalgamation can be substantial. However, effecting the debt equity swaps, though now possible pursuant to recent amendments made in the Companies Ordinance, are still subject to legal impediments. As you know, shareholders in Pakistan under the Companies Ordinance are entitled to pre-emptive rights in respect of further issue of shares. Further issue of shares to the lender can be done only if the existing shareholders choose not to subscribe for such shares. In light of the amendments in the Companies Ordinance, if three conditions are satisfied, then the pre-emptive rights can now be waived. These three conditions are:

(a) Special resolution of the company issuing the further shares;
(b) The issuing company being a public company; and
(c) Approval of the Corporate Law Authority.

Given the attraction of debt equity swaps followed by amalgamation, as I have discussed, the exemption to pre-emptive rights needs, in my view, to be broadened in the context of sick units.
Where, for example, a company has been unable to pay its debts for a period of say one year then, in respect of such sick companies, the lender should be able to subscribe further shares whether or not the Company is public and without prior approval of CLA, provided the company follows certain uniform guidelines that may be prescribed by the CLA. Consideration may also be given to requiring only an ordinary rather than special resolution of the members for the purpose of doing away with the pre-emptive rights.

**D. SCHEME OF AMALGAMATION HAS THE FORCE OF LAW:** There are substantial advantages, from a legal perspective, to structure an acquisition as an amalgamation rather than a purchase of assets. This is so because an amalgamation has the force of law and thus can over-ride legal obstacle that otherwise could arise in an acquisition.

Under ordinary contract law, rights, generally stated, can be assigned without the consent of the debtors. The liabilities of an entity, however, cannot be assumed by another entity without the consent of the creditors. However, in the context of an amalgamation sanctioned by the court, such creditor’s consent is not required.

Similarly, under the Stamp Act, transfer of moveable and immovable properties falls within the meaning of conveyance and attract substantial stamp duty. Technically speaking, the stamp duty is applicable on the instrument of transfer. In the context of an amalgamation, where movable and immovable properties are transferred, there is no instrument of transfer, but the transfer is effected by operation of law and thereby no stamp duty is applicable on the scheme of amalgamation sanctioned by the court or the State Bank, as the case may be. It may then be considered whether transfer of immovable properties can be structured by way of an amalgamation sanctioned by the court. This could result in substantial savings of stamp duty and registration charges. Though at first blush, this may sound attractive, there is a judicial pronouncement wherein the court refused to sanction an amalgamation where the main and real purpose of the scheme was to transfer very valuable immovable assets of the transferor company to the transferee company, which was just a paper company. The court was of the view that such scheme would not be in the public interest because by this device immovable assets were sought to be transferred without payment of Government dues. In other words, where the amalgamation is merely to transfer immovable properties, the same may not be considered in the public interest and the court may consequently not sanction such scheme.

Another latitude in the context of amalgamation that is available as compared to the otherwise applicable requirements of the Companies Ordinances relates to the objects of Memorandum of Association. As you know, a company can only pursue those objects which are intra vires the Memorandum of Association. In the case of an amalgamation of two or more companies, the fulfilment of this condition is not essential for sanctioning the scheme of amalgamation. The rationale for the same is that the provisions in the law are intended to be in the nature of “single window clearance” system to ensure that the parties are not subjected to unnecessary and cumbersome procedures for making repeated applications to authorities which might be needed to effectively implement the sanction scheme whose over all fairness and feasibility has already been adjudicated by a court. The notable exemption in this regard is with respect to the reduction of capital. The predominant view of Indian judicial authorities is that the provisions of the Companies Ordinance with regard to reduction of capital must be independently satisfied, apart from and in addition to the provisions of the Companies Ordinance relating to amalgamation. In an amalgamation scenario, a reduction of capital may occur where there is an overlap of holdings between the shareholders of the transferor and acquiring companies. In a normal setting, for instance, there is a share-for-share exchange offered to the shareholders of the transferor
company. However, in the case where shareholders of the acquiring company already own shares of the transferor company, the shares of the transferor company, to the extent of overlapping ownership, need to be cancelled. A reduction of capital, therefore, follows.

In this record, one view of the courts is that reduction of capital encompasses any situation where the paid-up capital of the company is reduced. The cancellation of share capital as a result of amalgamation, as mentioned, would, under this view, amount to a reduction in capital. A narrower interpretation, upheld by certain other courts, however, does not include the cancellation of shares as a reduction of capital. The rationale here is that there is no release of assets. The assets and liabilities of the transferor company simply transfer to and are vested in the acquiring company upon amalgamation. Consequently, if such a view is followed by Pakistani courts, then provisions relating to the reduction of capital do not need to be complied with in the context of amalgamation. I subscribe to this interpretation.

E. STATUTORY REQUIREMENT AND HIGH COURTS’ JURISDICTION: As I have mentioned in the beginning of my talk, amalgamation of companies, excluding banking companies, to be effective, require sanctioning by the High Court. A scheme of amalgamation is a contract between the amalgamating companies and like any other contract, cannot be binding on creditors and dissenting shareholders. However, once the scheme is sanctioned by the court, it has statutory force. Consequently, the scheme once sanctioned would be binding on creditors and shareholders who oppose the scheme, I will therefore briefly set out the statutory requirement that must be fulfilled to enable the court to sanction the scheme of amalgamation.

An application for amalgamation can be made by the company, its shareholders and even its creditors. It may be noted that such an application may be made even after a court has made a winding up order. The court has the power to cancel the winding up and allow the company to amalgamate. Therefore, if amalgamation is considered to be a viable option to revive an enterprise, the same would be available to enterprises that are presently in the process of being wound up.

The application has to be made in the High Court having jurisdiction which would be in the province where the company maintains its registered office. A problem ensues where two or more amalgamating companies have their offices in different provinces of Pakistan. Case law appears to suggest that a separate application has to be made and obtained in each of the High Courts where the registered offices of the amalgamating companies are situated. A practical solution to avoid going to different courts would simply be to shift the registered offices so that none of the amalgamating companies are registered in different provinces.

The relevant provisions in the Companies Ordinance being: Sections 284 and 287 apply only to friendly mergers and not to hostile takeovers. As such, the application has to be moved before the High Court by both the amalgamated and amalgamating companies. Section 289 in a very limited sense applies to hostile takeovers. I will discuss this provision later.

An amalgamation requires consent of 75% of the members or creditors present at the meeting at which a quorum is present. Such a meeting is to be held after the application is made to the court. In fact, it is the court that directs the holding of a meeting. In an amalgamation, it is typically a meeting of the shareholders that is called. However, the court in its discretion, may also call a meeting of the creditors. It is recommended that at the time of a filing the petition, written consent of a large majority of creditors in value be appended to the petition. The creditors will need to be satisfied that their security interests are not diminished in any way. Sometimes the scope of their
securities can in fact be enlarged. To take one example, suppose the acquiring company has granted a charge to the creditor on all its assets. Upon the amalgamation, the creditor would be entitled to a level of security greater than what it has bargained for because now the assets of the acquiring company would include the assets of the acquired company. As such, negotiations may be required with such creditors to limit the amount of their security up to a specified amount.

Two other procedural parts need to be mentioned. First, pursuant to certain provisions provided in certain court rules, publication of the proposed merger has to be made. Any interested party would be entitled to object to the same. Second, the court is required to give notice of an application for amalgamation to the Corporate Law Authority. The court is required to take the views of the CLA into consideration but is not bound by its recommendations.

Next, I will briefly set forth the criteria that the court may examine in deciding whether to sanction the scheme. In a Pakistani decision relating to amalgamation of Lipton Pakistan with Lever Brothers Pakistan, the following criteria was set forth:

1. The court must ascertain that the provision of the statute has been complied with. Essentially, the resolutions must have been passed by the statutory majority in value and by means of duly convened meetings.

2. The majority must have acted in good faith and not in a manner which may be construed as coercive to the minority.

3. Finally, the court must decide that the object of the scheme is fair and reasonable to an objective business person. However, if the court finds the scheme as a whole to be fair and reasonable, it is the duty of the court not to launch an investigation upon the commercial merits or demerits of the scheme which is the function of those interested in the amalgamation. In other words, the courts are not supposed to second guess business determinations made by the members and creditors, as the case may be.

Accountants and financial advisers play a very vital role in valuing the amalgamating companies. For example, if the value of the two companies is more or less the same, then one share of the amalgamated company would be exchanged for one share of the acquirer. There is also authority for the proposition that such exchange ratio need not exactly reflect the underlying value of the amalgamating companies. However, if it is required that the exchange ratio be precise, it is quite possible that shareholders of the acquired company would be entitled to certain fractional shares. This, for example, may be dealt with by utilizing the principle set forth in section 86 of the Companies Ordinance dealing with pre-emptive rights. All fractional shares can be combined into a jumbo certificate and then sold in the market. The cash proceeds upon the sale of the jumbo certificate could be distributed among the shareholders of the acquired company on a pro-rata basis.

Another point relating to amalgamation with respect to listed companies which is relevant in today’s environment is that case law has suggested that even though the stock exchange price would be a reliable index as to a company’s value, it need not be determinable. As such, if it is desired that the exchange ratio be determined on the basis of break-up value of the companies, the same, in my view, would be permissible.
I would next like to highlight certain considerations that a court has deemed irrelevant in deciding whether to sanction a scheme. In other words, the following are examples where the courts have felt comfortable in sanctioning the scheme:

1. The acquiring company is a new company with a nominal capitalization established for the purpose of amalgamating with the acquired company which is an existing company.
2. The acquiring company is a private limited company and the acquired is a public limited company.
3. The absence of any provision for dissenting shareholders in the scheme of amalgamation itself. The Companies Ordinance does not provide any specific appraisal rights for dissenting shareholders.
4. Also, objections raised to the effect that the scheme should not be sanctioned because one of the amalgamated companies is sick and the other is prosperous have been rejected by Indian and English courts. Thus, the court in Pakistan is highly unlikely to object to the amalgamation of a sick unit into a healthy one.

F. **TAKEOVERS** : The main distinction between a takeover and a merger is: that in a takeover, the control over the assets of the acquired company passes to the acquirer. In a merger, on the other hand, the shareholdings in the combined enterprise are spread between the shareholders of the two companies. Basically, the question is one of degree. Where the dominant and target company are of roughly equal size, a merger would make greater sense. Yet where the target company is much smaller, a takeover approach could be more efficient. Consideration for the takeover, in my view can be paid in the form of shares of the acquiring company or in cash.

Section 289 also provides a detailed discussion of the dissenting shareholders’ rights in the event of a takeover. Under section 289, where a company obtains nine-tenths of the shares under a scheme or arrangement, it has the power to compel the dissenting minority to part with its shares. Where nine-tenths of the shareholders have approved the proposed takeover, generally stated, prior court consent is not required. This is the biggest attraction of section 289. An application to go to court may still be made by the dissenting shareholders. However, this then takes the form of the minority shareholders’ remedy rather than a general requirement.

The procedure stipulated under section 289 allows the shareholders of the transferor company up to four months from the communication of the offer to accept the same. Such offer must be in accordance with the terms and conditions specified under sub-section(5) of section 289. Further the offer must be pre-approved by the Registrar, who shall also ensure that the other requirements under sub-section (5) have been complied with. In the even that nine-tenths of the shareholders in value of the transferor company do approve of the takeover, the acquiring company may, within a specified period, give notice in the prescribed manner to any dissenting shareholders that it desires to acquire their shares.

What is clear from a plain reading of 289 is that it enables the transferee company to acquire the shares of those who are willing to accept its offer without having to procure the prior approval of the court. Moreover, the section does not confer any right on the Court to consider the merits or binding nature of the scheme so far as it concerns the majority of shareholders who have willingly accepted it.
On the other hand, dissenting shareholders may, under the rights conferred upon them under section 289, make an application in the court within one month of being served with the notice by the majority. Any application made in this regard however would proceed on the assumption that the scheme and offer have been approved by the requisite majority of shareholders of the transferor-company and that they are fair. Only where the court finds some illegality like misrepresentation or fraud will it entertain an application from dissenting shareholders in the context of section 289.

As a side point, when nine-tenths of the shareholders of the transferor company approve the takeover, the acquiring company, under 289, is not only entitled but bound to acquire the shares of the dissenting shareholders on the terms accepted by the approving shareholders.

Section 289 also takes care of the situation where the dissenting shareholders do not give up their shares in their company. If the provisions of section 289 are satisfied, the acquiring company can pay for the shares of the dissenting shareholders to the transferor company itself. Such payment can be in the form of shares of the acquirer or cash. If applicable, the transferor company shall be bound to register the acquiring company as the holder of the shares instead of the dissenting shareholders. Any sums so received by the transferor company are required to be held in trust and for the benefit of the dissenting shareholders.

Finally, where a takeover is involved and less than ninety percent of the shareholders of the transferor company approve it, the proposal may still be sanctioned under sections 284-287 of the Companies Ordinance as an amalgamation. Although 289 and 284-287 apply to different situations, it is no defence to say that just because a takeover could not go through under 289, it may not be reviewed under 284-287. In fact, it may be so reviewed.

G. **RECOMMENDATIONS**

Given the apparently prevalent mood in the country that amendments to existing laws and adoption of new laws will somehow cure the ills of our society, in that same spirit, I would recommend a certain change in laws in respect of amalgamation:

1. The power to sanction a scheme under the Companies Ordinance should be given to the Corporate Law Authority instead of the courts. This would be in tandem with the powers of the State Bank. Various judicial authorities have held that since the State Bank is an expert in banking matters, courts will not second-guess decisions of the State Bank unless mala fide intent can be shown. Similarly, the CLA which is hopefully now becoming more autonomous and independent is the expert in respect of corporate governance and therefore should be given jurisdiction to sanction schemes of amalgamation. Perhaps more importantly the CLA route is probably much more expeditious as compared to going through the Court process.

2. Tax laws should be amended so that when a sick loss-making unit is merged into a healthy one, the healthy unit is entitled to set off and carry forward the losses of the amalgamated unit. This will prompt companies to acquire sick units and thus rehabilitate units which would have otherwise been bound to extinction.

3. More liberal laws should be promulgated whereby pre-emptive rights can be waived in the context of debt equity swaps. This will be of great assistance to lenders to substitute debt owed by companies for their equity and thereafter amalgamate one or more such units and hopefully sell the amalgamated entity for a reasonable price.
4. Guidelines should be prescribed by the CLA to facilitate takeover; especially hostile takeovers. This may do much to vibrate the depressed stock market.

Author(s)
If you would like further information on any issue raised in this note please contact:

Khozem A. Haidermota
HaiderMotaBNR
Senior Partner,
khoom@hmcobnr.com
+92 (021) 111-520-000

www.hmcobnr.com