MERGERS AND TAKEOVERS : A SOLUTION TO SICK INDUSTRIES IN NEPAL

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Introduction

At the very outset I would like to make a statement to the effect that, " Inefficient companies not generating wealth to the fullest possible extent are the social liabilities and waste of resources. Therefore the corporate law must be designed in such a way and market must be evolved in such a way that there is always a room for takeover of such inefficiently managed companies by those companies which see better prospect in its takeover." The issue of takeover and merger is a hotly contended corporate transaction. It involves the principle of survival of fittest and the very basis of the exercise in the end becomes making some extra dollar or a rupee for an equity investor and for investment banker.

Social Policies Behind Mergers and Takeovers

There are certain major social policies involved in promoting merger and takeovers. Firstly, merger and takeover puts an end to cutthroat competitions among the companies engaged in delivery of services and products in the same area. But this has also one serious disadvantage in that there could be always an attempt to monopolize the product or service and dictate the price to the consumers. This in turn could lead to artificial price rise and compromise in quality of service. In order to prevent any distortions in perfect competition market in any product due to such mergers and takeovers, the state has to enact the anti-trust or anti monopoly and restrictive trade practices law. Promotion of law and practice of merger and takeovers without corresponding anti-monopoly law could lead to complete control of economy by few business families.[2]

Secondly, merger and takeover may also lead to fantastic synergies in corporate world. This could lead to better quality in service and reduction in price too. For instance takeover of coal mine by railway companies in United States, takeover of film studios of Hollywood by film production companies of Los Angeles, merger of tea farms with tea processing company in India and many more combinations led to wonderful synergy in corporate world. This kind of combinations could

[1] LL.M, Columbia, (corporation), LL.M, Delhi, (constitution)
[2] Nepal to date doesn't have anti-trust or anti-monopoly law.

lead to benefits for equity investors of both the companies (merger company and survivor company) and yet benefit the society lot more.

Thirdly, merger and takeovers always keeps the management of companies on guard. This compels company managers to work hard and give the company maximum out put. If the management of company by any chance becomes weak and inefficient and consequently leads to decline in share value then there will always be threat of takeover by another company with lot more resources. In New York for instances there are paid consultants and investigators hired by companies to find out the companies which may be worth taking over. Companies in New York (mid seventies) made millions and billions of dollars overnight in taking right decisions for takeover and mergers. But there are many more who have gone bankrupt for taking wrong decisions. Hence the companies in USA and Europe often spend lot of money in investigation, analysis, valuation and future prospect of the companies. These investigations entail cost and they are deliberately incurred with the hope of finding a suitable company for takeover.

Types of Corporate Combinations

Corporate combinations can principally take three statutory forms : **mergers (and consolidations**); **asset acquisitions**; and **stock acquisitions** . While each of these forms comes with its own corporate law requirements-- as well as its own tax and creditor protection rules-- the basic end of each is largely the same : the assets (and liabilities) of two companies are brought under one corporate roof. In this article we intend to see the possibility of different types of corporate combinations under the existing company law of Nepal and their comparative study with that of Delaware General Corporate Law (USA).

(a) Mergers

Mergers are a statutory mechanism to combine two companies into one. In Merger there is a combination of two companies. One which merges (and looses its existence) is called merger company and the one with whom merger company is merged is called the surviving company. To give an example, if company "A" is merged into company B, then company A is known as ***Merger Company*** and Company "B" is known as ***Surviving Company***. Company A looses its existence and Company B continue to exist with additional assets and liabilities of Merger Company. By contrast, in a consolidation, two companies are combined and neither survives. In ***Consolidation*** both the companies loose their existence and emerge as a third entity with new name and new charter. In consolidation, a new

company is created by consolidation of both the pre-existing companies. Since there are some regulatory benefits to have a company survive, consolidations are very rare in practice.

In a merger, the assets and liabilities of both companies become assets and liabilities of the surviving company as a matter of law . The same is not true for the shareholders. In some mergers (so -called ***"cash mergers"***) , shareholders of one of the ***constituent companies*** (companies party to merger program) receive cash or debt securities, while shareholders of the other companies receive (or retain) stock of the surviving company. In ***"stock mergers"***, shareholders of both constituent companies receive stock of the surviving company.

It may be kindly noted that one of the most beautiful aspect of corporate law is the separation of shareholder personality from that of the personality of the company. Hence shareholders may come and go, but the company may go on. Hence in Mergers the designation of which company survives does not depend on the treatment of shareholders. It is some time possible to have a cash merger where the shareholders of the surviving company are cashed out and the shareholders of the other companies receive stock of the surviving company. To take an example, company A may be merged with company B. Company B will survive and company A will come to an end. However in this merger, the deal may take the form of cash merger. In this cash merger, the arrangement could be that the shareholders of Merger company, instead of selling their share to the surviving company B, may buy the shares of the surviving company and then become the owner of the surviving company.

A regular merger under section 135 of the Company Act requires the approval of General Body Meeting by special resolution. A special resolution has to be approved by 75 % of the total share value represented in the general body meeting of the company. Unlike in Delaware/USA and many other European jurisdiction, a regular merger under Section 135 of the Company Act of Nepal doesn't require the approval of the shareholders of survivor company. It is extremely surprising that the shareholders of the surviving company have not been given any say in the merger decision. The Act does not require the shareholders of the surviving company to approve the merger. The approval of share holder of the surviving company, however, will become mandatory if the merger involves change in the charter of the surviving company. The Act does not give any right to appraisal to the shareholders of the surviving company either. Right to appraisal is conferred only to the dissenting shareholder of merger company. This is one of the serious

lacuna in the Company Act of Nepal that needs to be addressed with immediate effect.

Many times the impact of the merger is more on shareholders of the surviving company rather than the shareholders of the merger company. There are times when the share price of the surviving company crash in the stock market due to wrong decision. The surviving company even go bankrupt and is forced to go in to liquidation.[3] It is not asking too much if the shareholders of a surviving company ask for their approval before they tie their fortune with another strange company.

It may also be noted that the company law of Nepal does not even address the issue of merger of subsidiary company with the holding company. Usually a holding company with its share holding of 75% share capital in any subsidiary company should be able to merge any time it wants. To require such a subsidiary company to pass a special resolution for merger does not make sense as it would be a forgone conclusion. However the law as it stands in Nepal the special resolution need to be passed to merge such subsidiary company with holding company. The rationale is that the merger has no major economic effect on the parent's shareholders (thus obviating the need to get their approval) and that, given the parents stock ownership, requiring approval by the subsidiary board and shareholders would be a meaningless formality.

When we compare the situation in most popular corporate law of United States (Delaware General Corporate Law) the things are quite different. For instance, a regular merger (under section 251 (c) of the DGCL) requires approval by the board of the directors and the shareholders of both constituent companies. Two sections of Delaware law ease this approval requirement for certain types of mergers. First, and more importantly, section 253 provides for short-form mergers. It is available when one constituent company (the parent) owns at least 90% of the stock of the other company. Generally, the only party that needs to approve a short - form merger is the board of directors of the parent. The rationale is simple and that is the merger has no major economic effect on the parent's shareholders.

The other section that eases approval requirements is section 251 (f) of DGCL. This section dispenses with the requirement of shareholder approval by the surviving company if shareholders of that company retain their shares, the charter of the surviving company is not changed, and the number of any new shares of the

[3] In Nepal there is no law for bankruptcy proceeding. Most of the companies directly go for liquidation and asset sale.

surviving company issued in the merger to shareholders of the other company does not exceed 20% of the shares of the surviving company outstanding prior to the merger. Mergers under section 251(f) thus require approval by one set of shareholders and two sets of board of directors. Incidentally, stock exchange rules require listed companies to obtain shareholders approval whenever they issue new shares in excess of 20% of outstanding shares.

In the United States, corporate wizards have invented several methods to avoid the process of shareholder approval. This becomes necessary for corporate leaders if they find the shareholders non-cooperative. In practice , shareholder approval by one company is often avoided (or rather, made into a formality) by structuring a merger as a " triangular merger ". In a ***triangular merger***, one company ("XYZ") forms a subsidiary ("***Sub***') and that subsidiary merges with the second company (" ***Target*** "). The merger requires approval of subsidiary company and Target company's shareholders and directors. Sub's sole shareholder, however, is XYZ and sub's share are voted by XYZ's managers (which will presumably also sit on sub's board of directors) Sub's shareholder and approval can thus be easily obtained. Both cash mergers and stock mergers can be structured as triangular mergers . In cash mergers, the shareholders of the company that are cashed out will always have to vote on the mergers. (Obviously, as XYZ does not itself participate in the triangular merger, XYZ's shareholders cannot be cashed out in one.) A triangular merger also has the benefit of shielding XYZ's other assets from Target's unknown future and undeclared liabilities if there are any. Since Target's operations will be run through a separate subsidiary, XYZ would not be "personally" liable if the liabilities of that subsidiary exceed its assets. This form of triangular merger is very much a possibility within the existing legal framework of Nepal.

(b) Asset Sales

In an asset sale, one company acquires the assets of another company by contract. The acquiring company can pay in cash or in its own shares; and if the selling company liquidates after the asset sale, the end result is economically very similar to merger. There is however some of the significant differences in asset sale and merger. Incase of merger both the assets and liabilities of the merger company are transferred to the surviving company by operation of law. But in asset sale the liabilities of the selling company do not get transferred to the buying company by operation of law. It can be done so only if the sale contract specifically says so. It is interesting to note that the law in Nepal does not require the shareholders

approval for sale of assets. Hence the question of giving appraisal right to dissenting shareholder also does not arise.

To compare the Nepalese law with that of Delaware General Corporate Law, it may be noted that as a matter of DGCL corporate law, sales of all or substantially all of the assets require the approval of the board of directors and the shareholders of the selling company. (See section 271 of the DGCL.) In Delaware State of USA, shareholders of the selling company, unlike shareholders in a merger, do not obtain appraisal rights. Approval by shareholders of the acquiring company is not required-- subject again to the caveat for stock exchange rules (which require shareholder approval for a decision to issue more than 10% of new stocks of shares) and charter amendments (which again require approval of shareholders). In Nepal too the shareholder approval of the buying company is not necessary. However this again is subject to the condition that if the asset purchase is being paid by issue of new shares and if it involves exceeding the authorized capital, then obviously the shareholder approval becomes necessary. Assets sales have few advantages over triangular mergers and one major disadvantage. One of the biggest advantage is that the acquiring company does not have to worry about the liabilities (known or unknown). And the disadvantage is, since assets are transferred by contract, not automatically as a matter of law, an asset sale required more extensive documentation and title work than a merger.

(c) Stock Acquisitions

In a stock acquisition, one company buys the stock of another company and thereby obtains indirect ownership of the other company's assets (subject to its liabilities). There are different legal requirements for accomplishing this task. When we see the company law of Nepal, there are some serious complications. Generally speaking, on the selling side, stock acquisitions require only shareholders who want to sell stock. Formally, no approval of the directors of the public company, the stock of which is sold, is required. On the buying side, no shareholder approval is required either, subject to the usual caveats.[4] If the stock acquisition is done on the basis of stock for stock exchange and if the issue of stock of the buying company to the shareholders of the selling company exceeds the authorized capital of the buying company then it will be necessary to amend

[4] The caveat is – issue of more than 10% of total shares require share holder approval. If the stock acquisition is done on the basis of stock for stock exchange and if the issue of stock of the buying company to the shareholders of the selling company is more than 10% of the total shares (of the buying company) then shareholder approval of the buying company becomes essential under Delaware Law of USA.

the charter of the Buying company. The amendment of the charter requires shareholder approval. Stock acquisition in such case requires the prior approval of shareholders by way of special resolution under Section 68 of the Company Act of Nepal. In Delaware State of USA, stock for stock acquisition involving issue of more than 10% of total issued shares of the buying company requires the shareholder approval. Stock for stock acquisition in any case has to also abide by the rule of law concerning insider trading as well.

If the company, the stock of which is acquired is closely-held or a subsidiary of a public company, a stock acquisition can by itself have the same economic impact as a merger –ownership by the buying company of all of the assets of the selling company-- and is often a useful way to structure an acquisition. If the company the stock of which is acquired is public, however, it is generally exceedingly difficult to make sure that all of the numerous shareholders of that company sell their shares. What is generally done instead is to buy up a large majority of the shares in a tender offer and, after completion of the tender offer, cash-out the remaining shareholders in a triangular merger. Since the shareholders of the private company are not authorized to sell their share to persons other than their own shareholders without the amendment of the charter to that effect, the question of tender offer and hostile takeover does not make sense in their case.

Both friendly acquisitions (i.e.; those approved by management of the acquired company) and hostile ones (i.e.; those opposed by it) are often structured as stock acquisitions via a tender offer followed by a merger. Friendly acquisitions are structured this way because the tender offer takes less time to consummate than a merger. (And once the tender offer is consummate, the acquiring company effectively controls the target.) Hostile acquisitions are structured this way because unlike a merger or an asset sale, a stock acquisition does not require approval by the target's board of director. It may however not be forgotten that although such approval is not technically required, Board of Directors of the Target company may have several means at their disposal to impede, and often block, hostile takeovers. There is a huge area for exploration on the techniques adopted by Target Company Board to block hostile takeovers. This topic obviously need separate consideration. Similarly, in mergers the dissenting shareholders always have a right to appraisal for their share value and opt out of program of merger and combinations. This is a right guaranteed to the minority shareholders and this also needs separate considerations.

Commercial Banks and Defaulting Companies in Nepal

In the past two to three years, Nepal Rashtra Bank have been putting tremendous pressures on commercial banks to go hard on defualing companies. Several mega companies including Fulbari Spa Resort Pvt. Ltd and Mount Everest Brewery have been blacklisted and are up on sale. Banks have adopted both the asset sale and share transfer as the means for recovery of the debts. In the asset sales companies bid in the auction for takeover and they are often funded by other commercial banks in making bids. In many cases the banks and prospective buyer company settle the debt through negotiation and share transfer. The advantage of recovery of debt through share transfer is that it can be sold in instalments and to various combinations of the investors. In a bid to buy the assets, a buyer has to arrange the entire purchase price. One of the techniques adopted by the banks these days in major consortium funding is that they not only ask the promoters of the company to pledge their assets but also pledge their shares as a security for payment.

Conclusions

Merger and takeovers take place in a matured corporate world. The development of market for mergers, takeovers and acquisitions require transparency and accountability in corporate governance, institutional investors, well developed capital market, liberal and well defined corporate law, perfect competition and financial discipline in corporate accounting. Nepal still lacks all these basic conditions for development of market for merger and acquisitions. Most of the public companies continue to be exploited by big families. There is lack of transparency in Corporate accounting. Often the figures presented in the statements presented to the company registrar and stock exchange does not reflect the real financial status of the company. Most often the majority shareholders of the public company deliberately default the transparency compliance in order to delisted. Delisting of public company from Stock Exchange enable them to practically freeze all the shares of the minority shareholders. Besides a delisted company gets out of the monitoring and reporting jurisdiction of the stock exchange. A public company shareholder is under a compulsion to sell the shares through the stock exchange. The public companies are managed by big business families who often use the public company to transfer the benefits and opportunities to the private companies separately owned by their own family members. Unless these public companies develop a fair corporate culture, it may be difficult for development of market for merger and acquisitions.