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IPBA NEWS AND LEGAL UPDATE



## Mergers and Acquisitions



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# IPBA JOURNAL

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# The President's Message



Dear Colleagues,

Time flies. I hope all of you have experienced a busy summer or winter with successes and enjoyable vacations.

One thing we need to pay more attention to is the number of members is 1,516 as of August 24, 2007, a 16.38 per cent drop from 2006. I hope every council member can spare some time to promote the IPBA. I recently went to Luoyang, an ancient city in Henan Province of Central China, and visited a law firm. After talking about IPBA membership and IPBA 2008 Annual Conference in Los Angeles, they immediately asked for application forms for membership and expressed their interest in attending the IPBA 2008 Annual Conference in LA. It reminds me that so long as we keep in mind the promotion of IPBA membership, more lawyers will join us. Let us really do something.

Mr Gerold W Libby has been doing an excellent job in the preparation of IPBA 2008 Annual Conference. I am sure it will be a very successful one. What worries me a bit is the visa problem for lawyers in the developing countries.

If IPBA 2008 Annual Conference LA Host Committee can find a way to help, it will be easier for those lawyers to be in our IPBA 2008 Annual Conference.

I would like to express my sincere thanks to Mr Arthur Loke and the Secretariat for their efforts and hard work, which makes my job easier and provides me an opportunity to learn from them. I also appreciate the work done by our officers and committee chairs in coordinating the various programs and organizing professional activities.

I look forward to meeting all our council members at the Kuala Lumpur Mid-Year Council Meeting.

*Zongze Gao*  
President

# The Secretary-General's Message



Dear IPBA Members,

The last few months have been purposefully busy for the Secretariat. All the Officers have been more active than ever before. Also, the enthusiasm and imaginative proposals of IPBA 2008 Annual

Conference organizers led by Gerold Libby, the President-elect, have kept the Secretariat busy and reflective as to what IPBA must do or be prepared to do to seize the 'opportunities' out there for more members, more revenue, and a more loyal membership base. Some of these issues to improve IPBA are already being discussed by the Officers, and if there is a new direction for IPBA that will result which can preserve the best qualities of IPBA and also give us a more dynamic and attractive organization, then so much the better for all of us.

Recently I attended the Presidents of Law Associations Conference in Jakarta as our President's representative. Most attendees were from national bar associations from Asia. The two main topics for discussion in this two-day conference was the response to foreign law firms wanting to set up offices in the various countries

whose economies have taken off, and also the issue concerning bar responsibilities in promoting the rule of law.

I can see how useful IPBA members can be to some of these bar associations in facing the issue of international law firms seeking entry to practice in local jurisdictions, as IPBA members have great depth of experience on this subject. I see us as a natural source of help to local bar associations in these matters. Even though bar associations are not our members, IPBA should extend our goodwill and co-operation to them whenever we can.

I shall be pleased to hear from those of you interested in this topic to give me some feedback as to what your jurisdiction's position is regarding this issue, and how IPBA can be of help to practitioners in your country. I see this issue opening an opportunity for us to recruit new members and to stay in touch with the leading members of the bar in this region. I do look forward to hearing from you.

*Best regards,*

*Arthur Loke  
Secretary-General*

# The IPBA 17th Annual Meeting and Conference in Beijing





## Tribute to Kenji Nakashima (1955–2007)

It is with deep sadness that I write about the passing of Mr. Kenji Nakashima. Kenji passed away on July 18, 2007, at the age of 52 as a result of complications arising from cancer, which he fought with great courage for two years.

Kenji graduated from the University of Tokyo in 1980. He was admitted to the Japanese bar in 1984 and joined Kitahama Law Office, where he remained for his entire career.

One of the most active IPBA members in Japan, Kenji was also one of Japan's most respected and influential insolvency professionals. Through his work, writing and teaching, Kenji was widely known in both domestic and international insolvency communities. It is difficult to summarize a career like Kenji's in a few paragraphs, but there are a few glowing examples of Kenji's work that stand out from the rest.

It was a lucky coincidence that Kenji was practicing in Los Angeles in 1991 when Maruko, Inc., a Japanese real estate giant, filed a corporate reorganization case in Japan and the trustee appointed in the proceeding filed a Chapter 11 case in the US to protect the company's assets in North America. This was the first parallel insolvency proceedings between the US and Japan. It was Kenji's genius and efforts, as the resident deputy trustee in the US that drove the case to a successful conclusion.

In 1995, Kenji was appointed as deputy trustee, and then trustee, in the corporate reorganization of Muramoto Construction Co., Ltd., a general contractor. At that time the economy in Japan was getting worse and the value of real estate was decreasing rapidly. No one knew how much further real estate prices would drop. Kenji developed an

innovative structure to reflect the selling price of collateralized assets to the secured claim amounts, which made the company's plan deflation-proof.

When Toshoku Ltd.'s corporate reorganization case was initiated in 1997, Kenji was appointed deputy trustee in charge of overseas matters, including the company's US subsidiary, which had filed a Chapter 11 case. Anyone who listened to Kenji's arguments in Davis Polk's conference room when negotiating with creditors and their counsel will never forget his strong and clear message, and the extremely persuasive logic of his arguments.

Kenji always played the role of leader and others pleasantly followed him. Not only did he play this role as a professional in complicated cases, but also as a friend, a teacher, a saxophone player in his firm's band and the director of a student theatrical company.

Kenji loved his wife, Sumie, and his two sons. When he learned of his disease, Kenji told me that

he was determined to live a dignified life as an example to his sons. Indeed, he did so, and in doing so, stands as an example to all of us.

We mourn the passing of Kenji Nakashima, as an outstanding professional, friend, husband and father.

*by Hideyuki Sakai<sup>1</sup>*

<sup>1</sup> Hideyuki Sakai is the managing partner of Bingham McCutchen Murase, Sakai & Mimura-Foreign Law Joint Enterprise in Tokyo, Japan and a member of the Insolvency Committee.



# Mergers and Acquisitions by Foreign Investors in China—Legal Framework and National Economic Securities Protection Rules



This article discusses how the Chinese government is actively taking legislative initiative in the hope of regulating foreign takeovers

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## Introduction

Long hailed as one of the most promising economic entities, China has been substantially attracting foreign investment. Statistics from Ministry of Commerce of the PRC ('MOFCOM') show that more than 570,000 foreign-invested enterprises have been set up since the open-up of the Chinese market in the 80's, attracting more than US\$665 billion in foreign investment. By September 2006, more than 200 countries/regions and over 480 of the Global 500 Companies have invested in China.

Looking at the Chinese market, the most popular option for foreign investors is probably to directly acquire their rivals ('M&A'), often those national champions with a considerable market share, thus indirectly acquiring the market share easily. They have encountered little difficulty until recently, where some deals have sparked off vigorous debate over the issues of national security and monopolization, as foreign investors are seen eager to take over the national champions, and even marching into the some strategically important industries.

In view of this, the Chinese government is

said to have been actively taking some legislative initiative in the hope of regulating foreign takeovers. Unsurprisingly, statistics show a cooling-off in the foreign investment since the second half of last year. Many have often attributed this to the Chinese government's ambivalent attitude in its future policy on foreign investment.

## M&A Rules and Relevant Regulations

### *M&A Rules*

On August 8, 2006, the MOFCOM, joined by the State-owned Assets Supervision and Administration Commission of the State Council ('SASAC'), State Administration of Taxation, State Administration for Industry and Commerce ('SAIC'), China Securities Regulatory Commission ('CSRC') and State Administration of Foreign Exchange ('SAFE'), amended and released the Provisions for Foreign Investors to Merge and Acquire Domestic Enterprises (the 'M&A Rules'). The M&A Rules, which take effect September 8, 2006, supersede the old M&A rules in China that were in place since April 12, 2003—the Interim Provisions for Foreign Investors to Merge and Acquire Domestic Enterprises ('Interim Provisions').

Consisting of 61 articles, as compared with the 26-article Interim Provisions, the M&A Rules which contain a number of key changes is by far

the most comprehensive regulation on regulating foreign takeovers in China:

- 1 On one hand, the M&A Rules permit the use of foreign corporation securities to acquire China companies. Although the 2003 rules did not expressly prohibit the use of shares as acquisition capital, the new rules make it clear that foreign companies can pay in the form of stock, cash or a combination of both when carrying out M&A deals in China. This new measure is in line with internationally-accepted practices and is seen as giving foreign investors a new financing option to carry out their Chinese acquisitions.
- 2 On the other hand, the M&A Rules grant MOFCOM express authority in anti-trust and M&A review. It is clear from the M&A Rules that China's key government agencies are increasing their attention to M&A activities, especially cross-border M&A activities and can be expected to be even more active in monitoring and regulating foreign M&A in China and prohibit foreign control transactions in key industries.

#### *Relevant Regulations*

The M&A Rules provide the basic framework in China for the approval and registration of acquisitions of domestic enterprises by foreign investors. Other regulations will also be applicable depending on the identities and industry sector(s) of the parties to the acquisition, whether foreign-invested enterprises ('FIEs'), state-owned enterprises ('SOEs'), or publicly listed companies.

- 1 FIEs  
Not all provisions of M&A Regulations apply to an M&A transaction for equity interest in an existing foreign-invested enterprise, but the Provisions for the Alteration of Investors' Equity Interests in Foreign-invested Enterprises (外商投资企业投资者股权变更的若干规定) shall first apply to these transactions. According to such Provisions, a direct equity interest acquisition/transfer in a foreign-invested enterprise requires the approval of the governmental authority for foreign investment which has originally approved the establishment of such foreign-invested enterprise. Furthermore, the consent of other partners of the target foreign-invested enterprise shall first be obtained and such other partners will have statutory pre-emptive rights to acquire the target equity interests of the transferring partner based on the same conditions. M&A Regulations shall apply if any provisions therein are not specified in

the Provisions for the Alteration of Investors' Equity Interests in Foreign-invested Enterprises.

- 2 SOEs  
The most important regulatory documents in relation to the issues of state-owned assets in an M&A transaction are Interim Measures for the Supervision and Administration of State-owned Assets of the Enterprises (企业国有资产监督管理暂行条例), Interim Measures for the Management of the Transfer of the State-owned Property Right of Enterprises (企业国有产权转让管理暂行办法), Interim Measures for the Administration of Valuation of State-owned Assets of Enterprises (企业国有资产评估管理暂行办法), etc. Such interim provisions establish a framework for foreign investment in SOEs and their transformation into FIEs. Such interim provisions shall also apply to other types of target enterprises if state-owned assets can be tracked in those other types of target enterprises.

The aforesaid relevant regulations on the administration of state-owned assets set out the following principle special requirements for the transfer of state-owned equity interests or assets:

- a The proposed M&A deal shall first be approved by the competent governmental authorities on the administration of state-owned assets;
- b The target enterprise shall verify the assets/equity interests and entrust an accounting firm to conduct an overall auditing. The approved valuation result shall be considered the basis for the transfer price of the target equity interests/assets.
- c For a state-owned target enterprise, formal consultation with the employees on their settlement arrangement is required by law.

- 3 Listed Companies  
The CSRC issued the Measures for the Administration of the Takeover of Listed Companies (上市公司收购管理办法, New Takeover Rules) on July 31, 2006 (effective September 1, 2006) following the release of the Measures of the Administration of Strategic Investment in Listed Companies by Foreign Investors (外国投资者对上市公司战略投资管理暂行办法, Strategic Investment Rules) by MOFCOM, SAFE, CSRC and other government agencies on December 31, 2005 (effective end of January 2006). Under the Strategic Investment Rules, if the foreign investor or its overseas parent owns no less than US\$100 million in assets or have no less than

US\$500 million of assets under management, the foreign investor is permitted to undertake a strategic investment of no less than 10 per cent of the shares in an A share listed company that has completed the share-trading reform (股权分置改革) and newly listed companies after the share-trading reform. Such investments are subject to MOFCOM approval and a three year lock up period. The Strategic Investment Rules offer foreign investors another option to invest in Chinese A shares in addition to the current Qualified Foreign Institutional Investors ('QFII') scheme under which foreign investors can apply for quotas to invest in the A shares.

- 4 Under the New Takeover Rules, a foreign investor now has the option to make a partial tender offer (in addition to a general offer) for the outstanding shares to obtain control of the listed Chinese target when the foreign investor has acquired 30 per cent or more of the shares. Previously, the purchaser must make a mandatory general offer for all outstanding shares to obtain control of the listed company. This is a significant change and it has seen to be offering greater flexibility, higher takeover efficiencies and lower costs for foreign takeovers of Chinese listed companies.

### National Economic Securities Protection Rules *Xugong Deal*

On October 25, 2005, Carlyle became the first foreign buyout group to gain control of a big Chinese state-owned company by paying US\$375

million for 85 per cent of Xugong—China's leading maker of construction machinery especially cranes, valued by the World Brand Laboratory as the most valuable brand in China's engineering-machinery sector. The deal was readily accepted by the local authorities and sent to MOFCOM for approval. Although this industry is officially open to foreign investment, Carlyle has been long awaiting for the approval by MOFCOM since.

Since the deal went public, there has been many objections across the nation, claiming that the deal would result in loss of technology to foreign investors, pose as a threat to the national economic security, or cause monopolization. There are also the skeptics putting forth that the state-owned assets are being cheaply sold.

The overwhelmingly strong opposition perhaps has sped up the promulgation of the M&A Rules on August 8, 2006, viewed by many as a statutory effort in tightening the control over foreign investment.

Still pending MOFCOM's approval, in October 2006, Carlyle agreed to reduce its stake in Xugong to 50 per cent at a consideration of US\$230 million, as concession to the authority. It was reported though, that MOFCOM did not approve of this amendment either, by reason of the strategic importance of the industry.

In a further attempt, Carlyle in March 2007 conceded to a non-controlling 45 per cent acquisition, with Xugong having majority representation on the board as well as the right to appoint a president to the joint venture. Yet, it is pending MOFCOM's final say.



Photo: Sorin Brinzeu

### *National Economic Securities Protection Rules*

In many developed countries, different mechanisms exist to protect their own national economic security and the national champions, often by engaging some means to control foreign entry into key industries and to avoid monopolization. The US has the Congress, Committee on Foreign Investment in the US ('CFIUS'), Exon-Florio and the antitrust law, and Canada has the legislation. Many countries have antitrust laws to resist potentially injurious takeovers. On the contrary, China does not have a specific securitization panel or laws conferring adequate protection in this connection. Rather, bits and pieces of the relevant provisions regulating M&As and antitrust are contained in various laws and regulations, which are far less than enough or easy to operate in reality. Now with the Xugong deal coming into the picture, many view that China is fast awakening to the call of protecting its national economic security and national champions.

#### **1 M&A Rules**

The most important provision on protecting national economic security and national champions can be seen in Article 12 of the M&A Rules. It requires a report to be filed with MOFCOM if a proposed foreign acquisition relates to a key sector, affects or may affect the national economic security or results in a change of control of domestic companies that own famous trademarks or traditional Chinese brands, failing which, MOFCOM may together with the relevant departments request the parties to terminate the transaction or to transfer the relevant shareholdings or assets or adopt some other effective measures, in order to eliminate the impacts on the national economic security so caused. In short, MOFCOM will have the power to veto a proposed M&A transaction. Although it remains unclear what 'national economic security' refers to, the law now provides MOFCOM a legal basis to act on in exercise of such wide discretionary power.

Another breakthrough is the antitrust review of outbound M&As. Under Article 53 of the M&A Rules, the following thresholds are provided, and meeting such thresholds will result in the mandatory antitrust review by MOFCOM and SAIC:

- a a party to the overseas acquisition owns assets of more than Rmb 3 billion in China;
- b the business turnover of a party to the overseas acquisition in the Chinese market in the current year is more than Rmb 1.5 billion;

- c the market share of a party to the overseas acquisition and its connected enterprise(s) in China has reached 20 per cent;
- d the market share of a party to the overseas acquisition and its connected enterprise(s) in China will reach 25 per cent as a result of the overseas acquisition; or
- e the number of FIEs in the relevant industry in China in which a party to the overseas acquisition has direct or indirect equity participation will exceed 15 as a result of the overseas acquisition.

By virtue of Article 53, MOFCOM and SAIC may veto such transaction if they view it to hinder the domestic fair competition or jeopardize the rights of consumers, hence enhancing the national economic security.

Nonetheless, the concept of 'market' in the M&A Rules has not been well understood, which is important in determining whether antitrust filing is necessary. Also, the M&A Rules has not established any specific organ for approving foreign takeovers

#### **2 The Guidelines on Antitrust Filing for Merger & Acquisitions of Domestic Enterprises by Foreign Investors ('Guidelines')**

On March 9, 2007, MOFCOM released the Guidelines to supplement the M&A Rules with a view to facilitating antitrust filing. Worth noticing is the concept of 'Relevant Markets' being introduced under Article 3 of the Guidelines for the first time, which to a certain extent aids the understanding of 'market' under the M&A Rules.

Still, there is no clear or detailed definition of 'Relevant Markets' under the Guidelines, though it addresses the particular issues such as (1) product markets and geographical markets; (2) the demand structure and supply structure of Relevant Markets; (3) the status of competition in Relevant Markets; and (4) certain information relating to the association of Relevant Markets.

At the very least, the introduction of the 'Relevant Markets' is another effort by MOFCOM in trying to perfect the mechanism guarding against monopolization and enhancing the national economic security.

#### **3 The Draft of the PRC Antitrust Law**

After some 19 years of drafting, the draft of the *PRC Antitrust Law* was presented to

the National People's Congress Standing Committee last June, meaning it has finally come under the legislature's scrutiny. Like antitrust laws in other countries, the draft of *the PRC Antitrust Law* has some important provisions to guard against foreign takeovers the national economic security.

It is proposed under Article 5 of the draft of *the PRC Antitrust Law* that the State Council set up a specific antitrust commission responsible for conducting, organizing and coordinating antitrust investigation. Such commission will also be the body governing the enforcement of antitrust law.

Article 17 of the draft of *the PRC Antitrust Law* would require the above mentioned commission be informed in respect of certain transactions that may cause monopolization. Such reports are mandatory where the sales in the preceding year, by the parties concerned exceeds Rmb 12 billion globally, and where the sales by one of the parties records over Rmb 0.8 billion within China. Under the same Article, the reporting thresholds may be subject to adjustment by the State Council, if the antitrust commission mentioned above views it necessary.

Many experts view the above provisions necessary to ensure a fair market, so as to protect the national economic security. However, as the draft of *the PRC Antitrust Law* is still being closely studied and the details have yet to fall in place, it only serves as a reference to a limited extent in ascertaining the PRC government's attitude towards foreign takeovers.

### Way Forward

The way the legislation is being put in place, albeit very slowly, shows China's initiative in controlling cross-border transactions for safeguarding its national economic security and national champions. Yet, what the foreign investors will face remains unclear, in view of the stagnant process of instating the relevant laws, especially the Antitrust Law. At this stage, a better way to ascertain this is perhaps by drawing reference to what the officials and relevant departments have to say:

1 In November 2006, Guo Jingyi, deputy director of the Department of Treaty and Law of MOFCOM, expressed in a forum that the national security issue triggered by foreign

takeovers was a valve of dual roles, both for damage control and safeguard, which China would not easily touch upon. In light of the promulgation of the M&A Rules, he also reasserted that foreign takeovers would still be encouraged and foreign investment be utilized for open-up of the market.

- 2 In January 2007, the SASAC and the MOFCOM issued a statement this January that the transfer of state-owned assets to foreign investors should be conducted in open property-right transactions on public exchanges.
- 3 In early March 2007, MOFCOM released an opinion on absorbing foreign investment, pointing out that the relevant laws should be perfected and fair competition be encouraged, foreign takeovers should be regulated and directed towards healthy development, hostile and monopolizing takeovers should be prevented, so as to ensure the national control in the important industries and key areas and uphold the national economic security.
- 4 Also in March 2007 during the annual sessions of the National People's Congress and the Chinese People's Political Consultative Conferences, a delegate urged to better protect the private section from overseas interest, saying that foreign takeovers threatened the national economic security.
- 5 A recent report by the investment study office of the National Development and Reform Commission ('NDRC') has made it clear that China should establish a specific organ for the investigation of foreign takeovers, which should consist of relevant personnel from departments including MOFCOM, NDRC and MOFCOM.
- 6 Apart from the above, some journals report that *Catalogue for the Guidance of Foreign Investment 2007* ('Catalogue') is currently under the final review by the government, which might restrict the entry into certain industries by foreign investment or might increase the threshold for such entry. It is speculated that the Catalogue will likely be applied to the Xugong deal and hence decide the outcome.

In view of the above, we conclude that the Chinese government is still very interested in keeping the foreign investment high, yet it has also realized that takeovers by such investment must be better regulated without compromising the national economic security. It is likely that the Chinese government will take into consideration of the voices across all fields and learn from other countries in deriving at the right laws.

# Mergers and Acquisitions in India



This article discusses the important issues arising from the transaction documents in acquisition deals and some of the legal and regulatory issues involved in such transactions

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Scouting for ‘merger and acquisition’ (‘M&A’) opportunities is an imperative part of corporate strategy for most companies. Large companies use this as a catalyst to be more competitive and cost effective and the relatively smaller ones to survive.

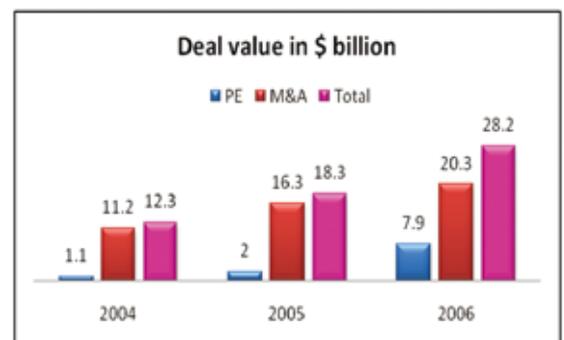
Sensing an opportunity, entrepreneurs today look at India as a lucrative market to venture into. Visibly, facts support this approach – there has been an upward surge in the number of merger and acquisition deals in India, which continues to multiply. The Asian M&A markets saw 3,352 deals worth 15.52 billion as of July 2007. With 553 deals worth \$31.40 billion, India is the second largest market after China. Clearly, this places India in a prime position in the global M&A arena.<sup>1</sup>

The upward trend of M&A merger activity in India and the surge in the number of private equity deals, especially inbound transactions, has led to many strategic investments, joint ventures and tie ups between Indian parties and foreign investors.

## The High Tide of M&A in India

The principle behind the surge in M&A deals is the tremendous increase in the confidence and support shown by banks and financial institutes

in the Indian companies. Given global liquidity and stock market prices, capital has become fairly inexpensive and therefore there is a high level of optimism. Also, with cross border deals maintaining their momentum, mergers and acquisitions in India are going to be on an uptrend, with significant deals expected to take place across sectors – auto ancillaries, retail, real estate, oil and gas and the financial sector. A large part of the rise in the M&A deals can be attributed to the contribution made by the private equity firms. The Private Equity (‘PE’) market in India continues to multiply every year – from US\$1.1 billion invested in 60 deals in 2004 to US\$2 billion in 124 deals in 2005 and US\$7.9 billion in 302 deals in 2006 – making it the fastest growing in Asia. An effect of this trend is also reflected in the change in the mindset of Indian companies, which now have successfully forayed into global markets, faced challenges and



have matured and grown in confidence. A host of external factors, like easy access to international funding, domestic funding through public issues in the domestic stock market, have also spurred international investors' interest in India Inc.<sup>2</sup>

That said, India still has a long way to go, given how big the global M&A pie is.

### Synergy

In India, M&A activity covers both true mergers where two undertakings entirely merge into a new entity, as well as other corporate transactions ranging from the acquisition of minority and majority shares to brand names.

Although defying the basics of mathematics, in the law of mergers and acquisitions, one plus one equals three, following the key purpose that is to create shareholder value over and above that of the sum of the two companies. The concept has proven to be most fruitful when target companies are suffering from acute losses, which they cannot recover from. The buyer company taking advantage of the situation can merge with the target company, thus acquiring all its assets and creating a more competitive and cost-efficient company. The target company will usually welcome the merger, as they know the chances of surviving alone are slim.

Mergers result in the formation of two or more companies into one, wherein the merging entities lose their identity. The process generally involves an exchange of shares between the two entities and no fresh investment is involved. More often than not, the buyer company retains its identity leaving no trace of the seller company.

In comparison, an acquisition does not involve the formation of any companies and no identities are thus lost in the process. It is simply aimed at gaining a controlling interest in the share capital of the company. In an era where corporate growth is the mantra for all business and in an age where regulations and policies to control the same have eased, mergers and acquisitions are becoming increasingly popular. They give business the opportunity to either expand in a completely new market or to extend their development in the existing market. Based on the objective profile of the offer, business operations such as mergers and acquisitions can be categorized as, horizontal, vertical circular or conglomerate and depending on which option the respective business decides to go with, the results and implications follow.<sup>3</sup>

The upside of M & A deals is what is commonly referred to as Synergy. 'Synergy is the magic force that allows for enhanced cost efficiencies of the new business.'<sup>4</sup> The force generally takes the form of cost saving and revenue enhancement and results in many viable

benefits for the company. The merged company on its commencement will although have duplication in those performing the various functions, once the merger is executed, there will be significant staff reductions and thus a considerable decrease in expenses. Contrary to what many philosophers will say, economies of scale suggest and propagate that size actually matters. A bigger company when buying anything, be it furniture or a new database, effectively saves more on costs. Another big advantage which specifically applies to conglomerate mergers is that it gives the companies an opportunity to expand to other markets and in effect substantially widen their horizon by giving it more sales and development opportunities.

Attractive as the thought of acquiring all assets and the magic of synergy seems, sometimes two plus two can also equal less than one. The flip side is that the buyer must also embrace all potential and current liabilities of the seller, for any liability of the seller would potentially be the sole responsibility of the buyer once the merger is executed. Whether it is compliance with environmental regulations, or checking the state of the seller's equipment, the buyer has to be extremely vigilant to all aspects of the seller's business. All implications need to be borne in mind by the buyer company before the merger is executed, as a merger only generates economic gain if as a result of the merger the two firms are worth more as compared to their worth whilst they were two separate legal identities. Thus, the due diligence of the target companies, which are intended to be acquired, is the most crucial and deciding factor of any M&A transaction.

### Legal Aspects and Transaction Issues in M&A deals

Legal counsel are usually roped in by the acquiring party to do a complete and comprehensive due diligence review of the investee company, before any investment is made in such company. The due diligence exercise which can be as extensive as personal interviews with the customers of the target company, is aimed at ascertaining the true position of the assets and liabilities of the target company as well as the reasonable price that should be paid by the investor for acquiring the shareholding or other interest, subject to the pricing guidelines applicable on foreign investors acquiring shares/fully convertible debentures in an Indian company.

In certain cases due diligence is also conducted by the management of the company or the seller. The scope of such due diligence is limited to gauging the ability to purchase, as well as other items that would affect the purchased entity or the seller after the sale has been completed.<sup>5</sup>

Any M&A transaction typically involves documentation including either a share purchase

agreement or a share subscription agreement as well as, at times, a shareholders agreement which spells out the rights and obligations of the parties going forward in the proposed venture.

Since most private equity deals in India, are not true mergers and more in the nature of an acquisition of interest by a foreign entity in an Indian undertaking, certain issues have to be borne in mind when finalizing transactions documents.

The most important issue under consideration usually is the percentage holding of the parties in the entity proposed to be formed to undertake the business. Since there are certain rights provided to minority shareholders at certain strategic shareholding levels under the Companies Act 1956 of India ('Act'), the same becomes crucial for both foreign and domestic investors. For instance, a shareholder with more than 25 per cent shareholding in an Indian company has the right to block a special resolution. Under the Act, certain matters can only be approved by a special resolution, which requires at 75 per cent majority. Some of these matters include altering the objects of an Indian company, alter or add to the articles of association of an Indian company, issue sweat

equity shares, change the name of the Indian company, buy back the securities of the company and reduce the share capital of the Indian company.

Other issues that are captured in the agreements include transferability instructions on the shares of the Indian company. It is common for parties to include restrictions such as pre-emptive rights in the shareholders agreement as well as the articles of associations of the Company. It may be noted that under the Act, the definition of a private company envisages that in such company there should be restrictions on transfer of shares. For instance, these restrictions may be in the form of pre-emptive rights *etc*, however it may be noted that the Honorable Supreme Court of India has ruled that even private companies would not be bound by any rights of first refusal if the same is not provided for in the articles of associations of the company. As for a public company, such a company in India cannot, by its very definition, have any restriction on transfer of shares. The Act (Section 111A) provides that there cannot be any restriction on the right to transfer of shares in public company and such right should remain unfettered. (*Rangaraj v Gopalakrishnan* (1992) 1 Comp LJ 11 (SC)).

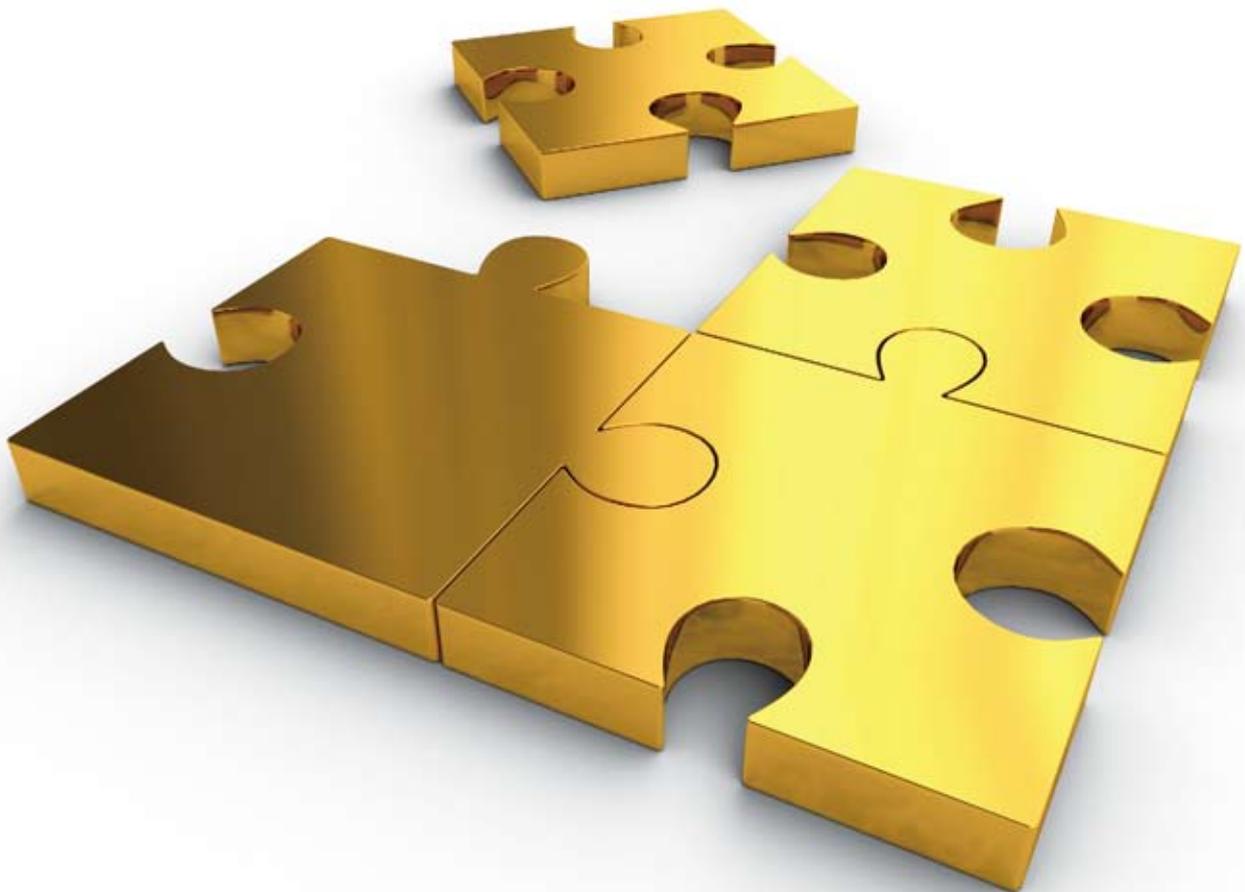


Photo: Androsov Konstantin

In addition to the above transaction issues, other significant legal aspects of acquisition transactions where foreign investors are involved include compliance with the foreign exchange laws of India. Transfer of shares of an Indian company by a person resident outside India to an Indian entity or *vice versa* is governed by the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000. In this regard, as a measure of further simplification of procedures (A.P. (DIR Series) Circular No. 16), government has decided to grant general permission and done away with the requirement of prior approval of Reserve Bank of India for transfer of shares and convertible debentures in respect of transfer of shares of Indian companies from residents to non residents and *vice versa* if the certain terms and conditions are met and reporting requirements as furnished in the circular is complied with.

Accordingly, banks have been asked to consider requests received from their constituents/customers for receipt/payment of amount on account of such transfers in accordance with relevant regulations, subject to obtaining the documents as required and ensuring that the transactions have been carried out in accordance with the conditions prescribed and the reporting requirements.

As regards subscription of shares by foreign entities, the price at which the shares are subscribed to by the foreign investor has to be in accordance with the pricing guidelines issued by the erstwhile Controller of Capital Issues.

In the case of listed Indian companies, any acquisition of shares is governed not only by the Act, but also the listing agreement signed by the target company with the relevant stock exchange and the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations 1997 as amended up to August 21, 2006 also referred to as the Takeover Code. The Takeover Code specifies the procedure for any attempted acquisition of substantial quantity of shares or voting rights of a company, which is listed at one or more stock exchanges in India.

The Takeover Code specifies various thresholds at which disclosures are required to be made by

acquirers as well as the trigger points for making of an open offer by an acquirer.

The automatic route as contained under the A.P. (DIR Series) Circular No. 16 as discussed above is not available to foreign investors acquiring shares of a listed company where the provisions of the Takeover Code are attracted.

### Conclusion

ICICI bank's private research division has come out with a Global Investment Outlook report, which says the total equity deals struck by Indian companies have crossed US\$50 billion in 2007. In the same timeframe last year the equity deals stood at US\$13.5 billion. These investments are also due to tightening of rules in China regarding foreign investment in Domestic Chinese firms. So many Global Investors have turned to India instead of China. The report expects the second half of 2007 to be even better than first, which should bring total investment in India to more than US\$100 billion by year end, a five fold increase over last year.

Clearly this year can be called the year for mergers and acquisitions, with augmented cash flows, high liquidity levels, change in mindsets and continued and notable reforms introduced by the Indian government to attract foreign investors. This facet now compares favorably to many economies in the global M&A arena. An upsurge in M&A has helped establish an outstanding record in innovation, growth and value creation across key sectors our sectors.

### Note:

- <sup>1</sup> Business World, website: [www.businessworld.in](http://www.businessworld.in).
- <sup>2</sup> Figures from Grant Thornton, Dealtracker Vol. – I, 2007 and Annual Issue 2006. Also see Business World, website: [www.businessworld.in](http://www.businessworld.in).
- <sup>3</sup> An analysis of mergers in the private corporate sector in India, P.L. Beena, March 2000.
- <sup>4</sup> Investopedia, website: <http://www.investopedia.com/university/mergers/mergers1.asp>.
- <sup>5</sup> Investopedia, website: <http://www.investopedia.com/terms/d/duediligence.asp>.

# Developments in Japanese M&A—2007<sup>1</sup>

This article discusses the emergence of Japan's new Corporate Law and how will it effect modern changes

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Recent developments in Japanese M&A law and practice have garnered significant attention, both domestically and overseas. Sweeping reforms in the laws governing M&A activity have been enacted, some of which will take effect shortly, and rapidly evolving market practices may herald the arrival of more modern and internationally-focused capital markets and corporate governance in Japan. The intent of the legislative changes is to modernize Japan's corporate laws, encourage M&A activity and bring the law more into line with international practice. Transactions that not long ago were almost without precedent, such as hostile tenders and proxy fights, have quickly become a part of the lay of the land, and Japanese companies are rapidly adjusting to the new realities.

The Japanese government spent several years preparing a plan to modernize its laws relating to corporations, culminating in the enactment in June 2005 of a new Corporate Law. The Corporate Law, most of which took effect in May 2006, was the most sweeping amendment to the laws governing corporations in over one hundred years. It is, in fact, the first time that a stand-alone Corporate Law has existed, as the laws governing corporations were previously scattered throughout Japan's legal code. The enactment of the new law therefore required that four laws be repealed and consolidated into the Corporate Law, and that 89 laws in total be amended. The new Corporate Law has replaced the rules relating to mergers that were contained in the Commercial Code and, when fully implemented, will greatly expand the range of possible transactions. Several of the most

significant of these provisions, however, will not take effect until May 1, 2007, and the impact of certain related tax law changes remains uncertain. It therefore remains to be seen whether these changes will have the broad impact that has been hoped for.

The modernization effort has also extended to regulation of financial products and securities markets, with the Securities and Exchange Law being replaced in 2006 with the new Financial Instruments and Exchange Law ('FIEL'). Among the developments resulting from the introduction of the FIEL is an overhaul of the regulations covering tender offers (known in Japan as 'TOB's). Like the Corporate Law, the FIEL's amendments to the TOB regulations are an effort to modernize—many would say 'Americanize'—the regulations.

## Corporation Law Amendments

### *Flexibility of Merger and Share Exchange Currency*

Perhaps the most significant change in the new Corporate Law from an M&A perspective is the deregulation of the types of currency that may be used in a merger or a share exchange (*kabushiki kokan*). A share exchange is a type of business combination which, upon the receipt of the requisite shareholder approval, all of the shares held by the public shareholders of the target are exchanged for shares in the acquirer, with the target becoming a wholly-owned subsidiary of the acquirer. Under the current rules, an acquirer may only offer shares in the surviving company to the shareholders of the disappearing company (in a merger) or to the shareholders of the company that will become a wholly-owned subsidiary (in a share exchange). These restrictions were somewhat liberalized with the enactment of the Law on Special Measures for Industrial Revitalization ('IRL') in October 1999, which provided limited exceptions to the general prohibition on cash consideration. Under the IRL, an acquirer may seek special approval from the

Ministry of Economy, Trade and Industry ('METI') to allow the acquiror and target to engage in a merger or share exchange for cash consideration. This treatment is only available to specific types of restructurings, and only where METI determines that the cash acquisition is necessary and proper. Approval under the IRL is therefore not an option for all acquirors.

The relevant provisions of the Corporate Law, which will become effective in May 2007, will enable an acquiror to use cash or any other assets as merger currency. In addition to opening the door to the use of securities such as convertible securities, this change will enable, for the first time, the widespread use of two major classes of transactions: cash-out mergers and triangular mergers.

### 1 Cash Mergers and Share Exchanges

A company will now be able to offer cash to the shareholders of a target corporation in a merger or share exchange, who will then have no continuing interest in the surviving corporation. This will make mergers more attractive in cases where a cash buyer wishes to acquire 100 per cent of a public company, as the acquiror will have the ability to acquire, for cash, the entire share capital of the target company in one step. In addition, it will enable cash buyers to quickly acquire control of a public company through a TOB, to be followed by a second-step cash squeeze-out merger using cash as consideration.

This will also level the playing field for buyers that do not have shares to offer as merger consideration, such as private companies, non-Japanese acquirors and private equity funds and other financial buyers. Such buyers will now have the opportunity to acquire a Japanese public company through a one-step cash merger or share exchange, or to acquire 100 per cent of a target by using a second-step cash merger following a successful TOB.

#### Potential tax issues

The benefits of this amendment may, however, be largely illusory, as a change to the tax code that makes cash squeeze-out transactions prohibitively expensive was enacted in October 2006. Under then-current rules, the taxation of cash transactions was similar to that in the US or Europe: the target company's shareholders would be taxed on any capital gains realized upon the receipt of their cash consideration, but the acquiror would not face any tax liabilities in connection with the purchase (with the acquired shares having a tax basis equal to the purchase price). Under the rules adopted in October, however, the entire transaction is deemed to be a non-tax qualified transaction, so

that not only will shareholders be taxed on their capital gains, but the tax basis of the assets of the target company must be revalued to reflect their fair market value—which would be equal to the implied purchase price of 100 per cent of the target company's shares. As many corporate assets, such as goodwill, real property and intellectual property, will typically have a low tax basis, their revaluation will result in an enormous taxable gain at an effective tax rate of up to 40 per cent.

Private equity firms and other cash purchasers in Japan have been actively exploring innovative transaction structures to avoid application of this revaluation tax. However, there remains significant uncertainty and risk—to the extent that some acquirors have postponed or abandoned potential acquisitions.

This uncertainty also puts foreign acquirors, financial buyers and private companies at a substantial disadvantage to domestic public companies that can use their shares as consideration in competitive bidding situations.

### 2 Triangular Mergers

The Corporate Law also will enable the use of shares of a third party such as a parent company as merger currency. Under the current rules, foreign acquirors have been limited to using the shares of a Japanese subsidiary as merger currency. In many, if not most, cases, this is simply not an option for a would-be foreign acquiror, as offering shares in an unlisted Japanese subsidiary is generally not an attractive proposition to Japanese shareholders. Nor would this be attractive to a foreign acquiror—as a practical matter, not all of the target shareholders would tender their shares in the tender offer, so minority shareholders would remain and constrain the acquiror's management of the company, as short-term share price considerations and minority rights would affect their decision-making. This effectively limited most foreign acquirors to the use of a cash tender offer for acquisition purposes.

The emergence of triangular mergers should serve as an alternative to a cash transaction for foreign acquirors desiring to acquire 100 per cent of a Japanese target company, who will now be able to use an unlisted Japanese subsidiary or a special purpose vehicle as an acquisition vehicle.

#### Potential tax issues

However, what the government has given with one hand, it (or, some would argue, the Japanese business lobby) is threatening to take with the other. The government is currently discussing new rules regarding the taxation of triangular mergers which, in their present form, would undermine the benefits of this new mechanism for foreign buyers. While the government's 2007 tax reform plans had

not yet been published as of the time of writing, a tax reform package announced by the ruling parties on December 14 would severely limit the benefits of the new triangular merger regime for most potential foreign acquirors. Similar to many major jurisdictions, the basic rule proposed as part of the tax reform package was that a triangular merger would not constitute a taxable event, thus allowing the shareholders of firms acquired through triangular mergers to defer their tax liability until the sale of the stock that they receive as consideration in the merger. After heavy lobbying from the *Keidanren* (the Japan Business Federation), however, the current draft of the tax reform package provides that this tax treatment would only be available if the two merging companies conduct business in related areas. In all other cases, target company shareholders would be taxed on their capital gains based on the value of the share consideration received in the merger or share exchange.

The effect (and, indeed, apparently the intent) of this provision is to make triangular mergers taxable transactions if the acquiring company is a special purpose vehicle. As foreign companies that seeking to enter the Japanese market for the first time would not have an operating subsidiary in Japan (or if its existing subsidiary does not conduct the same business as the target), this change in treatment will effectively mean that triangular mergers will be prohibitively expensive to such acquirors.

It is not yet clear when the final rules relating to the taxation of triangular mergers will be issued.

#### *Introduction of Short-Form Mergers*

One additional development of note in the new Corporate Law from a mergers and acquisitions perspective is the introduction of short-form mergers and share exchanges, which became possible in May 2006. The Corporate Law generally requires that a merger agreement be approved by a two-thirds majority of the shareholders of each corporation. Under the new short-form merger rules, however, if a parent corporation (a controlling corporation) holds at least 90 per cent are capital of a subsidiary (a controlled corporation), the controlled corporation can be merged into the controlling corporation without receiving approval of the controlled corporation's shareholders.<sup>2</sup>

This development may facilitate the restructuring of Japanese entities, and will simplify the acquisition of outstanding target shares in a second step transaction following a tender offer.

As noted above, however, the tax treatment of cash mergers and share exchanges will undermine the benefits of these simplified procedures.

#### **Amendments to Tender Offer Rules**

One major change accompanying the replacement of the Securities and Exchange Law with the FIEL is the adoption of new tender offer regulations. The amendments are intended to bring Japanese regulations into closer alignment with international



standards, improve disclosure and ensure impartiality between bidders.

To that end, significant changes have been made to both the TOB procedural requirements and the reporting requirements for participants in a TOB. The major procedural amendments include the following:

- a The permitted offer period for a tender offer will change from 20 to 60 calendar days to 20 to 60 business days.
- b If the target company takes defensive measures against the offer, the offeror may withdraw its offer and reduce its offering price. Under the prior rules, the withdrawal of an offer was permitted only in limited circumstances such as the bankruptcy of the target, or its entry into a competing merger transaction.
- c If an acquiror acquires more than two-thirds of a target's stock, it will be obligated to offer to buy all remaining holdings of shareholders who participated in the original TOB.
- d If a party that holds more than one-third of a company's shares rapidly acquires target company shares while a tender offer of another party is in place, the such shareholder will be obligated to also make a tender offer.

A shareholder will now also be required to make a tender offer if:

- a It acquires five per cent or more of a company's voting rights through off-market acquisitions; or
- b If an acquiror's off-market purchases exceeds 10 per cent of the target's stock when combined with the acquiror's existing holdings, wherever purchased.

Acquisitions of shares over a three-month period will be aggregated and treated as a single acquisition for purposes of the mandatory offer provisions. Any tender offer required under these provisions must be for at least one-third of the target's outstanding stock.

In addition, the categories of transactions to which the TOB rules will apply have been clarified. Largely motivated by Livedoor's rapid acquisition of a controlling stake in Fuji Television, the FIEL provides that purchases that will result in a shareholding of one-third or more of a listed company's shares, whether effected through the stock market or in privately negotiated transactions, will be subject to the tender offer rules.

In addition, there have been two major changes to the applicable disclosure requirements:

- a The reporting system for large shareholdings has been amended such that, if a shareholder's total shareholdings in a listed company exceed five per cent, the shareholder must submit a 'report on large shareholdings' within five days of the purchase that exceeded the five per cent threshold. Subsequent increases or decreases of one per cent or more will also necessitate the filing of a report within five days.
- b A requirement that the target company file a 'position statement report' regarding the offer has been introduced. The target company will also be given the opportunity to ask questions of the offeror, to which the offeror is obligated to respond. Target companies will also have the right to request extensions to the offer period.

### Defensive Measures

The long-standing Japanese system of stable capital markets characterized by cross-shareholdings among *keiretsu* groups and between major suppliers and customers has been slow to change. Recently, however, there have been signs that competitive capital markets, including a market for corporate control, are rapidly developing. These developments appear to be both a reaction to and a catalyst for the legal developments described above. Even before the new Corporate Law was adopted, the US investment fund Steel Partners made bids for Yushiro Chemical Industry Co Ltd in 2003 and Sotoh Co Ltd in 2004, and Sumitomo Mistui Financial Group Inc made an unsolicited merger proposal to UFJ Holdings Inc after it became public that it was involved in merger discussions with Mitsubishi Tokyo Financial Group Inc. These uncharacteristic transactions were swiftly followed by more unsolicited transactions, such as Livedoor's dramatic acquisition of control of Fuji Television through aggressive off-market purchases of Fuji's largest shareholder, Nippon Broadcasting System; Rakuten's bid for TBS; and Oji Paper's bid for Hokuetsu Paper Mills. More recently, shareholders of Tokyo Kohtetsu, led by the US based investment fund Ichigo Asset Management Ltd, rejected its proposed merger with Osaka Steel. This is believed to be the first time that a transaction recommended by management was rejected by a company's shareholders. Not long after that, US investment fund Steel Partners began a proxy fight in an attempt to stop Sapporo Holdings Ltd. from adopting defensive measures to ward off a proposed offer by Steel Partners to acquire Sapporo.<sup>3</sup>

While these transactions may herald the adoption of international-style corporate practices, they have also led to a backlash from many quarters. Hokuetsu's response to Oji's offer, for example, was clearly of the 'old Japan'—

style capitalism; after rejecting Oji's proposal, Hokuetsu quickly announced that it would issue new shares totaling 24 per cent of its outstanding stock to Mitsubishi Corporation at a seven per cent discount to the market price. Oji responded, to the delight of Hokuetsu's shareholders, with a formal tender offer to purchase 50.1 per cent of Hokuetsu's outstanding shares at a 35 per cent premium to the market price. Nippon Paper announced soon thereafter that it was purchasing 8.49 per cent of Hokuetsu's shares, dooming Oji's offer. In discussing its decision to purchase these shares, Nippon Paper's president said that an acquisition of Hokuetsu by Oji 'may disturb peace and order in Japan's paper industry.'<sup>4</sup>

Japanese corporations, faced with what many of them clearly view as unwelcome developments have scrambled to adopt defensive measures that US and European companies have developed in the face of similar markets for corporate control. The adoption of such measures had long been contemplated by government agencies in connection with the modernization of the Corporate Law. A Corporate Value Study Panel convened by METI and the Ministry of Justice issued guidelines regarding takeover defenses in May 2005. The guidelines adopted principals largely similar to those embodied in Delaware's corporate takeover case law, focusing on protecting shareholders' interests and corporate value, full disclosure and the reasonableness and necessity of any defensive measure that may be adopted.

Japanese companies have thus been quick to adopt the defensive measures that were made possible by the adoption of the new Corporate Law. In particular, the Corporate Law provides greater flexibility in areas such as the creation of different classes of shares and stock options, which has enabled the introduction of poison pills.

In addition, the new Corporate Law will permit a company to impose transfer restrictions on certain classes of shares, making it possible to create a 'golden share' that carries disproportionate voting rights. While this has been curtailed by the Tokyo Stock Exchange (the TSE), it remains a possibility in some circumstances.

The *Nikkei* newspaper reported before the end of February 2007 that 20 companies had already adopted takeover defense measures so far in 2007, and that nearly 200 have done so in total.<sup>5</sup> While a court recently ruled that poison pill

defenses adopted without shareholders approval are invalid, the number of companies adopting such measures is expected to increase as companies seek approval for them at their 2007 annual shareholders meetings.

### Stock Exchange Rules

Japanese stock exchanges have also adopted more stringent disclosure rules in recent months. The most significant of these, which has very recently taken effect, significantly expands the disclosure required in any press release announcing transaction that will result in the delisting of a TSE-listed company. The TSE has generally required that the press release include a much more detailed description of the determination of the offer price or merger or share exchange consideration. Early examples of this disclosure, which we understand have been heavily negotiated with the TSE before release, indicate that the TSE is requiring disclosure of the analyses conducted by each party's financial advisor in evaluating the fairness of the offer.

### Notes:

- <sup>1</sup> This article is based on our familiarity with Japanese law from our involvement in past and current transactions in Japan. However, we are not licensed to practice Japanese law, and the contents of this article should be confirmed by Japanese counsel before conducting any transaction.
- <sup>2</sup> The transaction will also not require the approval of the controlling corporation's shareholders if it issues less than 20 per cent of its stock to the controlled corporation's shareholders.
- <sup>3</sup> *Nikkei Newspaper* (2007). Steel Partners to initiate proxy fight for Sapporo control. March 13, Morning edition, page 11.
- <sup>4</sup> Wright, C. (2007). *Hostile bid subverts Japanese politeness*. Retrieved March 30, 2007 from <http://www.iflr.com/?Page=17&ISS=23208&SID=669484>
- <sup>5</sup> *Nikkei Newspaper* (2007). Nearly 200 firms introduce measure to foil hostile takeover bids. February 23, Evening edition, page 1.

# Arbitration of International M&A Disputes



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This article focuses on international arbitration in M&A disputes, its advantages, its effects and its procedural particularities

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### Introduction

Mergers and acquisitions ('M&A') are complex business transactions, in particular when they take place cross-border. They typically involve numerous corporate entities and lengthy, multifaceted agreements. As there is a multitude of specific problems and complications related to M&A transactions, it is inevitable that some deals result in disputes; all the more so since there is usually a considerable amount of money at stake.<sup>1</sup>

Arbitration has indeed emerged as the preferred method to resolve M&A related disputes, and today M&A is one of the fields of international business law with the highest proportion of arbitration agreements.<sup>2</sup>

### Advantages of Arbitration in M&A Disputes

Practice has shown that today, parties almost invariably agree on arbitration for the resolution of their disputes arising out of M&A.<sup>3</sup> Besides the more general arguments that speak in favor of arbitration (such as flexibility and finality of the arbitral award), there are a number of advantages which are of particular importance in the M&A context, especially when compared to state court litigation:

<sup>1</sup> The parties have the right to choose their own

arbitrators. Dealing with M&A disputes often means dealing with complicated valuation and accounting issues. The persons who decide the dispute must be knowledgeable about the industry and economic matters. State court judges may not always be qualified in this respect.<sup>4</sup>

- 2 Parties to an M&A deal usually strive to keep the fact of their dispute discreet and thus avoid publicity. They are also anxious to safeguard any confidential information *vis-à-vis* competitors.<sup>5</sup> Before state courts, confidentiality is not assured.
- 3 In disputes arising out of international transactions, it is important that the parties are free to choose the language of the proceedings. Court proceedings will invariably require the use of local language, whereas arbitration leaves room for the parties' discretion.<sup>6</sup>
- 4 Arbitrations often take place in a more amicable and business-like manner than litigation before state courts. Moreover, because economic aspects play a more central role, they frequently result in settlements.<sup>7</sup>

### Arbitration at Various Stages of M&A Transactions

The following section gives an overview, as well as a few practical examples, of the stages in mergers and acquisitions at which disputes may and do occur.

#### *The Negotiation Stage: Pre-closing Disputes*

M&A transactions usually begin with initial exploratory talks, an information memorandum, the signing of preliminary agreements and a negotiation phase which include due diligence investigations and discussions about the framework for the transaction.

Memorandum of Understanding or Letter of Intent Once the parties agree on the essential terms of the transaction, they typically wish to draw up and sign a Memorandum of Understanding ('MOU') or a Letter of Intent in which they outline the envisaged deal structure. Such 'pre-contracts' are often identified expressly as non-binding, but may create a quasi legal relationship which imposes certain obligations upon the parties, namely the duty to negotiate and act in good faith. Non-compliance with such duty may give rise to a dispute,<sup>8</sup> and may cause the deal-makers to consult their lawyers in particular on the binding nature of their 'agreement' and on how to enforce any obligation of the other party at that stage of the negotiations.

In order for such disputes to be resolved by means of arbitration, the MOU or the Letter of Intent needs to contain an arbitration agreement, which is not invariably the case. Alternatively, the parties may agree to submit the dispute to arbitration after it has arisen.

Confidentiality and exclusivity agreements MOU and Letter of Intent typically comprise agreements on a period of exclusive negotiations between the parties and on confidentiality regarding both the fact of the negotiations and the information that is being exchanged, in particular during the due diligence and in particular if the potential buyer is a competitor. Such clauses are often linked to contractual penalties and, typically, disputes will revolve around the aggrieved party's right to ask for damages or rapid injunctive relief.

#### Due diligence

The outcome of any due diligence is critical to the parties' further negotiations and generally has far-reaching consequences for the deal. The due diligence process therefore frequently gives rise to disputes. The most common area of controversy is the scope of the pre-contractual duties of disclosure of the seller. Questions that may arise concern the completeness of the information provided by the seller in the data room and the obligation of the seller to disclose certain sensitive information or difficulties at that early stage, without having been expressly asked to do so by the buyer.

#### *The Post-Closing Stage: Disputes Arising from Merger/Purchase Agreements*

Most M&A disputes arise after closing, *ie*, after the parties have signed the merger or purchase agreement and transferred the assets.<sup>9</sup>

#### Representations and warranties

Post-M&A arbitrations frequently result from claims of the buyer based on contractual representations and warranties. Many of the seller's representations about the target company

concern the correctness of its financial statements, the absence of liabilities other than those reflected in its latest balance sheet, the seller's title to the assets and compliance with applicable laws.<sup>10</sup>

An important source of disputes are ambiguous or incomplete representations and warranties which allow the buyer to easily claim that the seller is liable for breach of contract or misrepresentation. On the other hand, the seller may ask that certain claims be excluded by reference to independent assessments made by the purchaser or its knowledge gained in the due diligence process. If representations and warranties turn out to be inaccurate, *eg* certain assets on the balance sheet are inexistent or over-valued, the purchaser will claim damages or an adjustment of the price.<sup>11</sup> Disputes may also arise over representations as to pending or threatened litigation.<sup>12</sup>

#### Earn-out clauses—Price adjustment

Purchase agreements often provide for a provisional price combined with an 'open-ended' adjustment mechanism. The most common post-M&A disputes, by far, relate to earn-out provisions and purchase price adjustment calculations.

Earn-out clauses provide for an additional purchase price that the seller will receive, based upon the future earnings of the target over a stipulated period (earn-out period). Unsurprisingly, such clauses frequently end up being a bone of contention between the parties when the future performance does not meet the buyer's expectation.

Purchase price adjustment clauses may provide for an adjustment mechanism based upon a change in a specified benchmark, such as the net asset value of the target company, between the date of the financial statements that were used to negotiate the purchase price and the closing balance sheet upon which the purchase price is ultimately determined.<sup>13</sup> The following recent example demonstrates the kind of complications that can originate from purchase price adjustment clauses.

In an international arbitration administered by the Zurich Chamber of Commerce under a contract subject to German law, the claimant company had sold its shares in the defendant company to the defendant and its holding company. The defendant then changed its articles of association and increased its share capital by issuing new shares to a third company. The arbitral tribunal was required to interpret the price increase clause included in the share purchase agreement. It ruled that, although the clause did not expressly cover the increase of share capital, such increase nevertheless constituted a betterment that came under the scope of application of the price increase clause. Consequently, the arbitral tribunal ordered the defendants to pay additional amounts on the purchase price plus interest to the claimant. The defendants' motion to set the award aside was

denied by the Swiss Federal Tribunal.<sup>14</sup>

#### Valuation—Expert determinations

Most sale and purchase agreements contain valuation<sup>15</sup> or purchase price adjustment clauses providing for a two-stage dispute resolution mechanism, expert determination followed by arbitration.

At the expert determination stage, if the parties cannot agree upon a valuation or adjustment, an independent third party (forensic) accountant will be retained to determine the resolution of certain specific questions that are well circumscribed and generally facts-based.<sup>16</sup> However, the parties should ensure that the contract contains an effective appointment mechanism, failing which, the expert procedure might not be operative. On the other hand, clauses that name the expert may also be dangerous.

Both points were well illustrated in a recent case arising from a share purchase agreement between US and French parties which provided for a two-prong dispute resolution mechanism: expert determination followed by arbitration in Geneva. The contract listed a number of large audit firms from which the expert should be selected. By the time the dispute came about, however, all of the eligible firms had disappeared or merged, or were conflicted. The defendant refused to nominate its member on the panel of experts. The claimant turned to the Geneva courts to obtain an appointment by default, as provided in the contract. The Geneva court, in a decision of July 5, 2004, denied the application.<sup>17</sup> It considered that the arbitration law empowered the courts at the place of arbitration to appoint an arbitrator in case the other party was to default, but that these provisions did not apply to the nomination of experts. The applicable Code of Civil Procedure was no help either. It listed exhaustively the cases where a party may apply to the court for an expert appointment, but the list did not include cases where a party seeks the unilateral appointment of an expert to establish facts that are contentious among the parties.

During the expert determination process, the accountant-expert acts as an expert, not as an arbitrator, *ie* he or she neither tries to achieve a resolution of the dispute as a whole nor renders an award that could be enforced against an uncooperative party.<sup>18</sup> However, the parties can provide that the expert's determination of a specific factual issue will bind the arbitral tribunal dealing with a subsequent larger dispute. In general, expert determinations prove to be quick and cost-efficient procedures for resolving certain types of disputes.<sup>19</sup>

If and when the dispute moves to the second level (arbitration), the dispute is resolved as a whole, and results in a binding legal determination.

It is however not wholly independent from the expert determination stage. First, as noted above, the facts established by the expert may bind the arbitrator. In addition, the arbitrator may have to intervene prior to the expert, for instance in order to decide whether a dispute is subject to arbitration or should be deferred to the expert. The arbitrators might also be asked to determine the content of a given balance sheet item impacting upon an evaluation. The expert will then establish the correctness of a financial statement.<sup>20</sup>

The interface between such two (or parallel) dispute resolution mechanisms is a source of frequent disputes. The following 2002 case from the US is a good example of the problems that may arise if the dispute resolution clause is not sufficiently clear.

The parties had entered into a share purchase agreement which provided that the 'Final Share Price' for the sale was to be determined by the buyer's accountants and which specified that such determination '*shall be final and binding on Seller and Buyer and shall not be subject to any appeal, arbitration, proceeding, adjustment or review of any*

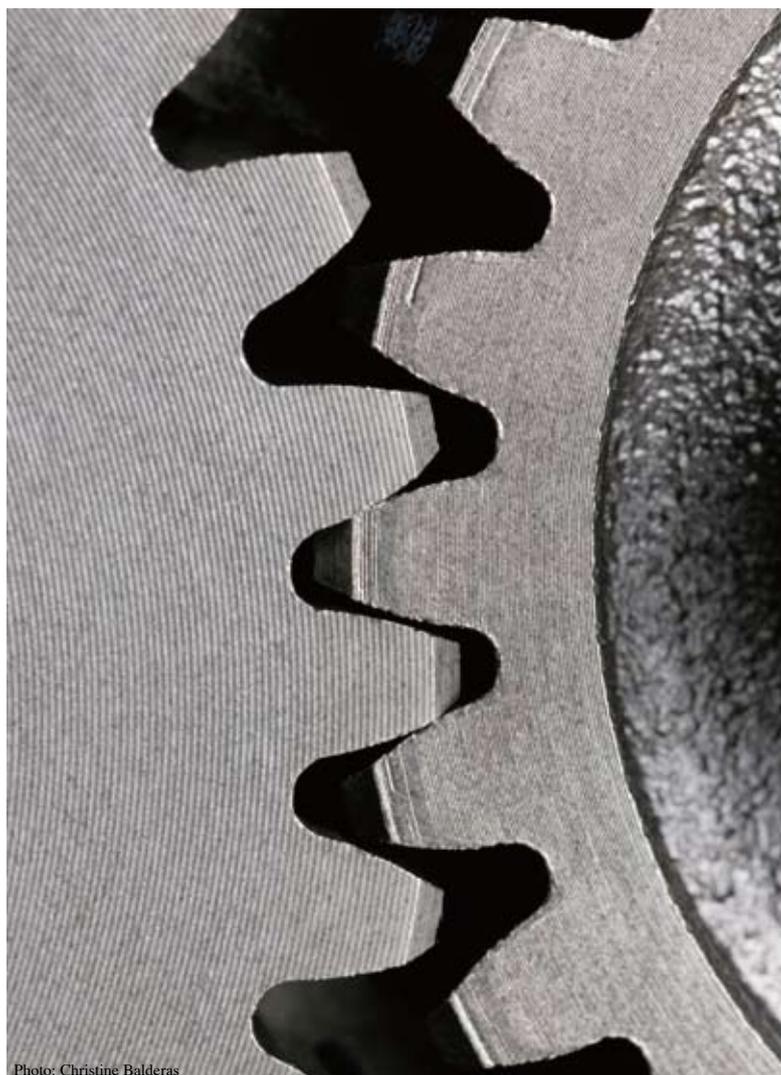


Photo: Christine Balderas

*nature whatsoever.*' The agreement also provided that all disputes arising under it were to be resolved by arbitration. Following the accountants' submission of a valuation substantially lower than that expected by seller, the seller initiated arbitration proceedings seeking to invalidate the accountants' determination. The buyer, in turn, sought to rescind the agreement and recover money already paid to the seller. The arbitral tribunal assumed jurisdiction and overturned the accountants' determination as flawed. The buyer brought a suit before the US District Court for the Southern District of New York, seeking approval of the arbitral award in his favor. The court instead vacated the panel's decision to overturn the accountant's determination. It held that the parties had committed the review of the valuation determination to the accountant under the purchase agreement and that the panel had exceeded its authority in reviewing that determination. The US Court of Appeals for the Second Circuit affirmed that decision.<sup>21</sup>

#### Put and sales options

Another area that is fertile for post-transaction disputes is put and sales options. Disputes generally revolve around the issue of whether or not an option has been triggered. The following two cases underline the practical importance of arbitration in this respect.

In the first case, the Dutch retailer Ahold announced that it had received a decision from an arbitration tribunal sitting in Sweden regarding the premium which was part of the price of a put option exercised by the Norwegian entity Canica AS for its 20 per cent stake in the Scandinavian joint venture ICA AB. According to the shareholders' agreement among Ahold, Canica and the third joint venture partner, ICA Förbundet Invest AB, Ahold was obliged to buy the shares offered by Canica. The arbitration tribunal rejected the challenge made by Canica to the premium rate and established such rate at 49.56 per cent, which corresponded to the outcome of the valuation made earlier by the valuation expert engaged by the partners in ICA AB.<sup>22</sup>

In a series of arbitrations in Switzerland and Sweden, panels of arbitrators recently had to decide a dispute regarding the control over one of Russia's largest mobile telephone companies, OAO MegaFon IPOC International Growth Fund Ltd (Bermuda) and LV Finance Group Ltd (British Virgin Islands) fought over stock option agreements and over the transfer of OAO MegaFon shares to IPOC. In the first arbitration, the ICC arbitrators in Geneva found that IPOC had validly exercised and paid for its option and ordered LV Finance to transfer the shares.<sup>23</sup> In August 2006, however, the award was quashed by the Swiss Federal Tribunal and remanded to the arbitrators

for reconsideration in view of certain pieces of new evidence.<sup>24</sup> In the parallel *ad hoc* arbitration case in Zurich, the panel held that the option agreement was unenforceable due to illegality and dismissed the claim.<sup>25</sup>

### Procedural Particularities of M&A Arbitration

A number of procedural problems are typical in the context of M&A arbitration.

#### *Multi-party and Multi-contract Disputes*

M&A arbitrations often arise out of multi-party situations, or multi-contract structures, especially on the purchaser's side.<sup>26</sup> This creates problems regarding the constitution of the arbitral tribunal, namely in view of the principle of equal participation, *ie* each party's right to appoint its 'own' arbitrator. The rules of most modern arbitration institutions, such as the Singapore International Arbitration Centre ('SIAC'),<sup>27</sup> the International Court of Arbitration of the ICC,<sup>28</sup> the London Court of International Arbitration ('LCIA'),<sup>29</sup> the China International Economic and Trade Arbitration Commission ('CIETAC'),<sup>30</sup> and the Swiss Rules of International Arbitration<sup>31</sup> today provide for adequate solutions to solve this practical problem, consistent with the principle of equal treatment of the parties.<sup>32</sup> In transactions involving several parties and/or multiple contracts, it may therefore be sufficient to insert model clauses of such institutions into the agreements.

#### *Extension of Arbitration Agreements to Third Parties*

Lawyers dealing with M&A arbitrations are frequently confronted with the issue of extension of the proceedings to third parties who have not signed the arbitration agreement. This is in particular an issue with group of companies' structures and series of transactions.<sup>33</sup> As there is a multitude of possible situations, the rules of national and international arbitration institutions—unlike in the case of multi-party disputes—rarely provide for any guidance.<sup>34</sup> On the one hand, an extension to non-signatories may take place by virtue of a number of legal theories under the applicable law, such as legal succession or alter ego and piercing the corporate veil. However, as many arbitral tribunals are reluctant to extend the arbitration to third parties on these grounds, it is advisable to provide clearly which parties are bound by the arbitration agreement and to ensure that they all sign.

Without their consent, third parties cannot be joined, nor can parallel arbitration proceedings involving distinct parties be consolidated. A noteworthy exception are the 2004 Swiss Rules of International Arbitration which admit, in appropriate circumstances, the joinder of a third party or the consolidation of arbitration proceedings even if the parties are not identical.<sup>35</sup>

### Production of Documents

Given the factual complexity in most M&A arbitrations on M&A transactions, extensive disclosure of documentary evidence may be required.<sup>36</sup> Since it is common for much of such information to be ‘sensitive’, document requests may raise confidentiality issues and require specific procedures, such as production of documents in camera, in particular when the parties involved are competitors.<sup>37</sup>

The scope of discovery in international arbitration depends not so much upon the rules of the chosen arbitral institution and the domestic procedural rules of the place of the arbitration or—in case of *ad hoc* arbitrations—on the provisions of the arbitration agreements as written by the parties, but largely upon the legal culture of the parties, their counsel and the arbitral tribunal. In recent years, the gap between the civil and common law approach have narrowed down considerably in the sense that international arbitration practitioners now tend to agree on the use of targeted document disclosure whilst usually rejecting the use of common law style ‘full blown’ discovery.

### Remedies Awarded

In M&A disputes more than in other areas, arbitrators might be called upon not only to decide on the amount of a price adjustment or to award damages to the prevailing party, but also to tailor the award in order to meet the needs of the particular situation.<sup>38</sup> This may include awards for specific performance or awards shaping new arrangements between the parties, such as buy/sell options, if so requested and if permissible under the applicable substantive law.<sup>39</sup>

### Conclusion: Drafting Arbitration Agreements in the M&A Context

In view of the high likelihood of post-closing disputes as discussed above, a ‘watertight’ arbitration agreement that ensures an efficient dispute resolution must be a crucial feature of any M&A contract. Unfortunately, but maybe understandably, dispute resolution clauses do not always get the attention they deserve. Transaction lawyers who prepare M&A agreements are often under tremendous time pressure, and may not always be sufficiently familiar with arbitration law to appreciate the importance of the arbitration clause and the careful drafting required. This is particularly so in the case of proposed multi-tier dispute resolution mechanisms providing for mediation, expert determination and other forms of ADR.

The model clauses of the reputable arbitration institutions have made their proof in many cases. In case of doubt, it is thus advisable to opt for a tested model clause rather than modify them or provide for an *ad hoc* mechanism. In any case,

dispute resolution clauses should be drafted in close cooperation between the transactional and the arbitration lawyers to ensure that the result fits the specificities of the deal. Of particular importance is the clear delimitation between expert determination and arbitration, and the provisions allowing for multi-party disputes.

### Notes:

- <sup>1</sup> Christian Borris, ‘Streiterledigung beim Unternehmenskauf’, in *Law of International Business and Dispute Settlement in the 21st Century*, Liber Amicorum Karl-Heinz Böckstiegel, 2001, p 75; Axel Baum, ‘Drafting of Arbitration Clauses and Organization of the Arbitral Procedure in the Area of M&A’, in *Tagungsbeiträge zur DIS-Vortragsveranstaltung “Schiedsgerichtsbarkeit bei M&A”*, 24/25 April 2001, Dresden, DIS-Materialien Bd VIII/01, p 77.
- <sup>2</sup> Klaus Sachs, ‘Schiedsgerichtsverfahren über Unternehmenskaufverträge – unter besonderer Berücksichtigung kartellrechtlicher Aspekte’, *SchiedsVZ* 2004, p 123; Bernd Ehle, ‘Arbitration as a Dispute Resolution Mechanism in Mergers and Acquisitions’, in *The Comparative Law Yearbook of International Business*, Campbell (ed), The Hague, Kluwer Law International, 2005, pp 287-311.
- <sup>3</sup> Christian Borris, *op cit*, p 80; Klaus Sachs, *op cit*, *SchiedsVZ* 2004, p 123: ‘[n]owadays, arbitration agreements in international and national M&A transactions are rather the rule than the exception.’
- <sup>4</sup> Wolfgang Peter, ‘Arbitration of Mergers and Acquisitions: Purchase Price Adjustment Disputes’, *Arbitration International*, Volume 19, Number 4, 2003, p 503.
- <sup>5</sup> Eugen Salpius, ‘Einige Gedanken zur Gestaltung von Schiedsklauseln in Mergers & Acquisitions-Verträgen’, in *Tagungsbeiträge zur DIS-Vortragsveranstaltung “Schiedsgerichtsbarkeit bei M&A”*, 24/25 April 2001, Dresden, DIS-Materialien Bd VIII/01, at p 74; Christian Borris, *op cit*, p 76.
- <sup>6</sup> Klaus Günther, ‘Die Bedeutung von Schiedsvereinbarungen im M&A Bereich’, in *Tagungsbeiträge zur DIS-Vortragsveranstaltung “Schiedsgerichtsbarkeit bei M&A”*, 24/25 April 2001, Dresden, DIS-Materialien Bd VIII/01, p 12.
- <sup>7</sup> Eugen Salpius, *op cit*, pp 72, 73.
- <sup>8</sup> Klaus Sachs, *op cit*, *SchiedsVZ* 2004, p 125.
- <sup>9</sup> Klaus Sachs, *op cit*, *SchiedsVZ* 2004, p 125.
- <sup>10</sup> Wolfgang Peter, *op cit*, pp 492-493.
- <sup>11</sup> See for example *C and K v S Compagnie SA*,

- Geneva Court of Justice, decision of 15 October 1999, *ASA Bulletin* 2000, at pp 793-802 and Swiss Federal Tribunal, decision of 27 October 1995, *ASA Bulletin* 1996, pp 277-283, resulting from arbitration proceedings.
- <sup>12</sup> See Award in ICC Case Number 9617, in: *Les cahiers de l'arbitrage* 1/2006, p 39.
- <sup>13</sup> Wolfgang Peter, *op cit*, pp 491, 492; Christian Borris, *op cit*, p 75.
- <sup>14</sup> Swiss Federal Tribunal, decision of 16 March 2004, 4P.14/2004, *ASA Bulletin* 4/2004, pp 770-781.
- <sup>15</sup> With respect to the valuation of shares, see *Partial Award* made by the Permanent Court of Arbitration, dated 22 November 2002, Case Number 2000-03, *Horst Reineccius (Claimant Number 1), First Eagle SoGen Funds, Inc (Claimant Number 2), Pierre Mathieu and La Société Hippique de la Châtre (Claimant Number 3) v Bank for International Settlement (respondent)*, *ASA Bulletin* 2004, pp 116-131; partial award, *inter alia*, on the applicable standards for valuation of shares, pp 120-122.
- <sup>16</sup> Anke Sessler and Corina Leimert, 'The Role of Expert Determination in Mergers and Acquisitions under German Law', *Arbitration International*, Volume 20, Number 2, 2004, pp 151-165; Wolfgang Peter, *op cit*, pp 501, 502; Fritz Nicklisch, 'Der Ingenieur als Schiedsgutachter und Quasi-Schiedsrichter bei internationalen Bau- und Anlagenprojekten', in *Festschrift für Walter J Habscheid*, 1989, pp 217-231.
- <sup>17</sup> Decision JTPI/9028/2004, in *ASA Bulletin* 4/2006, p 779, see also Article by Michael Schöll, *Réflexions sur l'expertise-arbitrage en droit suisse*, *ASA Bulletin* 4/2006, p 621.
- <sup>18</sup> Anke Sessler and Corina Leimert, *op cit*, p 152.
- <sup>19</sup> Christian Borris, *op cit*, p 80.
- <sup>20</sup> Klaus Sachs, *op cit*, *SchiedsVZ* 2004, p 124.
- <sup>21</sup> See *Norman Katz v Herbert Feinberg*, United States Court of Appeals for the Second Circuit, decision of 26 April 2002, 167 F Supp2d 556, 565-66 (SDNY 2001), affirmed, 290 F3d 95 (2d Cir 2002).
- <sup>22</sup> *Neue Zürcher Zeitung* (NZZ) of 11 October 2004, p 23, 'Ahold bekommt Recht – Überhöhte Forderung für ICA-Kauf zurückgewiesen'.
- <sup>23</sup> See *IPOC International Growth Fund Ltd (Bermuda) v LV Finance Group Ltd (British Virgin Islands)*, ICC Case Number 12875/MS, final award of 16 August 2004, Mealey's International Arbitration Report, Volume 19, Number 9, September 2004, at pp 6-8, A-1-A-17.
- <sup>24</sup> Swiss Federal Tribunal, decision 4P.102/2006 of 29 August 2006, in *ASA Bulletin* 3/2007, p 550.
- <sup>25</sup> IPOC's motion to set the award aside was rejected by the Swiss Federal Tribunal, decision 4P.168/2006 of 19 February 2007.
- <sup>26</sup> Bernard Hanotiau, 'Problems Raised by Complex Arbitrations Involving Multiple Contracts-Parties-Issues – An Analysis', *Journal of International Arbitration*, Volume 18, Number 3, 2001, pp 253-360; Konstadinos Massuras, *Dogmatische Strukturen der Mehrparteienschiedsgerichtsbarkeit*, 1998, p 7.
- <sup>27</sup> Singapore International Arbitration Centre (SIAC), Arbitration Rules (3rd edition, 1 July 2007), Rule 8 ('Multi-party Appointment of Arbitrator(s)').
- <sup>28</sup> International Court of Arbitration of the International Chamber of Commerce, Rules of Arbitration, Article 10 ('Multiple Parties').
- <sup>29</sup> London Court of International Arbitration Rules, Article 8 ('Three or More Parties').
- <sup>30</sup> China International Economic and Trade Arbitration Commission (CIETAC), Arbitration Rules, Article 24 ('Multi-Party').
- <sup>31</sup> Swiss Rules of International Arbitration (2004), Article 8 ('Appointment of Arbitrators in by-party or multi-party proceedings').
- <sup>32</sup> Klaus von Schlabrendorff, 'Schiedsgerichtsbarkeit bei M&A – Mehrparteiensituationen und Inter-Omnies Wirkung', in *Tagungsbeiträge zur DIS-Vortragsveranstaltung "Schiedsgerichtsbarkeit bei M&A"*, 24/25 April 2001, Dresden, DIS-Materialien Bd VIII/01, p 35.
- <sup>33</sup> Jan-Michael Ahrens, *Die subjektive Reichweite internationaler Schiedsvereinbarungen und ihre Erstreckung in der Unternehmensgruppe*, Frankfurt 2001.
- <sup>34</sup> Klaus Sachs, 'Erstreckung von Schiedsvereinbarungen auf Konzernunternehmen', in *Tagungsbeiträge zur DIS-Vortragsveranstaltung "Schiedsgerichtsbarkeit bei M&A"*, 24/25 April 2001, Dresden, DIS-Materialien Bd VIII/01, p 54.
- <sup>35</sup> Article 4 of the Swiss Rules of International Arbitration (2004); see also Gilliéron/Pittet, in *Zuberbuehler/Mueller/Habegger, Swiss Rules of International Arbitration*, Zurich 2005, pp 36 and seq.
- <sup>36</sup> Klaus Sachs, *op cit*, *SchiedsVZ* 2004, p 125.
- <sup>37</sup> Axel Baum, *op cit*, pp 79, 81.
- <sup>38</sup> Klaus G nther, *op cit*, p 13.
- <sup>39</sup> Wolfgang Peter, *op cit*, p 505.

# Mergers and Acquisitions— A Cakewalk or a Ball-buster



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This paper discusses the legislation that governs inbound and outbound mergers and acquisitions in India

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## Introduction

Corporate Restructuring through Mergers and Acquisitions ('M&A') which have been a regular feature in the developed and free economy nations like the US and the UK has now caught on like wildfire in India too, with an M&A reported every business day.

The multifarious reasons, ranging from deriving benefits from economies of scales to obtaining tax advantage, from having access to better technology to improving debt-equity ratio and from enjoying higher corporate status to enhancing the profitability, have made M&A the most sought after dream of any corporate tycoon.

A **merger** is a combination of two companies into one larger company. Such actions are commonly voluntary and involve stock swap or cash payment to the target. Stock swap is often used as it allows the shareholders of the two companies to share the risk involved in the deal. A merger can resemble a takeover but result in a new company name (often combining the names of the original companies) and in new branding, in some cases, terming the combination a 'merger' rather than an 'acquisition' is done purely for political or marketing reasons.

An **acquisition**, commonly known as a 'takeover' in the corporate world, is the buying

of one company (the 'target') by another (the 'acquirer'). An acquisition may be friendly or hostile. While in the former case, the companies cooperate in negotiations; in the latter, the takeover target is unwilling to be bought or the target's board has no prior knowledge of the offer. Usually though, an acquisition refers to a purchase of a smaller firm by a larger one; sometimes a smaller firm acquires management control of a larger or longer established company and keeps its name for the combined entity. This is known as 'reverse takeover' which happened in the case of **Arcelor-Mittal** takeover.

Inbound and outbound mergers and acquisitions have dramatically increased in India recently. According to the Investment Bankers, M&A deals in India will cross US\$100 billion this year, which is double the last year's level and quadruple of 2005. Industry reports forecast that there will be continued acceleration of outbound transactions from India in sectors such as pharmaceutical, automotive, and textiles. Inbound investments in infrastructure, real estate, retail, and logistics have started emerging. India's M&A environment is vibrant due to positive regulatory mechanisms, globally accepted business processes, and a robust and optimistic investment climate. In the recent policy announcement, the country has given capital subsidy of 25 per cent on investments for setting up semiconductor and nano-technology manufacturing units. This will, probably, further fuel cross-border M&A deals in the electronics industry.

In the first two months of 2007, corporate India witnessed deals worth close to US\$40 billion. One of the first overseas acquisitions by an Indian

company in 2007 was **Mahindra & Mahindra's** takeover of 90 per cent stake in Schoneweiss, a family-owned German company with over 140 years of experience in forging business. What hit the headlines early this year was **Tata's** takeover of **Corus** for slightly over US\$10 billion. On the heels of that deal, **Hutchison Whampoa** of Hong Kong sold their controlling stake in **Hutchison-Essar** to **Vodafone** for a whopping US\$11.1 billion. Bangalore-based **MTR's** packaged food division found a buyer in **Orkala**, a Norwegian company for US\$100 million. Service companies have also joined the M&A game. **PricewaterhouseCoopers** acquired the taxation practice of Mumbai-based **RSM Ambit**. There are many other bids in the pipeline.

### Legal Aspects of M&A

Mergers and Acquisitions are regulated under various laws in India. The objective of the laws is to make these deals transparent and protect the interest of all the shareholders.

#### *Companies Act 1956*

Though nowhere defined in the Companies Act, 1956, the provisions of the Companies Act govern the procedure in respect of M&A. Sections 390 to 396A, often termed as a complete code in itself, lays down the statutory requirements required to be complied with for the merger or acquisition of a company. The Companies (Second Amendment) Act, 2002 has transferred to the National Company Law Tribunal ('NCLT') the powers vested in the court under Sections 391 to 396. However the Amendment Act has not become effective as yet. Accordingly relevant references to the 'High Court or Court' will stand replaced with the 'Tribunal' after the provisions of Amendment Act are enforced. A proposed scheme of M&A is prepared and is presented before the High Court in whose jurisdiction the companies (Amalgamating and Amalgamated) are situated. Sections 390-396A is like a 'single window clearance' in so much as whenever a scheme of M&A, incorporating anything requiring a prolonged statutory procedure under the Companies Act, is sanctioned by the High Court, there is no need to comply with the procedure laid down for the matters which are integral to the scheme of M&A *eg* reduction of share capital of a company may form part of a compromise and arrangement and when the court sanctions the compromise and arrangement as a whole, reduction of share capital is also sanctioned without the company following the procedure laid down in Section 100 of the Act. According to Section 390, which is the interpretation clause for this code, the term 'company includes not only a company constituted under the Companies Act,

1956, but also the companies liable to be wound up under this Act *ie* **companies falling under schedule X, foreign companies.**

- 1 **Permission for merger** – It has been a controversy whether a company whose object clause is silent about the power to amalgamate is required to insert such power before amalgamating. Various judicial pronouncements have made it clear that amalgamation is a power and not an object. In re: Sir Mathuradas Vissan Ji Foundation, Bombay High Court held that no such alteration is required. Every company has inherent power to amalgamate with the other companies, since the statute itself via Section 394 grants such power.
- 2 **Approval of board of directors** – The board of directors of the individual companies should approve the draft proposal for amalgamation. The Board Resolution should, besides approving the scheme, authorize the managements of the companies to further pursue the proposal.
- 3 **Application in the High Court** – An application for approving the draft amalgamation proposal duly approved by the board of directors of the individual companies should be made to the High Court.
- 4 **Approval of Shareholders and Creditors** – Shareholders and Creditors approval is *sine qua non* for Court's sanction. This approval is obtained at specially convened meetings held as per court's directions [Section 391(1)]. The individual companies should hold separate meetings of their shareholders and creditors for approving the amalgamation scheme. At least, majority in number and 75 per cent in value of shareholders and creditors present and voting, in separate meetings, voting in person or by proxy, must accord their approval to the scheme.
- 5 **Approval of the stock exchange** – As per Clause 24(f) of the Listing Agreement all the listed companies are required to file the scheme of merger or amalgamation with all the stock exchanges where it is listed at least one month prior to filing it with the High Court and obtain its objections to the proposed scheme.
- 6 **Sanction by the High Court** – After the approval of the shareholders and creditors, on the petitions of the companies, the High Court will pass an order, sanctioning the amalgamation scheme after it is satisfied that the scheme is fair and reasonable. The date of the court's hearing will be published in two newspapers, and also, the regional director of the Company Law Board will be intimated.
- 7 **Filing of the Court order** – After the Court

order, its certified true copies will be filed with the Registrar of Companies.

- 8 **Transfer of assets and liabilities** – The assets and liabilities of the acquired company will be transferred to the acquiring company in accordance with the approved scheme, with effect from the specified date.
- 9 **Payment by cash or securities** – As per the proposal, the acquiring company will exchange shares and debentures and/or cash for the shares and debentures of the acquired company. These securities will be listed on the stock exchange.

*The Competition Act 2002*

An essential feature of the Competition Act, 2002 is regulation of combinations, which include Acquisitions, Mergers and Amalgamations. A combination for the purposes of the Competition Act covers three kinds of transactions when they cross the threshold limits specified in Section 5:

- (1) Acquisition of shares, voting rights or assets by a person or enterprise of another;
- (2) Acquiring of control by a person over an

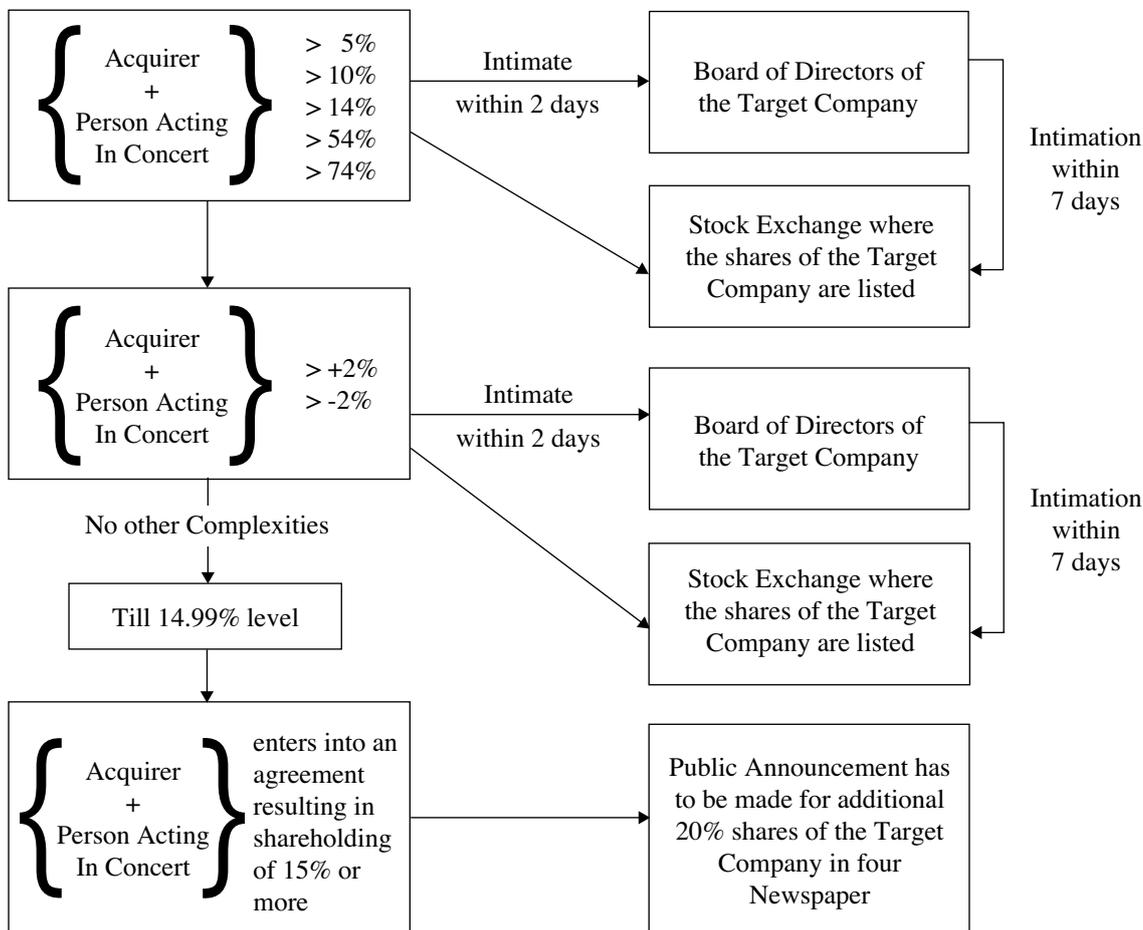
- enterprise;
- (3) Merger or amalgamation between or amongst enterprises.

Merger regulation is particularly tricky as the authorities attempt to see the future, so to speak, while making a determination of whether there would be any adverse effect on competition. The Indian Competition Act recognizes the fact that mergers do tend to bring about advantages as well. Section 20(4)(m) and (n) states that the CCI must take into account the ‘relative advantage, by way of the contribution to the economic development, by any combination having or likely to have appreciable adverse effect on competition’; and ‘whether the benefits of the combination outweigh the adverse impact of the combination, if any.’

*SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 (As amended up to May 2007)*

These regulations require mandatory disclosure by the acquirer at different stages of acquisitions. Following chart is illustrative of the disclosure requirements.

**Disclosure Requirement Chart**



A takeover can be friendly or hostile. In Friendly Takeover, the management of two companies enter into negotiations and an agreement is reached by consensus. However, when the acquirer company does not offer the target company the proposal to acquire its undertaking but silently and unilaterally pursues efforts to gain control against the wishes of the existing management, such act of the acquirer company is known as Hostile Takeover. India has experienced lately more than 800 successful friendly takeovers and 13 hostile takeover attempts, out of which only three were successful.

SEBI (SAST) Regulations, 1997 governs the acquisition of companies. It lays down various guidelines and checkpoint to regulate pre and post merger issues.

Checkpoints before making the public announcement:

- 1 Appointment of Merchant Banker
- 2 Drafting of the Public Announcement and Letter of Offer to be given to the existing shareholders of the Target Company
- 3 Arranging cash for opening Escrow Account
- 4 Opening Escrow Account

### Mandatory Requirements

- 1 **First Trigger point:** An acquirer, who intends to acquire shares or voting rights, singly or jointly with persons acting in concert, which, along with his existing shareholding, would entitle him to exercise 15 per cent or more voting rights, can acquire such additional shares only after making Public Announcement to acquire at least 20 per cent of the voting capital of the Target Company from shareholders of the Target Company through an open offer.
- 2 **Creeping Acquisition:** An acquirer who holds 15 per cent or more but less than 55 per cent of shares or voting rights of the company, shall not acquire additional shares or voting rights entitling him to acquire more than five per cent in any financial year, unless Public Announcement is made by such acquirer to acquire at least 20% through open offer. Thus Creeping acquisition can be made at the maximum rate of five per cent in any financial year.
- 3 **Second Trigger Point:** An acquirer, who holds 55 per cent or more but less than 75 per cent of shares in a company shall not acquire any additional shares unless such acquirer makes a



Public Announcement to acquire at least 20 per cent through open offer.

Beware!

The regulations set forth by the new takeover code aim at enhancing the level of the investor's protection in several ways. Being statutory in nature, violation of its principles attracts several penalties. These, *inter alia*, include SEBI's right to initiate criminal prosecution under Section 24 of the SEBI Act. SEBI issues directions to persons found guilty not to further deal in securities, prohibits persons from disposing of any securities acquired in violation of the regulations and takes actions against the concerned intermediary who is registered with the SEBI. The act also empowers SEBI to adjudicate fines as penalties for certain violations of the regulations *viz.* insider information, disclosure of misleading information and non-disclosure of material information. Indeed, there have been a number of instances where SEBI has initiated penal actions against the acquirers under these provisions for violation of the Regulations.

Non compliance of vital regulatory provisions *viz.* increasing the scope of cooling period to cover bid for any listing for one year (for non-fulfillment of obligations) by the acquirer would now attract more stringent penalty provisions such as:

- 1 Forfeiture of escrow
- 2 Payment of interest to the shareholders for delay in payment of consideration
- 3 Prohibiting entry into the board of the target during the offer period

### Income Tax Act 1961

A discussion on the law of mergers is incomplete without reference to the fiscal legislation. Section 72A of the Income Tax Act, 1961 deals with the carry forward of losses where the merger is between a sick unit and a profitable one.

Also the capital gain tax, which is leviable in case of transfer of capital assets, is not leviable in case of transfer of shares in an Indian Company held by a foreign company to another

foreign company in pursuance of a scheme of amalgamation of two foreign companies as from assessment year 1993-94 is not regarded as transfer for the purpose of levying tax on capital gains.

In the case of amalgamation, if the amalgamating company transfers to the amalgamated company, which is an Indian company, any asset representing capital expenditure on scientific research, provisions of Section 35 would apply to the amalgamated company as they would have applied to the amalgamating company if the latter had not transferred the asset.

### Conclusion

The concept of takeover had an unprecedented rise in the early 1990s with liberalization and globalization of the Indian economy. In the meantime, the Securities and Exchange Board of India ('SEBI') also notified Substantial Acquisition of Shares and Takeovers ('SAST') Regulation, which laid down the procedure to be followed by an acquirer for acquiring the majority shares or controlling interest in another company. The object of takeover code is to ensure equality of treatment and opportunity to all shareholders. It offers protection to them, in the event of substantial acquisition of share and takeovers. These regulations have also empowered SEBI to make investigations into sale of securities or likely acquisition to ascertain the violation of these regulations and to initiate criminal prosecution against the guilty. The regulations aim at orderly functioning of the stock markets and achieving protection of the investors.

Until only recently, India's economic system was relegated to a regulated economy designed to meet the planned objectives of a socialist pattern of economic development. The number of mergers and acquisitions has increased manifold since the introduction of the New Economic Policy of 1991. However, Corporate India has a long way to go. Hopefully, the lawyers, bankers, accountants, financial consultants, and merchant bankers will provide adequate guidance and know-how to their corporate clients to help the merger cult catch fire in India at an unprecedented manner.



# IPBA SCHOLARSHIPS

The Inter-Pacific Bar Association is pleased to announce the establishment of the IPBA Scholarship Programme to enable practicing lawyers to attend the IPBA's Eighteenth Annual Meeting and Conference, which will be held in Los Angeles from April 27 to April 30, 2008.

## What is the Inter-Pacific Bar Association?

The Inter-Pacific Bar Association ('IPBA') is an international association of business and commercial lawyers with a focus on the Asia-Pacific region. Members are either Asia-Pacific residents or have a strong interest in this part of the world. The IPBA was founded in April 1991 at an organising conference held in Tokyo attended by more than 500 lawyers from throughout Asia and the Pacific. Since that time, it has grown to become the pre-eminent organization in respect of law and business within Asia with a membership of over 2,000 lawyers from 71 jurisdictions around the world. Lawyers in most law firms in the Asia-Pacific region and internationally that have a cross-border practice are members of the IPBA.

## What is the Inter-Pacific Bar Association Annual Meeting and Conference?

The highlight of the year for the IPBA is its annual multi-topic four-day conference. The conference has become the 'must attend event' for international business and commercial lawyers. In addition to plenary sessions of interest to all lawyers, programs are presented by the IPBA's eighteen specialist committees. The IPBA annual meeting and conference provides an opportunity for lawyers to meet their international colleagues with Asian practices and to share latest developments in cross-border practice and professional development in Asia. Previous annual conferences have been held in Tokyo (twice), Sydney (twice), Taipei, Singapore, San Francisco, Manila, Kuala Lumpur, Auckland, Bangkok, Vancouver, Hong Kong, New Delhi, Seoul, Bali and Beijing attracting as many as 700 lawyers plus accompanying persons. Next year the conference will be held in Los Angeles from April 27 – April 30, 2008.

## What are the IPBA Scholarships?

The IPBA Scholarship Programme was originally in honour of the memory of M.S. Lin of Taipei, who was one of the founders and a past President of the IPBA. Today it operates to bring to the IPBA Annual Meeting and Conference lawyers who would not otherwise be able to attend and who would both contribute to, and benefit from, attending IPBA conference and to endorse the IPBA's interest in the development of law and practice in Asia.

## Who is eligible to be an IPBA Scholar?

[1] Lawyers from Developing Countries

*To be eligible, the applicants must:*

- (a) be an indigenous lawyer in Vietnam, Laos, Cambodia, Myanmar, Mongolia or the Pacific Islands;
- (b) be fluent in both written and spoken English (given this is the conference language); and
- (c) currently be involved in a cross-border practice or wish to become engaged in a cross-border practice.

[2] Young Lawyers

*To be eligible, the applicants must:*

- (a) be under 35 years of age **and** have less than five years of practice;
- (b) be fluent in both written and spoken English (given this is the conference language);
- (c) have taken an active role in the legal profession in their countries;
- (d) currently be involved in a cross-border practice or desire to become engaged in a cross-border practice; and
- (e) have published an article in a reputable journal on some topic related to the work of one of our committees or provide some other objective evidence of committed involvement in the profession.

Preference will be given to those applicants who could not otherwise attend the conference, for example, because of personal or family financial circumstances and/or because they are working for a small firm which could not afford to send them to the conference. Applicants from multi-national firms will normally be considered only if they have a substantial part of their attendance expenses provided by their firm.

In order to spread the benefit of these Scholarships further, applicants should set out the amount you or your firm could pay towards the airfare and conference fee, taking into account your personal and family circumstances and your firm's situation.

## Each IPBA Scholar will receive:

1. Return economy class transportation from the scholar's home city to Los Angeles.
2. Waiver of the Los Angeles Conference registration fee.
3. Accommodation in a conference hotel for four nights.
4. *Per diem* living expenses of \$20 per day.
5. Waiver of IPBA annual membership fees for 2008, 2009 and 2010.

## How does one apply to be an IPBA Scholar?

To apply for an IPBA Scholarship, please obtain an application form and return it to Kaori Hashimoto at the IPBA Secretariat in Tokyo no later than **October 31, 2007**. Application form is available either through the IPBA website ([www.ipba.org](http://www.ipba.org)) or at the IPBA Secretariat.

Please send applications to the IPBA Secretariat at:

Roppongi Hills North Tower 7F  
6-2-31 Roppongi, Minato-ku  
Tokyo 106-0032, Japan

Telephone: +81-3-5786-6796  
Facsimile: +81-3-5786-6778  
E-mail: [ipba@tga.co.jp](mailto:ipba@tga.co.jp)

## What happens once a candidate is selected?

The following procedures will apply after selection:

1. The Secretary-General will notify each successful applicant that he or she has been awarded an IPBA Scholarship. The notification will be provided at least two months prior to the opening of the conference. Unsuccessful candidates will also be notified.
2. Airfares and accommodation will be arranged by the Los Angeles Conference Host Committee and/or the IPBA Secretariat after consultation with the successful applicants.
3. A liaison person will introduce each Scholar to the IPBA and generally help the Scholar to obtain the most benefit from the Conference.



# An Invitation to Join the Inter-Pacific Bar Association

The IPBA is an international association of business and commercial lawyers who reside or have an interest in the Asian and Pacific region. The IPBA has its roots in the region, having been established in April 1991 at an organizing conference in Tokyo that was attended by more than 500 lawyers from throughout Asia and the Pacific. It is now the pre-eminent organization in the region for business and commercial lawyers, with over 1,600 members from 70 jurisdictions.

The growth of the IPBA has been spurred by the tremendous growth of the Asian economies. As companies throughout the region become part of the global economy, they require additional assistance from lawyers in their home country and from lawyers throughout the region. One goal of the IPBA is to help lawyers stay abreast of developments that affect their clients. Another is to provide an opportunity for business and commercial lawyers throughout the region to network with other lawyers of similar interests and fields of practice.

Supported by major bar associations, law societies and other organizations throughout Asia and the Pacific, the IPBA plays a significant role in fostering ties among members of the legal profession with an interest in the region.

## **IPBA Activities**

The breadth of the IPBA's activities is demonstrated by the number of specialist committees overleaf. All of these committees are active and have not only the chairs named, but a significant number of vice-chairs to assist in the planning and implementation of the various committee activities. The highlight of the year for the IPBA is its annual multi-topic four-day conference, usually held in the first week of May each year. Previous annual conferences have been held in Tokyo (twice), Sydney (twice), Taipei, Singapore, San Francisco, Manila, Kuala Lumpur, Auckland, Bangkok, Vancouver, Hong Kong, New Delhi, Seoul and Bali, attracting as many as 700 lawyers plus accompanying guests.

The IPBA has organized regional conferences and seminars on subjects such as Practical Aspects of Intellectual Property Protection in Asia (in five cities in Europe and North America respectively) and Asian Infrastructure Development and Finance (in Singapore). The IPBA has also co-operated with other legal organizations in presenting conferences — for example on Trading in Securities on the Internet, held jointly with the Capital Market Forum.

The IPBA also publishes a membership directory and a quarterly *IPBA Journal*.

## **Membership**

Membership in the Association is open to all qualified lawyers who are in good standing and who live in, or who are interested in, the Asia-Pacific region.

• Standard Membership	US\$195 / ¥23,000
• Three-Year Term Membership	US\$535 / ¥63,000
• Lawyers in developing countries with low income levels	US\$ 100 / ¥11,800
• Young Lawyers (under 30 years old)	US\$ 50 / ¥6,000

Annual dues will cover the period of one year starting from January 1 and ending on December 31. Those who join the Association before August 31 will be registered as a member for the current year. Those who join the Association after September 1 will be registered as a member for the rest of the current year and for the following year.

Qualified lawyers who attend the IPBA Annual Meeting and Conference and pay the non-member conference fee will be automatically registered as a member for the then current year ending on December 31.

Membership renewals will be accepted until July 31.

Selection of membership category is entirely up to each individual. If the membership category is not specified in the registration form, standard annual dues will be charged by the Secretariat.

Further, in order to encourage young lawyers to join the IPBA, a Young Lawyers Membership category (age under 30 years old) with special membership dues has been established.

IPBA has established a new Three-Year Term Membership category which will come into effect from the 2001 membership year.

There will be no refund of dues for cancellation of all membership categories during the effective term, nor will other persons be allowed to take over the membership for the remaining period.

## **Corporate Associate**

Any corporation may become a Corporate Associate of the Association by submitting an application form accompanied by payment of the annual subscription of (¥50,000/US\$500) for the then current year.

The name of the Corporate Associate shall be listed in the membership directory.

A Corporate Associate may designate one employee ('Associate Member'), who may take part in any Annual Conference, committee or other programs with the same rights and privileges as a Member, except that the Associate Member has no voting rights at Annual or Special Meetings, and may not assume the position of Council Member or Chairperson of a Committee.

A Corporate Associate may have any number of its employees attend any activities of the Association at the member rates.

- Annual Dues for Corporate Associates US\$500 / ¥50,000

## **Payment of Dues**

Payment of dues can be made either in US dollars or Japanese yen. However, the following restrictions shall apply to payments in each currency. Your co-operation is appreciated in meeting the following conditions.

1. A US dollar cheque should be payable at a US bank located in the US. US dollar cheques payable in Japan may be returned to sender depending on charges.
2. A Japanese yen check should be payable at a Japanese bank located in Japan.
3. Japanese yen dues shall apply to all credit card payment. Please note that the amount charged will not be an equivalent amount to the US dollar dues.
4. Please do not instruct your bank to deduct telegraphic transfer handling charges from the amount of dues. Please pay related bank charges in addition to the dues.

## **IPBA Secretariat**

Roppongi Hills North Tower 7F, 6-2-31 Roppongi, Minato-ku, Tokyo 106-0032, Japan  
Tel: 81-3-5786-6796 Fax: 81-3-5786-6778 Email: ipba@tga.co.jp Website: www.ipba.org

See overleaf for membership  
registration form



# IPBA SECRETARIAT

Roppongi Hills North Tower 7F, 6-2-31 Roppongi, Minato-ku, Tokyo 106-0032, Japan  
Tel: 81-3-5786-6796 Fax: 81-3-5786-6778 Email: ipba@tga.co.jp Website: www.ipba.org

## IPBA MEMBERSHIP REGISTRATION FORM

### MEMBERSHIP CATEGORY AND ANNUAL DUES:

- Standard Membership.....US\$195 or ¥23,000
- Three-Year Term Membership.....US\$535 or ¥63,000
- Lawyers with low income levels in developing countries.....US\$100 or ¥11,800
- Young Lawyers (under 30 years old).....US\$ 50 or ¥ 6,000

Name: Last Name \_\_\_\_\_ First Name / Middle Name \_\_\_\_\_

Birthday: year \_\_\_\_\_ month \_\_\_\_\_ day \_\_\_\_\_ Sex: M / F

Firm Name: \_\_\_\_\_

Jurisdiction: \_\_\_\_\_

Correspondence Address: \_\_\_\_\_

Telephone: \_\_\_\_\_ Facsimile: \_\_\_\_\_

Email: \_\_\_\_\_

### CHOICE OF COMMITTEES:

- |   |  |
|---|--|
| <input type="checkbox"/> Aerospace Law                      | <input type="checkbox"/> Insurance                           |
| <input type="checkbox"/> Banking, Finance and Securities    | <input type="checkbox"/> Intellectual Property               |
| <input type="checkbox"/> Corporate Counsel                  | <input type="checkbox"/> International Construction Projects |
| <input type="checkbox"/> Cross-Border Investment            | <input type="checkbox"/> International Trade                 |
| <input type="checkbox"/> Dispute Resolution and Arbitration | <input type="checkbox"/> Legal Practice                      |
| <input type="checkbox"/> Employment and Immigration Law     | <input type="checkbox"/> Maritime Law                        |
| <input type="checkbox"/> Energy and Natural Resources       | <input type="checkbox"/> Tax Law                             |
| <input type="checkbox"/> Environmental Law                  | <input type="checkbox"/> Technology and Communications       |
| <input type="checkbox"/> Insolvency                         | <input type="checkbox"/> Women Business Lawyers              |

### METHOD OF PAYMENT (please read each note carefully and choose one of the following methods):

- US\$ Check/Bank Draft/Money Order  
– payable at US banks in the US only (others may be returned to sender)
  - Japanese yen ¥ Check/Bank Draft  
– payable at Japanese banks in Japan only (others may be returned to sender)
  - Credit Card – **Please note that Japanese yen dues shall apply to payment by credit cards.**  
 VISA       Master       Amex (Verification Code): \_\_\_\_\_  
 Card Number:      Expiration Date: \_\_\_\_\_
  - Bank Wire Transfer – Please make sure that remitting bank’s handling charges are paid by the remitter him/herself.  
 to      The Bank of Yokohama, Shinbashi Branch (Swift Code: HAMAJPJT)  
 A/C No. 1018885 (ordinary account)  
 Nihon Seimei Shinbashi Bldg 6F, 1-18-16 Shinbashi, Minato-ku, Tokyo 105-0004, Japan
- Signature: \_\_\_\_\_ Date: \_\_\_\_\_

### PLEASE RETURN THIS FORM WITH REGISTRATION FEE OR PROOF OF PAYMENT TO:

Inter-Pacific Bar Association  
Roppongi Hills North Tower 7F, 6-2-31 Roppongi, Minato-ku, Tokyo 106-0032, Japan  
Tel: 81-3-5786-6796 Fax: 81-3-5786-6778 Email: ipba@tga.co.jp