

## M&A Hotline

August 07, 2012

### DEMERGER: SELECTIVE TRANSFER OF COMMON ASSETS & LIABILITIES ALLOWED!

The Hon'ble Delhi High Court vide its judgment dated July 23, 2012, in the case of Indo Rama Textile Ltd., In re<sup>1</sup> has held that in a demerger, transfer of all common assets and/or liabilities relatable to undertaking being demerged is not required so long as the assets and liabilities transferred, by themselves, constitutes a running business and the business can be carried on uninterruptedly with such assets and liabilities alone. The Court further held that compliance of Section 2(19AA) of the Income-tax Act, 1961 ("**IT Act**") is relevant only for determining whether the demerger is tax neutral or not as per the IT Act and non-compliance of the same does not in any manner result in the arrangement not being regarded as a 'demerger' under Section 391 to 394 of the Companies Act, 1956 ("**Companies Act**").

#### FACTS

Indo Rama Synthetics Limited ("**IRSL**") ("**Respondent**") was initially in the business of spinning mill ("**Spinning Business**") in Pithampur, Madhya Pradesh and later expanded its business to polymer production ("**Polymer Business**") in Butibori, Nagpur. Respondent decided to vertically split its business by a scheme of arrangement ("**Scheme**") by demerging the Spinning Business to Indo Rama Textile Limited ("**IRTL**") while the Polymer Business was to be retained by the Respondent. Scheme as approved by the Delhi High Court (for IRTL) and Madhya Pradesh High Court (for IRSL) in 2003 inter alia provided as follows:

- **Clause 3** : IRSL shall on a going concern basis transfer all its properties, estates and interest in the Spinning Business pursuant to section 394(2) of the Companies Act or be transferred or deemed to have been transferred to IRTL.
- **Clause 17** : Demerger of Spinning Business as a going concern to IRTL is in accordance with Section 2(19AA)2 of the IT Act.
- **Clause 36** : Dispute between the parties under the scheme shall be referred to sole arbitrations of Shri O.P. Lohia residing in Delhi, or his nominee.

IRSL and IRTL entered into a five year Memorandum of Understanding ("MOU") in 2005 where IRSL agreed to share facilities from the common storage with IRTL for its Spinning Business as per the Scheme and the last MOUs dated March 2003 and April 2004.

Spentex Industries Limited ("**Applicant**") amalgamated with IRTL on December 20, 2006. Applicant in 2007 raised the issue that IRSL acted contrary to MOU in demanding more money for use of common facilities and refused to pay the same. Respondent consequently withdrew the common facilities made available to Applicant vide IRTL.

An application was filed under Section 392(1)(b)3 of the Companies Act by Applicant for modification of Scheme sanctioned by Delhi High Court on February 27, 2003 as well as for an order directing the Respondent to transfer the common assets including the part of the housing colony occupied/used by the workers/employees of IRTL to the Applicant or in the alternative to pay to the Applicant the value of the aforesaid assets amounting to INR 61,30,56,983 (Indian Rupee Sixty One Crore Thirty Lakh Fifty Six Thousand Nine Hundred Eighty Three Only).

#### ISSUE

- Is it necessary to transfer all common assets and/or liabilities relatable to the undertaking in a demerger?

### CONTENTIONS OF THE PARTIES

#### Applicant

- It was represented to the shareholders of IRSL and also it was the intention of the Scheme that the Spinning Business shall be transferred to IRTL as a going concern so as to be within the meaning of Section 2(19AA) of the IT Act, the said contention was reinforced by stating that IRSL has taken benefits under Section 2(19AA) of the IT Act as they have not paid any capital gains tax on the said transfer. Section 2(19AA) provides that in a demerger all the properties of the undertaking being transferred should become the properties of the resulting company.
- As per Section 394(2)(2)<sup>4</sup> of the Companies Act, the entire Spinning Business as a whole stood transferred and became the property of IRTL. Hence, by operation of law, the title of the properties of the undertaking that vested in IRSL prior to demerger stood transferred to IRTL upon sanction of the Scheme.
- Retaining an undertakings' property and then making it available as a resource under the contract for fees is not in

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statutory compliance and this incomplete transfer would not satisfy the requirement under Section 2(19AA) of the IT Act.

## Respondent

- Demerger of any undertaking is tax neutral if inter alia transfer of the undertaking is on a going concern basis (i.e. the undertaking or any part thereof, being transferred, should be capable of being transferred and being run independently for a foreseeable future). Undertaking as defined in Explanation 1 to section 2(19AA) of the IT Act does not include individual assets or liabilities or any combination thereof not constituting a business activity<sup>5</sup>. The language "taken as a whole" as explained in the definition of "Undertaking", was used in the context of "business activity" and not "Undertaking". Therefore, to qualify the pre-requisites of demerger under Section 2(19AA) of the IT Act, what was essential is that the unit/division/Undertaking/part of the Undertaking or the business activity as a whole being transferred should constitute a running business, which should be capable of carrying on uninterruptedly with such assets and liabilities alone.
- Further, it was contended that so long as the resulting company can be run as an independent unit with the assets transferred, the parties under the scheme of arrangement under Sections 391 to 394 of the Companies Act would be free to mutually agree to retain any particular asset/liability, even though the same was directly or indirectly, relatable to the undertaking being demerged. To support the contention, the case of Premier Automobiles Ltd. v. ITO & Anr.<sup>6</sup> was referred which held that in a slump sale one has to read the terms and conditions of the arrangement and the entire arrangement in whole so as to ascertain the true intention of the parties and merely because there is a schedule of assets on record, it cannot be said that there is a sale of itemized assets hence, it was said that although under the arrangement certain land was retained by the transferor, it was clear that the business activity, being a separate line of business, was transferred as a going concern and therefore, the transaction was that of a slump sale.

## JUDGMENT

The Hon'ble Court held that

- In a Demerger, transfer of all common assets and/or liabilities is not required so long as the undertaking can run as an independent unit with the assets transferred.
- While not accepting Applicants interpretation of clause 17 in the Scheme, it was held that the court cannot rewrite the scheme of arrangement approved in the meeting called under Section 391(2) of the Companies Act, but it can only make such modifications as it may consider necessary for proper working of the compromise or arrangement.
- In order to ensure that the Scheme serves larger public interest, clause 36 of the Scheme was ordered to be modified to the extent that in the event of any dispute, doubt or issue arising between the parties, the same shall be referred to a sole arbitrator to be appointed with the consent of the parties.

## REASONING BY COURT

- Merely because certain common assets and liabilities have not been transferred, the transaction would not cease to be demerger of an Undertaking, provided the assets and liabilities transferred, by themselves, constitutes a running business and the business can be carried on uninterruptedly with such assets and liabilities alone.
- To ensure that the undertaking has been transferred as a going concern or not, while sanctioning a scheme of arrangement, the Court can examine whether essential and integral assets like plant, machinery and manpower without which it would not be able to run as an independent unit have been transferred to the resulting company.
- The Applicant erred in contending that the common infrastructure was liable to be made available to IRTL by virtue of Section 2(19AA) of the IT Act as division of assets was indicated in the scheme.
- Compliance with Section 2(19AA) of the IT Act is not to be seen pre-merger but post-merger and that too by the tax authorities only. The said section is relevant only for the purposes of determining whether the Scheme is tax neutral or not and hence, it has consequences for Respondent only and not the undertaking. Considering Applicant's interpretation of clause 17 of Scheme which mentioned the Scheme to be in accordance with Section 2(19AA) of the IT Act would amount to rewriting the Scheme. Court relied on the principle laid down in the case of S.K. Gupta and Anr. v K.P. Jain and Anr<sup>7</sup> to say that the Court cannot rewrite the scheme approved in the meeting called under Section 391(2) of the Companies Act, but it can only make such modifications as it may consider necessary for proper working of the compromise or arrangement. Hence, the court modified the dispute Redressal mechanism in clause 36 because at time of demerger in 2003 both IRSL and IRTL were owned and managed by O.P. Lohia group but now both groups are managed by different business entities.
- Considering Applicant's<sup>8</sup> interpretation of clause 17 of Scheme which mentioned the Scheme to be in accordance with Section 2(19AA) of the IT Act would amount to rewriting the Scheme. Court relied on the principle laid down in the case of S.K. Gupta and Anr. v K.P. Jain and Anr<sup>7</sup> to say that the Court cannot rewrite the scheme approved in the meeting called under Section 391(2) of the Companies Act, but it can only make such modifications as it may consider necessary for proper working of the compromise or arrangement. Hence, the court modified the dispute Redressal mechanism in clause 36 because at time of demerger in 2003 both IRSL and IRTL were owned and managed by O.P. Lohia group but now both groups are managed by different business entities.
- The Court observed that the Applicant overlooked the primary function of the Court, namely, to ensure that the Scheme serves larger public interest, that means, to ensure both the existing and resulting unit are economically and technically viable. Consequently, merely because certain common assets and liabilities have not been transferred, the transaction would not cease to be demerger of an Undertaking, provided the assets and liabilities transferred, by themselves, constitutes a running business and the business can be carried on uninterruptedly with such assets and liabilities alone.

## CONCLUSION

Principle enshrined in this case is that, in a demerger under a scheme of arrangement, the parties are free to mutually agree and selectively transfer the common assets related to the undertaking, provided the undertaking can run as an independent unit with the assets transferred. The Court judiciously choose to not interfere with the Scheme as approved by shareholders and creditors and also reiterated the settled position of law that it is necessary to satisfy conditions under Section 2(19AA) of IT Act for tax neutral demerger but these conditions have no bearing on demerger under the Companies Act.

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You can direct your queries or comments to the authors

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<sup>1</sup>Co. Petition No. 4 of 2003, Co. Appl. No 762 of 2009, July 23, 2012.

<sup>2</sup>Demerger has been defined under Section 2(19AA) of the IT Act. Demerger "in relation to companies, means the transfer, pursuant to a scheme of arrangement under sections 391 to 394 of the Companies Act, 1956 (1 of 1956), by a demerged company of its one or more undertakings to any resulting company in such a manner that—

(i) all the property of the undertaking, being transferred by the demerged company, immediately before the demerger, becomes the property of the resulting company by virtue of the demerger;

(ii) all the liabilities relating to the undertaking, being transferred by the demerged company, immediately before the demerger, become the liabilities of the resulting company by virtue of the demerger;

(iii) the property and the liabilities of the undertaking or undertakings being transferred by the demerged company are transferred at values appearing in its books of account immediately before the demerger; the resulting company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis;

(v) the shareholders holding not less than three-fourths in value of the shares in the demerged company (other than shares already held therein immediately before the demerger, or by a nominee for, the resulting company or, its subsidiary) become shareholders of the resulting company or companies by virtue of the demerger, otherwise than as a result of the acquisition of the property or assets of the demerged company or any undertaking thereof by the resulting company;

(vi) the transfer of the undertaking is on a going concern basis;(vii) the demerger is in accordance with the conditions, if any, notified under sub-section (5) of section 72A by the Central Government in this behalf. "

Explanation 1.—For the purposes of this clause, "undertaking" shall include any part of an undertaking, or a unit or division of an undertaking or a business activity taken as a whole, but does not include individual assets or liabilities or any combination thereof not constituting a business activity."

<sup>3</sup>Section 392 of Companies Act provides the Power of Tribunal To Enforce Compromises And Arrangements. It states:

"(1) Where the Tribunal makes an order under section 391 sanctioning a compromise or an arrangement in respect of a company, it --

(b) may, at the time of making such order or at any time thereafter, give such directions in regard to any matter or make such modifications in the compromise or arrangement as it may consider necessary for the proper working of the compromise or arrangement."

<sup>4</sup>Section 394(2) of Companies Act provides "Where an order under this section provides for the transfer of any property or liabilities, then, by virtue of the order, that property shall be transferred to and vest in, and those liabilities shall be transferred to and become the liabilities of, the transferee-company; and in the case of any property, if the order so directs, freed from any charge which is, by virtue of the compromise or arrangement, to cease to have effect."

<sup>5</sup>In the Judgment Business activity has been said to mean operations or combinations of operations carried on by the undertaking and constituted as a whole.

<sup>6</sup>264 ITR 193 (Bom).

<sup>7</sup>[1979] 3 SCC 54, the said case has been referred affirmatively by the courts in India at several instances, the last instance been the Delhi High Court decision in In Re: Spice Communications Limited and Anr., [2011] 108 SCL 372 (Delhi).

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