CORPORATE RESTRUCTURING

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Introduction

The recent financial crisis of the late 1990s have underlined how extensive and severe weaknesses in corporate finance and governance can have unexpected and extremely serious consequences on the social and economic aspects of a country. As a result of this, many international financial institutions recognized the need for a strategy to avoid the severity of crises in the corporate sector. Today, corporates extensively rely upon reconstruction, mergers, acquisitions, and takeovers to meet the challenges of a dynamic and ever changing global business environment.

Restructuring is the latest buzzword in corporate circles. Companies are competing with each other in search of excellence and competitive edge, experimenting with various tools and ideas. The changing national and international environment is radically changing the way business is conducted. Moreover, with the pace of change so great, corporate restructuring assumes paramount importance. The concept of restructuring involves embracing new ways of running an organization and abandoning the old ones. It requires organizations to constantly reconsider their organizational design and structure, organizational systems and procedures, formal statements on organizational philosophy and may also include values, leader norms and reaction to critical incidences, criteria for rewarding, recruitment, selection, promotion and transfer.

Corporate restructuring is the processes through which business organizations grow and restructure themselves for more profitability. These processes are undertaken to enhance growth, increase shareholder value and extract maximum synergy. The definitive objective of corporate restructuring is to achieve higher productivity and utilize all probable expansion opportunities.

The process of Corporate restructuring has, over the last few years, run at an exceptional level. Due to rapid privatization, globalization and liberalization, India is re-shaping itself from conglomerate structure to focused organizations in order to be core competent. Corporate Restructuring has become a powerful tool to accomplish this objective.

Corporate Restructuring

Let us first understand what ‘restructuring’ is. Restructuring is the corporate management term for the act of partially dismantling or otherwise reorganizing a company for the purpose of making it more

efficient and therefore more profitable. It is a general expression for major corporate changes aimed at greater efficiency and adaptation to changing markets. Spin-Offs, Recapitalizations, Strategic Buyouts and major management realignments are all developments frequently associated with corporate restructurings.

A corporate reconstruction arises where a corporate group reorganizes its business structure like transferring assets between corporations that are members of the corporate group and generally involves selling off portions of the company and making severe staff reductions. Corporate restructuring is often done as part of a bankruptcy or of a takeover by another firm, particularly a leveraged buyout by a private equity firm.[1] One of the purposes of corporate restructuring is to have an optimum business portfolio, by deciding whether to retain, divest or diversify the business. Business portfolio restructuring can be done in a variety of ways like amalgamations, merger, demerger, slump sale, takeover, disinvestment, joint venture, foreign franchises, strategic alliance, etc.

Another way of explaining corporate restructuring is that it is a significant modification made to the debt, operations or structure of a company. Such a type of corporate action is usually made when there are significant problems in a company, which are causing some form of financial harm and putting the overall business in jeopardy.

Corporate restructuring demands an in-depth understanding of the nature of organizations, its internal and external threads, functions, processes and the cultural and human resource factor. It involves restructuring the assets and liabilities of corporations, including their debt-to-equity structures, in line with their cash-flow needs to promote efficiency, restore growth, and minimize the cost to taxpayers. Corporate governance refers to the framework of rules and regulations that enable the stakeholders to exercise appropriate oversight of a company to maximize its value and to obtain a return on their holdings. It involves the dismantling and rebuilding of areas within an organization that need special attention from the management and CEO. The process of corporate restructuring often occurs after buy-outs, corporate acquisitions, takeovers or bankruptcy and is considered necessary where a company needs to improve its efficiency and profitability and requires expert corporate management.

Corporate restructuring provides the necessary objectivity and methodical support to bring a company back on the road to success. It involves making radical changes in the composition of the businesses in the company's portfolio. This type of corporate action is usually made when there are significant problems in a company, which are causing some form of financial harm and

putting the overall business in jeopardy.

REASONS

There are several reasons for restructuring such as:

Induce Higher Earnings: The two basic goals of corporate restructuring may include higher earnings and the creation of corporate value. Creation of corporate value largely depends on the firm's ability to generate enough cash.

Control Core Competence: With the concept of organizational learning gaining momentum, companies are laying more emphasis on exploiting the rise on the learning curve. This can happen only when companies focus on their core competencies. This is seen as the best way to provide shareholders with increased profits.

Divestiture and Networking: Companies, while keeping in view their core competencies, should exit from peripherals. This can be realized through entering into joint ventures, strategic alliances and agreements.

Ensure Clarity in Vision, Strategy and Structure: Corporate restructuring should focus on vision, strategy and structure. Companies should be very clear about their goals and the heights that they plan to scale. A major emphasis should also be made on issues concerning time the frame and the means that influence their success.

Provide Proactive Leadership: Management style greatly influences the restructuring process. All successful companies have clearly displayed leadership styles in which managers relate on a one-to-one basis with their employees.

Empowerment: Empowerment is a major constituent of any restructuring process. Delegation and decentralized decision making provides companies with effective management information system.

TYPES OF RESTRUCTURING

Business firms engage in a wide range of activities that include expansion, diversification, collaboration, spinning off, hiving off, mergers and acquisitions. The different forms of restructuring may include:

Expansion: Expansions may include mergers, acquisitions, tender offers and joint ventures. Mergers per se, may either be horizontal mergers, vertical mergers or conglomerate mergers. In a tender offer, the acquiring firm seeks controlling interest in the firm to be acquired and requests the shareholders of the firm to be acquired, to tender their shares or stock to it. Joint ventures involve only a small part of the activities of the companies involved.

Sell-Off: Sell-Off may either be through a spin-off or divestiture. Spin-Off creates a new entity with shares

being distributed on a pro rata basis to existing shareholders of the parent company. Split-Off is a variation of Sell-Off. Divestiture involves sale of a portion of a firm/company to a third party.

Corporate Control: Corporate control includes buy-backs and greenmail where the management of the firm wishes to have complete control and ownership.

Change in Ownership: Change in ownership may either be through an exchange offer, share repurchase or going public.

Characteristics

The selling-off of portions of the company, such as a division that is no longer profitable, can greatly improve the company's financial standing. Staff reductions are often accomplished partly through the selling or closing of unprofitable portions of the company and partly by consolidating or outsourcing parts of the company that perform redundant functions such as payroll, human resources, and training.

Other characteristics of restructuring can include:

- Reorganization of functions such as sales, marketing, and distribution.
- Refinancing of corporate debt to reduce interest payments
- Changes in corporate management (usually with golden parachutes[2]).
- Outsourcing of operations such as payroll and technical support to a more efficient third party.
- Moving of operations such as manufacturing to lower-cost locations.
- Renegotiation of labor contracts to reduce overhead
- A major public relations campaign to reposition the company with consumers
- Forfeiture of all or part of the ownership share by pre restructuring stock holders (if the remainder represents only a fraction of the original firm, it is termed a stub[3]).

Restructuring Methods

There are several methods of restructuring and each has its own set of advantages and disadvantages for companies and investors.

SELL-OFFS

A sell-off, also known as a divestiture, is the outright sale of a company subsidiary. Normally, sell-offs are done because the subsidiary doesn't fit into the parent company's core strategy. The market may be

undervaluing the combined businesses due to a lack of synergy between the parent and subsidiary. As a result, management and the board decide that the subsidiary is better off under different ownership. Besides getting rid of an unwanted subsidiary, sell-offs also raise cash, which can be used to pay off debt.

EQUITY CARVE-OUTS

many companies are resorting to equity carve-outs to improve the shareholder value. A parent firm makes a subsidiary public through an initial public offering (IPO) of shares, amounting to a partial sell-off. A new publicly-listed company is created, but the parent keeps a controlling stake in the newly traded subsidiary. A carve-out is a strategic avenue a parent firm may take when one of its subsidiaries is growing faster and carrying higher valuations than other businesses owned by the parent. A carve-out generates cash because shares in the subsidiary are sold to the public, but the issue also unlocks the value of the subsidiary unit and enhances the parent's shareholder value. The new legal entity of a carve-out has a separate board, but in most carve-outs, the parent retains some control. In these cases, some portion of the parent firm's board of directors may be shared. Since the parent has a controlling stake, meaning both firms have common shareholders, the connection between the two will likely be strong.

However, there are times when companies carve-out a subsidiary not because its doing well, but because it is a burden. Such an intention won't lead to a successful result, especially if a carved-out subsidiary is too loaded with debt, or had trouble even when it was a part of the parent and is lacking an established track record for growing revenues and profits.

SPIN-OFFS

A spinoff occurs when a subsidiary becomes an independent entity. The parent firm distributes shares of the subsidiary to its shareholders through a stock dividend. Since this transaction is a dividend distribution, no cash is generated. Thus, spinoffs are unlikely to be used when a firm needs to finance growth or deals. In Spinoffs, the subsidiary becomes a separate legal entity with a distinct management and board.

Like carve-outs, spinoffs are usually about separating a healthy operation. In most cases, spinoffs unlock hidden shareholder value. For the parent company, it sharpens management focus. Once spinoff shares are issued to parent company shareholders, some shareholders may be tempted to quickly dump these shares on the market, depressing the share valuation.

TRACKING STOCK

A tracking stock is a special type of stock issued by a publicly held company to track the value of one segment of that company. The stock allows the different segments of the company to be valued differently by

investors. Let's say a slow-growth company trading at a low price-earnings ratio (P/E ratio) happens to have a fast growing business unit. The company might issue a tracking stock so the market can value the new business separately from the old one and at a significantly higher P/E rating. Why would a firm issue a tracking stock rather than spinning-off or carving-out its fast growth business for shareholders? The company retains control over the subsidiary; the two businesses can continue to enjoy synergies and share marketing, administrative support functions, a headquarters and so on. Finally, and most importantly, if the tracking stock climbs in value, the parent company can use the tracking stock it owns to make acquisitions.[4]

Corporate Restructuring in India

Business Restructuring in India has been time-consuming and expensive. A strong requirement of conducive regulatory environment, a complex tax framework, court processes and an endless list of compliance issues obstruct the process and impair competent and valuable rearrangement of resources through restructuring. With the advent of foreign investment following liberalization in 1991, Indian industry experienced global competition within the country and it had to reorganize its own business in the manner best suited to competition and collaboration.

All innovations and inventions in terms of corporate and principles happen abroad, and then are being carried to Indian environment. Corporate restructuring, out of all emerging concepts of findings ways to serve shareholders better, has been a very successful concept abroad and its been followed all the more in high context cultures like India.

The rapidity with corporate finance due to external factors like increased price volatility, a general globalization of the markets, tax asymmetric, development in technology, regulatory change, liberalization, increased competition and reduction in information and transaction costs and also factors like liquidity needs of business, capital costs and growth perspective have lead to practice of corporate restructuring as a strategic move to maximize the shareholder's value.

in the initial years of economic liberalization, Indian companies failed to create sufficient value from acquisitions, as compared to MNCs. However, with the passage of time, Indian companies have begun developing the necessary capabilities to create more value from deals.

Reorganizing and restructuring of business has been an on-going process over the past few years and corporates have resorted to restructuring in one form or another. The need to restructure has been driven by various factors such as:

- Consolidation of business in highly fragmented industries like cement where volumes play a pivotal role in order to make optimum use of the capacities and to achieve economies of scale in marketing.

- Companies which have diversified into unrelated business due to the licensing system, regulatory controls and high corporate taxes are now looking at the possibility of grouping of these business under one corporate entity, or moving out of their non-core business.

The same business when spread over various companies of an industrial group proves to be an operational handicap, since in the liberalized scenario it would not be possible to support the same business of another entity in the group, with financing and other related business supports without first having to go through the legal procedures of inter corporate loan, guarantees etc. In short restructuring brings about a high degree of focus and flexibility of approach.

Indian industry needs to significantly restructure and reorganize. The existing legal provisions no doubt covers reorganization and restructuring, but the cost and the delay are so enormous that it either prevents or dissuades the parties from pushing

Multinational corporations are also entering India. Meanwhile, Indian companies, sensing attractive opportunities outside the country are also venturing abroad. Tata Steel has bought Singapore-based NatSteel for $486 million. Videocon has bought the colour picture tubes business of Thomson for $290 million.

Such global forays have become a possibility because foreign exchange is no longer a scarce commodity. They have also become a necessity because in globalizing industries, only players with global scale and reach can survive.

Legal Implication of Restructuring

THE COMPANIES ACT, 1956

Section 394 of the Companies Act largely talks about reconstruction, restructuring and amalgamation of companies. Chapter V containing Sections 390 to 396A of the Act is a complete code in itself. It provides for the law and procedure to be complied with by companies for compromises, arrangements and reconstruction.

The scheme of compromise and arrangement scheme under Section 391 of the Act provides for all matters which the Company Court should consider and also the conditions under which it has to exercise its powers.

Section 390 gives the interpretation of certain important terms used in Sections 391 and 393 of the Act.

The Section 10 E of the Companies Act deals with the constitution of the Company Law Board. Though the Central Government constitutes the Board, the provisions indicate that it is independent of government intervention in matters of exercise of its jurisdiction. Section 10 F provides that appeals against orders of the Company Law Board can be filed before the concerned High Court. The Company Law Board has been empowered to make its own regulations and accordingly regulations have been framed in 1991.

INCOME-TAX ACT, 1961

A restructuring in which the value of the business undertaking is not en-cashed does not lead to taxable income. Under Section 47(vi) of the Income Tax Act, transfer of assets to the transferee company pursuant to a scheme of amalgamation is not a 'transfer' and does not attract capital gains tax.

Similarly, shares allotted to shareholders of the transferor company are not a transfer for attracting capital gains.

IMPLICATIONS OF STAMP DUTY

Different States in India have different rates of stamp duty for restructuring. The order passed under section 394 being of a vesting nature, it is inconceivable that the court order should be classified as 'conveyance' under the stamp act and subject to payment of exorbitant amounts of stamp duty.

The implications of such provisions of the stamp act is two fold;

- It seeks to impose stamp duty on an instrument which is not an executed document between the parties but an executable order of the court and;

- By implication it seeks to override the vesting effect of the order under section 394 and make it subject to payment of stamp duty.

- It leads to an incongruous position of a State enactment on stamp duty, amending the provisions of Companies Act.

Conclusion

Corporate and financial restructuring takes time. However, to avoid an unnecessarily long period of uncertainty and slow growth, a country's government needs to enhance efforts to resolve these systemic problems. A comprehensive approach requires an active government that will eliminate obstacles to restructuring; facilitate both formal and informal debt workouts; and establish an effective new legal, regulatory, accounting, and institutional framework.

Restructuring transactions for corporates should be outside the purview of Section 269 of the Income-Tax Act approval to avoid unnecessary administrative delays to the restructuring process. The transfer of any immovable property arising out of the demerger should not attract any stamp duty. Restriction on acquisition and transfer of shares in respect of dominant undertakings under Sections 108A-108G under the Companies Act should be removed, and the transfer of capital assets as part of restructuring should not attract any sales tax liability.

It is essential to recast Section 72A of the Income-Tax Act to support corporate mergers and acquisitions. Permission and uncertainties surrounding the Section have been a major hurdle to industry. It would be better if all the tax allowances of the sick merging company _ such as unabsorbed depreciation and business loss _ were allowed for carry-forward/adjustment by the merged company without having to obtain specific permission from the prescribed authority. Nor should companies be forced to resort to such artificial stratagems as reverse mergers.

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[1] See: http://en.wikipedia.org/wiki/Restructuring

[2] Golden Parachute is a clause (or several) in an executive's employment contract specifying that they will receive certain significant benefits if their employment is terminated. These benefits may include severance pay, cash bonuses, stock options or a combination of the items.

[3] A stub is the stock representing the remaining equity in a corporation left over after a major cash or security distribution from a buyout, a spin-out, a demerger or some other form of restructuring removes most of the company's operations from the parent corporation. A stub may retain the name of the original corporation, or in some cases may take another name as part of the restructuring.

[4] See: http://www.indianmba.com/Faculty_Columnl