ANALYZING THE REGULATORY ARBITRAGE POTENCY OF THE INDIAN CORPORATE RESTRUCTURING REGIME, IN THE SPECIFIC CONTEXT OF REVERSE MERGERS FROM THE LENS OF INVESTOR PROTECTION

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The concept of corporate restructuring may be primarily defined as the systemic alteration of corporate composition; entailing the "re-organization" of business activity [classified as principal revenue generation/operation; Investment (Portfolio-Holding) and Financing][i] in furtherance of the optimal fulfilment of organizational objectives (subject to the mitigation of extraneous and intrinsic cost- inclusive of 'Agency Costs'). Corporate restructuring, may hence be characterized as a modus operandi of evolutionary business survival- fostering the dynamic mitigation of detrimental costs (often impairing fundamental profitability/metrics of financial health)- attributable to both internal and external business ecosystems. The 3 forms of corporate restructuring- derived from the classification of business activity, entail: financial, organizational and investment portfolio restructuring.[ii] Financial restructuring would amount to the alteration of corporate capital structure or the principal financing activities of a business. Organizational restructuring would amount to the alteration of principal business operations (entailing the combination of productive factors- and their organization i.e., human capital deployment, sales strategy deployed). Investment portfolio restructuring would pertain to the alteration of a company's investments (potentially subject to any degree of control/stake retained by the company devoid of the materiality of 'holding characterization') and/or investment structure (potentially definitive of the composition of its principal business operations). Such classes of corporate restructuring transactions, may be subject to concurrent

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relevance, with a specific restructuring attempt (i.e., The acquisition of a competing business), potentially amounting to financial, organizational and investment portfolio restructuring.

The aforementioned extraneous costs warranting corporate restructuring, may be best exemplified through the impetus of a hypothetically evolving regulatory regime; while an intrinsic cost may be exemplified through Jensen's Free Cash Flow Hypothesis, warranting multi-dimensional corporate restructuring, impacting every class of business activity in the light of managerial 'Agency Costs'.[iii] The free cash flow hypothesis stipulates the managerial tendency to improperly diminish 'excess-cash' potentially in the possession of a profitable company, post the organic sustenance of every positive Net Present Value- Investment. The disparity between the capital consumption requisites of the contemporary corporate composition and the quantum of accessible capital; coupled with the potential incongruity of managerial vision, with the original objectives of the business, post the accomplishment of the milestone of profitability (validated by the collective shareholder body), may result in capital seepages (in the form of detrimental acquisitions/ improper use).

Consistent Corporate Restructuring, with the growth of the company, may therefore be observed as a proactive measure in the inhibition of capital seepages.[iv]

The fluidity of intra-organizational control and the diminished managerial authority of the previous status-quo, being characteristic of the practice of corporate restructuring, may however emerge as obstacles to the proactive inhibition of capital seepages. An alteration of corporate composition, provides for opportunity for the Key Managerial Personnel and/or the controlling interest of the company (either directly/vicariously)- determinative of the adopted corporate restructuring scheme[v], to disregard the preceding corporate governance regime, and exploit regulatory lacunae, for the advancement of selfish interest, as best exemplified by the Sunbeam-Oster case.[vi] The use of 'restructuring' as a method of the artificial inflation of corporate valuations, and the subsequent derivation of significant unwarranted earnings post the sale of the company by the Key Managerial Personnel, were substantiated by this case.

The distinction between the unlawful evasion of regulatory impetus; and the lawful avoidance of regulatory costs, through the modus of corporate restructuring is therefore significant, in the ascertainment of transactional validity (from the lens of adherence to the multi-fiduciary interest model).

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The transaction of 'Reverse-Mergers', initially being a practice of financial and investment-portfolio restructuring, with subsequent implications upon operational activities; best exemplifies the dualistic nature of corporate restructuring in either inhibiting or aggravating environment induced capital seepages. The premise of this essay is that the optimality of adopted capital restructuring schemes is contingent upon the relevant jurisdiction of the transaction. Reverse Mergers entail the catalysation of accessing capital markets for private companies (advancing liquidity)[vii], devoid of the detrimental legal, accounting and underwriting costs, coupled with the foreseeable fluctuation of market-capitalization of the conventional Initial Public Offering process, potentially entertained by management (amounting to capital seepages). In its rudimentary essence, a reverse merger entails the conversion of shareholding in an unlisted company, to a listed public company, either through the amalgamation of a public listed company and a private company; succeeded by an asset swap by the shareholders of the originally private company; or through the use of further intermediaries- Wholly Owned Subsidiaries. A reverse merger may thereby entail the conversion of a private limited company to a public listed company; through the acquisition of the latter by the former. The 'cost-avoidance' centric objective of reverse mergers as a form of corporate restructuring, is contrasted by the possible evasion of liability pertinent to the non-adherence of the conventional disclosure and listing requisites of Initial Public Offerings/accessing capital markets. With the advent of cross-border reverse mergers, such duality has resulted in grave detriment to retail investors, in excess of 500 billion USD, in the context of the U.S, as exemplified by the numerous cases of fraudulent Chinese Companies, gaining access to American capital markets, through misrepresented financial performance, and the subsequent evasion of due liability.[viii]

It is therefore in the best interest of retail investors and the health of capital markets, for the regulatory allowance of capital seepage mitigation (i.e., avoidance of detrimental legal and capital-access costs) through the practice of reverse mergers; along with the proactive-deterrence of the fraudulent and unlawful evasion of liability[ix]- arising from the disregard of statutory public listing requisites. The essay explores the jurisdictional arbitrage opportunity available to prospective investors (retail and institutional) in entities- subject to potential reverse mergers, in the Republic of India, due to the successful prophylactic regulatory impetus. Comparative references are drawn to the reactionary law and policy of reverse merger

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regulation in the United States; which may benefit from the derivation of influence from the contemporary Indian regulatory framework.

Such a proposition for the multi-jurisdictional application of the Indian corporate governance framework- in the specific context of investor protection, during reverse merger transactions, is in furtherance of the argument of Professor Umakanth Varottil[x],found in his article, cautioning against the transplantation of American and European corporate governance frameworks in India. In the specific context of the regulation of reverse mergers, the 'Caveat Emptor' approach, adopted by western jurisdictions in the conception of investor protection policy; may benefit from a paradigm shift, towards the precursory enforcement of the statutory requisites of public-capital-access (amounting to the proactive protection of prospective investors). The use of reverse mergers for the optimal attainment of public listed status and the access to expansionary-liquidity; by private companies, in recent times, was subject to the enhancement of procedural efficiency, by policy- allowing reverse mergers into publicly listed shell companies.[xi] While the feigned objective of the policy was to eradicate the conflict of independent financial, investment and organizational structures (in the consolidated publicly listed entity post reverse merger); the public listing of a shell company may amount to significant detriment to prospective investor interests. The vacuous nature of shell companies, devoid of potentially collateralized assets/business activity; results in insecurity for potential shareholders, who may experience the unproductive diversion and theft of their capital (subject to obfuscation and layering).

The ease of shell company incorporation and public listing, would also eradicate any qualification requisites for companies granted access to capital markets- removing any performance thresholds, behind the facade of access-equalization; at the significant detriment of investors who may be duped into investing in entities devoid of a track record of successful financial performance (one of the core tenets of eligibility for ideal public listing).[xii]

The vacuous corporate composition of a shell company, subject to potential reverse merger, may also result in the absence of commitment to the original objectives of the business activity (post the accumulation of public capital); and may facilitate circumvention from the ambit of the object clause of the Articles of Association. Investors may also be misinformed of the prospective principal revenue generating activity of the consolidated entity.[xiii] The conventional corporate liability that may be imposed upon the Key Managerial Personnel of a

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company, in the case of non-adherence to the proclaimed principal revenue generating activity- contained in the prospectus, prior to an Initial Public Offering, may be evaded with the pursuit of the reverse merger, into a listed shell company.

While the perils of permitting a shell company, devoid of prior corporate composition, to list on a public stock exchange, may be observed; the role of reverse mergers in facilitating the revival of sick enterprises (subject to prior public listing; or requiring access to immediate further capital i.e., for repaying leverage to avoid default) cannot be overlooked- with specific reference drawn to the tax incentive structure applicable in the jurisdiction of India.

The two forms of reverse mergers explored in this essay are: ‘direct reverse mergers’ and ‘triangular reverse mergers’. Direct reverse mergers are contingent upon the existence of 2 separate corporate-personalities: a public listed entity and a private company; subject to consolidation. Triangular reverse mergers, entail the integration of Wholly Owned Subsidiaries, into the structuring of the merger transaction. Direct reverse mergers may entail the sale of the public listed entity to the unlisted private company; subsequently altering the nature of the private company- eradicating restrictions upon raising capital from the general public and the prior prohibition of accessing capital markets in a private state. In the absence of a direct acquisition of the public listed entity; direct reverse mergers may also entail the preliminary acquisition of controlling interest from the shareholders of the public listed entity, by the shareholders of the unlisted private company; following which the entities may be consolidated; with the ultimate recalibration of the capital structure.[xiv] Direct reverse mergers may also consist of arrangements of asset-swaps- incentivizing the transfer of controlling interest in the ‘public listed entity’ to the shareholders of the private company. The triangular reverse merger may be subject to the same regulatory impetus; however, the integration of the private company is not directly with the public listed entity, but instead with a wholly owned subsidiary of the same- intended to bear an emblematic impact of corporate personality alteration.[xv]

In the context of justifying my thesis of the impact of jurisdiction upon the ascertainment of reverse merger optimality; the responsive and consequential regulation of direct reverse mergers (inclusive of the ambit of triangular reverse mergers) in the United States, is contrasted with the pre-emptive role of Indian regulatory impetus.

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The contemporary regulation of reverse mergers in the United States, has evolved from the status quo of the years 2009-2012; during which the perpetration of en-masse investor fraud and the evasion of subsequent liability through the modus of reverse mergers took place.[xvi] The tone of providing caution to prospective investors in reverse merger transactions; devoid of protectionary measures, of equivalent impact, is however characteristic of both past and present regulation. In the year 2011, the Securities & Exchange Commission, observed the prevalence of reverse mergers, as a practice of accessing American capital markets, amongst mainland Chinese enterprises.

Due to the absence of enforceability of the veracity of SEC mandated public disclosures, for companies utilizing the cross-border reverse merger route; several privately held Chinese companies, engaged in the artificial inflation of market valuation (post reverse merger), through the projection of inaccurate financial performance and business practices (devoid of any form of investor verification, aside from physical production-facility visit). The practice of inflationary accounting, practiced by the Chinese firms, was exempt from liability, beyond the ambit of SEC suspension of trading, due to the absence of robust enforcement mechanism, and the 'Caveat Emptor' approach, adopted by US regulators, in the avoidance of blame.

The capital raised, and diverted out of the jurisdiction of the U.S, and into mainland China, was never recovered; resulting in a loss exceeding 500 billion USD, for American investors, devoid of restitution/any form of reclamation. [xvii] The allowance of the incorporation, listing and acquisition of 'public shells' (up till today) may be accredited for the absence of any reclamation scope, due to the absence of collateralized assets/business activity.

'Public Shells' in the American jurisdiction may be characterized as one of 3 forms, in accordance to the provisions of Rule 4501 of the Securities Act, 1933[xviii] and Rule 12b-22 of the Securities Exchange Act, 1934.[xix] Public Shells may either be newly incorporated and formed with the specific purpose of facilitating acquisition and subsequent backdoor listing; or be subject to prior incorporation- with further differentiation on the basis of 'corporate form': either pursuing minimal business activity (in the developmental stage) or being subject to the disposal of assets/business activities (post liquidation).

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I believe, the fundamental fallacy of the American regulation of reverse mergers, may be accredited to the initial allowance of the automatic listing of newly incorporated shell companies (devoid of any track record of financial performance)[xx] and the automatic allowance (devoid of requisite government approval) of cross border reverse mergers with public listed entities subject to prior incorporation, assuming the position of 'Public Shells' post liquidation/disposal of assets and/or business activity.

The Indian jurisdiction on the contrary, is devoid of scope for such evasion of liability and violation of investor confidence, due to the distinct position of the legality of shell company listing. While shell companies, are not subject to any express prohibition from public listing; any company attempting to publicly list in a stock exchange, is subject to the precursory requisites of Chapter II, Regulation 6 of the SEBI (Issue of Capital and Disclosure Requirements) Regulations 2018. Regulation 6 (1) (b)[xxi] prescribes the requisite of consolidated profitability for the past 3 years, as an eligibility threshold for public listing, and shell companies incorporated with the objective of catalysing the access of capital markets for potential private entities – while circumventing the conventional IPO route, would not qualify. The requisite of profitability for a minimum period of 3 years, was an eligibility metric for listing in the jurisdiction of India, since the year 2009, with the applicability of chapter III, regulation 26 (1) (b) of the SEBI ICDR 2009.[xxii]

The U.S regulation, was primitive in comparison, with the initial allowance of the listing of newly incorporated shell companies, catalysing reverse mergers (subject to gross abuse by Chinese Enterprises as exemplified).[xxiii]

The requisite of prior profitability however, has not prejudiced the Indian Government's allowance of the utilization of reverse mergers, for the revival of loss-making sick enterprises (either public or private in nature). In fact, the Indian government further incentivized the optimal restructuring of sick enterprises through the modus of reverse mergers by the conception of Section 72 (A) of the Income Tax Act, 1961.[xxiv] Newly consolidated entities (inclusive of the pre-amalgamation sick enterprise), may benefit from the ability to mitigate tax liability; while creating allowances for depreciation/losses attributable to the previously sick enterprise. The proactive distinction of the Indian regulatory regime between pre-existing publicly listed shell companies- deemed sick enterprises; and potentially newly listed shell companies, is indicative of greater depth. While the Companies Act 1956, was devoid of any

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restrictions on reverse mergers; the Companies Act 2013, entails a general ban on the exploitation of the reverse merger route to evade the listing obligations and disclosure requisites (inclusive of capital disclosure requisites) pertinent to the conventional IPO process; and the concurrent liability arising from potential non-adherence. Section 232 (h) of the Companies Act, restricts the access of private unlisted enterprises attempting to reach the Indian capital markets through amalgamation with a listed entity; attempting to alter corporate personality while eradicating capital subscription restraints.

Section 232 (h) mandates the final form, of a consolidated entity- consisting of the amalgamation of an unlisted and listed company- as unlisted in nature. Hence the only way the status of being 'publicly listed' can be achieved is through the mandate of state approval, obtained post the adherence to statutory requisites (provided vicariously through the SEBI-being an instrument of state). The procedure of obtaining 'public listed status' is contingent upon the involvement of the stock exchange, the SEBI and the National Company law Tribunal (being the redressal mechanism for investor claims). Contrary to the American jurisdiction, which was unsuccessful in enforcing the restitution of the defrauded investors by the Chinese Companies; the Indian NCLT, obtains de-facto jurisdiction for the provision of remedies to Indian investors, even in the case of cross border reverse mergers.

In accordance to circulars issued by the SEBI on February 4th 2013[xxv] and May 21st 2013[xxvi]: (i.) The amalgamation of listed and unlisted companies can only take place, post the derivation of SEBI approval (ii.) The SEBI may inspect and scrutinize- in the interest of protecting prospective investors; any potential scheme of restructuring, reached via reverse merger. In a more recent circular issued by the SEBI, on March 10th 2017; the proposal issued to prospective shareholders, by the consolidated entity arising from a reverse merger, for the accumulation of further capital, would be held to a higher degree of scrutiny- emblematic of a prospectus- with the requisite of absolute veracity, being imposed. Contrary to the numerous cases of fraudulent Chinese enterprises in the U.S; the success of the Indian statutory framework may be observed from the numerous cases of successful domestic and cross border reverse mergers- ranging from the Godrej Soaps case and the ICICI Bank Case to the listing of Yatra and Videocon.[xxvii] Indian case law pertinent to the characterization of reverse mergers, may be found at the High Court level, with the Gujarat High Court pioneering the test for the recognition of a takeover through reverse merger, in the Bihari Mills Case.[xxviii] The case upheld the crucial requisite of

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disparity between the quantified valuation and net-worth of the acquiring company and the target company, along with the prospective change in control- for the ascertainment of a takeover; and the public listed nature of the target of the acquisition; for the ascertainment of the modus of reverse merger.

In conclusion, the regulation of reverse mergers in the jurisdiction of India, is subject to comprehensive statutory definition and concurrent successful application, observed from the nature of Indian precedent pertinent to reverse mergers (devoid of predominant fraud-cases). Reverse mergers in India do not entail the abdication of conventional listing obligations; and do not entail the evasion of liability attributable to potential non-adherence. The degree of protection offered to retail investors, is significantly higher in the context of Indian reverse merger regulation; hence investors in Indian capital markets- considering entities subject to prior restructuring via reverse mergers, may benefit from Jurisdictional Arbitrage.

ENDNOTES

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