PRACTICE GUIDES

India M&A

Second Edition

Contributing Editor
PM Devaiah

LEXOLOGY
Getting The Deal Through

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Practice Guide

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Key Labour and Employment Issues in M&A Transactions

Disha Mohanty and Anup Kumar[1]

Mergers and acquisitions (M&A) are tools used for the growth of business and optimisation of resources. M&A transactions have a significant influence on the employees of target entities, and the success of these transactions depends on a fair balance being struck between employees' security and business interests.

'Merger' is not defined in the Companies Act 2013 or the Income Tax Act 1961. Generally, a merger means the combination of two or more entities and their businesses into a single entity. In a merger, only the resultant entity continues to exist and all other entities are dissolved.

An acquisition involves either:

- purchase of controlling shares of one entity by another person or entity (share purchase acquisition); or
- purchase of a business in the form of assets and liabilities along with employees on a going-concern basis (commonly referred to as a 'slump sale acquisition').

In some cases, a buyer purchases certain identified assets and hires only selected employees of the target entity, but not the entire business on a going-concern basis. Such transactions are generally categorised as pure asset purchase transactions (asset purchase acquisition).

M&A and employment arrangements

Mergers

Mergers are carried out under the supervision of the National Company Law Tribunal (NCLT), which a quasi-judicial body. The scheme of merger of entities is placed before the NCLT for its approval. The scheme of merger, among other things, contains provisions about the rights and benefits that will be provided to the employees of merging entities by the resulting entity.

1 Disha Mohanty and Anup Kumar are principals at G&W Legal.

Share purchase acquisition

In a share purchase acquisition, a buyer purchases the shares of the target entity, and the employees remain with the target company.

Slump sale acquisition

A slump sale acquisition involves the transfer of business in a manner that enables the acquirer to carry on the business seamlessly as a going concern. In a slump sale acquisition, the entire business including its employees, all open and effective contracts and liabilities should be transferred as a part of the business without cherry-picking certain identified assets, liabilities or employees. This is a requirement under the Income Tax Act 1961, where the parties wish to avail themselves of tax benefits under the acquisition. The parties can explore asset purchase acquisition where they do not intend to take advantage of tax benefits. Generally, in a slump sale acquisition, the employees are transferred without any break in service and the acquirer assumes obligations in respect of all employees' benefits, such as gratuity, pensions, accrued leave and other rights for the period of employment with the target or transferor entity.

Asset purchase acquisition

An asset purchase acquisition is purely a contractual arrangement between the parties, where a buyer is free to identify the assets and employees for purchase or hire. Under asset purchase arrangements, parties have the option to decide whether the identified employees will be offered continuity of employment, or whether the relevant employee will resign from the target and be rehired afresh by the buyer.

Employment arrangements

Usually, after such transactions, the buyer or the resultant entity implements employment-related restructuring, which may include changes in the designation of employees, their remuneration, perquisites, other employee benefits, work policies and service conditions. Before implementing any employment-related restructuring, it is important to take into account certain legal considerations.

Legal considerations

It is critical for parties involved in a transaction to consider the vast amount of legislation that may apply to employees being transferred, taken over or whose services are to be terminated.

The parties must understand the rights of different categories of employees: workmen and non-workmen (see below).

It is also relevant to identify whether the business to be acquired qualifies as a factory under the Factories Act 1948. The legislation covers issues such as occupational safety and work conditions for factory workers and typically applies to businesses in the manufacturing sector.

In addition, manufacturing industries are usually subject to the Industrial Employment (Standing Order) Act 1946, which requires employers that meets the prescribed thresholds (discussed below) to have in place 'Standing Orders'. These contain terms of employment

including hours of work, wage rates, shift working, attendance and late arrival, provisions for leave and holidays, and termination or suspension or dismissal of employees.[2]

All of the above considerations may have an impact on M&A transactions and associated employment restructuring.

Classification of employees

Employees in India are broadly categorised into workmen and non-workmen. The Industrial Disputes Act 1948 (ID Act) deals with investigations and settlement of industrial disputes, provides statutory protection to workmen in certain matters, such as termination, transfers, and closure of establishments. The ID Act, among other things, also deals with the transfer of business undertakings in relation to workmen.

Workmen

The ID Act defines a 'workman' as any person who is employed in any industry to do any manual, unskilled, skilled, technical, operational, clerical or supervisory work for hire or reward, regardless of whether the terms of employment are express or implied. The following categories of employees are excluded from the definition of workmen:

- persons employed in an administrative or managerial capacity; and
- persons employed in supervisory work and earning more than 10,000 Indian rupees per month.

The definition of a workman is broad enough to cover all employees, except those performing managerial or supervisory functions, but has been a matter of constant debate over the years. Courts across India have examined the issue and have issued differing verdicts

It is common for an employee to be performing managerial or supervisory work as well as work that may be technical, skilled, unskilled or operational in nature. Several courts have ruled that where an employee performs multiple roles, the dominant nature of work performed by such persons in the usual course should be considered while deciding if the employee is a workman or a non-workman.

Generally, software employees and other white-collar workers performing technical work will fall under the category of workmen.[3] That being said, classification of white-collar employees as workmen is a hotly debated (and frequently litigated) topic and courts in India are yet to conclusively prescribe clear parameters for such determination.

Non-workmen

All employees other than workmen, namely employees performing managerial and supervisory functions, will fall under the category of non-workmen.

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2 It is important to consider state-specific amendments to this central legislation, as some states prescribe different applicability parameters. Although the Act applies to both manufacturing and non-manufacturing establishments, some states have exempted knowledge-based service sector industries from its applicability.

3 *K Ramesha v Nitin Pande and Ors*, ID No. 372/2013 before the Additional Labour Court, Chennai.

After classification of employees into workmen and non-workmen, parties should analyse the provisions of the ID Act that may regulate the restructuring of employment pursuant to M&A transactions.

Protection and benefits to workmen under the ID Act

As per the ID Act, in cases where ownership or management of an undertaking is to be transferred, whether by agreement or by operation of law, to a new employer, every workman who has been in continuous service for not less than one year in that undertaking immediately before such transfer is entitled to:

- notice of one month or payment of wages in lieu of notice;
- compensation equivalent to 15 days average pay for every completed year of continuous service, or any part thereof over six months.

However, no compensation is to be paid or notice is to be provided if all of the following conditions are met:

- the service of the workman has not been interrupted by such transfer or change in ownership or management of the undertaking;
- the terms and conditions of employment after such transfer are same or more favourable than those applicable immediately before the transfer; and
- the workman is provided the benefit of continuity of service for the services performed just before the transfer. Employees earn certain benefits such as holiday leave, maternity benefits, gratuity benefits (see 'Due diligence' below), and severance pay benefits only after they have worked for a certain specified minimum period, which varies for different statutes and resultant benefits. The continuity of employment provisions ensures that a person's length of employment just before the transfer of a business flows through to the purchaser of the business or the new entity. This helps to ensure that the new employer or management, upon consummation of the transaction, is liable to pay compensation on the condition that the service of the workman has been continuous and has not been interrupted by the transfer.[4]

These requirements under the ID Act clearly apply in respect of workmen for any merger, slump sale acquisition and asset purchase acquisition. Changes to the terms and conditions of employment and benefits available to the affected workmen employees after the transfer to resultant or transferee entity is possible, provided they are issued notice and paid compensation as discussed above.

The provisions of the ID Act discussed above would not apply be in the case of a share purchase acquisition, since in such transactions, change in shareholding pattern of the employing entity does not result in change of employer.

The rights of non-workmen

The rights of non-workmen in M&A transactions are governed primarily by the employment contract. Unlike in the case of workmen, the law does not require that non-workmen should

4 Section 25FF of the Industrial Disputes Act 1947.

be offered continuity of employment with the same or better terms of employment after the acquisition of an undertaking or by the resulting entity upon a merger. However, from a practical perspective, employers tend to treat non-workmen employees at par with workmen, if not better, in so far as benefits are concerned.

A review of the terms of the employment contracts of non-workmen employees is important, in order to understand the incentives and compensation that may be trigged pursuant to an M&A transaction.

Consent requirements

In November 2011, the Supreme Court of India, in the case of *Sunil Kr Ghosh v K Ram Chandran*,[5] ruled that workmen cannot be forced to work under different management without their consent, and the workmen unwilling to work under new management are entitled to retrenchment[6] compensation in terms of the ID Act.

This case involved the transfer of ownership of a consumer electronics factory by Philips India Limited (Philips) to Kitchen Appliances India Limited (KAIL) without taking the prior consent of employees. Although the relevant employees of Philips working in the factory were transferred without any interruption in the service and working conditions and the terms of service after the transfer were the same as those applicable before the transfer, several employees objected to the transfer of the factory from Philips to KAIL.

The ID Act does not expressly require employers to obtain consent from the relevant employees before transfer the ownership or management of the establishment to a third party. The only requirements prescribed under the ID Act in the case of transfer the ownership of the establishment to a third party are:

- ensuring that the service of the workman has not been interrupted;
- terms and conditions of employment after such transfer are the same or more favourable than those applicable immediately before the transfer; and
- that the workman is provided the benefit of continuity of service for the services performed just before the transfer.

However, the Supreme Court introduced new jurisprudence on the right of employees in a merger or acquisition, whereby the transferor entities are now required to obtain consent from workmen before effecting any change ownership or management of the establishment.

As such, transferee entities should seek written consent from its workmen before concluding any transaction. Although the present case dealt with 'workmen' and the ID Act, it is unclear if employers are required to seek consent from all employees, including non-workmen. Given the Court's inclination towards upholding the principle of natural justice, an employer should consider treating non-workmen at par with workmen at least on issues relating to consent.

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5 *Sunil Kr Ghosh v K Ram Chandran*, 2011 (14) SCC 320.

6 'Retrenchment' under the ID Act means termination by the employer of the service of a workman for any reason whatsoever, otherwise than as a punishment inflicted by way of disciplinary action, but does not include: voluntary retirement of the workman; retirement of the workman; termination of the service as a result of the non-renewal of the contract of employment on its expiry; or termination of the service of a workman on the ground of continued ill-health.

Employees who refuse to be transferred before any merger or acquisition will have to be paid severance compensation. Severance compensation in respect of workmen is generally referred to as retrenchment compensation, which is equivalent to 15 days average pay for every completed year of continuous service, or any part thereof over six months. Consent should be sought before the effective date of the transaction, failing which the workmen may also be entitled to payment of wages in lieu of notice.

The severance compensation in respect of non-workmen will depend on the terms of the employment contract. Generally, employment contracts envisage termination of employment upon prior notice of specified duration.

In addition to severance compensation, employees (both workmen and non-workmen) will be entitled to other accrued employment benefits such as gratuity (see 'Due diligence'), leave encashments, and other contractual benefits that may have accrued before severance of employment.

Approval requirements

In several cases, some form of employment restructuring takes place either before or after the completion of the M&A transaction. This restructuring may involve job redundancy or closure of certain business verticals.

In cases where any restructuring results in dismissal of workmen or closure of any business vertical, then depending on the nature of the establishment and the number of workmen employed, the requirement of seeking prior approval from labour authorities may be triggered.

For instance, in cases where more than 100 workmen are employed in establishments that are factories or mines, dismissal of workmen can be effected only with prior approval from the jurisdictional labour department of the government. In addition, three months' prior termination notice or payment in lieu of notice is to be provided to the affected workmen.[7]

Due diligence

There are several legal aspects of human resources that should be reviewed before acquiring or merging entities. Human resource due diligence is critical to understand the practical challenges that may be faced should the parties move ahead with a proposed transaction. The due diligence should focus on the following key areas.

Trade unions and collective bargaining

A large number of proposed M&As hit a roadblock because of resistance from trade unions at the target entity. It is important to ascertain if the target entity has any trade union in place and to review collective bargaining agreements, if any. Typically, manufacturing facilities have some form of union and these trade unions are linked to political parties, which increases their bargaining power. Some states in India are reputed to have a culture of powerful trade unions that wield great influence with businesses and negotiate with management for increasing employee benefits for their members. It is critical to identify such trade unions and determine if any union has objections to a proposed merger or acquisition, their grievances, if any, and the possibility of resolution.

7 Section 25N of the Industrial Disputes Act 1947.

Statutory benefits

Social security benefits include contributions made by employers and employees under the Employees' Provident Funds and Miscellaneous Provisions Act 1952 and the Employees State Insurance Act 1948. These contributions are made as per the monthly earnings of employees and a different formula applies for the computation of contribution for different categories of employees. It is important to ensure that the target has computed the social security benefits correctly and deposited them with the authorities.

In the case of *McLeod Russel India Limited v Regional Provident Fund Commissioner of Jalpaiguri and Others*,[8] the Supreme Court of India held that the transferee business entity will be held liable in case of a default on the part of the transferor entity in respect of social security benefits, even if the parties executed an agreement stating that the transferor entity will be held liable.

Similarly, the Payment of Gratuity Act 1972 requires employers to pay a gratuity to employees on superannuation, death or disablement due to accident or disease, retirement, or resignation, provided the person has completed five years of continuous service with the employer. In the case of death and disablement, the condition of a minimum of five years' service is not applicable. For every completed year of service or part thereof more than six months, the employer has to pay gratuity to an employee at the rate of 15 days' wages that was last drawn by the employee concerned. However, there is a limit on the maximum gratuity payable under the Payment of Gratuity Act 1972, which is 2 million Indian rupees or such higher ceiling as agreed in the employment agreement. Although the gratuity is payable if an employee serves the employer for at least five years, the employer is required to make adequate provisions in its books of account every year to meet future gratuity liabilities. Due diligence should focus on determining if adequate provisions have been made by the target in respect of gratuity liability to employees, and all former employees who were due gratuity have been paid adequately.

In addition to social security benefits, employers are required to make adequate provisions to meet future liabilities for other accrued benefits such as leave encashment and maternity benefits.

Contractual benefits

Typically, companies sign employment agreements with new employees and such agreements govern the contractual relationship between the parties. Such agreements cannot override any statute, but govern the relationship for issues that are not covered by statute. Compensation and benefits provided to employees are covered in such agreements. Companies often provide compensation in various forms and the quantum of benefits often exceeds what the law mandates. Other contractual benefits may include a car and driver for senior executives, bonuses (discretionary or performance-linked) and stock options. Since in many cases the benefits to be provided by the resulting entity or the acquirer to the transferred employees should be the same or better than those that were provided to them before the transaction, it is important to have clear visibility on the contractual obligations that will be assumed by the acquirer.

8 Civil Appeal Number 5927 of 2014 arising out of SLP(C) No. 7704 of 2008.

Employees stock options

Many employers provide employees with stock options as a way of offering additional compensation and incentives. In cases of foreign companies having subsidiaries in India, the stock options are mostly granted by the foreign parent company. In cases of acquisitions and mergers, there may be a need to cancel the options granted to the employees, or to integrate such option schemes into the buyer's policies and schemes. Additionally, some employees may already own shares of either the foreign parent company or the employer company as part of the employee stock options schemes. The provisions of the stock options schemes should be sufficient to cover situations where options may have to be cancelled, or the equity issued to employees may have to be bought back, including provisions to adequately compensate relevant employees for cancelled options and stocks bought back.

The foreign exchange control regulations of India, primarily the Foreign Exchange Management Act 1999 and accompanying rules, impose certain conditions subject to which foreign parent companies of Indian subsidiaries grant stock options or issue shares to Indian employees, including buyback of shares. Foreign parent companies of Indian subsidiaries should have due regard to foreign exchange control regulations regarding the cancellation of stock options and buyback of shares before granting any stock option or shares to employees of an Indian entity.

Bonus

The issue of bonuses is often hotly disputed between employers and employees. While some companies have provisions in specific employment contracts, others have general bonus policies applicable or all or a category of employees. It is critical to determine whether bonus payments are documented and, if so, whether bonuses are mandatory at the end of a specified period or discretionary based purely on management's decision or performance-linked, which is applicable mainly for sales employees. Disputes often arise in the interpretation of bonus provisions, and often after employees have left the company. As such, it is advisable to look out for specific payment triggers and relevant contractual obligations during due diligence.

Consultants and contractors

Review of agreements with consultants and contractors are relevant to determine the rights and benefits that flow to them. Sometimes, an employer may continue engaging certain persons as consultants for a long tenure and provide them rights that are almost similar to those of employees. It is important to carefully review the consultant agreements to determine if any consultants or contractors acquire any special rights and consequences thereto, or if each consultant is properly classified as a consultant. The misclassification of employees as independent contractors is a pervasive problem and can result in liability for unpaid taxes, wages and employee benefits. Additionally, review of consultant agreements is helpful to understand the challenges that may be faced in the transfer of consultants and contractors to the acquirer or the resulting entity.

Threatened litigation and existing employment claims

The due diligence should focus on relevant employment-related restructuring, retrenchments, layoffs and other forms of job reduction undertaken by the target company in the last three to five years to determine the possible adverse consequences that may flow from such events. If

such activities were undertaken, the diligence exercise should determine whether the company complied with applicable law and termination and severance provisions in employment contracts.

Thorough due diligence should be done to understand any threatened employment-related litigation and claims that are outstanding against the target, the nature of claims and the possible outcomes. In this regard, disclosure should be taken from the target regarding all such claims and cases that may be pending or threatened against the target company.

Intellectual property

For many knowledge-based or research-driven organisations, the target entity must have in place proper documents to ensure ownership of the intellectual property created by employees. Many organisations do not maintain the relevant intellectual property ownership and assignment documents. In such cases, further assessment should be carried out to understand if it is possible to rectify this before the transaction is concluded, and to determine the challenges that may be faced in the process.

Company policies

It is critical to understand whether the target company is complying with laws such as the Indian anti-sexual harassment law, the Sexual Harassment of Women at Workplace (Prevention, Prohibition and Redressal) Act 2013. In doing so, the target company must have a documented policy in place for dealing with complaints of sexual harassment and must comply with annual filing requirements with the relevant government authority.

In addition, emerging issues such as maternity benefits, provisions of crèche facilities to working mothers, affirmative action and disability benefits must be covered by target companies by way of policies.

Finally, due diligence should determine whether the target company has adequate anti-corruption, anti-fraud, and ethics policies.

Some companies do not maintain proper handbooks or company policies. In the absence of critical policies, it becomes difficult to determine the basic conditions of employment that should apply to the relevant employees after the transaction.

Issues to cover in transaction documents

Typically, M&A agreements cover some employment issues. On the basis of findings during due diligence, the agreement should cover the following:

- disclosure by the target of all employees, contractors, subcontractors, consultants, agents, interns and apprentices, including the position, location and compensation structure;
- disclosure of all material violations of labour law, including those resulting in any possible penalties (monetary or otherwise) on the target entity and/or its directors and management;
- disclosure of all existing and threatened claims, cases and litigation before any authority, government department, court or tribunal; and
- impact of non-compliance including any indemnities for labour law violations.

Integration of new policies and procedures

The critical challenge lies in the integration of the transferee's employment policies with those of the resulting entities or the acquirer. The emphasis should be on ensuring that terms and conditions of employment after such transfer are the same or more favourable than those

applicable immediately before the transfer. An often faced dilemma is when the employees of the acquirer or resulting entities, working at the same or similar designation as that of transferred employees, are receiving better benefits than what the transferred employees were getting before the transfer. In such a situation, a decision needs to be taken if the additional benefits are to be provided to transferred employees.

Proposed legislative changes and impact

The government has proposed to repeal several existing pieces of legislation and consolidate them into four separate Labour Codes, namely:

- the Code on Wages 2019, which will consolidate the laws relating to wages, bonuses and related matters;
- the Industrial Relations Code 2020, which will regulate conditions of employment in industrial establishment or undertaking, investigation and settlement of industrial disputes;
- the Occupational Safety, Health and Working Conditions Code 2020, which will regulate occupational safety and health and working conditions of the persons employed in an establishment; and
- the Code on Social Security 2020, which will contain laws relating to social security with the goal to extend social security to all employees and workers either in the organised or unorganised sectors.

These codes have been framed and notified recently. The central government and state governments are in the process of framing relevant rules under these codes for their implementation.

The codes are unlikely to bring about any significant changes from the current legal regime. The provisions in the codes on labour and employment are very similar to those under current legislation.

Appendix 1

About the Authors

Disha Mohanty
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Disha is a principal at G&W Legal. She leads the firm's labour and employment team. She has advised various multinationals, including Fortune 500 companies on legal aspects of doing business in India, particularly on dealing with employment-related issues in India.

She has extensive experience advising clients on a broad spectrum of employment law matters, including support on mergers and acquisitions. Her work often includes providing guidance to organisations with respect to integration of employees after a merger, restructuring and revamping of employment contracts and employee handbooks; non-disclosure agreements; codes of conduct; and employment termination procedures.

Disha regularly assists clients in drafting and implementation of cross-border secondment arrangements, advice on best practices for organisational structure, remote workforce management, employment of contract workers, etc. She also assists on issues such as compensation structure and employee stock options schemes, dismissal and workforce reduction, disciplinary proceedings retrenchment and restructuring pursuant to mergers, acquisitions and transfers of business.

She frequently advises on HR investigations, regulatory compliance issues, conducting compliance checks or audits, employment-related due diligence and providing guidance on implications of non-compliance and assistance with implementing rectification measures. To this end, she helps organisations devise appropriate risk mitigation strategies and advises on best practice in such situations.

Anup Kumar
G&W Legal
Anup Kumar is a principal at G&W Legal, and part of the firm's commercial and labour and employment teams. Over the years, Anup has developed expertise in helping multinationals set up operations in India by guiding them extensively on regulatory compliance and employment law issues.

Anup has many years' experience advising clients on a host of legal issues on employment and industrial relations and workforce management. He has assisted various companies in conducting internal investigations for employee misconduct, policy violations, embezzlement, kickbacks, harassment and compliance checks. He also undertakes assessment of compliance and training programmes for Indian subsidiaries and joint ventures of multinational companies, to ensure that the employees are sensitised about compliance with local as well as foreign anti-bribery legislation such as the US Foreign Corrupt Practices Act and the UK Bribery Act.

He has also assisted companies in disputes with employees and former employees, including in mediation proceedings, and representation before labour tribunals and other civil and criminal courts.

Among various other labour law issues, he regularly advises on legislation governing social security, long-term benefits, employee insurance and disability benefits, payment of bonuses, engaging of apprentices and maternity benefits.

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