IN-HOUSE VIEW

India M&A

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The In-House View: India M&A provides a contemporary analysis of the legal framework, opportunities, challenges and risks that arise in connection with M&A transactions in India. It serves as a nuanced snapshot and useful tool for industry practitioners doing business in this key jurisdiction.

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Key Labour and Employment Issues in M&A Transactions

Mergers and acquisitions (M&A) are tools used for the growth of business and optimisation of resources. M&A transactions impact target-entity employees and the success of these transactions depends on establishing a fair balance 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, buyers purchase certain identified assets and hire 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 of companies are carried out under the supervision of the National Company Law Tribunal (NCLT) and/or the jurisdictional Regional Director(RD) of the Ministry of Corporate Affairs, which are quasi-judicial bodies. The scheme of merger of entities, which is placed before the NCLT and/or RD for approval, contains, among other things, provisions about the rights and benefits that the resulting entity will provide to the employees of merging entities.

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 transferring the entire business as a going concern 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. The parties can explore asset purchase acquisition where they do not intend to take advantage of tax benefits. In a slump sale acquisition, the employees are transferred without any break in service and the acquirer assumes obligations in respect of all accrued employees' benefits and liabilities, such as gratuity, pensions, 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 may identify the assets to purchase and employees to hire. Under asset purchase arrangements, parties can 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 in M&A 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 and service conditions. Before implementing any employment-related restructuring, it is important to consider certain legal considerations.

Legal considerations

Parties involved in a transaction must 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).

Classification of employees

Employees in India are broadly categorised into workmen and non-workmen. The Industrial Disputes Act 1948 (ID Act) deals with the settlement of industrial disputes and 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.

It is common for an employee to perform multiple roles, such as managerial or supervisory work, as well as work that may be technical, skilled, unskilled or operational. Several courts have ruled that where an employee performs multiple roles, the dominant nature of work performed 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.[1] That being said, the 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.

After the 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 to a new employer, whether by agreement or by operation of law, every workman who has been in continuous service for not less than one year immediately before such transfer is entitled to:

- notice of one month or payment of wages in lieu of notice; and
- 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 in respect of workmen employees:

- the service 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 the same or more favourable than those applicable immediately before the transfer; and
- the transferee entity assumes the accrued employment benefits for the services performed by the employees for the transferor entity. Employees earn certain benefits such as 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. The continuity of employment provisions ensures that a person's length of employment with the transferor entity 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 benefits and compensation on the condition that the service of the workman has been continuous and has not been interrupted by the transfer.[2]

These requirements under the ID Act apply to workmen for any merger, slump sale acquisition and asset purchase acquisition.

The provisions of the ID Act discussed above would not apply in the case of a share purchase acquisition, because a change in the shareholding pattern of the employing entity does not result in a 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 be offered compensation if they are not provided with 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 employment contracts of non-workmen employees is important to understand the incentives and compensation that may be triggered 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*,[3] ruled that workmen cannot be forced to work under different management without their consent, and the workmen unwilling to work under new management can terminate their employment and be entitled to severance compensation as per the ID Act, which is equivalent to 15 days' average pay for every completed year of continuous service, or any part thereof over six months.

This case involved the transfer of ownership of a consumer electronics factory by Philips India Limited (Philips) to Kitchen Appliances India Limited (KAIL) without 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 of ownership or management of the establishment to a third party. The only requirements prescribed under the ID Act in the case of transfer of 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 before the transfer.

However, the Supreme Court introduced a 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 in ownership or management of the establishment.

As such, transferor entities should seek written consent from their workmen before concluding any transaction. Although the present case dealt with 'workmen' and the ID Act, it is unclear if employers must seek consent from non-workmen employees. Given the

Court's inclination towards upholding the principles of natural justice, an employer should consider treating non-workmen at par with workmen at least on issues relating to consent.

Workmen who refuse to be transferred before any merger or acquisition must be paid severance compensation. Severance compensation in respect of workmen 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 well in advance (ie, at least 30 days) of 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.

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 the dismissal of workmen or closure of any business vertical, 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.[4]

Due diligence

Human resource due diligence is critical before acquiring or merging entities 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

Many proposed M&As encounter 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 to increase 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.

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. 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*,[5] the Supreme Court of India held that the transferee business entity will be held liable in case of a default by 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, 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, employers must pay a gratuity to employees 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 a gratuity is payable if an employee serves the employer for at least five years, the employer must 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 whether all former employees who were due for gratuity have been paid adequately.

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

Contractual benefits

Typically, companies sign employment agreements with new employees and such agreements govern the contractual relationship between the parties. 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 vehicle and chauffeur for senior executives, bonuses (discretionary or performance-linked) and stock options. Since in many cases, the benefits to be provided by the resulting or acquirer entity 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 resulting or acquirer entity.

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 stock options schemes must have adequate provisions 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 options or shares to employees of an Indian entity.

Bonus

The issue of bonuses is often disputed between employers and 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 when interpreting bonus provisions, and sometimes 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

A review of agreements with consultants and contractors is 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 with 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.

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 past 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 outstanding against the target, the nature of the 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 the 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. It must comply with annual filing requirements for the relevant government authority.

In addition, emerging issues such as maternity benefits, provisions of crèche facilities for working mothers, affirmative action, and disability benefits must be covered by target companies through 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. Without 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 should cover the following critical issues:

- disclosure by the target of all employees, contractors, subcontractors, consultants, interns and apprentices, including their 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 its directors;
- disclosure of all existing and threatened claims, cases and litigation before any government department, court or tribunal; and
- indemnities for labour law violations.

Integration of new policies and procedures

The critical challenge lies in integrating the transferor'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.

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 establishments or undertakings, 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 to extend social security to all employees and workers either in the organised or unorganised sectors.

These codes have been notified, but the central and state governments are currently framing relevant rules under these codes for their implementation. Most states and union territories have framed draft rules under these codes – however, these are yet to come into force.

The codes are unlikely to bring about any significant changes from the current legal regime, except that small factories and mines where fewer than 300 workmen are employed may be exempt from approval required for closure of establishments or for dismissing employees pursuant to a corporate restructuring. The provisions in the codes on labour and employment are very similar to those under current legislation.

Footnotes

1. ^ *K Ramesha v Nitin Pande and Ors*, ID No. 372/2013 before the Additional Labour Court, Chennai.
2. ^ Section 25FF of the Industrial Disputes Act 1947.
3. ^ *Sunil Kr Ghosh v K Ram Chandran*, 2011 (14) SCC 320.
4. ^ Section 25N of the Industrial Disputes Act 1947.
5. ^ Civil Appeal Number 5927 of 2014 arising out of SLP(C) No. 7704 of 2008.