Rationalization of Entities: Simplify and Streamline your Business

Technological advancements have made it easier for people to connect across the globe. In this pursuit of growth and global presence, many businesses set up multiple entities across the globe. Many Groups establish legal entities in those expanding markets to maximize the ease of doing business in the particular territory.

As one of the fastest-growing economies in the world, India has been a favored destination for global businesses to set up their legal entities. The fact that India reported the highest Foreign Direct Investment (FDI) worth USD 83 billion in 2021-22 despite the Ukraine–Russia conflict and COVID-19 pandemic also reflects the sentiment that India is one of the most preferred destinations for investments globally.

Any foreign entity planning to start a Business in India can embody a place of business in India in the form of a Liaison Office or Project Office or Branch Office and never the less a Company incorporated under the Companies Act, 2013 based on the activities allowed to be undertaken by each of such entities as stated under the Foreign Exchange Management Act, 1999.

Leading causes of Redundant Entities

It has been observed that many foreign entities initially prefer to start with the opening of Representative Offices in the form of Liaison Office/Branch Office/Project Office (LO/BO/PO), which have limited operating powers and business conducting abilities as per Indian legislation. Subsequently, based on the initial experience, when a foreign entity wishes to expand its operating powers in India, it establishes itself in the form of a body corporate, making the LO/BO/PO redundant as a conversion of these is not permissible under Indian regulations.

In many cases, any consolidation of business groups globally through acquisitions, mergers, takeovers, etc., results in multiple entities in India, making one of the entities redundant. Furthermore, many corporate restructuring exercises like demergers and hive-off also render an entity unwanted. Apart from that, a foreign entity may switch the line of business, making them establish more than one body corporate, making some redundant in case of failure or cessation of such businesses.

Ramification of Redundant Entities

This redundancy in the form of the above has some implications, including but not limited to:

- Unnecessary administrative and employee costs, additional compliances and reporting requirements, etc., which are time-consuming and cost-inefficient.
- Each country has its regulatory framework that the companies are mandated to follow. In India, the overall regulatory requirements like audit, compliances, filings, and reporting are relatively on the higher side as compared to other developed countries and the cost of maintaining an inoperative Company without any underlying assets, employees, etc. is also significant.
- Furthermore, this results in the needless utilization of the resources of the business, which otherwise can be put to use in some other productive areas.

The above implications may negatively affect the bottom line of the business's financial statements. It may also complicate the business organizational structure and make it difficult to manage from a governance standpoint. Rationalization of the group structure by eliminating or restructuring redundant entities can help optimize the cost and free up the resources and management time to focus on the business needs.

Rationalization of Entities

Rationalization can be termed as the structural modification of the organization that leads to strategic change in the firm’s size to improve its productivity. The rationalization of entities can be achieved by the transfer of non-core companies/business divisions, closure of redundant entities, merger/consolidation of entities, demergers for consolidating the similar nature of businesses in one entity, etc.

Modes of Rationalization

Rationalization can be done in many forms, there is no defined model for it. The following factors can largely determine or impact the method of rationalization:

- Commercial objective of the rationalization.
- Regulatory framework applicable to the proposed rationalization.
- The cost of the rationalization transactions including tax costs.

Having said that, the following are the generally adopted mode of rationalization:

1 Transfer of non-core companies or business divisions

Transfer of a particular business division/vertical or company is one of the common methods of rationalizing the entity or ownership structure. It may be the case of backward integration of businesses or to improve the bottom line of the financial statements, the management can opt to transfer its business or transfer the ownership of the company as it may be beneficial to it. Any business/ownership can be transferred in different ways as follows:

a. Transfer of shares of the companies

This method is preferred when the owners intend to transfer the company's ownership to another person or body corporate. Under this model, the company remains alive and only the ownership is transferred to another person. This method is well-suited when underlying assets, intellectual properties, or benefits (like tax benefits) or advantages are attached to the company. Here, the investor can transfer his shares to another person or body corporate, resident or non-resident, by complying with various provisions as may be applicable to it. For ease of doing business, the Indian Government has allowed the transfer of shares under the automatic route instead of the approval route. Only a few sensitive sectors are under the approval route.

b. Slump Sale/Demerger

This option is suitable when the stakeholders want to hive off or divest a business division/vertical of the company along with the assets and liabilities pertaining to the division. This typically happens when owners want to focus on core business areas or there is a realignment of the business objective. This is achieved by the transfer of the non-core businesses or the loss-making business divisions by slump sale/demerger. It is the transfer of a business undertaking as a whole, on a 'going concern basis, wherein the acquirer wants to acquire the whole setup of a business undertaking along with all the assets and liabilities of the target company but without acquiring the target company which houses the businesses.

2 Mergers/Amalgamations

Often a single entity may incorporate various subsidiary companies for multiple businesses or due to global mergers/acquisitions, multiple entities in the same jurisdiction become group entities. In such cases, a merger can be opted to consolidate multiple entities into one as per the requirements of the management.

The outcome is the transfer of assets and liabilities of one entity (the transferor entity) into another legal entity (the transferee entity). The transferor entity is dissolved automatically without liquidation. The advantage of the merger is that, once it is approved, all the assets, liabilities, employees, rights, benefits, obligations, outstanding issues, and contingent liabilities of the transferor entities are vested with the transferee entity.

3 Closure of entities

Another way to rationalize the organizational structure is close down the redundant entities. In the case of solvent companies, the following are the options for closure of these entities in India as per the conditions prescribed and to be followed:

a. Voluntary Liquidation under Insolvency and Bankruptcy Code, 2016

Voluntary liquidation is the private process for solvent companies where a liquidator is appointed to wind up the affairs of the company and make an application to the Tribunal for its dissolution. The basic requirement for this process is that either the company has no debts or will be able to pay its debts in full from the proceeds of assets to be sold in the voluntary liquidation and that the company is not being liquidated to defraud any creditor. This concept of voluntary liquidation was recently introduced and is being widely used now for the closure of solvent companies. It is a private and time-bound process, which has substantially reduced the timelines for the closure of the companies.

b. Removal of name from the records of Registrar

The Companies Act, 2013 and the LLP Act, 2008 provide the option to exit the business by removing the name of the Company/LLP from the Registrar of Companies subject to conditions mentioned in the respective acts. It is an easy route for Companies/LLPs that are non-operational.

c. Closure of LO/BO/PO

As the purpose of embodying LO/BO/PO comes to an end, the foreign entity looks to close these entities in India. In the case of closure, the foreign entity needs to adhere to the procedure laid down under applicable regulatory provisions. It is a two-stage closure procedure involving the Registrar of Companies and the Reserve Bank of India.

It is pertinent to note that other issues in relation to the closure of an entity need to be evaluated and addressed in each of the above-mentioned options.

Key Takeaway

Rationalization helps in consolidating and simplifying the business and streamlining the management process. Before finalizing any strategy, it is crucial to analyze the management's objective and the business capabilities along with a complete evaluation of the pros and cons of the strategy. Along with regulatory requirements, other aspects such as direct and indirect tax implications, exchange control requirements, valuations, employee-related aspects, and other contractual obligations have a bearing on the rationalization strategy. After a complete breakdown of influencing factors and a complete assessment of the strategy, the company can move ahead in a suitable direction to achieve its business objectives and improve functionality.

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