Easing Out Minority Shareholders: How Easy is it?

Minority shareholders can cause substantial roadblocks in the journey of an acquirer intending to obtain 100% stake and control of a target company, especially if the acquirer intends to slice out the minority presence post-acquisition. The question which arises is, what are the methods of easing out minority shareholders?

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M&A has become the order of the day. Companies are on a constant prowl to expand and the most preferred route is mergers and acquisitions. However, in the wake of acquiring companies and increasing the market share, majority shareholders often undermine the presence of the minority in target companies. Minority shareholders can cause substantial roadblocks in the journey of an acquirer intending to obtain 100% stake and control of the target company, especially if it is listed and the acquirer intends to slice out the minority presence from the company post-acquisition. Understandably, the question which arises is what are the methods of easing out minority shareholders? What are the potential problems the acquirer may face in its endeavour to squeeze out minority shareholders pursuant to a takeover and in eventually making the target its Wholly-Owned Subsidiary (WOS)? With the help of a case study, these principal questions are addressed in this article.

Case study

X, a company based in Germany, intends to acquire Y, a listed Indian company engaged in the business of manufacturing automotive components. Y is listed on two stock exchanges in India. A holds 51% – the majority shares – of Y, while B holds 9% and the remaining 40% vest with the public at large. In the manufacture of automobile components, 100% foreign direct investment is allowed under the automatic route in India. In accordance with the listing agreement of Y with the stock exchanges, the minimum public shareholding required for continuous listing is 25%.

Pursuant to A's willingness to sell 51% to X, A and X enter into a Memorandum of Understanding (MOU). X wants to acquire Y in a phased manner. The eventual objective of X is to squeeze out the minority public holdings from the company, thereby acquiring a 100% stake in Y. The following sections will examine the various steps involved in the process of converting Y into a WOS of X and the associated challenges.

Shareholder thresholds

At this stage, it is important to highlight the thresholds that the acquirer has to keep in mind while structuring investments in India, because they either result in certain minority rights or the ability to block certain actions. These thresholds are critical while planning acquisitions and, more particularly, play a key role when the transaction must conform with the sectoral caps imposed by the regulators in accordance with the prevailing foreign investment policy. The following generally applies in the context of both public and private companies:

(i) Ten percent: The approval of at least 10% of the shareholders is required for the requisition of an extraordinary general meeting or for an application to the Company Law Board (CLB) for relief, if there is oppression or mismanagement (as defined in the *Companies Act, 1956* by the majority shareholders.

(ii) Fifty-one percent: The approval of a minimum of 50% of the shareholders is required for an ordinary resolution, including for alteration of the share capital; declaration of dividend; election, removal, and remuneration of directors; approval of annual accounts; appointment of external auditors; appointment of other officers; and other routine matters relating to the conduct of a company.

(iii) Seventy-five percent: At least 75% of the shareholders must approve a matter before it is passed as a special resolution, including for capital increases, alteration in the memorandum and articles of the company, changing the registered office address of the company from one state to another, change in the name of the company, buy-back of shares, proposed mergers or liquidation. Therefore, a minority shareholder with more than 25% voting rights would have the ability to block special resolutions.

It is apparent that minority shareholders are guaranteed certain rights under Indian law. Minority shareholders with qualified minority may initiate action against decisions of the majority in a court of law. According to section 399 of the act, a qualified minority consists of at least one hundred shareholders or one-tenth of the total number of shareholders, whichever is less, or any shareholder(s) holding one-tenth of the issued share capital of the company fully paid-up. Moreover, minority shareholders who hold more than 25% of the shares will have the ability to obstruct special resolutions, seek intervention of the CLB and, therefore, impede the functioning of the company at some level.

Majority versus Minority: Throwing out minority shareholders

Since the target is a listed company, the provisions of the Securities and Exchange Board of India (SEBI) *Substantial Acquisition of Shares and Takeovers, 1997* (Takeover Code) will apply as a first step. The Takeover Code is triggered and a public announcement becomes mandatory in two situations: when there is an acquisition of shares beyond a threshold limit or when there is a change in control over the management of the target company. This article does not intend to focus on the nuances of the Takeover Code. (See 'Balancing SEBI Regulations in Overseas M&A' in the October 2006 issue of the *Asialaw India Review*.)

Upon gaining substantial shares in the target, the acquirer normally reconstitutes the Board and management team while slowly inching towards the objective of making it a WOS. In order to achieve this, the acquirer will have to gradually ease out the minority shareholders. Two methods commonly used to achieve this objective are delisting and subsequent capital reduction.

Delisting

The SEBI *Delisting of Securities Guidelines, 2003* ("Delisting Guidelines") apply in cases of (a) voluntary delisting by promoters of a company; (b) acquisition of shares of the company, consequent to which public shareholding falls below the minimum limit stipulated in the listing conditions or agreement, which may result in the delisting of securities; (c) compulsory delisting by stock exchanges; or (d) consolidation of holdings in a company by a person, resulting in the decline of the public shareholding below the limit specified in the listing conditions or agreement which may result in delisting of securities.

The reasons for delisting are varied and range from a desire to divest public money to lowering public accountability and the tedious process of confirming with onerous compliance rules. Once delisted, companies need not maintain all different statutory registers and can reduce costs such as printing annual reports, mailings and running share departments. In functional terms, this ensures a greater freedom to operate the company and in fewer checks and balances.

In order to undertake the delisting process, it is essential that the target company be listed for at least three years. Prior approval of shareholders by way of special resolution, followed by a public announcement in accordance with Schedule I of the Delisting Guidelines, is mandatory. Prior to the announcement, the target company must appoint a merchant banker registered with SEBI and, thereafter, apply to the delisting exchanges in the format specified by the exchange along with a copy of the special resolution. The schedule necessitates that the public announcement should contain details including the floor price, its method of calculation, opening and closing dates of bidding, name of stock exchanges from which the securities have to be delisted, the reason for delisting, shareholding pattern and the capital structure of the company.

Shareholders must determine the exit price in accordance with the book building process. The offer price must have a floor price, which is the average of 26-weeks traded price as quoted on the stock exchange where the shares of the target are most frequently traded. There is no ceiling on the maximum price. In the event of delisting of the securities, the acquirer must allow the remaining shareholders a period of six months to tender securities at the same price.

The potential problem which an acquirer may encounter in case of delisting is obtaining prior approval of the shareholders by a special resolution. It is under these circumstances that the shareholder thresholds discussed above become pertinent and require consideration while planning a strategy for the acquisition. Thus, if the acquirer can only acquire up to, say, 71% instead of 75% stake, the remaining 29% would continue to vest with the minority shareholders whose consent would be crucial for the delisting process.

In the case study, upon acquisition of a substantial stake (assuming 75%) in the target, the acquirer has the option of delisting to reduce the minority shareholders in accordance with the method of voluntary delisting explained above. After delisting, assuming that the acquirer succeeds in increasing its stake to 90%, it would still have to remove 10% minority shareholders.

Minority shareholders who choose to remain in delisted companies expose themselves to the potential inability to ever sell their shares, leaving dividends as their sole return on investment. If the majority shareholders choose to buy out the minority, they must be offered a price consistent with the future value of the business, but this is not really implemented as the focus remains on the market price.

Reduction of share capital

Once a company de-lists, it can either remain public or become a private company. As the number of shareholders falls below 50, which is the maximum for a private company, they can convert themselves from a public company to a private company which, in contrast to an unlisted public company, has to comply with less stringent statutory norms.

Diminution of share capital of the target Y is another method of ousting minority shareholders. Section 100 permits a company to extinguish capital which is in "excess of its wants". However, the following criteria must be fulfilled:

(i) The articles of the company must contain a provision for reduction of capital. In the absence of such a provision the articles must be amended to give the power to the company to effect the reduction,

(ii) Shareholders must pass a special resolution for effecting the reduction of capital, and

(iii) The company must obtain sanction from the court for reducing the capital. The company has to convince the court about the proposed diminution of share capital.

The act permits reduction of capital by diminishing the nominal amount of (a) the shares so as to leave a less sum unpaid; or (b) any shares by writing off or repaying paid-up capital; or (c) by combining (a) and (b); or (d) shares by extinguishing the existing liability on certain shares, writing off or repaying the whole amount paid-up thereon and cancelling them.

The act does not prescribe the manner in which the reduction is to be effected. The acquirer intending to acquire a 100% stake has to induce the minority (non-promoter) shareholders to sell their shares at the price offered by them. In this manner, the minority shareholders can be eliminated from the company. Technically, the capital of the company will reduce since the share capital will be extinguished by writing off the shares which were held by minority shareholders. Frequently, the amount of excess capital, as decided by the company, corresponds to the non-promoter holding while all the promoter shares remain untouched. This leads to a natural conclusion: the objective to use section 100 to force out the remaining minority shareholders and gain absolute control over the target company.

Depending upon the shareholding structure of the target company, obtaining special resolution may be a matter of concern. Once again, shareholder threshold limits would assume importance. For instance, if the acquirer has a 71% stake in the target, obtaining 75% majority in favor of the resolution would be difficult. However, assuming that the acquirer succeeds in obtaining the special resolution required for the purpose of reducing the capital, it still cannot force minority shareholders to exit the company. Minority shareholders may want to continue to be a part of the target company and not leave the company.

The Indian company law shields minorities' interest by providing an adequate platform at CLB to raise grievances in case of oppression or mismanagement by the majority shareholders of a company. In circumstances when the minority is forced to exit the company by way of offering a nominal value for the shares held by them, the minority shareholders can approach the CLB to seek appropriate relief. The latter, if satisfied, has the power to intervene in the decisions of the majority shareholders. The CLB can order the majority shareholders to purchase the shares of the minority shareholders at a fair price. Further, if the minority shareholders wish to continue to be stakeholders in the company and do not want to sell their shares, they can obtain an injunction from CLB prohibiting the majority shareholders or acquirer from taking any action that may be averse to their interest.

Indian jurisprudence has taken a view that the interest of the minority must be protected. In *Reckitt Benckiser (India) Ltd, 122 (2005) DLT 612*, the primary objection of the respondent was that the proposed reduction of capital was discriminatory and *mala fide* and an attempt to throw out the public shareholders so that the entire control of the company rests with the promoter by acquiring 100% equity. The Delhi High Court observed that "no doubt the effect of reduction of capital is to extinguish the public shareholding but if the objectors do not want to part with their equities, the company shall not insist upon the same. If some of the minority members have no objection to part with their shares at the offered rates, the share capital held by them is reduced. The objectors cannot have any grievance as far as others are concerned as their rights are protected."

In another case, *Sandvik Asia Ltd. case, [2004] 50 SCL 413 (Bom)*, the main grievance of the opposing shareholders was that minority shareholders who wanted to continue in the company could not do so as majority shareholders (constituting 95.54% of the company) voted in favor of the resolution to reduce the capital. The counsel for minority shareholders argued that the majority has the right to reduce the capital; however, it should be fair and equitable. In the instant case, minority shareholders were not given any option under the proposal. They were given a cut-off date and told to accept the offer or leave the company after being paid the offered amount. This, according to the court, was highly inequitable and unfair as minority shareholders had no choice but to leave the company and the majority shareholders cannot bulldoze the minority in this manner.

Notwithstanding the above, the fact that in the past, several companies have adopted the method of delisting securities from stock exchanges and acquired 100% ownership through Section 100 cannot be ignored. Foreign corporations that hold more than 90% of the equity in Indian companies whose stocks are close to being de-listed normally adopt such methods. If the company succeeds in convincing and obtaining a sanction from the court, minority shareholders have little choice but to part with their stake in the company. In this way, the acquirer is able to accomplish the goal of 100% control over the target company.

Conclusion

The task of easing out minority shareholders may not be easy. The use of section 100 pursuant to delisting has caught the attention of several foreign companies. However, it should be noted that this route is actually not in consonance with the spirit of the section. The rationale of the section is to enable companies to restructure their capital. But, by using it to acquire 100% stake in Indian companies, foreign companies have skillfully managed to maneuver through section 100 and undertake "restructuring" at the cost of the minority shareholders. Understandably, the acquirers aim to maintain their "privacy" to keep their trade secrets, technologies and ideas within the "family" by ousting the public, but at the same time, it is important to protect the minority interest.

Delisted companies using section 100 are well within their rights to go private. But the problem lies in the method of achieving this objective. Usually, minority shareholders have absolutely no say in a decision that concerns the company in general and them in particular. The companies' interpretation of section 100 in selectively cancelling shares is arbitrary and clearly discriminates against a group of shareholders. If this method is to be followed, the acquirer must compensate minority shareholders on fair terms. Also, introduction of cogent regulations that would enable fair pricing for minority shareholders would go a long way in appeasing both the majority and the minority.

In our case study, the acquirer can adopt the aforesaid strategy of delisting followed by capital reduction under section 100. However, it should ensure that minority shareholders are reasonably paid off for the shares held by them and not thrown out unceremoniously. Finally, it is worth mentioning that experience has shown that the art of buying out minority shareholders, in reality, lies in the negotiation skills of the buyer or acquirer. If the acquirer succeeds in convincing the minority shareholders to sell their shares by offering an attractive price, squeezing out the minority may not be difficult. A good bargain and a good price will be a win-win situation for both the majority as well as the minority.

About the author

Priti Suri is the proprietor of PSA, Legal Counsellors. She has two decades of experience on three continents in diverse areas of international commercial law, mergers and acquisitions, joint ventures, technology transfers, and arbitration and litigation. After earning an LL.M. in the United States, she took part in the ABA's International Legal Exchange programme and worked at law firms in the US. Based in Paris in the early 1990s, she returned to India in February 1997 to set up the practice in New Delhi. She represents clients in a broad spectrum of industry ranging from automobiles, defence, energy, information technology, infrastructure, pharmaceuticals and telecommunications.

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