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Court Ruling Makes Squeezing Out Minority Shareholders Easier

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Introduction

Indian jurisprudence has typically taken the view that the interest of the minority must be protected. In circumstances where minority shareholders are forced to exit the company, they can approach the Company Law Board to seek appropriate relief. If the minority shareholders wish to continue to be stakeholders in the company, the board may grant injunctive relief prohibiting the majority shareholders or a potential acquirer from taking any action that might adversely affect the minority's interest. Further, Indian courts have held that if minority shareholders do not wish to part with their shares, the company cannot compel them to do so.

However, the legal position on squeezing out minority shareholders recently came under scrutiny before the Bombay High Court. In light of previous conflicting rulings on this matter, the recent division bench judgment in *Sandvik Asia Limited v Bharat Kumar* Padamsi (2009(3)BomCR57) is of interest to unlisted private or public companies because it permits a company to buy out minority shareholders against their wishes by virtue of a resolution to reduce the company's share capital.

Rights of Minority Shareholders

Sections 397 to 399 of the Companies Act provide for the protection of minority shareholders against certain actions taken by the majority shareholders, such as unfair dilution of shares and related party transactions. In circumstances where the minority is forced to exit the company by way of the majority offering a nominal value for their shares, any shareholder may raise an objection before the Company Law Board on the grounds that it believes that the company's affairs are being conducted in a manner that is prejudicial to the company's interest or oppressive to company members. If the board is satisfied by the objection, it has the power to intervene in the decisions of the majority shareholders. In the absence of any rules or guidelines, the board has the power to allow or reject an offer of shareholder buy-out. The judicial trend so far suggests that the board has primarily allowed majority shareholders to acquire the minority's shares only if the fairness standard is met. The onus to prove otherwise is on the dissenting shareholders.

Facts

Indian law permits reductions of share capital by companies that are in the process of reorganization. Sections 100 to 105 of the Companies Act deal with reduction of capital. If so authorized by its articles of association, a company - by way of a special resolution (at least a 75% vote by shareholders present and voting) - can reduce its share capital and, subject to court approval, is free to choose the manner in which such reduction is achieved.

In *Sandvik* the promoters constituted 95.54% of the unlisted public company, with the remaining 4.46% being held by non-promoters. Further, an overwhelming majority of 99.95% of the shareholders (including a majority of the non-promoters) passed a special resolution for the reduction of capital in accordance with the articles of association. The resolution was to reduce the company's share capital by paying off or returning to shareholders (other than promoters) the value of their shares at a rate of Rs850 per share (ie, Rs100 on face value and a Rs750 premium per share). The company petition was filed under Section 100 of the Companies Act and sought approval by the court. This petition was opposed by the company's minority non-

promoter shareholders.

Counsel for the minority shareholders argued that the majority had the right to reduce the capital subject to the process being fair and equitable. Since the minority shareholders had no option but to accept the offered amount, the single bench of the Bombay High Court held that the bulldozing of numerous shareholders was highly inequitable and unfair. Hence, the company petition was dismissed. The company appealed to the division bench of the Bombay High Court, whose verdict overturned the single judge's order based on the contentions of the counsel.

Contentions of appellant

While justifying the process, counsel for the appellant contended that by virtue of Section 100 of the act, a company can reduce its share capital - if so authorized by its articles of association - by way of a special resolution in any manner it so chooses. If the majority's intention is to attain a 100% stake in the company, Section 100 of the act permits such reduction of share capital by which the minority (non-promoter) shareholders may be ousted. Further, the appellant emphasized that only approximately 0.05% of the votes polled were opposed to the special resolution, and that a miniscule minority should not be permitted to override the vote of the overwhelming majority of shareholders. It was additionally highlighted that with the delisting of the company from the stock exchanges, the company's shares were not freely traded. As such, the proposed reduction provided (i) a reasonable price of Rs850 per share, which was considerably more than the book value of Rs687 per share, and (ii) a lucrative mode of exit for the non-promoter shareholders. It was also submitted that the non-promoter shareholders did not challenge the amount offered to them as unjust or unfair.

Contentions of respondent

Counsel for the respondent primarily contended that the scheme for the reduction of share capital proposed by the special resolution would wipe out a class of shareholders, namely the non-promoters, and that this was unfair and inequitable. The respondent submitted that a public company inviting participation from the public cannot be permitted to extinguish an entire class of public shares by means of reduction of capital under Section 100 of the Companies Act in order to facilitate the real object of making the company a 100% subsidiary of the promoters. Further, Section 100 of the act cannot be interpreted to undermine the legislative policy which is directed at preventing the acquisition of public shares and, as such, cannot be resorted to in order to extinguish an entire class of public shareholders. The court's confirmation of a reduction of capital is a safeguard for the protection of the minority shareholders and the court should consider whether the reduction of capital is fair and equitable to the creditors and shareholders, and whether it is in the public interest.

Decision

The division bench noted the above contentions of the counsel and underlined the fact that the courts have the power to confirm a scheme for reduction which applies selectively to a class of shareholders. However, only a scheme that provides for the uniform treatment of shareholders and is just and equitable will be confirmed by the court. As such, the principal question to be considered was whether the special resolution which proposed to wipe out a class of shareholders after paying them just compensation was unfair and inequitable.

An important feature considered by the division bench was the overwhelming majority of the minority that approved the resolution for reduction of capital and the fact that only an insignificant number of shareholders raised the objection. Another significant aspect was that the shares were of no commercial value to the dissenting shareholders and, in all reasonable probability, would never bring them any profit. The minority shareholders at no point suggested that the amount that was being paid was in any way too low and insisted only on retaining their holdings. The division bench noted that the applicant had not convincingly shown that the offer was obviously and convincingly unfair.

Based on the above contentions, the bench ruled that once it had been established that a very small number of minority non-promoter shareholders would be paid a fair value for their shares, the court would have been unjustified in withholding its approval of the resolution. As such, a special resolution which proposes to wipe out a class of shareholders after paying them just compensation is not unfair or inequitable. Further, relying on a century-old judgment, the court was of the view that apart from the interest of creditors, the question of whether each member shall have his or her shares proportionately reduced, shall retain his or her shares unreduced or shall have his or her shares extinguished upon receiving a just equivalent is an internal matter for the company. Further, the court held that it might be advantageous for the company to adopt the latter alternative.

In the absence of any claim on the basis of Sections 397 to 399 of the act with regard to oppression and management of the company, it was clear that at issue was not the fair price offered for the shares, but the proposed unfair reduction of capital on the basis of

Section 100 of the act.

Comment

This judgment severely affects shareholders' rights and has opened up the possibility of squeezing out minority shareholders through a reduction of capital that is held by minority shareholders alone. In the absence of any explicit guidelines with respect to the selective reduction of capital, majority shareholders that hold more than 75% of the shareholding can easily pass a special resolution for reduction of capital. As such, by following the procedures, there is no overt violation of the act. By allowing the company to reduce its capital in this manner, the court has effectively established a precedent whereby majority shareholders will utilize Section 100 of the act to create a wholly owned subsidiary.

Effectively, this verdict is likely to reduce the incentive for a minority to frustrate a purchaser that wishes to use the Section 100 procedure, unless there is an obvious reason why the use of the procedure should be prevented (eg, where it is being used to force the minority to sell on clearly unfair or unfavourable terms).

This matter is under appeal to the Supreme Court; however, majority shareholders will take confidence from this ruling and hold it as an established precedent.

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