'SQUEEZING OUT MINORITY': A CORPORATE LEGAL FIASCO

Introduction

A 'Freezeout' is a situation where in a transaction, controlling shareholder buys out the minority shareholders in a publicly traded corporation, for cash or the controller's stock. 'Freeze outs' are also known as 'Squeeze-outs' ("**SO**"), 'Parent-subsidiary mergers', 'Minority buyouts', 'Take outs', or 'Cash-out mergers'.In India the term SO has been widely used in both academic and professional practices.

SO is basically a way to oust the minority shareholders from their respective positions, being held in a public company. The Companies Act, 1956 ("**Act**"), provides for protection of minority shareholders against certain actions taken by the majority shareholders, such as unfair dilution of shares, related party transactions, etc. However, the Act is silent of protection of minorities in case of SO. The ultimate agenda of a majority shareholder is to acquire unfettered rights to conduct the business of a company in the manner it deems fit. Thus the concept of SO, well-recognized in many jurisdictions internationally, becomes increasingly significant.

International Position

Florida in USA first codified the laws related to SO in the mid-1920s, followed by*Delaware* in the 1950s, and the Model Business Corporation Act in the 1960s. Further the Delaware court in the case of *Sterling v. Mayflower Hotel Corp., 93 A.2d 107 (Del. 1952)*,advanced by stating thatSO would be subject to judicial review for 'entire fairness' to the minority shareholders. The seminal case on SO in the modern era is *Weinberger v. UOP, 457 A.2d 701 (Del. 1983)*. In this case theDelaware Supreme Courtstated thatthe entire 'fairness review' requires both review on the matter of 'fair dealing' and 'fair price' as a whole.

Further, the position of *Weinberger v. UOP*was strengthened by the Delaware Chancery Court in the case of *Re MFW Shareholders Litigation 67 A.3d 496 (Del. Ch.2013)*. In this case the court established a precedent to apply business judgment rule to the merger of a company with its majority shareholder, in which an offer was made to buy out the minority group. The Court established two protections for minorities in case of such mergers: firstly, the transaction must be negotiated and approved by an independent special committee of directors and secondly, it must be approved by an un-coerced, fully informed, majority section of the minority shareholders of the target company. This decision increased the role of the minorities in protecting their own interests and attempted to safeguard them from SO.

Indian position:

The only provision which distantly deals with minority SO is section 395 of the Ac
Section 395 of the Act is a rarely used provision under which an acquirer company can make an offer to shareholders of a target company and if 9/10th of the shareholders accept the offer, the rest of the shareholders can be squeezed out by giving them notice.

However, in absence of any corresponding Rules and Regulations dealing with SO, the minority groups have only option to seek protection from the Company Law Board ("**CLB**"). But the judicial trend so far suggests that the CLB would allow the scheme or contract if the fairness standard is met and the onus to prove otherwise shall be on the dissenting shareholders.Majority shareholders usually resort to two directions in order to SO shares of minorities,firstly, by reducing the share capital of a company by buy-backing shares from minorities or secondly, by floating merger or takeover scheme.

Minority shareholders can be squeezed out of a company by reducing share capital through buy back of specific shares.Buyback of shares are generally done with the consent of the shareholders. Even in the Securities Exchange Board of India (SEBI) Buyback Regulations it is mandatory that the shareholder has to specifically come forward and offer his shares in writing. However, the detailed Buy back Regulation issued by SEBI can be avoided by a special resolution under Section 100 of the Companies Act, 1956 provided it's authorized by the articles of association of the company.

The phrase 'any shareholders' in section 101of the Act indicates that a reduction of share capital need not necessarily be *qua* all shareholders of the company, but can take place from one or more amongst the body of shareholders.[1] Thus an offer of buy back of shares to any group of shareholders is possible under the said provision.

In case of listed companies, the stock exchanges, which are governed by the SEBI, have the jurisdiction to determine whether such schemes are contrary to the listing guidelines as well as various regulations and guidelines issued by SEBI. In case of unlisted companies, the SO of minority shareholders are completely left to the approval of the court as the Companies Act has failed to recognize the right of shareholders to exit a company at their will.

Schemes of arrangement involving reduction of capital whereby the company would reduce the share capital of all shareholders other than the promoters/ controlling shareholders will also amount to a SO. Such arrangements do not incur any financial burden on the majority shareholders, as the consideration for the reduction always came from the company (and not the shareholders).

A Bombay High court division bench has approved such an arrangement scheme the case of *Sandvik Asia Limited v. Bharat Kumar Padamsi*[2] as there was nothing contrary to law in it.

Also the bench has expressly stated that a special resolution which proposes to wipe out a class of shareholders after paying them just compensation cannot be termed as unfair and inequitable.

Squeeze out of minority shareholders is possible at the time of takeover of a company in order to take control of a company by the majority shareholders of the acquiring company.

It has been held by the Bombay High Court in the *Hoganas India Ltd.* Case that, it is not proper to uphold the convening of a meeting of two classes together who falls into two different classes having different rights and interest regarding the resolution of a meeting. In a given case that would allow the majority having a common interest to ride rough shod over the minority representing a distinct interest but as has been averred, the moot question has always been what constitutes a "class".

Once a resolution has been passes as per the requirements under section 395 of the Act, i.e. passes by holders holding at least 9/10thin the value of the shares of the shares to be transferred and are at least 3/4th in number of the holders of those shares, then the settled position in this regard is if the court finds that the rights and interest of the shareholders whose meeting is convened are common, then the courts doesn't withhold its assent for such takeovers.The court is generally not concerned with the commercial decision of the shareholders until and unless the court feels that the proposed merger is manifestly unfair or is beingproposed unfairly and/or to defraud the minority shareholders.[3]

Thus S.395 of the Companies Act allows squeeze out of only the dissenting minority shareholders of a company. This provision does not allow a squeeze out of minority shareholders when the takeover offer is not accepted by the majority of the minority shareholder block of a company.

Companies Bill 2013

New clause 236 of the Companies Bill, 2013 seeks to put an end to the SO fiasco and enables an acquirer who holds 90% or more of the issued share capital of the company to squeeze-out the minority shareholders. However, the provision is not clear about whether substantial acquisition of the issued equity share capital shall be the only criteria to trigger the statutory right to SO minority shareholders or will an acquisition of voting rights be considered as well.

Also SOs of minority shareholders may require the consent of the Board of Directors given by a resolution at a meeting of the Board if it's brought under the rules/regulations made under clause 188 of the proposed Companies Bill, 2013.

1. *Elpro International Ltd., In re* (2008) 86 SCL 47 (Bom)
2. Appeal No. 308 of 2004, Order dated April 4, 2009

In the *Sandvik Asia Ltd. case*, the parent foreign company held 95.54 % of the share capital. A scheme of reduction of capital was proposed under which the 4.46 % shares held by the public was proposed to be bought back at Rs. 850 per share.

It was claimed by the company that 99.50 % of the shareholders approved the scheme at the meeting but the court noted that 95.54 % of the shares were held by the promoters themselves who were, in any case, not selling their shares.

3. *Miheer H. Mafatlal vs. Mafatlal Industries*,JT 1996 (8) 205

Class Action Suits under Companies Act, 2013

On January 2009, India's capital market witnessed their biggest corporate scandal widely compared with the Enron scandal of United States (**US**). The 'Satyam scandal' referred to as 'India's Enron', whereby 300,000 shareholders of Satyam Computer Services (now Mahindra Satyam) sued the company for their fraudulent activity. Satyam's founder Ramalinga Raju confessed to misstate the accounts and the company stock. Consequently, the shareholders claimed damages worth Rs. 5,000 crore. However, due to lack of any legal mechanisms to safeguard the interest of such shareholders, Satyam's shareholders were denied of their right to claim back their invested amounts. Aiming to end this, the Indian Parliament drafted the Companies Bill, 2009 and introduced provisions enabling such affected shareholders to file 'class-action suit' similar to 'class-action suit' prevalent in US and UK. 'Class Action', which is also known as 'Representative Action', is actually a form of lawsuit where a large group of people collectively brings a claim to the court through a representative. This form of lawsuit finds its origin in United States and is predominantly tried in their federal/state courts. Similar provisions were introducedin the Companies Bill, 2011 (**Bill**) pursuant to the Dr. J.J.Irani Committee Report. Recently, thePresident of India has given his assent to the Bill which consequently repealed the earlier Companies Act, 1956, with the Companies Act, 2013 (**Act**).

Class-action law suit in US

The concept of class-action was first introduced in US in the year 1938 through the Federal Rules of Civil Procedure (**FRCP**). Rule 23 of the FRCP prescribes the requirements which need to be fulfilled in order to bring class action suit against any entity.

Subsequently, the Class Action Fairness Act, 2005 was enacted which led to the expansion of federal jurisdiction over large class action lawsuits. Shareholders class action arises generally in matters such as breach of employment terms by the company, unfair labour practices by the company, destruction of wealth due to mismanagement of company affairs, accounting fraud, violation of securities regulations etc. Such tremendous growth in class actions lawsuits led to the establishment of law firms specialized in organization such cases. Some of the large class action suits filed were Master Tobacco ($206 billion), Dukes vs. Wal-Mart ($11 billion), Enron ($7.20 billion), WorldCom ($6.20 billion). The numbers are staggering.

Class action law suit in India

Class action suits in India have so far been filed under the guise of Public Interest Litigations which needless to say does not provide much assistance to the distressed shareholders. Another remedy which the shareholders may avail is by filing claims against oppression and mismanagement before Company Law Board (**CLB**) under sections 397 and 398 of the Companies Act, 1956. Despite the fact that the CLB has been active in considering cases under these section; their scope is fairly limited and may not is not available for all instances of breaches of duties either by the company or its management. There are few drawbacks of the suit filed under Section 397/398 of the Companies Act, 1956 which has been addressed in the Bill. Firstly, under the Bill the depositors can file class action suits, but not a under oppression and mismanagement. Secondly, oppression and mismanagement case can be filed against the company and its statutory appointees only, while a class suit can be filed against an expert or advisor or consultant or any other person and also against an auditor as the case may be. Thirdly, petitions under oppression and mismanagement can be filed for past mismanagement and to prevent for its recurrence, while class action suit can even resist the management or directors of company to take certain actions which may result in future adverse consequences.

Section 245 and 246 of the Act specifically deals with the class-action suits. These clauses permit investors to approach the National Company Law Tribunal (**NCLT**) if they believe that the affairs of the company are being conducted in a manner detrimental to the interest of the company and its shareholders.

Section 245 of the Act provides that a certain number of shareholders or depositors are entitled to bring an action before the NCLT if they are of the opinion that the management or conduct of the affairs of the company are being conducted in a manner prejudicial to the interests of the company or its members or depositors. The action can be against the company for restraining it from various acts such as those that are ultra vires the memorandum and articles of association, that are based on a resolution of shareholders obtained through suppression of material facts, or that are contrary to the provisions of the Companies Act or any other law applicable to the companies. Furthermore, interestingly the shareholders are also entitled to claim damages for fraudulent actions, unlawful conduct or mis-statements made by the company, its directors, and in certain cases even the auditors (including the audit firm) or any expert or advisor or consultant of the company.

Significant features that have been introduced vide clause 245 of the Bill are mentioned herein below.

- Class action suit can be filed by members and deposit holders only. Other stakeholders such as creditors, bankers, debenture holders etc are deprived of filing a suit for class action.
- There is a threshold limit in terms of the support required for bringing an action. The class action must be supported by at least 100 shareholders, or such percentage of total number of shareholders or those holding such percentage of shares in the company as the Central Government may prescribe. However, in case the company does not have a share capital, the class action suit need to receive support from not less than one-fifth of the total number of its members.
- The NCLT is required to consider a number of factors while considering an application such as whether the shareholders are acting in good faith or have any personal interest in the action, or whether the act or omission involved has been authorised or ratified by the shareholders.
- In case the NCLT discovers that the person filing such class action suit filed it in frivolous and vexatious manner, the NCLT will be empowered to impose costs on the initiating shareholders.
- Failure to comply with an order of the NCLT, made in pursuance to the class action suit, will attract criminal punishment against every person responsible for such non-compliance.

It is pertinent to note that the Act empowered the NCLT to deal with the cases related to class action suits, relieving the normal courts from further burden. This will not only relieve the judicial system but will also ensure that such actions are dealt expeditiously. Further, professionals such as auditors, experts, advisors or consultants or any other persons associated with the company will exercise more independence, diligence and efficiency in their work. Therefore manipulations by professionals to the company may be expected to decline. However, the limitations imposed with regard to the threshold limit on the number of persons required to file class action suit may limit the applicability of the provisions to a considerable extent.

Reduction of Limit for Overseas Direct Investments

As a move to curb the weakening Indian rupee, RBI on August 14, 2013 imposed restrictions on the amount of foreign exchange to be remitted by Indian companies and resident individuals overseas. According to the said notification, RBI reduced the limit for Overseas Direct Investment (ODI) made by Indian party in all its Joint

Ventures (JVs) and / or Wholly Owned Subsidiaries (WOSs) abroad under automatic route, from 400% of the net worth of an Indian Party to 100% of its net worth. Any ODI in excess of 100% of the net worth shall be considered under the Approval Route by the Reserve Bank of India.

RBI also reduced the limit for remittances made by Resident Individuals, under the Liberalised Remittance Scheme (LRS Scheme), from USD 200,000 to USD 75,000 per financial year. Resident Individuals have, however, now been allowed to set up Joint Venture (JV)/Wholly Owned Subsidiary (WOS) outside India under the ODI route within the revised LRS limit.

RBI added that the reduced limit would also apply to remittances made by Indian companies setting up entities abroad in the energy and natural resources sectors, but would not apply to investments made by Navratna Public Sector Undertakings such as ONGC Videsh Ltd. and Oil India Ltd.

RBI, through subsequent notification, announced few clarifications on the above restrictions which includes-

- that the restrictions shall apply with prospective effect and therefore all ODI investment made before August 14, 2013 in compliance with the earlier limit of 400% of the networth will continue to be allowed;
- the higher limit of 400% shall be retained for ODI through ECB; and
- the above limit of 100% of its net worth shall not apply to the financial commitments funded out of EEFC account of the Indian Party or out of funds raised by way of ADRs / GDRs by the Indian Party.

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New Companies Act, 2013 notified

Most awaited Companies Act, 2013 (Act No. 18 of 2013) has been notified in the Gazette of Government of India. Further, the Government has also published new rules based on the said Act of 2013 for suggestions and recommendations.

SEBI takes action on Unregistered Investment Advisory and Portfolio Management Activities

SEBI, as a part of investigation, conducted surprise visits to the premises of one Mr. Imtiyaz Khanda & one Mr. Ghaniwala and found that they were providing investments advice and intraday tips on behalf of M/s Laxmi Traders and M/s Sai Traders. SEBI directed the proprietary concerned to cease and desist from acting as an investment and portfolio managers either directly or indirectly and immediately withdraw & remove all advertisements, representations, literatures, documents, publications and website etc.

RBI eased rules relating to Portfolio Investment Schemes for NRI's

These measures were mainly taken by RBI to Pull In the foreign currency in view of deteriorating the economic situation, depreciating rupees. Key features include opening of separate sub-account of NRE/NRO accounts in terms of Foreign Exchange Management (Deposit) Regulations, 2000 , however, NRIs are debarred from investing in an Indian Company which is engaged in Chit Funds, Agriculture & Plantations, real estate business except township development, roads or bridges, educational institutions, recreational facilities.

Cabinet has cleared Infrastructure projects worth Rs. 1.83 Lakh Crore

Pursuant to Government's target of carrying out Food Security Programme, Cabinet Committee on Investment has cleared 3 dozen infra projects to get investment cycle rolling again. Reliance Power's*Sasanproject* has been given Stage I clearance, L&T Metro Rail Project (*Hyderabad)* has got all approvals and GMR's *kishangarh expressway*will be approved soon.

Banking Ombudsman says Sharp Rise in Online Bank Frauds

Banking Ombudsman for Karnataka stated that complaints related to Credit Card and Internet Based Transactions has rose tremendously from 732 to 1279 from 2011-12 to 2012-13.Websites such as lyca.uk, denguemail.ru, sports.com, were one of the fraudulent websites which duped their victims by promising them jobs and rewards in lieu of money.To tackle such menace on internet based transactions RBI has issued guidelines that require bank to authenticate transaction via text message.

RBI increased FDI limit in Asset Reconstruction Companies

RBI by its circular dated 19th August 2013 increased the ceiling for FDI in ARCs from 49% to 74% subject to the condition that no sponsor may hold more than 50% of shareholding in an ARC either by way of FDI or FII.RBI also increased the FIIs investment in Security Receipts

(SR) limit to 74%.

RBI on External Commercial Borrowings (ECBs) from foreign equity holder

As per the new RBI Circulated dated 4th September 2013, borrowings in the form of ECB cannot be utilized for general corporate purpose. It has been decided to permit eligible borrowers to avail of ECB under the approval route from their foreign equity holder company with minimum average maturity of 7 years for general corporate purposes subject to the conditions mentioned in the said circular. The circular can be referred here.

RBI puts an end to the 80:20 plan

One of the most popular schemes developed by the real estate sector for buyers, the 80:20 plan has been put an end to by the Reserve Bank of India. It allowed buyers to pay 20 per cent of the price upfront and the rest on possession. The monthly installments in between were handled by the developers.

Government approves 17 proposals of Foreign Direct Investment

On recommendations of Foreign Investment Promotion Board (FIPB) in its meeting held on July 29, 2013, the Government has approved17 Proposals of Foreign Direct Investment (FDI) amounting to Rs. 992.61crore approximately.

CCI imposes penalty on shoe companies

In a case filed by Director General-Supplies & Disposal (DGS&D), New Delhi regarding a tender for supply of polyester blended duck ankle boots rubber sole, the Competition Commission of India (CCI) has imposed a penalty of Rs. 625.43 Lakhs on 11 Companies. The said 11 Companies were found to have violated the provisions of Competition Act, 2002 which deals with anti-competitive agreements. CCI has further imposed penalty @ 5% on the average of the gross turnover for financial years 2008-09, 2009-10, and 2010-11.