DEMERGERS AND MINORITY RIGHTS: REGULATORY FRAMEWORK

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Introduction

Mergers and demergers perform an important role in corporate restructuring. Over the past few years with the increase in economic activity instances of mergers and reconstructions have also kept pace.[1] This need for reconstruction arises from the fact that firms need to maximise synergy and economies of scale, by removing inefficiencies to seek profitability.[2] The causes can be wide and varied ranging from shareholder activism, failure of internal controls, capital structure (free up cash flows), currency and interest rate shocks (in cases of MNCs) to underperformance, family squabbles, tax planning, reverse synergy, corporate governance etc.[3] In a nutshell, the age of specialisation demands better risk-reward trade off which drive firms towards creation of separate legal and operational entities.[4] To satisfy this need of firms, corporate restructuring provides avenues through many forms such as merger, consolidation, acquisition, demerger, joint venture, buy-back, delisting etc. The focus of this article is on demergers.

Demerger is a species of reconstruction which results in creation of a separate entity. The rationale is allowing firms to pursue profitability by evolving specialised niches. It involves in transfer of assets and thereby value of investors. The majority rule laid down in *Foss v. Harbottle*[5] is a cardinal principle of company law however many a times issues can come up with minority investors. In recent times such complexities have arisen in the demerger of *Macmillan India*[6] and *Century Textiles*[7]. The regulatory framework for reconstruction can run into hurdles when all shareholders are not of the same opinion. In such a scenario, minority squeeze becomes highly probable. Since demerger can involve transfer of shares between entities or medication of rights held by right holders, the risk dilution of value of

[1] Chande, A. (2018). 2018 setting new records for Indian M&A. [online] Grant Thornton UK LLP. Available at: https://www.grantthornton.co.uk/insights/2018-setting-new-records-for-indian-ma/ [Accessed 4 May. 2020].

[2] Ramanujam, S. (2006). Mergers et al. 2nd ed. Gurgaon, Haryana: Wadhwa and Company Nagpur, pp.159-171.

[3] Verma, J., Kumar, S. and Balakrishnan, K. (2008). Bharat's Corporate mergers, Amalgamations & Takeovers. New Delhi: Bharat Law House, p.234.

[4] Salter, M. and Weinhold, W. (1978). Diversification via Acquisition: Creating Value. [online] Harvard Business Review. Available at: https://hbr.org/1978/07/diversification-via-acquisition-creating-value [Accessed 2 May. 2020].

[5] [1843] ER 189

[6] Upadhyay, P. (2008). Macmillan demerger plan miffs minority shareholders. [online] economictimes.indiatimes.com. Available at: https://economictimes.indiatimes.com/news/company/corporate-trends/macmillan-demerger-plan-miffs-minority-shareholders/articleshow/3312304.cms [Accessed 6 Jun. 2020].

[7] Vyas, J. (2018). Minority holders' ire may mar vote on Century's demerger. [online] The Economic Times. Available at: https://economictimes.indiatimes.com/markets/stocks/news/minority-holders-ire-may-mar-vote-on-centurys-demerger/articleshow/66340706.cms [Accessed 6 Jun. 2020].

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investors cannot be denied.[8] Equity shares represent ownership in a firm and any transfer of them has far reaching consequences.

Within this context, the present article discusses the regulatory framework in cases of demergers and the remedies available to minorities.

Regulatory Framework for Demergers

Demergers are executed by way of schemes of arrangement under Section 230-234 of Companies Act, 2013. The definition of demerger can be found under the Income Tax Act. According to this section, the following conditions are essential for demerger:[9]

1. The demerger must be a transfer by the transferor company to a transferee company of one or more undertakings belonging to the transferor company;
2. The transfer should be achieved pursuant to the scheme of arrangement under Section 230-234 of Companies Act, 2013.
3. All the property and related liabilities of the undertaking transferred, immediately before the demerger, must become the property of the transferee company by virtue of the demerger, and not by virtue of sale or otherwise as a result of the acquisition of the property or assets of the transferor company or any undertaking thereof by the transferee company;
4. The property and the liabilities transferred must be transferred at values appearing in the books of account of the transferor company immediately before the demerger. Revaluation of assets must be ignored;
5. The consideration to be paid by the transferee company should be paid to the shareholders of the transferor company and not to the transferor company. Such payment must be in the form of the shares of the transferee company. Allotment to the shareholders of the transferor company must be in proportion to the shares held by them in the transferor company;
6. The shareholders holding not less than ¾ in the value of the shares in the transferor company (other than shares already held therein immediately before the demerger, or by a nominee for, the resulting company or, its subsidiary) must become shareholders of the transferee company or companies by virtue of the demerger;
7. The transfer of the undertaking is on a going concern basis;

As the definition goes, demerger results in arrangement within the bounds of Section 230-32 of Companies Act. For any demerger, consideration is a mandatory requirement and can involve allotment of shares as mode of payment.[10]This is done by valuing the demerged entity and comparing it with the original company. In other words there arises a need for proper business valuation which in turn will help in fixing the exchange ratio to arrive at further allotment of shares[11].

Companies Act provides that any demerger needs to be in accordance with the conditions, if any, notified under Section 72A (5) by the Central government. It can be executed through, agreement between promoters; under scheme of arrangement; or under legally enforceable orders by appropriate authority. The idea is to preserve the entity through rejuvenation or

[8] Verma, J., Kumar, S. and Balakrishnan, K. (2008). Bharat's Corporate mergers, Amalgamations & Takeovers. New Delhi: Bharat Law House, p.238.

[9] Income Tax Act 1961. Section 2(19AA).

[10] [1995] 19 CLA 196 [Cal]

[11] Income Tax Act 1961. 2(41A)

rehabilitation[12]. Here it is not sold to some outsider but it is altered in such a manner that the persons now carrying it on substantially continues to carry it on.[13] As such it has impacts on the financial and operational capacities of the firm.[14] The rationale for demergers is similar to that of reconstruction and is affected in the same way through schemes of arrangement. The jurisprudence of previous companies act had made demerger a species of arrangement under Section 391 to Section 394.[15] Hence by implication this jurisprudence is carried forward into the new regime. Arrangement has been defined to include a reorganization of the share capital of the company through either[16]:

- Consolidation of shares of different classes; or
- Division of shares into shares of different classes.

The regulatory framework section 230 provides for role of NCLT in formulating a scheme for demerger. However this provision provides for relaxation in case 90% of creditors in value agree to the scheme. This section further lays down the procedural and certification requirements, such as the valuation report and auditor's report etc. Section 230(4) provides the criteria for persons eligible to object to the scheme. It says that only those persons who hold 10% or more shares or those who have an outstanding debt amounting of at least 5% or more have the right to object. Further, the approved scheme would become binding on all when it is:[17]

- Approved by 3/4th in the value of creditors or class of creditors or members or class of members present and voting in favour; and
- It is sanctioned by the tribunal.

Hence it is visible that the scope of persons who can object to the scheme is narrow enough to exclude a substantial portion of public shareholding. The regulatory framework further provides for power to NCLT to enforce compromise or arrangement.[18] In *Dr Ved Mitra v. Globe Motors Ltd.*,[19] it was said that Section 392 (Section 231 in new act) shows not only the ambit of the power conferred on the court but also the responsibility conferred. Hence, the court said that the power to modify the scheme implies in itself all incidental powers like convening a meeting of the members to elect directors. The combination of Section 231 and 232 allows tribunal to exercise its power keeping in mind fairness to employees and dissenting shareholders. At the same time, section 235 provides for fair exit option to dissenting shareholders. It contains provisions regarding power and procedure to acquire shares of dissenters. An escrow account has to be created from which

[12] Kerala State Cashew Development Corporation v. Commissioner of Income Tax [1994] 205 ITR 19 (Ker)
[13] Sampath, K. (2018). Law And Procedure For Mergers/Amalgamations, Takeovers, Joint Ventures, LLPs & Corporate Restructure. 11th ed. Snow White Publications, p.613.
[14] Investopedia. (2019). Restructuring Is an Action a Company Takes to Limit Financial Loss and Improve Business. [online] Available at: https://www.investopedia.com/terms/r/restructuring.asp [Accessed 3 Apr. 2020].
[15] Re [2004] 44SCL 461 (Bom)
[16] Companies Act 2013. 230.
[17] Companies Act 2013. 230(6).
[18] Companies Act 2013. 231.
[19] 48 Comp. Cas. 64 (Del)

consideration is disbursed as shares are transferred, based on the value determined by registered valuer.

In cases of arrangements, guidelines have been laid down by Supreme Court in *Needle Industries case*[20]. Supreme Court had laid down that if the power is exercised by the directors not for the benefit of the company but simply and solely for their personal aggrandizement to the detriment of the company, the court will interfere and prevent the directors from doing so. There must be good faith and reasonability on part of directors and the object must not be extra venous. To ensure that the value is not eroded or diluted, pre-emption right is provided to existing shareholders.[21]

The problem in this regulatory framework comes because unlike western nations where economic infrastructure allows for mobilisation of funds to stocks in early stages, India does not have a diffused shareholding pattern. The result of this deferred start has been that in India there is concentrated shareholding. The Delhi High Court has said that *"modern Indian corporate entity is not the result of multiple small individual shareholders but predominantly overwhelmingly state-supported funding structure at all stages and there exists the only handful of the majority shareholders holding overwhelming power in the company"*[22]. The chances of shareholders divided into two clearly identifiable groups are greater in a company having a small number of shareholders than in a company which has a large body of shareholders. This creates problems over long term where minority can be subjected to strong-arm tactics of minorities. While there is a fiduciary duty owed by majority share holders[23], the possibility of squeezing out minorities cannot be overlooked. This is somewhat contained by the exceptions to the majority rule:

- The activity objected to being ultra vires or illegal.
- The activity undertaken demands that it must have been sanctioned by a special resolution.
- The activity is an infringement of personal rights of shareholders.
- The activity amounts to a fraud on the minority shareholder.
- The activity is unfairly prejudicial to a minority shareholder.

A large body of jurisprudence in India points that the majority rule cannot be applied mechanically in all the cases. It has been held in *Shyam S. Rastogi v. Nona Sona Exports Pvt.* Ltd.[24], that "*the court is not a mere conduit pipe or stamping authority to whatever scheme that may be laid before it. Not often, motivations in the moving of such schemes are oblique. It is in fact for the court to first look at the scheme whether it has any strength or merits of its own and is financially viable or a mere attempt to take back affairs and the assets of the company which had been earlier perforce taken over at the time of winding up."* Through this it is amply clear that adjudicating authority is well within its powers in evaluating the pros and cons of the scheme. This power when

[20] AIR 1981 SC 1298
[21] Companies Act 2013. 62.
[22] *ICICI Bank v. Parasrampuria Synthetics Ltd.* (2002) 9 SCC 428
[23] *Narayandas Shreeram Somani v. Sangli Bank Ltd* 1965 SCR (3) 777
[24] 59 Com Cases 832 (Del)

read in light of Section 231, can be interpreted to be broad enough for courts to examine the decision of majority. On the same note, in *Re: M.G. Investment and Industrial Co. Ltd. vs. New Schorrock Spg. and Mfg. Co. Ltd*[25] the court had said that unless the minority is coerced into agreeing with the majority, the court would not go against the wishes of the majority. On reading of both the judgments it can be concluded that courts have reserved the power to the extent of evaluating the entire scheme. A hue of this power can be seen in NCLAT's decision on Tata Sons case, which was later stayed by Supreme Court.

Through the above mentioned cases we catch a glimpse of the proactive role that adjudicating authorities play in restructuring. While judiciary has tried to maintain distance from the internal affairs and avoid lifting of corporate veil, it cannot be denied that at times circumstances have warranted its intervention. However, the emphasis has been on allowing the internal affairs to be handled by internal people. The Indian legal system has not shied away from taking action and evolving the jurisprudence when needs arise. The *Needle Industries* case is a prime example in this regard where Supreme Court evolved elaborate guidelines with regards to arrangements and amalgamations. The essence of judgment and prevailing position of law is that courts will interfere when scheme is unreasonable or when there is a breach of trust on part of directors.

While the law is more or less settled instances of minority dissatisfaction have not abated. In such a scenario unsatisfied minority shareholders can pursue different remedies. One of the recourse for minorities is of derivative action. A derivative action is legal action or a civil suit brought by a minority of company members in their own names seeking a remedy for the company in respect of a wrong done to it.[26] It can be brought where the wrong complained of is a fraud by the majority of the members on the minority and the wrongdoers are in control of the company in general meeting, because they control the majority of the shares in the company, hence they will not permit an action to be brought in the name of the company. Further, if the company has no right to bring an action then no derivative action can be allowed. A minority shareholder cannot have a larger right to relief than the company itself would have had if it were the plaintiff. It has been held in *Nirmal Amilal Mehta v Genelac Ltd. & Ors*[27] that where directors themselves are wrong doers and in charge of the company as they have wrongfully alienated and transferred the property of the company in breach of their fiduciary duty as directors, derivative action by a shareholder would be maintainable for wrong done to the company as an exception to the rule in *Foss v. Harbottle*.

Second remedy available is that of representative action. A representative action is an action brought by or against one or more persons as representative of a larger group. The persons who are bring represented must have the same interest in the proceedings.

[25] [1972] 42 CompCas 145 (Bom)

[26] Chandratre, K. (2009). Bharat's law & practice relating to oppression & mismanagement. 1st ed. New Delhi: Bharat Law House, p.33.

[27] (2009) 88 CLA 243 (Bom)

This type of action is appropriate when collective personal rights are to be enforced. Since in such actions, the judgment is applicable to all, it prevents the duplicity of proceedings.

Third remedy is that of personal action. Such an action is brought by a person who has been wronged and wishes to recover the damages. Generally, contractual rights which are conferred upon a shareholder under articles of association are enforced through such actions.[28]

Conclusion

On being aware of the practical realities, it cannot be denied that majority rule has withstood the test of time because of its practicality and simplicity. While it is the way to go as of now, the courts have proactively come to the rescue when minority value is at risk of erosion. The Companies Act and jurisprudence in India gives certain rights to minorities which can be explored in case of dissatisfaction. Even though the present system may not be perfect but in light of exigencies of business and need for a conducive business environment, scarce alternatives are available. The scope of persons who can object to a scheme can be broadened while ensuring that legal adjudication takes minimal time to preserve the value for investors. The most apt way would be majority keeping in mind the interests of minorities. Further it needs to be understood that legal friction between majority and minority more often than not leads to erosion of value for both. To maintain a flourishing business co-operation and understanding is needed between parties.

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[28] Chandratre, K. (2009). Bharat's law & practice relating to oppression & mismanagement. 1st ed. New Delhi: Bharat Law House, p.31.