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PROTECTED ON PAPER: WHY INDIA'S TAKEOVER CODE FAILS MINORITY SHAREHOLDERS

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THE PROMISE

The Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, popularly referred to as the SEBI Takeover Code, was drafted with a definite aim in mind, namely, that whenever a control change takes place, the ordinary shareholder shall have to be taken care of.

A cornerstone in protecting such interests is the so-called open offer procedure. According to Section 3(1) of the Takeover Code, any acquirer who has acquired twenty-five percent of share capital of a listed company is bound to make a public offer to acquire at least another twenty-six percent of shares from other investors.[1] The price is determined using a set of formulas which include market values and deal prices of shares, and the period of making such offers should be minimum to give the chance to the sellers to accept the offer.[2] At least theoretically, this is a perfect exit route for the little guy.

WHY THE NUMBERS ARE DECEPTIVE

The rationale for these figures is rather simple. Under the Indian company law, a twenty-five percent ownership comes with significant rights of blocking the special resolution. This is a clear indication of acquiring some form of control, something that SEBI appropriately identified. What follows is the mandatory open offer of twenty-six percent aimed at reaching

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[1] Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, reg. 3(1).

[2] Id. reg. 7.

up to fifty-one percent, thereby ensuring that control is smoothly shifted without any lengthy struggle.[3]

There is, however, a dilemma that is overlooked through the above arithmetic. While the open offer is mandatory, the actual acquisition need not be done, unless, of course, enough number of shares are tendered by the minority shareholders. The deal goes ahead even without such acquisition.[4] Consequently, the minority shareholder who failed to act on time because they were not sufficiently informed or did not understand the language used in such a transaction ends up becoming a part owner of a firm owned by someone else against their consent.

THE LOOPHOLES THAT SWALLOW THE RULE

Aside from the weakness of the open offer per se, there are loopholes in the Code that crafty acquirers have found ways to take advantage of. One such loophole is the creeping acquisition clause. According to regulation 3(2), if an acquirer has at least twenty-five but not more than seventy-five percent of the issued shares of a target company, he can acquire a further five percent during the fiscal year without needing to make another open offer.[5] Year after year, the acquirer can increase his holding without ever having to cross the line where another open offer becomes inevitable.

This pricing formula itself constitutes an injustice by default. The Code demands that the offer price cannot be below the weighted average price of the shares during a period prior to this.[6] This is an ex post facto determination. It lets the minority know what the value of the business was in retrospect before its takeover was publicly known. It provides zero information regarding the future worth of the company, now that it has been taken over by someone with different capital and management. It makes the minority shareholder deal with the past to decide on the future.

Indirect acquisitions also introduce an extra layer of complexities. In cases where a parent company is taken over abroad, the Indian subsidiary company is practically under new control,

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[3] Id. reg. 8(1).

[4] Id. reg. 8(1).

[5] Umakanth Varottil, Takeover Regulation in India: A Critical Assessment, 6 Indian J. L. & Tech. 1, 14 (2010).

[6] Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, reg. 8(2).

but without the takeover requiring any of the Indian open offer norms to be satisfied at all, because nothing of its shares has changed hands.[7]

THE AWARENESS PROBLEM

Even if the Code is working well, there remains a far more critical issue limiting its impact: most individual investors in India do not even know of the existence of the open offer until after the fact. As per the present system, disclosure occurs through newspaper notices and filings at stock exchange websites.

This method is sufficient if one is a professional investor who has compliance officers working on this issue. But for a retail investor living in a Tier-2 city, this disclosure is practically non-existent. Even the limited period allowed for submitting offers is inadequate; by the time he realizes that there is a public offer taking place and decides whether the price offered is good, the period would already be over.

WHAT REFORM SHOULD LOOK LIKE

This gap can be narrowed through a few key changes. First, the mandatory minimum acceptance criteria must be introduced. The minimum acceptance criteria means that, after a certain number of shares are tendered by the minority shareholders, the acquirer must accept those shares compulsorily. This change would make open offers mandatory in nature.

Second, historical pricing criteria need to be combined with forward-looking price valuations. These forward-looking price valuations consider how much synergy will result from the acquisition. Even the SEBI's advisory board has mentioned the drawbacks of relying entirely on historical prices.[8]

Finally, sending notifications directly to registered shareholders through emails and SMS must be made mandatory in case of open offers. It is possible and very inexpensive for the acquirer to do so.[9]

CONCLUSION

[7] Companies Act, 2013, § 236(1) (India).

[8] Securities and Exchange Board of India, Report of the Takeover Regulations Advisory Committee 42 (2010).

[9] Companies Act, 2013, § 235 (India).

The SEBI Takeover Code for India is not a bad law. It has been designed with good intentions and has provisions which would work perfectly under ideal circumstances to serve the interests of the small shareholder. However, the gaps in the law's enforcement provisions, pricing formula, disclosure scope and indirect acquisitions make life difficult for the shareholder as the process always benefits the acquirer.

The minority shareholder is not present at the negotiation table and does not design the terms of the deal or control the schedule of events. The only thing he has is the law. And when the law provides a doorway but no key, then obviously it has failed to achieve its objectives.