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Squeeze out clause – A perspective

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'Squeeze Out' provisions in the Companies Act, 1956 enable the majority shareholder holding above a prescribed threshold limit to "squeeze-out" the minority shareholders and acquire the entire shareholding in a company.

Shareholding – Majority rule & minority rights

Shares in a company comprise a bundle of rights and responsibilities subject to the conditions and terms of its Memorandum and Articles of Association as well as the Act. Mutual agreement among shareholders on the manner in which a company is managed is the fundamental principle of corporate management and ownership. Such mutual agreement is a contract between shareholders and is enshrined in the articles of association and subject to consensus amongst themselves. It is not possible for each shareholder to participate in the decision making process on a day to day basis and hence the principle of majority owned and controlled corporations affords operational convenience in corporate decision making.

The "Rule of Majority" principle finds its roots as early as in the year 1843 as stipulated in *Foss* v. *Harbottle*[1] where, it was held that the courts would not generally interfere with the decisions of the company which it was empowered to take insofar they have been approved of by the majority and made exceptions to breaches of charter documents, fiduciary duties and fraud or oppression and inadequate notice to shareholders.

It is to be seen whether the system of "Rule of Majority rule" jeopardize the rights of the minority shareholder and squeeze them out of the company?

Majority Rule - Justifications quantified

Utilitarians have always justified majority rule in terms of the convenience in decision making. This theory is supported by the economic approach that higher rights and authority is directly proportional to percentage of ownership, giving the majority greater decision making power[2]. This would translate into a right of this majority beyond a specified threshold to decide whether it needs minority shareholders and if not the power to buy them out regardless. In terms of Squeeze out by third party bidders, Grossman and Hart[3] characterize minorities as free riders on investment risks thereby justifying the

1 (1843) 67 ER 189

2 Ataollah Rahmani, A comparative Study of Justifications for majority rule in Corporations: The Case of England and Iran, 282[I.C.C.L.R. 2007, 18(8) 279-294, (2007)]

3 Grossman S. and O. Hart, Takeover Bids, The Free Rider Problem and the theory of Corporation, Bell Journal of Economics 11, 42-64.

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right of such bidders to squeeze out minority shareholders.

The more legal justification often adopted by courts is based on the *Foss* v. *Harbottle* rule that the majority proprietors are the beneficiary of a trust of the company and every person who enters the company, by the very terms of its incorporation, agree to be bound by the decision of the majority. The only rider to this principle has been the 'business purpose' test which at once can challenge the wisdom of the majority and challenge their decision on grounds of fiduciary duty to cater to the best interest of the company[4].

Minority Rights - Right to one's own property

On the other hand, squeeze outs are considered as a depravation of property and when squeeze outs are enforceable under law, they amount to dispossession of property under the law. Under this approach dispossession of property must occur only in cases of public or general interest[5]. However, this argument has been overturned by European courts by equating public interest with 'efficient management' of companies thereby justifying 'legal' provisions enabling squeeze out.[6]

Another objection to squeeze out rights to the majority is based on grounds of fairness. Minority shareholders cannot be rendered powerless in terms of their shareholding in the company. However, Courts in India do not seem to support a right to be consulted unless statutorily provided for and have upheld majority attempts to cordon off minority rights through indirect squeeze outs[7].

Current legal position

Section 395 of the Companies Act provides for the process of squeezing out shareholders who dissent to an acquisition of shares otherwise approved by shareholders holding 9/10th in value within four months of the offer. The 'transferee company' may give notice to the dissenting shareholders in the next two months expressing its interest in buying their shares and then becomes entitled and obliged to buy such shares upon the expiry of one month from the date of notice.

If the transferee already owns 10% or more of such shares then the scheme needs to be approved by shareholders holding 9/10th in value and being ¾th in number of the shareholders holding such shares. The dissenting shareholder ought to be offered the same price as the other shareholders in such a case. The transferor company is paid the amount towards the shares of such shareholders and it is liable to disburse the same in their favor.

Upon notification, the dissenting shareholder may approach the tribunal to allow its application which would entitle such

4 Supra Carney at 97.
5 Christopher Van and en Lientie, Supra foot note 6 at 13.
6 Id at 14.
7 Sandvik Asia Ltd. In Re [2009] 92 SCL 272 (Bom)

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shareholder to continue to hold its share. The court shall allow such application if it were shown that the process was unfair or the price offered was undervalued, or the scheme was unjust, unconscionable or consent obtained thereto involved fraud[8]. It cannot be a scheme by the majority to expropriate the minority.

The various safe-guards under Section 395 lead to companies using 'reduction' provisions under Section 100 to squeeze out minorities by extinguishing their share in return of consideration. These provisions do not have the high voting requirements as in case of Section 395 and a special resolution suffices to approve the scheme therein. Such schemes have been upheld by the court in *In re Sterlite Industries*[9] and *Sandvik Asia* v. *Bharat Kumar Padamsi*[10] whereby the courts have allowed companies to squeeze out minorities indirectly under a scheme of reduction. The courts therein held that the Act allowed companies to extinguish share capital and the court would uphold such a scheme in all cases where creditors have consented and the shareholders have received fair compensation. The court ignored the well accepted principle of *"Quando aliquid prohibetur ex directo, prohibetur et per obliquum"* or in plain English, what cannot be done directly cannot be done indirectly.

In case of listed companies, the Securities and Exchange Board of India has provided for various open offer triggers under the SEBI (Take-over) Code, 2010. Both direct and indirect acquisitions of shares are regulated by the said code. The code provides for voluntary public offer to those acquirers having 25% to 75% holding in the shares. The takeover code is designed to provide shareholders with necessary information and a limited option to exit. However, it does not regulate or protect against squeezing out.

Companies Bill, 2012

The Companies Bill ("Bill") awaits the approval of the Rajya Sabha. Clause 236 of the Bill provides an option to the acquirers or the persons acting in concert holding 90% or more of the issued equity share capital to notify the company of their intention to squeeze/ buy out the remaining equity shares. The point of relevance in relation to the proposed squeeze out clause is that, it obligates the majority to notify the intention to buy out the shareholding and does not give away the right to the majority shareholders to buy out the minority shareholding outright. Further, the Bill does not provide for any time requirement within which an offer has to be made by the majority.

Further, as per the Bill, the tribunal shall send notices to the central Government and the SEBI (in cases of listed companies) when a scheme

[8] A Ramaiyya, Guide to the Companies Act 4210 [17th ed. Part II Lexis Nexis Butterworths (2010)]

[9] Manu/MH/0338/2002

[10] MANU/MH/0237/2009

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for reduction of capital is presented before it, thereby allowing objections to be raised by the regulators. Reduction provisions in the Bill provide an additional level of protection to the minority shareholders from being "squeezed out" under other provisions.

Conclusion

Minority rights cannot be seen as a 'management' problem and must be given due recognition and importance. The principle of majority rule is to afford greater flexibility to decision making. However it cannot be used to deprive a person or groups of persons of their property. The principle in *Foss* v. *Harbottle* is still relevant and the court was right in ruling that every shareholder is bound by the terms of incorporation of the company (and it operated as a set of mutually binding obligations) however in the process of implementing the objectives of the company one cannot override the legitimate expectations of the parties under the contract. Minority rights need to be looked at with greater care and caution and the principle of majority rule should not jeopardize the democratic system of corporate governance and turn itself into ignoring the minority and placing all the authority with the majority to do as it wants.

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Notifications & Circulars

FDI - Group Company defined: The Department of Industrial Policy and Promotion (DIPP) has through its Press Note No. 2 of 2013, dated 3-6-2013 provided the definition of 'Group Company' which shall now form part of the Foreign Direct Investment Policy currently in force from 5th April, 2013. 'Group company' shall now mean two or more enterprises which directly or indirectly are in a position to exercise 26% or more voting rights or appoint more than 50% of the board of directors of the other enterprise.

FDI in multi-brand retailing – Clarifications:

Important clarifications on conditions to be satisfied to seek approval for foreign direct investment (FDI) in multi-brand retailing have been issued by the Department of Industrial Policy and Promotion (DIPP) on 6th June, 2013. Some of them are:

- The 30% mandatory sourcing requirement from small and medium enterprises (SME) shall refer to sourcing of manufactured or processed products and, procurement of fresh produce shall not be counted;
- The 30% sourcing requirement shall be only with respect to the front end store of the multi brand retailer (MBR);
- The entire 50% investment in back-end infrastructure shall be only in greenfield assets. The entity shall not be allowed to acquire the supply chain or back end assets of an existing company;
- Investment in an existing back-end infrastructure company shall not be counted for the 50% investment requirement in back-end infrastructure;
- FDI in non-FDI approved as well as

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FDI-approved States in back-end infrastructure will be counted for the 50% investment requirement in back end infrastructure as long as the investment is an additionality;

- The business of wholesale cash and carry retailing and multi-brand retailing shall have to be undertaken by two separate entities even though they may have the same investors;
- The MBRT entity cannot undertake B2B activities and e-commerce;
- The front-end stores set up by MBRT entity will have to be 'company owned and company operated' and franchising will not be allowed;
- Certificate issued by District Industries Centre will be sufficient to confirm status of supplier as 'small industry';
- For determining whether a city has a population of more than 10 lakh, census data alone shall be relied upon;
- If the foreign investor approaches a State Government not included in the list of states supporting FDI in multi-brand retailing, consent from the State Government and a suitable amendment to the policy by Central Government shall be sufficient for investment by MBRT entity.

Listed Companies undertaking Scheme of Arrangement - Clarification on compliances: Securities and Exchange Board of India (SEBI) has issued clarifications on the subject of scheme of arrangement undertaken by listed companies. Some of the important clarifications by Circular No. CIR/CFD/DIL/8/2013, dated 21-5-2013, are as follows:

- Valuation Report from an independent Chartered Accountant shall not be required if there is no change in the shareholding pattern of the resultant company;
- In case a wholly-owned-subsidiary of a listed entity is merged with the parent listed company where the shareholders and the shareholding pattern of parent listed company remain the same, it will be treated as 'no change in shareholding pattern';
- Only such schemes which specifically involve alterations in promoter shareholding (promoters or promoter group entities) will require public shareholder resolution with a simple majority through postal ballot or e-voting;
- In case of companies listed solely on regional stock exchanges seeking exemption as to the minimum public offer, the company shall obtain in-principle approval for listing equity shares on any stock exchange having nationwide trading terminals;
- For companies listed solely on a regional stock exchange not seeking exemption as to minimum public offer, any one stock exchange having nation-wide trading terminals shall provide a platform for dissemination of information of such scheme.

Export of goods and software – Time-limit for realization and repatriation of export proceeds reduced: The Reserve Bank of India has prescribed time-limit of twelve months for

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realization and repatriation of export proceeds for goods and software in case of units in SEZ while such time-limit has been reduced from twelve months to nine months in case of units other than in SEZ. A.P. (DIR Series) Circular No. 105, dated 20-5-2013 issued for other than SEZ units, makes such provisions effective from 20-5-2013 till 30-9-2013. The A.P. (DIR Series) Circular No. 108, dated 11-6-2013 issued for the purpose of SEZ units is effective from 11-6-2013 and would be valid for one year.

News Nuggets

Single-brand retail covers sub-brands?

The Department of Economic Affairs (DEA) in the Finance Ministry has sent a reference to the Department of Industrial Policy and Promotion (DIPP) in one of the cases that an entity is selling under several sub-brands under the garb of selling under single brand retail trade. One of the views is that as long as single brand is found on all the sub-brands, there may not be any violation of the single brand retail FDI norms. However, DIPP maintains that there is no concept of sub-brand and that if the company sells more than one brand it is a multi brand player. News reports suggest that the DIPP has sent its official response in this regard.

Crossholding among the telcos

The Department of Telecom (DoT) is working on a proposal to disallow crossholding by one telecom firm in another, competing in the same circle. As per the present conditions of Unified Access Service License (UASL) granted by the DoT, no single company or a legal person, either directly or through its associates, can have "substantial equity" (an equity of 10% or more) holding in more than one licensee company in the same service area for the basic, cellular and unified access services. Now, the proposed change bars a licensee, even the promoter of the licensee, to hold any beneficial interest, either directly or indirectly, in another telecom company operating in the same circle. The proposed changes will have far reaching impact, as some of the telecom companies already have some beneficial holding in others, which will need restructuring.

An act to punish dishonesty in relation to sporting events

In view of the recent incidents in Indian cricket relating to spot fixing, the government is seeking to legislate a special act on criminalizing activities which threaten the integrity of the sport. The Attorney General has opined that the central government can frame a law under the Union List to regulate dishonest practices in sports. The Ministry of Law has drafted an act for punishing 'Dishonesty in relation to sporting events' and sent it to the Ministry of Youth Affairs and Sports (MYAS) for consultation. The MYAS is in the process of revamping the law in consultation with experts, to deal with the peculiarity and uniqueness of sports.

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Ratio Decidendi

Competition law and sports objectives: The Competition Commission of India has held that Hockey India is in a dominant position in the market for organizing private professional hockey leagues in India and is in a position to restrict the freedom of movement of players which makes it dominant. However, it was also held that requirement of No Objection Certificate, which arises from the efficiency dimensions that it introduces to the game, does not amount to a blanket restriction for players to play in other events involving foreign teams/ clubs. Though the commission did not find any violation of Section 3 or 4 of the Competition Act, it felt that it would be appropriate if Hockey India were to put in place an effective internal control system to ensure that its regulatory powers are not used in any way in the process of considering and deciding on matters relating to its commercial activities; and also set up a streamlined fair and transparent system of issuing NOCs. The Commission noted that sanctioning an event is a regulatory function of sports bodies and cannot be found foul of, per se, for violation of competition laws as it is necessary to prove that the application of system was not in accordance with sporting objectives.

The case pertained to the alleged imposition of restrictive conditions by Hockey India, on players for participation in un-sanctioned prospective private professional leagues resulting in undue restrictions on mobility of players and on prospective private professional leagues leading to denial of entry to competing leagues. The commission noted that inherence-proportionality test, which is applicable to all Rules, provides that if the alleged restrictive conditions is inherent to the objectives of the sports federation and the effect of restrictive condition on economic competition among stakeholders or on free movement of players is proportionate to legitimate sporting interest perused, the same may not be viewed as anti-competitive. It was also observed that adoption of Bye laws does not amount to a horizontal agreement in contravention of Section 3(3)(b) of the Act. [*Dhanraj Pillay* v. *Hockey India* – CCI Order dated 31-5-2013 in Case No. 73/2011]

Terms of Shareholders' Agreement will not regulate internal management of company unless captured in the Articles of Association: The High Court of Delhi has overruled the decision of the Company Law Board (CLB) wherein the CLB had held that since there was no bar on affirmative vote in the Articles of Association of the company, a provision in a Joint Venture Agreement providing for affirmative votes must be given effect to even if it is not incorporated in the Articles of Association of the company. The CLB had held that Section 9 of the Companies Act which provides that the Companies Act will have effect over anything contrary provided in the Memorandum of Association, Articles of Association or any other agreement executed by a company is applicable only to public limited companies. The High Court held

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that while Sections 81 to 89 (related to share capital) and Sections 171 to 186 (related to company meetings) of the Companies Act in so far as they relate to issuance of shares do not apply to private companies, there is no basis for concluding that Section 9 of the Act *per se* does not apply to private companies. It was noted that plain reading of Section 9 makes no such exception.

The Court further held that clauses in any agreement between the shareholders shall not be enforceable in matters related to internal management of the company just because it is not repugnant to the Companies Act. Such clauses in the agreements between shareholders shall be enforceable only when they are incorporated in the Articles of Association of the company as also previously held by the Supreme Court of India in various cases such as *V. B. Rangraj v. V. B. Gopalakrishnan*, AIR 1992 SC 453. [*World Phone India Pvt. Ltd.* v. *WPI Group Inc., USA*- [2013] 178 Comp Case 173 (Del)]

Competition law and franchise agreement: The Competition Commission of India has held that issue of dominance would not arise in a franchise agreement in respect of manufacturing and selling product under trade name of franchiser and as per his specifications. The Commission noted that when the informant entered into a franchise agreement with the opposite party, he had many options, as many players were active in the field of selling the product and it cannot be said that the franchiser had no competitors and therefore was able to operate independent of competition. It was noted that the dispute between the parties was business/commercial dispute regarding implications of the franchise agreement and there was no competition issue. The Commission hence found out that it was a fit case for closure under Section 26(2) of the Competition Act. [*Official Beverages* v. *SAB Miller India* – CCI Order dated 31-5-2013 in Case No. 81/2012]

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