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Role of Shareholders in Corporate Restructuring

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ABSTRACT

Corporate restructuring is the re-organization of the share-capital of the company or reorganizing the legal ownership and financial structure of the company.The idea of the 'structure' as such, is strongly linked to the existence of an objects clause in the Memorandum of Association. In the present study it is attempted to juxtapose the idea of 'restructuring' with how the law has evolved with regard to the 'structure' of a company. However, as the years progressed, companies began to include practically every conceivable activity in their object clause, and therefore, the doctrine, to that extent was practically eclipsed. It is precisely in this setting and context that this article aims at evaluating the role of shareholders in 'restructuring', with a critical analysis of available mechanisms for articulating dissent and an analysis of the exit option available for dissentor.

Key Words: Restructuring, Memorandum of Association, Shareholders, Financial Structure

Introduction

Corporate restructuring, broadly speaking, entails fundamental or radical changes in the company that could be in the nature of amalgamation, merger, take-over or could involve changes of a lesser degree, involving re-organization of the share-capital of the company. [1] Before proceeding to a technical and law-based analysis of this issue, it is attempted to juxtapose the idea of 'restructuring' with how the law has evolved with regard to the '**structure**' of a company.

The idea of the 'structure' as such, is strongly linked to the existence of an objects clause in the Memorandum of Association.The Doctrine of Ultra Vires as propounded in *Ashbury Carriage Co. case*[2], gave a resounding affirmation to the fact that a company must stick to activities that are listed in its Memorandum of Association, and the activities outside the scope of the MoA were to be void. However, as the years progressed, companies began to include practically every conceivable activity in their object clause, and therefore, the doctrine, to that extent got practically eclipsed.

The MoA, and the object clause in particular, is the premise on which the company is established, and lists the activities that the Company would undertake. To the extent that the acts done are inta-vires, the shareholder has a limited right to question the prudence of the management. However, as pointed out, restructuring entails changes which are fundamental in their character, and potentially change the very 'premise' on which a shareholder subscribes to the share capital of the company. It is precisely in this setting and context that this discussion

aims at evaluating the role of shareholders in 'restructuring', with a critical analysis of available mechanisms for articulating dissent and an analysis of the exit option available for dissentor.

Also, restructuring may also be sometimes carried out as a subterfuge to conceal the misdeeds of the management, or could also be in the nature of oppression on minority. The role of the courts in granting a scheme would therefore be analyzed with reference to this aspect. It is after all, if not a legal duty, but a duty nonetheless, of a shareholder to apprise the court of any circumstances that he believes that would prejudicially affect the interests of the company (as against the company represented by its majority shareholders), and therefore this aspect of the role of a shareholder is crucial.

Role of shareholders in restructuring of shareholding

Issue of bonus shares: The capitalization of profits should be within the scope of AoA of the Company, and shareholders are required to pass a resolution in a meeting for the abovementioned purpose. It is submitted that issue of bonus shares is generally welcomed by the shareholders because of the intrinsic prospects of gaining more shares in the company. However there are many other factors that an unassuming shareholder would not factor in, and would willingly give his consent for issue of bonus shares.

In the case of IDBI issuing bonus shares[3], at least two major concerns were raised, one that thecompany will not be able to maintain the profitability and dividend, pursuant to the issue, and that it will not be able to maintain the EPS.[4] A shareholder also questioned the prudence of the management as similarly placed companies were going in favour of buy-back (which could enhance shareholder value) instead of issuing bonus shares. Concerns were also raised, as to why EGM notice was not sent to all the shareholders.

It is submitted that the law cannot assist a shareholder beyond a certain point. All it can do, and indeed does, is to give him an opportunity to take an informed decision on these matters. It is then, upto the shareholders to vote and decide. Additionally the law allows only free reserve, securities premium and Capital redemption reserve to be utilized for this purpose and expressly bars reserves created by revaluation of asset from being utilized.[5] This serves as a sufficient safeguard.

Alteration of share capital: Under Section 61 of the Companies Act 2013, the authorized share capital of a company can be altered by passing a resolution to this effect in the general meeting. (The AoA should permit alteration in share capital). Any consolidation or division of shares, in as much as it results in shares of a larger amount than its existing shares it permitted. However, any consolidation or division that interferes with the voting pattern/ voting percentage of shareholders requires prior approval of NCLT.

In the case of British India Corporation Ltd. vs Shanti Narain[6], the company first passed a resolution to bring at par deferred shares with ordinary shares by consolidating them into shares of Rs. 1 each, (before this resolution, the deferred shares and ordinary shares were not at par), and subsequently passed a special resolution to consolidate the ordinary and deferred shares. It was held that permission of the court was required for effecting this change as the resolution to consolidate ordinary shares and deferred shares had also the effect of modifying the conditions of the Memorandum of the Company.

Reduction in share capital: While, on the face of it, it is the creditors who are affected by any reduction in share-capital, and the shareholders in any case, receive due consideration in case of a buy-back or a reduction in capital in general, a scheme of reduction of share capital can sometimes carry overtones of oppression on minority by majority. It is conceivable that the majority may vote, and nothing in law prevents them from passing a resolution to the effect that their own shareholding shall not be touched, and the reduction would take place by reduction in shares of minority, which is in the nature of 'squeeze out'. While it is true that such a scheme needs approval from the court, the courts have been of the opinion that the company enjoys autonomy on the issue of reduction in share-capital and how it is to be carried out, subject only to the provisions of the act, and there is nothing in law that prevents a non-uniform reduction in capital with regard to the shareholders.

However in Ramesh B. Desai v. Bipin Vadilal Mehta[7] the Supreme Court did acknowledge that the courts are duty bound to examine if a scheme, particularly the one that deals differentially with shareholders, to check if it is unfair, or inequitable.

Role of shareholders in schemes for compromise and arrangements including mergers and amalgamation.

A scheme backed by 3/4th majority can be put up for consideration of thetribunal. There are primarily three aspects, distinct from each other that court, though the analysis of them may involve considerable overlap. The first requirement is a procedural one, that is that the procedure prescribed by the act is duly followed, secondly, that the majority has acted in good faith for the benefit of class as a whole, and thirdly that the arrangement is such that a man of business prudence would ordinarily approve.[8]

It is precisely at this juncture that it is submitted that the new Companies Act of 2013 makes a regressive step by changing the law to the effect that for objecting to a scheme of compromise or arrangement minimum of 10 percent holding is necessary. The old act enabled any member to furnish objection to the court. Imposing a minimum threshold for furnishing objection is antithetical to the fundamental principle of natural justice, whereby an opportunity must be given to any person to at least REGISTER HIS DISSENT AND

FURNISH REASONS THEREOF, which may even catalyse further dissent from other shareholders, who may have given their assent, oblivious to some crucial aspects that may have missed their collective wisdom.

The reason behind keeping this minimum threshold has been that it would ward off frivolous objections. However, this can be addressed by simply incorporating provisions for enabling courts to impose fine, if any objection is later found to be totally devoid of merit or it is found that it was furnished only to delay or derail the whole process, or was malafide.

To take away the right of a member to voice his concern, by linking the reasons for such denial to his stake in the shareholding, mitigates against the very idea of protecting minority interest in case of a radical change in the structure of a company.

To understand how exactly a shareholder can pro-actively thwart a restructuring that smacks of malafide on the part of management, it is also important to examine the role of the court in this whole process.

In Miheer H. Mafatlal V. Mafatlal Industries Ltd.[9], the court categorically reiterated that the majority decision is not only supposed to reflect the interest of the majority, but it should be in the interest of the class of shareholders as a whole. It is argued in this context that such a determination is not really a matter of how many or how much of the shareholders are prejudicially affected, but the fact that the scheme must be just and fair to the class as a whole.

The act also requires full and fair disclosure of the facts attending the scheme in question. This full and fair disclosure is required at two stages. The first stage involves making it to the shareholders before they vote in favour or against the scheme[10]. The second stage involves furnishing the information to the tribunal, to enable it to come to a conclusion that whether the scheme is fair and equitable.

Even to achieve this objective, it is necessary that all shareholders are taken on board, and any dissenting voiced must be disseminated to all others, and therefore the minimum threshold requirement of 10 percent shareholding must be done away with.

Companies with totally dissimilar objects clause

In Re:Mcleod Russel (India) ltd[11]. A merger was proposed between a company engaged in tea business and investment and a company engaged in the manufacture of electrical appliances, and the court did held that there is in law, no need for any kind of unison between the object clause of the two merging companies.

The courts generally stop-short of questioning the commercial wisdom of the decision taken, and restrict their scope to examining for any supervening irregularity or unfairness in the whole process.

The law being that companies with totally different object clause can still proceed to a merger, it is only fair that any shareholder, irrespective of his stake, should be allowed to object to the restructuring as such a restructuring goes against the fundamental premise on which he had subscribed to the capital of the company.

Some important INTERVENTIONS BY SHAREHOLDERS in the past 5 years. [12]

1. Ramalinga Raju, the then CEO of Satyam Computer Services, had proposed buying Maytas Properties by utilizing the cash pile-up of the Company. Many of the shareholders objected leading to a legal battle, and subsequent to the scam of the abomentioned person being unearthed, the deal was actually called off.
2. Essar Energy Essar Global was seeking to buy 22% stake in Essar Energy by valuing the former at one-sixth of its listing price in 2010. Minority shareholders in Essar Energy, objected to the transaction, on the grounds of the price being undervalued. The company had to then reconsider the terms of the deal.
3. Suzuki's decision to push MSIL to sign a contract with its subsidiary to purchase cars on disadvantageous terms was met with objections by mutual fund institutions, and the proposal was sought to be put before the minority to seek their approval.

In this way, shareholder-activism can enable to the Company to sieve out vested interests of the promoter, and any mala-fide practice cloaked in the garb of 'restructuring' can at once be nipped in the bud, if shareholders are given a fair chance to voice their dissent.

Restructuring by sale of assets

The sale of assets of a company does not trigger the take-over code, and therefore there is no exit option available to the shareholders. The Companies end up selling their core divisions, while the benefits do not accrue to the minority shareholders. This is because of malpractices like undervaluation of assets like property, coupled with the fact that minority shareholders can neither block the sale nor do they get an exit option, since it does not involve taking over of shares. Piramal Healthcare transferring its formulations business to Abbott, Kanoria

Chemicals selling its chemical unit to Aditya Birla Group are some recent sales which have involved sale of undertaking. [13]

Restructuring by takeover of shares

According to the current take over code regulations, if the person acquires 25 percent or more of the voting rights or shares, then he has to make an open offer. An acquirer can acquire a maximum of 75% in a public company. Another important aspect is that in any year, after the acquirer has obtained 25 percent shares, he cannot acquire more than 5 percent shares in a year without coming up with an open offer. [14]

One important aspect which needs critical examination is that if 9/10th of the shareholders assent to the transfer, the transferee company gets the right to acquire the interest of the dissenting shareholders[15].

While a presumption of fact that a scheme approved by majority is bonafide, and that the onus lies on the dissentor to establish that the scheme is inequitable seems reasonable and sound; leaving the tribunal or court as the ONLY avenue for dissent for voicing dissent appears a bit unfair. The dissenting shareholder, should at least be entitled to a preliminary response from the management as to why his dissent does not deserve to be seriously considered, and it is only after this stage that court should be called upon to finally adjudicate on whether the allegation of unfairness is ill-founded or not. This approach would be more in sync with the principles of natural justice, and the law, while maintaining a presumption of fact that the scheme is based on commercial prudence and well-founded, should not obstruct or obliterate the avenues through which a dissentor can reasonably have his voice heard.

Conclusion

There is no doubt that the law on this issue seeks to balance the rights of shareholders (dissenting or assenting), with the overarching idea that any commercial decision which is backed by majority, and is prima facie a result of ordinary commercial prudence, should not be met with legal hurdles as to its execution, and the law if at all should facilitate the process of restructuring, which is inevitable in today's business paradigm, whereby most companies seek to diversify. At the same time, it needs to be borne in mind that an average investor either abstains from voting, or lacks the expertise to make an 'informed choice' and thereby ends up voting in favour of any proposal that the management would endorse. In view of this, it is proposed that the law should be generous towards any dissenting shareholders and must in fact assist them in voicing their concerns, rather than imposing minimum threshold requirements for registering dissent. It is only in this way, that a culture of shareholder-activism can be inculcated into the psyche of the ordinary investor.

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Case Studies

[1]s See Section 390 of the Companies Act, 1956 for 'arrangement'
[2] (1875) LR 7 HL 653
[3]*See* http://www.hindu.com/businessline/2001/01/24/stories/14240836.htm
[4] Earnings Per Share.
[5] Section63 of the companies act 2013.
[6]AIR 1935 All 310
[7] Appeal (civil) 4766 of 2001
[8] Cases and Material on Coporate Law II N.L.U. Delhi, page 173
[9] (1996) 4 Comp. LJP. 124
[10]Section 393(1) (a) of the companies act 1956
[11] (1997) 13 SCL 126(Cal).
[12] http://businesstoday.intoday.in/story/minority-shareholders-disagree-strongly-with-company-policy/1/204586.html
[13] http://articles.economictimes.indiatimes.com/2012-02-14/news/31059589_1_takeover-code-minority-shareholders-open-offer
[14]*See* SAST regulations 2011
[15] Cases and materials on corporate law II, NLU delhi.