Comments on Securities and Exchange Board of India (SEBI)'s discussion paper on "Exit offer to dissenting shareholders"

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1 Table of recommendations

S.No.	Pertains to paragraph	Proposed changes/suggestions	Rationale
01	–	The SEBI must, as part of the ongoing process for reviewing the *Companies Act, 2013*, recommend the deletion of Sections 13(8) and 27 of the *Companies Act, 2013*. Alternatively, the recommendations in items 2 to 6 of this table must be considered for the proposed regulations.[1]	a) The statutory obligation to buy-out dissenting shareholders, cannot be linked to any market failure. b) The risk that the company may change the terms of its functioning is factored in the price at which the investor acquired the shares. Guaranteeing an exit to equity holders on the ground of changes to the functioning of the company, is antithetic to the concept of equity. c) The relationship between a company, its owners and management are essentially a contract. When an investor subscribes to equity shares, he subscribes to the term that the company will be bound by decisions taken by a certain majority. d) There is no case for minority shareholder protection in the circumstances enumerated in Sections 13(8) and 27 of the *Companies Act, 2013*. e) The provisions increase the transaction cost of entering into contracts and incentivise oportunistic behaviour on the part of shareholders.

[1]The recommendations in items 2 to 6 of this table may be stipulated, in the proposed regulations, as conditions for exercising the right to be bought-out under Sections 13(8) and 27 of the *Companies Act, 2013*.

02	1	The obligation to buy-out dissenting shareholders must be triggered only upon satisfaction of certain conditions listed below, in line with the legislative intent of Sections 13(8) and 27 of the *Companies Act, 2013*. a) The company must have proposed the change within: i) eighteen months from the date of issuance of the shares; and ii) such change is not in the ordinary course of business. b) Alternatively, if the obligation is kept for an unlimited period of time, it must be triggered only if: i) such change is not in the ordinary course of business; and ii) the proposed change disproportionately benefits the promoters or majority shareholders.	a) Where the main object of the company for which the money was raised or a material contract, is altered immediately after a public issue, there is arguably a case that the change was forseeable and pre-deliberated. The period of eighteen months has been recommended as it will allow the company to run one audited cycle before making a change in the main objects clause or changes to a material contract. b) Promoters and majority shareholders should not be saddled with the obligation to provide an exit where a change occurs in the ordinary course of the business of the company. c) In the longer term, decisions of a company may change in line with changing circumstances. Since the legislative intent is to discourage unjust enrichment of promoters and majority shareholders, an obligation to buy-out dissenting shareholders must be triggered only in limited situations where such revisions are manifestly beneficial to the promoters and/or majority shareholders.
3	2	The obligation must be restricted to shareholders who have subscribed to the shares on the basis of the prospectus. The obligation must not be extended to shareholders in the secondary market.	Investors in the primary market, subscribe to the securities of a public listed company, on the basis of the prospectus (which includes the objects of the company) issued by that company. This is not the case for investors in the secondary market, who trade in securities on the basis of assessment of associated risks and returns.

4	3	The offer price must be the Volume Weighted Average Price (VWAP) for a period of sixty trading days, preceding the date of announcement of the change which triggers the obligation to buy-out the dissenting shareholders.	The main concern in the present case is that the dissenting shareholders must get a fair value for their shares. The *Achutan Committee Report* observed that a 60 trading day average is neither too long nor is it faced with the issue of higher volatility. The market price parameter is, therefore, the best judge of the prevailing market price of any share. Hence, the offer price must be the VWAP for a period of 60 trading days preceding the date of the special notice that is circulated to shareholders proposing the change.
5	5	The condition that the obligation will not be triggered if a large portion of the funds have already been utilised, may be supplemented with the requirement to furnish an auditor's certificate. The certificate will certify that the threshold amount has been utilised for the object for which it was raised.	Aid in practical implementation of the condition that the promoters or person in control should give exit opportunity only if the amount used is less than a specified percentage of the total amount raised for the objects of the issue.

6	7	a) The merchant banker must be appointed before the exit price is finalised. b) The issuer must provide adequate information to the stock exchanges to enable the dissenting shareholders to make an informed decision on whether to accept the offer. c) The consequences of non-compliance must be restricted to a direction to the company to not implement the special resolution which triggered the obligation to buy-out dissenting shareholders.	a) The discussion paper states that the company must intimate the stock exchanges the price at which they will buy-out the dissenting shareholders. Subsequently, the promoters and shareholders in control must appoint the merchant bankers and finalise the exit price in accordance with the regulations made by SEBI. Thus, it is unclear which is the final exit price being offered to dissenting shareholders, the one which is informed to the stock exchange or the one which will be finalised with the merchant bankers. b) The proposed regulations must mandate that the information to the stock exchanges must include (i) the identities of the dissenting shareholders who are eligible to sell their shares; and (ii) such information as will enable them to make an informed decision on whether to exit the company at the price offered. c) The discussion paper is silent on the consequences of not complying with the process or what is the safeguard provided to the dissenting shareholders if consideration is not paid to them by the promoters or shareholders in control.

A Note on exit offer to dissenting shareholders

A.1 Introduction

Sections 13(8) and 27 of the *Companies Act, 2013* obligate the promoters and majority shareholders of a listed company to buy-out dissenting shareholders in two circumstances:

1. where the company has passed a special resolution amending the main object for which money was raised from the public;
2. where the company has passed a special resolution amending the terms of a contract referred to in the prospectus.

The said provisions require SEBI to frame regulations governing the conditions and procedure for such compulsory buy-outs. SEBI has issued a discussion paper outlining its approach towards this subject and the proposed regulations.

This note contains our feedback on the discussion paper. The note is divided into two parts:

1. Section II of the note contains an executive summary of our feedback.
2. Sections III of the note explains the rationale for each item of the feedback.

A.2 Executive Summary of Recommendations

1. SEBI must, as part of the ongoing process for reviewing the *Companies Act, 2013*, recommend the deletion of Sections 13(8) and 27 of the *Companies Act, 2013*. This is because the said statutory obligations cannot be linked to any market failure, increase the transaction costs of entering into contracts for companies and incentivise opportunistic behaviour on the part of shareholders.
2. Alternatively, the following recommendations must be considered:
   (a) The obligation to buy-out dissenting shareholders must be triggered only upon satisfaction of certain conditions, namely, that the company must have proposed the change within eighteen months

from the date of issuance of the shares and the proposed changed is not in the ordinary course of business of the company. Alternatively, if the obligation is kept for an unlimited period of time, it must be triggered only if such change is not in the ordinary course of business and the proposed change disproportionately benefits the promoters or majority shareholders. This will effectuate the legislative intent of the provisions, without making them over-inclusive.

(b) The obligation must be restricted to shareholders who have subscribed to the shares *on the basis of the prospectus*. The obligation must not be extended to shareholders in the secondary market.

(c) The offer price must be the VWAP for a period of sixty trading days, preceding the date of announcement of the change which triggers the obligation to buy-out the dissenting shareholders.

(d) On the procedure for payment to the dissenting shareholders, the merchant banker must be appointed before the exit price is finalised. The issuer must provide adequate information to the stock exchanges to enable the dissenting shareholders to make an informed decision on whether to accept the offer.

(e) The consequences of non-compliance must be restricted to a direction to the company to not implement the special resolution which triggered the obligation to buy-out dissenting shareholders.

A.3 Rationale and details

A.3.1 Problems with the primary law

Recommendations:

Sections 13(8) and 27 of the *Companies Act, 2013* must be deleted.

In June 2015, the Ministry of Corporate Affairs constituted a Companies Law Committee to make recommendations to the Central Government on issues arising from the implementation of the *Companies Act, 2013*. The Discussion Paper also refers to some changes that SEBI proposes to seek to the primary law. SEBI must, as part of the ongoing process for reviewing the *Companies Act, 2013*, recommend the deletion of Sections 13(8) and 27 of the *Companies Act, 2013*.

Rationale:

A.3.1.1 No case for State intervention:

1. *No market failure*: The general rule in public economics is that markets work well in the absence of State intervention. State intervention should, therefore, be limited to circumstances in which the market does not work well. These circumstances are referred to as market failures. Market failures which necessitate State intervention are:

   (a) Information asymmetries between market participants;

   (b) Concentrated market power;

   (c) Externalities resulting from market practices;

   (d) Public goods.

   Sections 13(8) and 27 of the *Companies Act, 2013*, which obligate promoters and majority shareholders to buy shares of dissenting shareholders, cannot be traced to any of the abovementioned market failures, as explained below:

   (a) There is no information asymmetry amongst the shareholders who vote for and against the resolution. The company provides them with the same information when it supplements the special resolution with a notice explaining the reasons for the resolution.

   (b) The element of market power is irrelevant where shareholders are voting on decisions of a company.

   (c) Shareholders approving or dissenting to certain resolutions of the company does not result in externalities.

   (d) There are no public goods involved when making decisions in relation to the affairs of a company.

   In the absence of the abovementioned market failures, State intervention in the form of obligating promoter and majority shareholders to buy out the dissenting shareholders in the company, cannot be justified.

2. *Equity is risk-bearing*: An equity share is essentially a risk-bearing instrument. Where a person acquires the shares of a company, he is entitled to:

(a) the residual profits of the company, once the creditors have been paid;

(b) participate in the decisions of the company, by exercising voting rights attached to his shares; and

(c) sell his shares in the capital market.

The risk that the company may change the terms of its functioning is factored in the price at which the investor acquired the shares. Guaranteeing an exit to equity holders on the ground of changes to the functioning of the company, is antithetic to the concept of equity.

3. *Equity is a contract*: The relationship between a company, its owners and management are essentially a contract. The terms of the contract are codified in the *Companies Act, 2013*. When an investor subscribes to equity shares, he subscribes to the term that the company will be bound by decisions taken by a certain majority.

4. *No case for minority shareholder protection*: Globally, the rights of minority shareholders are protected by law in two circumstances:

   (a) Oppression and mismanagement by the majority - Here, the minority shareholders have a right to approach the court to plead for injunctive relief against oppressive behaviour or mismanagement, by the majority.

   (b) Change in control - Here, some jurisidictions obligate the acquiror to offer an exit to the minority shareholders on account of a change in control of the company.

   The circumstances enumerated in sections 13(8) and 27 of the *Companies Act, 2013* do not involve any of the abovementioned elements. The provisions hugely depart from international practice on protections to minority shareholders, without making a meaningful case for such departure.

A.3.1.2 Difficulties with the provisions:

1. *Extra-ordinary and unforseeable costs for the promoters or majority shareholders*: The provisions impose unforseeable costs on the promoters and the majority shareholders. Every resolution will have some shareholders who have voted for it, some who have specifically voted against it and others who do not vote. It is not possible to identify

in advance the number of shareholders who will vote against the resolution and the value of shares at that time. The provisions, thus, impose an unascertainable financial burden on promoters and majority shareholders.

2. *Incentivising opportunistic behaviour*: The provision may incentivise opportunistic behavior on the part of shareholders, at the expense of the company. Therefore, even if the resolution is beneficial to the company, shareholders may choose to vote against it to avail the benefits of the provisions, in the hope that the resolution will not go through without their vote. This may, in fact, end up defeating a resolution which would have otherwise been passed, in the absence of such incentives.

3. *Makes contracts expensive for the company as a whole*: Section 27 of the *Companies Act, 2013* will make it more expensive for companies to enter into contracts as the counterparty is always at a risk of inflexibility. The provisions restrict the flexibility to re-negotiate contracts and makes re-negotiation expensive for the company.

4. *Restricts contract-flexibility*: Section 27 of the *Companies Act, 2013* necessitates a special resolution nearly every time a contract, referred to in a prospectus is modified. Additionally, the management may refrain from asking for a re-negotiation of contracts to avoid these provisions, although such re-negotiation may have potentially benefitted the company.

A.3.2 Applicability

Proposal:

The discussion paper recommends that the obligation of the promoters and majority shareholders to buy-out dissenting shareholders must be triggered only where:

1. the company proposes to change contracts which may substantially affect the main line of business or revenue generation of the company; and

2. the offer is dissented by a specified percentage, say, 10 percent shareholders.

Recommendation:

Aligning the obligation with legislative intent:

The purported legislative intent underlying Sections 13(8) and 27 of the *Companies Act, 2013* is to ensure that promoters and majority shareholders do not exercise control to enrich themselves at the cost of the company. The promoters and controlling shareholders must, therefore, be required to give an exit opportunity to the dissenting shareholders in the primary market, only in circumstances where the proposed changes are manifestly and disproportionately beneficial to them. Therefore, the proposed regulations must circumscribe the right to demand an exit only in the following conditions:

1. *Where the change is proposed within the first eighteen months*: The company proposes to change the objects for which the money was raised or the terms of a contract referred to in the prospectus:
   (a) within the first eighteen months from the date on which the securities were issued; and
   (b) such change is not in the ordinary course of the business of the company.
2. *Change benefits promoters to the exclusion of the company*: In the alternative, if the obligation is kept for an unlimited period of time, it must be triggered only if:
   (a) Such change is not in the ordinary course of business of the company; and
   (b) the proposed change disproportionately benefits the promoters and majority shareholders. For practical implementation purposes, the audit committee may be entrusted with the job of certifying this.

Rationale:

1. Where the main object of the company for which the money was raised or a material contract, is altered immediately after a public issue, there is arguably a case that the change was forseeable and pre-deliberated. However, this would not be the case for changes which occur in the longer term.

2. The period of eighteen months has been recommended as it will allow the company to run one audited cycle before making a change in the main objects clause or changes to a material contract. After the first audited cycle, a change may be motivated by the results of the audited accounts and annual report of the company.
3. In the longer term, decisions of a company change, in line with changing circumstances and information available. For instance, a company may change the location of a proposed project due to unforseen changes such as a sudden change in State policy, which was not forseen at the time of the public issue. Similarly, contracts of key management personnel or supply contracts may change with time.
4. In any event, the promoters and majority shareholders should not be saddled with the obligation to provide an exit where a change occurs in the ordinary course of the business of the company.
5. The legislative intent is to discourage unjust enrichment of promoters and majority shareholders. In particular, section 27 of the *Companies Act, 2013* is meant to target revision of related party contracts, to the detriment of the company. Hence, an obligation to buy-out dissenting shareholders must be triggered only in limited situations where such revisions are manifestly beneficial to the promoters and/ or majority shareholders, to the exclusion of the company as a whole.

Comments on conditions suggested in the Discussion Paper:

The conditions suggested in the Discussion Paper are fairly subjective and do not serve the legislative intent of the provisions:

1. A change which affects the main line of business of the company may, in fact, benefit the company as a whole. Imposing an obligation to buy out the dissenting shareholders when there is no disproportionate benefit to the promoters or majority shareholders, was not the legislative intent underlying these provisions.
2. A contract which affects the revenue generation of the company, affects the company as a whole, and not merely the promoters and majority shareholders. Moreover, a change in the contract may positively affect the revenue generation of the company.
3. The condition that atleast 10% of the shareholders must have specifically dissented to the resolution may create incentives amongst share-

holders to discourage other shareholders from voting for the resolution, to achieve the 10% threshold.

A.3.3 Eligibility of shareholders to avail the benefit

Proposal:

The Discussion Paper recommends that the investors, both in the primary and secondary market, who are holding shares on the date on which the proposal becomes public, should be given an exit.

Recommendation:

The promoters and controlling shareholders of a public listed company must be required to give an exit opportunity to the dissenting shareholders, *only* if those shareholders have subscribed to the shares of the company in the primary market. This should *not* be applicable to shareholders in the secondary market.

Rationale:

Investors in the primary market, subscribe to the securities of a public listed company, on the basis of the prospectus (which includes the objects of the company) issued by that company. This is not the case for investors in the secondary market, who trade in securities on the basis of assessment of associated risks and returns.

A.3.4 Offer price for exit

Proposal

The discussion paper recommends that the exit price maybe determined in terms of the *SEBI (SAST) Regulations, 2011*, which, in cases of frequently traded shares, is the highest of the following:

- VWAP paid during fifty two weeks immediately preceding the date of the announcement.

- Highest price paid for any acquisition during the twenty six weeks immediately preceding the date of the announcement.
- Volume weighted average market price for a period of sixty trading days immediately preceding the date of the announcement.

Recommendation:

Exit price must be determined in terms of the market price parameter

Exit price for dissenting shareholders must be the VWAP for a period of sixty trading days preceding the date of the announcement.

Rationale:

Since the discussion paper recommends exit price in terms of the *SEBI (SAST) Regulations, 2011*, it is important to understand the rationale behind it and its applicability in the present case.

The *SEBI (SAST) Regulations, 2011* is based on the recommendations of the *Achutan Committee Report*, which deliberated upon the minimum offer price for minority shareholders in the case of a takeover. The *Achutan Committee Report* concluded that the offer price payable to public shareholders should be "not inferior" to that paid to substantial shareholders. Hence, it recommended the minimum offer price to be the highest of the following:

- **Highest negotiated price per share:** of the target company for any acquisition under the agreement attracting the obligation to make a public announcement. (Clause 4.11)
- **Market-price parameter:** VWAP for a period of sixty trading days preceding the date of public announcement.
- **Look-back parameter:** VWAP paid or payable for any acquisition during the 52 weeks immediately preceding the date of announcement or the highest price paid or payable for any acquisition during the 26 weeks immediately preceding the date of announcement, whichever is higher.

The fundamental principle that the offer price payable to public shareholders should be "not inferior" to that paid for substantial shareholders, applicable in the *SEBI (SAST) Regulations, 2011*, is not applicable under the present

situation. The main concern in the present case is that the dissenting shareholders must get a fair value for their shares. The *Achutan Committee Report* observed that a 60 trading day average is neither too long nor is it faced with the issue of higher volatility. The market price parameter is, therefore, the best judge of the prevailing market price of any share. Hence, the offer price must be the VWAP for a period of 60 trading days preceding the date of the special notice that is circulated to shareholders proposing the change. This is any price after that day may factor in the effect of the proposed change going through. The dissenting shareholders must not get the benefit or suffer the volatility in the prices of the shares, which is attributable to the proposed change.

A.3.5 Exit offer

Proposal

The discussion paper recommends that where a company has already utilized a higher percentage of the amount raised and intends to change the objects to some extent due to certain reasons, then in such cases, the promoters or person in control should give exit opportunity only if the amount used is less than a specified percentage of the total amount raised for the objects of the issue, e.g. 75 percent.

Recommendation:

For the purpose of practical implementation, this condition may be supplemented with the need to furnish an auditor's certificate. The certificate will certify that the threshold amount has been utilised for the object for which it was raised.

A.3.6 Procedure for exit

Proposal

The process recommended in the discussion paper for providing an exit opportunity to dissenting shareholders can be divided into three stages (a) Passing of special resolution (b) information dissemination to stock exchanges and public (c) payment of consideration to dissenting shareholders.

Recommendation:

1. The discussion paper states that the company must intimate the stock exchanges the price at which the they will buy-out the dissenting shareholders. Subsequently, the promoters and shareholders in control must appoint the merchant bankers and finalise the exit price in accordance with the regulations made by SEBI. Thus, it is unclear which is the final exit price being offered to dissenting shareholders, the one which is informed to the stock exchange or the one which will be finalised with the merchant bankers.

2. The merchant banker should be appointed as soon as the special resolution is passed. The promoters and shareholders in control can then finalise the exit price with the merchant banker and then inform the stock exchanges along with other details.

3. The proposed regulations must mandate that the information to the stock exchanges must include (a) the identities of the dissenting shareholders who are eligible to sell their shares; and (b) such information, as will enable them to make an informed decision on whether to exit the company at the price offered.

4. The merchant banker should not be an associate of the promoters or shareholders in control. This measure will ensure that the merchant banker acts independently.

5. The discussion paper is silent on the form of consideration to be provided to the dissenting shareholders. For example, in case of an open offer, the escrow account mandated to be opened by the acquirer can be in the form of cash, bank guarantee issued in favour of the manager and deposit of frequently traded and freely transferable shares. The discussion paper is also silent on how and when consideration will be released from the escrow account. The merchant banker should operate the escrow account on behalf of the promoters and shareholders in control and the amounts should be released only after the consent of the merchant banker.

6. The discussion paper is silent on the consequences of not complying with the process or what is the safeguard provided to the dissenting shareholders if consideration is not paid to them by the promoters or shareholders in control. The penalties must be limited to a direction that the company should not implement the special resolution, without acquiring the shares of the dissenting shareholders.