Corporate Governance and Merger and Acquisition – A Study on Regulatory Impact

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The Indian economy has undergone a major transformation and structural change following the economic reforms of 1991. Every business enterprise in India realizes the need to grow and expand. Many of them have a product or access to technology which is limited or which cannot be upgraded in a short span of time.[1] Major restructuring of businesses, mergers and acquisitions have emerged as one of the most effective methods and have become part of the long term business strategy of corporate in India.

It can be said that there are three distinct trends in mergers and acquisition activity in India post 1991. The initial period of intense investment activity was followed in 1995 by a wave of consolidation within Indian industry. This went on to become an acquisition spree by MNC's following the relaxation of the FDI. Indian companies focused on capital and business restructuring to achieve economies scale and scope. The post 2002 scenario witnessed Indian companies venturing abroad and making acquisitions in developed and other developing countries.[2]

The opening up of the Indian economy and financial sector, changes in the regulations relaxing the overseas investment coupled with surges in economic growth and decreasing interest rates have made all that a possibility. It is not just that the large conglomerates like those of Tata group or the Birla group who have looked west for acquisitions, emerging multinationals like those of Apollo Tyres' and Sun Pharma too have had successful acquisitions abroad. It is not like all deals of acquisition abroad have been success stories. The acquisition attempt by Bharti of MTN of South Africa could not succeed due to intervention of the South African government.[3]

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[1] (Nishith Desai Associates 2014)

[2] (Reddy and Mantravadi 2007) at page 3936

[3] Bharti Airtel a flagship company of Bharti Enterprises – India's largest and first private telecom service provider. The business at bharti Airtel has been structured into three individual strategic business units of Mobile Services, Airtel Telemedia Services & Enterprise Services. The mobile business provides mobile and fixed wireless services

It is not like it is just the private sector that is outward bound even the government ownership companies are looking outward. Oil India and ONGC Videsh's acquisition of stake for about $ 2.5 billion in the Rovuma-I gas field in Mozambique is a case in point.

In the pharma world itself six major acquisitions of Indian companies have taken place in the last few years – Ranbaxy, Dabur Pharma, Shanta Biotech, Piramal Health Care, Matrix Lab and Orchid Chemicals, and more are on the anvil. Further, there have been several other tie-ups between MNCs and domestic companies – viz, GSK with Dr Reddy's; Pfizer with three companies – Aurobindo, Strides Arcolab and Claris Life Sciences; Abbot with Cadilla Health Care and Astra Zeneca with Torrent. The regulatory approach towards cross border acquisitions has seen a tremendous shift in favour of cross-border investments. In India the ODI Regulations (Transfer or Issue of any Foreign Security) Regulations, 2004, is seen as an extension of the process of liberalization initiated by the Government of India. The regulations contain detailed provision governing investments made as well as to be made by an Indian company by grant of 'general permission' to make a direct investment outside India. An Indian company is permitted to invest in a joint venture or a wholly owned subsidiary up to 400% of the net worth of the Indian company as on the date of last audited balance sheet without seeking prior approval of the RBI. In contrast an Indian company needs prior approval of RBI to make any direct investment in a foreign entity engaged in real estate business or banking business.[4]

This current research seeks to look into the regulatory impact on the deals carried out by the Indian companies either domestic or otherwise. The various laws of India which a M&A deal attracts are the Companies Act 2013, the Competition Act, the Income Tax Act, the relevant Stamp Act, the SEBI Takeover Code and the FEMA provisions besides the mandatory court permissions.

The 2013 Act simplifies the procedures, introduces provisions relating to reverse mergers and squeeze out provisions, valuation by registered valuers. While the sections pertaining to the merger provisions in the new Act are yet to be notified. The court driven process under the 1956 Act will continue to be applicable. Besides the Companies Act, the Competition Act of 2002 applies to mergers and acquisitions. Under the exercise of the authority under the Competition Act of 2002 the Competition Commission of India, a body established under the Competition Act administer the Procedure in regard to the transaction of business relating to combinations Regulations, 2011. These regulations are in supplement to Sections 5 and 6 of the Competition Act. The Competition Commission has been conferred with extra-territorial jurisdiction to fulfill its mandate of eliminating practices having an appreciable adverse effect on competition in India. This essentially means that every acquisition that

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using GSM technology across 23 telecom circles while the Telemedia branch provides broadband & telephone services. And the enterprise services provide end to end telecom solutions to corporate customers. The MTN group together with its subsidiaries provides communication services, principally cellular network access and business solutions. It is provider to 40 million subscribers in 21 countries. Negotiations between Bharti and MTN first foundered in May 2008 as the South African government wanted the company to retain a South African identity and pressed for a "dual listing" structure. Such an arrangement would enable the companies to maintain two separate set of shareholders but combine cash flows and operations. Bharti was poised to take a 49%state for roughly $14billion in cash and stock with the shareholders of MTN and MTN receiving a 36% interest in Bharti for about $10 billion in cash and shares.

[4] (Nishith Desai Associates 2014)

involves the acquirer or the target, wherever incorporated having assets or a turnover in India in excess of the prescribed thresholds shall be subject to scrutiny by the CCI.[5] A company is said to be resident in India if it is an Indian company or if the control and management of its affairs is situated wholly in India. Indian courts have indicated that control and management would rest where the head and brain of the company is situated i.e, situs of the meeting of the board of directors of the company. Companies resident in India are subject to corporate tax of 30% on business profits derived on a worldwide basis. Long term capital gains (from sale of long term capital assets) are taxed at a lower rate of 20% while short term capital gains are taxed at the ordinary corporate tax rate. Capital assets such as shares shall be treated as long term if they are held for a period exceeding 36 months (except in case of listed securities in which case the shares shall be treated as long term if they are held for a period exceeding 12 months) otherwise they will be treated as short term capital assets. From a tax perspective long term capital gains arising on a sale of equity shares through the recognized stock exchanges in India are exempt from tax provided securities transaction tax (STT) is paid. All other gains on sales of assets are taxable. Section 115BBD of the Indian Income Tax Act provides that dividends received by an Indian Company from a foreign company in which the Indian company holds 26% or more in nominal value of the equity share capital of the company is taxed at a lower rate of 15%. India currently does not have any participation exemption or thin capitalization or controlled foreign regime. Resident companies are taxed on their worldwide income including any interest earned from foreign sources. Such interest is taxable at the ordinary corporate tax rate of 30%. Indian companies may claim double tax relief under an applicable tax treaty with respect to taxes held outside India. The Indian Income Tax Act also grants unilateral relief to residents in cases where they derive income from a country with which there is no existing tax treaty.[6] Judicially anti avoidance rules have been developed. India has traditionally followed the form over substance principle. To avoid abusive transactions referred to as 'impermissible avoidance arrangements' GAAR (General Anti Avoidance Rules) has been adopted from the 1st of April 2015. GAAR provisions shall apply only if tax benefit arising to all parties to the arrangement exceeds INR 30 million in a relevant financial year. Under GAAR the tax authorities have the power to disregard entities in a structure, reallocate income and expenditure between parties to the arrangement, alter the tax residence of such entities and the legal situs of assets involved, teat debt as equity and vice versa. The expression 'impermissible avoidance arrangement' (IAA) has been defined very broadly to mean nay arrangement where the main purpose is to obtain a tax benefit. Besides a number of anti avoidance rules also exist under Indian tax laws to cover various arrangements including arrangement involving transfer of assets by a resident to a non resident where a resident continues to enjoy the benefit of income arising from such assets.[7]

[5] (Nishith Desai Associates 2014)
[6] (Nishith Desai Associates 2014)
[7] (Nishith Desai Associates 2014)

1 Chapter 1: Take Over

Takeover regulations aim at fair and equitable treatment of the shareholders in a situation of acquisition of a listed company. The regulations provide for mandatory exit rout to the shareholder by the acquirer.

Takeover as a substantial acquisition of Assets by corporate structures and the acquirer company taking over the responsibilities from the corporate restructuring the managements and entity thereto, can be either friendly (wherein the acquirer on the accord of the controlling group acquires those shares) or hostile (an approach to which the controlling group does not approve of but the acquirer attacks to obtain shares and interests).

Takeover regulation on the other hand is a mechanism to facilitate efficient corporate restructuring. It also is aimed at curbing conflicts of interest related to transfers of control. The primary role of takeover regulation is to enable fitter corporate governance by restraining opportunistic managerial behavior. Provisions of takeover regulation apply and aim to control transactions to regulate conflicts of interest between the management and shareholders of the target and the bidder. In doing this it minimizes potential conflicts.

Takeover is considered as the fundamental change in the corporation which entirely reworks and reorganizes the rights and powers of a corporate structure and thus leads to certain basic fundamental changes as in the internal realignments of the corporation's financial and governance structure; sale of assets and stock acquisitions; voting insurgencies and hostile tender offers. Takeovers are also considered to have an effective role in sketching the duties and liabilities of the Director towards the economy and the society as a whole.

Takeover laws have been enacted by most of the countries, prescribing a systematic framework for acquisition of stake in listed companies, thereby ensuring that the interests of the shareholders of listed companies are not compromised in case of an acquisition or takeover. Protection of the interests of minority shareholders is fundamental corporate governance in case of listed companies. Highest standards of corporate governance and transparency ought to be ensured in the management and operation of companies that have public participation as the public shareholders rely on management and the promoters while investing in the company. In line with international jurisprudence, SEBI enacted the SAST 2011 (Substantial Acquisition of Shares and Takeovers) Regulations which regulate the acquisition of stake in Indian listed companies and ensure transparency in the affairs of the company. The interests of the public shareholders are protected by the Takeover Code by obligating the acquirers to mandatorily provide an exit option in case of a takeover or substantial acquisition, ensuring a fair, equitable and transparent functioning of the securities market.

The first appearance of Takeover in India was with the mandate in SEBI Act 1992, which empowered SEBI to regulate substantial acquisition of shares and takeovers by suitable measures. Prior to the 1990's, takeovers in India were regulated by the Companies Act 1956. As per the law then, any bidders who acquired 25% or more of a company's shares were required to make a public offer to the shareholders of the company. Bidders circumvented the provision by acquiring just under 25% but using the shareholding to control the target.

This gave birth to the 1994 takeover regulations, in 1995, a review committee was set up and this was reviewed by 1997 January leading to the SAST Regulations of 1997. A second review was set up in 2001 which provided its report in 2002 leading further amendments. In 2009 a Takeover Regulations Advisory Committee (TRAC) was set up with the mandate to examine and review the 1997 code. Based on the recommendations made by the TRAC the current 2011 code was brought into effect from the 23rd October 2011.

The takeover regulations ensure that public shareholders of a listed company are treated fairly and equitably in relation to a substantial acquisition in or takeover of a listed company thereby maintaining stability in the securities market. It is also the objective of the takeover regulations to sure that the public shareholders of a company are mandatorily offered an exit opportunity from the company at best possible terms in case of substantial acquisition in or change in control of a listed company. Specific provisions of takeover regulation apply to control transactions to regulate conflicts of interest between the management and shareholders of the target and bidder.

Bidders are required to retain an investment bank which is required to inform the target company and the stock exchange about the disclosures across the world. The information includes the offer price, identity of the acquirer, purpose of the acquisition, plans for the target, as well as other information. Offers have to remain open for 20 days, mandatory offers are required after reaching the 10% threshold. The minimum offer price is the average of the highest and lowest price over a period of two weeks prior to the offer. There are also limitations on the ability of the bidder to withdraw an offer.[8]

The 2011 Takeover regulations revamped and rewrote the rules for public mergers and acquisitions.

1.1 Key aspects of Take over regulation

The Securities and Exchange Board of India (SEBI hereinafter) is the regulator for the publicly traded companies. SEBI through its 2011 regulations (Substantial Acquisition of Shares and Takeovers Regulations, 2011; hereinafter SAST 2011/Takeover Code) restricts and regulates the acquisition of shares, voting rights and control in listed companies. Acquisition of shares or voting rights of a listed company entitling the acquirer to exercise 25% or more of the voting rights in the target company or acquisition of control obligates the acquirer to make an offer to the remaining share holders of the target company. The offer must be to further acquire at least 26% of the voting capital of the company.[9] This obligation is subject to the exemptions provided under the Takeover Code. Exemptions from open offer requirement under the Takeover Code inter alia include acquisition pursuant to a scheme of arrangement approved by the Court.

[8] (Gaughan 2011) at page 94
[9] Regulation 3 read with regulation 7 of the Takeover code.

The provisions of the Takeover Code relating to the requirement of making an open offer pursuant to an acquisition of shares of a listed company is triggered on an acquisition of 25% or more of the paid up share capital or voting rights of the company[10] or on an acquisition of 5% or more in any financial year, where the acquirer already holds 25% or more of paid up share capital or voting rights of the target company.[11] An open offer is the offer made by a potential acquirer XXXX

1.2 Hostile Take Over

Hostile takeovers and regulatory barriers play a central disciplinary role in corporate governance. Hostile takeovers thereto are considered as an exception to takeovers since there are just few "good buy" to restructure profitability with the suitor going over the heads of unwilling management and wooing the shareholders directly. These circumstances increases and directly holds the director responsible for the economic benefits from the corporation. However, while understanding what type of companies are "taken over", measures of profitability, size of the corporations are the determinants to such takeovers and there are periods when the shift in the capital market is driven by activities like M&As.

The hostile takeover bid is more of a strategic weapon, it widens the range of possibilities and initiates many a restructuring in anticipation of takeovers. The board of directors is legally bound to protect the interests of the shareholders. They are the tools of management and a mechanism of governance. Independent directors play a very critical role here as they are often thrown into a decisive position when a takeover bid manifests.[12] The shareholders in contrast with the management, in a situation of hostile takeover of the company in which they own a portion of the equity, may be in a better position to maximize their wealth by selling to the highest bidder. Hostile takeovers are in effect a contest between the incumbent and the acquiring management teams, it is usually in the best interests of an individual shareholder to contribute to the ousting of incumbent management teams if the acquirer offers an amount of money at the time of takeover that is larger than the net present value of the future cash flows the firm would generate in the absence of the takeover. Shareholders from the target company may benefit merely by the announcement itself because bids are usually accompanied by a significant increase in share price. A failure of a hostile bid on the other hand provide an early warning signal about failures in the internal corporate governance system, inducing fresh operational and structural improvements.[13]

Hostile bids of takeover are perceived as wholly implausible in India due to heavy concentration of promoter holdings, in an average Indian company.[14] SEBI takeover code too incorporates features which are favorable towards entrenched management.[15] The same reasons of heavy promoter

[10] Regulation 3(1) SAST 2011
[11] Regulation 7, SAST 2011
[12] See (Dewhirst Summer 1992)at page 269
[13] (Guillen 2004)
[14] (Shaun 2007) at page 803
[15] (Jairus n.d.) available at : http://eprints.soas.ac.uk/10920/1/QEH_banaji.pdf last accessed January 2016.

shareholding, substantial shareholding of Indian financial institutions and the necessity of obtaining onerous government approvals - are provided for hostile cross border takeover bids as well, in addition to the provisions of the Indian takeover code which favors promoters.[16] Hostile takeover and regulatory barriers to it have been against the element of better corporate governance as it ultimately boils down to the boardroom being the venue rather than the market for corporate control.[17]

The attempt by Arun Kumar Bajoria to acquire board presence on Ballarpur Industries (BILT) and Bombay Dyeing is worth mentioning here. The Bajoria announcement that he along with friends and associates, hold a 6 percent stake in BILT and a near 16 per cent stake in Bombay Dyeing riled both LM Thapar, who controls BILT, nor Nusli Wadia who owns 41 per cent of Bombay Dyeing. Both have alleged that Bajoria has violated the then SEBI's takeover code (1997).[18] It provoked prominent business men to lead a delegation to the securities regulator and complain about Bajoria's claim and that the regulations[19] regarding takeovers were loaded against the promoters.

The basic tenet of any hostile takeover is valuation. If the valuation, perceived or otherwise of the stock price is much more in realized value vis a vis acquired value would it make sense. In other words, only if the company's shares are under priced in relation to its potential is worthwhile for anyone to acquire it.[20]

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1.3 Corporate Governance and Takeovers

Mergers and particularly hostile takeovers play a central disciplinary role in corporate governance. Takeovers of all nature tend to imply changes in the top management. Hostile takeovers invariably trigger top team removal.[21] This is the market discipline which favours the shareholders and not the incumbent management. Shareholders, should have the freedom of choice of selling out when the prices rise in a situation of a hostile takeover and also at the same time should have the option to stay put in the perchance the share prices would improve under an effective management as compared with the incumbent management.[22]

The example of Modi Rubber may be referred here. It was the first company in which all the development financial institutions progressively divested their cumulating stake in a coordinated fashion to the highest bidder. This was a provocative gesture enough for the chambers of commerce of FICCI

[16] (Shaun 2007) at page 803
[17] (Bratton 2007) at page103
[18] (Editorial EPW 2000)
[19] According to the Code, an acquirer of shares must notify the company whose shares are being acquired as well as the stock exchange and the market regulator when the shareholding reaches 5 per cent.
[20] (Editorial EPW 2000)
[21] (Bratton 2007) at page105
[22] (Editorial EPW 2000)

and ASSOCHAM to appeal to the government to intervene and stop such auction. Six FIs – IDBI, ICICI, UTI, GIC and LIC together owned 44.5% of MRL's equity with Modi group, the promoted holding 23% of equity.

The core issue in this case was accountability of the management towards its shareholders. The FIs had been negotiating a price with the promoters when that failed they moved for sale to the highest bidder in the market. However the Modis' objected to this with the argument that they had the right of refusal and a negotiated price.

Minority shareholders exiting may be countered by the management's offer bettering the offer of the acquirer with a price matching or better. This would also force the management of thinking strategies for improving their subsequent acts.

Chapter 2: Merger Laws of India

1. Domestic

2. Cross-Border

Governed by the Companies Act Mergers and acquisitions in India is one of the key mechanism to multiply economic units through mutual agreements between firms and the high court playing the role of a supervisory body along with the members and directors of the firms trying to maintain healthy equilibrium of small scale and high scale industries in terms of outputs and equity shares in the developing nation. An acquisition or a merger thus, is a strategic step to increase market share or diversify into alternative markets and thus it can be both domestic as well as cross border depending the comparative synchronization of the businesses with the ultimate effect being maximization of profits or capital. When both the companies are Indian it would be of Domestic Nature whereas when ion er of the entities is incorporated outside India it would be a case of Cross border M&A.

In Hindustan Lever Employees' Union v Hindustan Lever Ltd the concept of mergers as in between two Indian entities is cited and the various aspects thereto as to how a merger of two companies engaged in similar lines of business leads to consolidation of share and wards off competition and Companies may also undertake to such M&As as into broaden the shareholding capacity of corporations and an effective way to eliminate competition and is an exemplary example of Domestic Merger adjudicated upon by the court of law.

In Joint Ventures & Mergers and Acquisitions in India- Legal and Tax aspects kinds of mergers and specific requirements thereto is discussed to provide an insight in the overall equipment of the mechanism in India. Moreover, procedural aspect of merger and acquisitions in Indian Scenario is explained and in accordance with the statute the cross border as well as the domestic mergers is provided and the company law jurisprudence thus provides the legal mechanism to facilitate all such mergers. In the Moschip Case the provisions in Section 394(4) was elaborated further by the Andhra Pradesh High Court and the concept highlighted in case of cross border merger wherein one Indian entity and a foreign company is involved.

Thus to understand the merger laws enshrined in the Company Law Jurisprudence of India the case study of approaches taken by the various Courts of law of the country while deciding the same will lay down the ground stone to a tested and dried approach of understanding the merger laws in India.

Chapter 3: Squeeze Out and Sell Out

1. Squeeze Out Right and the Sell out Right

2. Protection of Private Property

3. Directors Role and Responsibility

Squeeze out Rights are the compulsory acquisition of stakes of small group of Shareholders from a joint stock company by the means of compensation or cash whereas the sell out rights are complete opposite of squeeze out rights as the rights of the minority shareholder to demand from majority shareholder to buy his shares.

In Structuring Mergers and Acquisitions Squeeze Out is defined as the acquisition of the minority or unaffiliated shares of a public, or private, company by the remaining shareholders and typically relates to the acquisition by the majority shareholder of the shares of a publicly traded subsidiary that are not owned by the majority owner. Squeeze outs can be the result of situations such as Poor market performance, conflicts with parent company and capitalize on synergies and is further entailed with valuation of these squeeze outs.

Reading these rights would require constant comparative analysis of the details and wide angled views upon the squeeze out rights and sell out rights from the EU jurisprudence and the levels of thresholds of United Kingdom corporations as to understand the requirements to be met with to qualify as Squeeze out and sell out rights as detailed in the “Study Of The Application Of Directive 2004/25/EC On Takeover Bids” by Marccus Partners which in the PowerPoint presentation presents a lookout from the EU jurisprudence on the Squeeze out rights.

To understand the realization of such rights in India and their effective presence a recently decided case is to be studied Securities and Exchange Board of India v. Sterlite Industries Ltd. wherein the squeeze out rights have been recognized with the procedural requirements needed for the same as in the statutory provision in the Indian Company Law Jurisprudence.

Chapter 4: Governance in Cross Border Mergers and Acquisitions

1. Director’s Duties

2. Business Judgment Rule

3. Revlon Standard,

4. Fairness Standard

5. Investor Protection

Since Cross Border Mergers are not identical to the traditional mergers the activities involved therein consist of certain higher level of activities and multifarious activities and requirement from those corporations involved and since the globalization of economies have led to a certain increase in such mergers , in order to maintain the competitive advantage , maintenance of customer relationships with multinational entities and survival there arises a requirement to achieve an apt governance requirement as a complimentary effect.

In Valuation for M&A Building Value in Private Companies emphasis is on the prerequisite of considerations in respect of the Strategic buy side requirements and the sell side requirements in order to carefully analyses the business prospects and the evaluation thereto for the consideration of the strengths and the weaknesses to determine areas of opportunities and challenges for the corporations with the justified requirement of understanding the scalability of the pros=ducts and services, the understanding of the cultural aspects and formalities with respect to the business practices , taxation issues, labour matters, geopolitical issues and the valuation requirements and above all the due – diligence team to indulge in pre planning and coordinated behavior of the corporations. Since the seller side as well as the buyer side is sensitive enough in any cross border negotiation there should be a requirement to strategize fair negotiations and expertise involvement to allow removal of discrepancies in any manner whatsoever.

The innovation in a Cross border Merger is more than the amalgamation of an entity of which one corporation is India and another foreign therefore the nuances have to be from all the possible viewpoints be checked and cross checked to achieve the optimum benefits for the sake of which the merger was initiated in the first place- the taxation issues, capital or the shareholder perspective or any element that constitutes a corporation.

Chapter 5: Regulatory Oversight

1. Position of SEBI

2. Position of Competition Commission of India