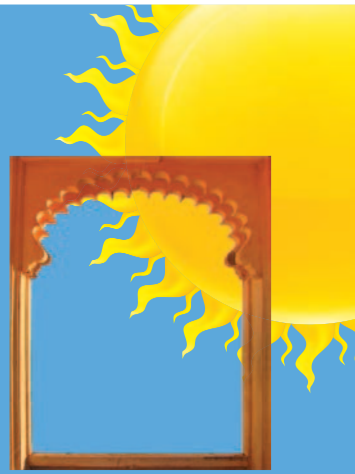
NSE

Quarterly Briefing

October 2013 | No. 3



MERGERS & ACQUISITIONS AND CORPORATE GOVERNANCE

Chief Contributor: Vikramaditya Khanna*

Executive Summary

- Mergers & Acquisitions (M&A) are an important and growing area of modern business.
- Governance actors, such as the board, independent experts, and shareholders, can play an important role in preventing value-decreasing M&A and protecting minority shareholders.
- The acquisition methods in India present considerable room for governance actors to have an impact.
- Minority protection is still in need of further strengthening in India, especially in squeeze out transactions.
- Cross Border M&A is an area of increasing activity and one where greater activity by governance players will be of significance.

* Member, NSE CECG and William W. Cook Professor of Law, University of Michigan Law School.

Mergers & Acquisitions (M&A) in India are becoming increasingly important and transformative transactions. Although there has been considerable variation across the years, India has witnessed a substantial increase in deal volume over the last decade, both domestically and globally. In 2012 the deal volume in India was estimated at about USD 41 Billion.[i]

Snapshot: M&A in India

Top quarter	~$17Bn (Q1, 2007) & (Q1, 2012)
Top Sector (by value)	Pharmaceuticals, Medical & Biotech
Top Sector (by deals)	Industries & Chemicals
Top Cross – Border quarter	~$14Bn Q4, 2006 (outbound) ~$15Bn Q1, 2007 (inbound)

See http://www.mergermarket.com/pdf/IndiaMARoundUpQ12013.pdf

In spite of this, the experience with M&A has not always been value-enhancing. Often deals do not lead to enhanced profitability for the acquiring firms, may harm the target's minority shareholders, or the acquiring firm may simply pay too much for the target.

Better governance can help reduce the risks of unsuccessful or over-priced M&A deals as well as reducing the likelihood of harm to minority shareholders. However, the relationship between governance and M&A goes both ways. The possibility of M&A can influence the performance and governance of firms too. The logic is that if a firm performs poorly then its share price is likely to decline and that makes it an attractive target for acquisition. The risk of such an acquisition (and the likely change in management that it precipitates) may work to encourage the target firm's leaders to perform better and have better governance. Given the complexity of the interactions between governance and M&A and the transformative nature of many of these deals, it is imperative to understand the governance mechanisms and laws that are involved in M&A in India.

Regulation of M&A in India

Some areas of law relevant to M&A are given below.

Some Areas of Law Relevant to M&A

- Company and Capital Markets Laws
- Competition Laws
- Tax Laws
- Foreign Direct Investment
- Treaties
- Intellectual Property
- Dispute Resolution

Although the list of laws relevant to M&A is quite lengthy, the inquiry here is limited to Company and Capital Markets Laws.

Most M&A transactions in India are conducted as either: (i) Schemes of Arrangement, (ii) Takeovers (within SEBI's Takeover Code) or as (iii) Reductions of Capital. The discussion addresses each of these separately and lays out the evolving roles of various players in the governance tapestry (e.g., the board, independent experts, shareholders). Also, updates on the new Companies Act 2013 are provided as appropriate.

Schemes of Arrangement

Schemes of arrangement are regulated under sections 391 to 394 of the Companies Act 1956 and, now, sections 230 to 240 of the new 2013 Act. These schemes are court-approved vehicles for effecting a merger or other corporate restructuring. If the requirements are met, then dissenting shareholders can be compelled to relinquish their shares for the court-approved consideration.

Scheme of Arrangement Requirements

- Court Approval
- Approval by majority in number representing 75% in value of the relevant class(es) of creditors or shareholders.
- Independent expert valuation report (already required for listed firms)
- Compliance with applicable accounting standards

Similar regimes are present in other Common Law jurisdictions. One notable exception is that restructurings via private arrangements (e.g., sales of some assets or business lines) are outside the scope of these rules.

Although the legislative regime puts in place numerous protections (e.g., high voting thresholds and expert valuation reports), it is clear that their implementation has left much to be desired. Quite often, disclosure is weak and valuation reports are pithy and uninformative. Against this background, the role of various players in the firm's governance becomes critical.

In terms of preventing value-decreasing M&A deals, the role of the Board – as chief strategic advisor and monitor - is crucial. In addition to advising management about the proposed deal's likely success, the Board can also gather information on whether the valuations are appropriate, what the key findings of due diligence are, what steps have been taken to protect minority shareholders and so forth. This is particularly important on issues of risk management in cross border deals, such as liability and public relations risks (e.g., products liability, environmental) and anti-corruption concerns. This is strengthened by the increasing frequency with which boards rely, and are required to rely, on experts in informing their decisions.

However, in terms of protecting minority shareholders, the Board may be less effective in the Indian context. There is little to guide board activity and no significant duties on directors or controlling shareholders towards minorities.[ii] Failing to protect minorities could lead to more reluctance on the part of minorities to invest or result in a larger discount on share prices when investing. In either case, there is harm to capital markets in India.

Aside from the involvement of the board, is there a case for a mechanism that allows "independent" members of the board to play a special role? Many M&A transactions may be motivated by controllers or top management who have invested a great deal (e.g., time, money and reputation). Hence, it may well be critical to have the oversight of a less interested, but still independent group to reduce the chances of a failed M&A. Further, independent board members can play an important role in protecting minorities. A specially constituted independent committee to address concerns over fairness to minority shareholders may be quite helpful. Although requiring independent committees in this context has not yet become common practice in India, it may well be on the horizon. The recent requirement in the 2013 Act that related party transactions require approvals by disinterested shareholders in a special resolution is a step in this direction. Perhaps this requirement might extend to M&A transactions between related parties (e.g., squeeze outs).

Along with the board, we see an increase in reliance on third party gatekeepers. In India, this is usually seen in the role of external advisors such as accounting firms, investment banks and also lawyers. They can play a significant role in advising promoters, the board, and others about the likely risks and rewards of a particular M&A transaction (including valuation studies, which could be relevant to minority protection as well).

Finally, there is the prospect of increased activism by shareholders to block wasteful or harmful M&A deals (e.g., the Maytas situation). Although retail investors in India have not been very active in the oversight of M&A transactions, there has been some stirrings of interest from Institutional Investors. This is facilitated both by moves from the Securities and Exchange Board of India (SEBI) to encourage greater involvement by these investors as well as by the recent entry into India of proxy advisory firms that may provide information and other matters to those investors inclined to exercise oversight in M&A.

SEBI has also been keen to directly regulate schemes of arrangement via its circulars. In 2013, SEBI required that listed companies pursuing such schemes are to (i) file copies of the documents with the exchange 30 days prior to the process starting in court and the exchange is to consider SEBI's comments, (ii) provide much more detailed information on the scheme (e.g., detailed valuation, fairness opinions) and (iii) get the approval of two-thirds of the public shareholders for the scheme (in addition to any other requirements under statute). Although these requirements may well serve to protect minority investors, their efficacy is yet to be tested.

Takeover Code

Another method of acquisition is a takeover offer where the acquirer makes a direct offer to the shareholders of the target firm. Until quite recently, SEBI's Takeover Code (from 1997) provided little role for the board in overseeing such an acquisition. That changed in 2011 when SEBI amended its Takeover Code and required boards to constitute a committee of independent directors, entitled to hire its own experts to advise it, to provide recommendations to shareholders about the takeover offer.

Requiring an independent committee to assess the offer underscores the importance of independent board members in preventing unwise M&A transactions and protecting minority shareholders. In addition, given that independent experts (e.g., on valuation) are required to be involved, their role in the process is cemented. The Takeover Code also puts in place a number of pricing measures that work to protect minorities from very low priced acquisitions. However, acquirers can avoid the restrictions of the Code by structuring the transaction in such a manner that it does not trigger the Code. [iii]

Reduction of Capital

A reduction of capital, under sections 100 to 105 of the 1956 Act (and sections 66 to 69 of the 2013 Act), is an increasingly common way to achieve a squeeze out – a type of acquisition where the target's minority shareholders are bought out by the target's controller.[iv] These provisions allow a firm to selectively acquire the shares of some shareholders (e.g., the minority). The key protection is the requirement that there be an affirmative vote in favor of the reduction of capital by 75% of all shareholders (not of each class of shareholders). This has become the preferred method of effectuating a squeeze out for controllers because this voting threshold is easier to satisfy than the threshold in a scheme of arrangement. Further, there is limited court supervision.

Because most acquisitions relying on a reduction of capital involve a controlled firm, there is, as a practical matter, a more limited role for the board. Indeed in the context of squeeze outs there are as yet no significant duties cast on the controller (as there are in the US) or directors to protect minority interests. There is also a lesser role for independent experts and for shareholder activism given the relatively lower voting threshold. SEBI has tried to regulate this area by making changes in the listing agreement (e.g., valuation reports), and that may prove to be useful, but their effectiveness is yet to be seriously tested.

Conclusion

Clearly, these three forms of structuring an acquisition come with different requirements and protections, with varying degree of involvement for different governance actors.

Further, the analysis shows that boards in India are in a position to opine on the likely profitability of an M&A deal, but are not in as good a position to protect minority interests. This is a potential area of reform and one that has become the focus of increased attention.

Finally, the increasing trend of cross-border M&A (both inbound and outbound) presents great opportunities for the board to demonstrate its advisory, monitoring and risk management roles. The 2013 Act also provides a potential boost to this activity by allowing for foreign acquisition of Indian firms (under section 234).

It is clear that a better understanding of the interaction between governance and M&A in the context of the evolving legal framework will allow the governance actors to contribute more meaningfully to the company's governance in the company's mergers and acquisitions.

Partial Checklist for M&A Transactions to Avoid Value-Decreasing M&A and Harms to Minority Shareholders

- Board examines valuation, due diligence, and risk management concerns (especially for cross-border transactions)
- Reliance on Independent Experts for Valuation and Other Matters, including investment bankers, attorneys and accountants.
- Steps taken to ensure fairness for Minority Shareholders
- Interaction with Shareholders
- Discussion with Top Management Team and Promoters

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i) See India Inc.’s M&A Deal Tally Touches $41 bn: Grant Thornton, BUSINESS TODAY, December 5, 2012. Available at: http://businesstoday.intoday.in/story/india-?inc-?manda-?%20deal-?tally-?touches-?$41-?bn-?grant-?thornton/1/190405.html.

ii) Under section 166(2) of the 2013 Act, directors should also consider other stakeholders.

iii) Takeover defenses are not permitted unless there is prior shareholder approval. The practical significance is limited as most Indian firms are not diffusely held.

iv) It is possible to effect a squeeze out under section 395 of the 1956 Act, but it is highly unlikely given its onerous requirements.

About NSE CECG

Recognizing the important role that stock exchanges play in enhancing corporate governance (CG) standards, NSE has continually endeavored to organize new initiatives relating to CG. To encourage best standards of CG among the Indian corporates and to keep them abreast of the emerging and existing issues, NSE has set up a Centre for Excellence in Corporate Governance (NSE CECG), which is an independent expert advisory body comprising eminent domain experts, academics and practitioners. The ‘Quarterly Briefing’ which offers an analysis of emerging CG issues, is brought out by the NSE CECG as a tool for dissemination, particularly among the Directors of the listed companies.