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INDIRECT TAKEOVER CONTROVERSIES

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In the few years since its inception in 1989, the Securities Exchange Board of India (hereafter SEBI) has come in for more flak than kudos. Its original mandate was to protect the interests of investors in securities. For this purpose, a number of guidelines and regulations have been published.[1] The intended objective of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 1997[2] (hereafter the code) is to create a regulatory framework that facilitates takeovers, yet provides adequate safeguards for shareholders.

It is well accepted that no legislator can plug every loophole in the law. In trying to reconcile the demands of economic growth with investor protection, the takeover code falls short in certain areas. Certain possibilities of circumventing the provisions of the code while not expressly violating them, exist. Specifically, there are some grey areas with respect to the mandatory public offer requirement. Covert acquisitions through indirect methods are still possible in a number of ways.

The mandatory public offer requirement is contained, *inter alia*, in Regulation 11(1)[3], which provides that no acquirer who has acquired between 10% and 51% of the shares or voting rights in a company, shall acquire additional shares or voting rights entitling him to exercise more than 2% of the voting rights, in any period of 12 months, unless he makes a public announcement to acquire shares. In

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1 See SEBI Guidelines on Disclosure and Investor Protection, SEBI (Insider Trading Regulations) 1992.

2 The new code replaces the earlier Regulations promulgated in November 1994.

3 SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 1997, Regulation 11(1): "No acquirer who together with persons acting in concert with him has acquired, in accordance with the provisions of law, not less than 10% but not more than 51% of the shares or voting rights in a company, shall acquire, either by himself or through or with persons acting in concert with him, additional shares or voting rights entitling him to exercise more than 2% of the voting rights, in any period of 12 months, unless such acquirer makes a public announcement to acquire shares in accordance with the Regulations."

addition, Regulation 12[4] provides that no acquirer shall acquire control over a target company, without making a public announcement to acquire shares.

The Bhagwati Committee noted that mere acquisition of securities that would confer voting rights on a later date should not trigger the application of the code at the time of acquisition, before such voting rights are attracted. The ambit of the code is focused on "change in control" of the target company, as evidenced by Regulation 12. However the term "control" has not been defined exhaustively, as a result of which SEBI has the discretion to decide whether there has been a violation of the regulations. The regulations, as mentioned earlier, are attracted only when securities are converted into shares with voting rights.[5]

However, until shares are registered, voting rights do not accrue to the acquirer.[6] Therefore, it is possible to interpret Regulation 11(1) of the code to mean that acquisition of equity shares in respect of which transfers are not registered would be allowed, even though this might result in acquiring more than 2% of voting rights of the company within a twelve month period. Although the process seems convoluted, it would technically not be a violation of the code. Section 108(1A)(b)(i) of the Companies Act, 1956, prescribes a period of twelve months for the presentation of the instrument of transfer. However, under section 108(1D), this period may be extended if the applicant is able to convince the Central Government of the need to do so. Thus, 4% shares may be acquired in one year and only 2% registered. The next year, the instrument of transfer may be revalidated by the Registrar of Companies, and another 2% registered. Thus, by the creeping acquisition route, holdings can be consolidated very quickly without violating Regulation 11(1) of the Code.

Linked to the issue of change in control is the definition of 'shares' in the code, which itself is a subject of controversy. Regulation 2(1)(k) of the code gives

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4 SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 1997, Regulation 12: "Irrespective of whether or not there has been any acquisition of shares or voting rights in a company, no acquirer shall acquire control over the target company, unless such person makes a public announcement to acquire shares and acquires such shares in accordance with the Regulations:

Provided that nothing contained herein shall apply to any change in control which takes place in pursuance to a resolution passed by the shareholders in a general meeting."

5 SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 1997, Regulation 2(1)(k) read with Regulation 11(1).

6 Under section 87(1) of the Companies Act, 1956, holders of equity shares have a right to vote, in respect of such capital, on every resolution placed before the company. Logically, this right to vote on matters of corporate governance cannot accrue to the shareholder before he or she has been recognised as such, by the registration of the shares and the entry of the shareholder's name in the register of members.

an exhaustive definition.[7] Thus, it includes securities within the meaning of section 2(h)(i) of the Securities Contracts (Regulation) Act, 1956 (hereafter SCRA). It is well settled that shares of unlisted companies are not securities within the meaning of SCRA.[8] SEBI has no jurisdiction over the issue of shares of unlisted public limited companies. When shares of unlisted companies are acquired, there can be no question of open offers. Therefore, if an unlisted company holds a substantial stake in a listed target company, an acquisition of the former will result in an indirect takeover of the listed company. The only remedy available to SEBI in such a case would be to deem this a case of "change of control" of the listed company, and hence a violation of the public offer clause.

Another controversial issue is whether a takeover can bypass the provisions of the code in the case of acquisition of share warrants. According to section 115(2) of the Companies Act, 1956, a share warrant holder has the option of converting the warrant into a share with voting rights. Thus, it would seem that Regulation 2(1)(k) of the code does cover warrants. However, according to the Supreme Court in *Sri Gopal Jalan & Co.* v. *Calcutta Stock Exchange Association Ltd.*[9], shares come into existence only on their allotment. Since in the case of warrants no allotment of shares take place, a warrant, even if converted into a share cannot be considered a share under Regulation 2(1)(k) of the code. A warrant is also not a security under the SCRA.

Under section 111(1) of the Companies Act, 1956, the company can refuse to register a transfer of shares with sufficient cause. "Sufficient cause" has been elaborated by courts in great detail.[10] Section 111A(3) empowers the Company Law Board to direct that the register of members of a company be rectified after a transfer has taken place, if such transfer is violative of the SEBI Act or Rules or any other law. These provisions, which are in the nature of rights of a company to ward off a takeover threat, have been rendered ineffective by section 7 of the Depositories Act, 1996. This section makes it mandatory for a depository to transfer shares once it receives an intimation from the depository participants. Thus, depositories will transfer shares without referring them to the Board of Directors of the target company. A takeover could, therefore, take place without the knowledge

7 "Shares" means shares in the share capital of a company carrying voting rights and includes any security which would entitle the holder to receive shares with voting rights.

8 *Dahiben Umedbhai Patel* v. *Norman James Hamilton*, [1985] 57 Comp Cas 700. See also *Brooke Bond India Ltd.* v. *U. B. Ltd.*, [1994] 79 Comp Cas 346.

9 [1963] 33 Comp Cas 862.

10 *Bajaj Auto Ltd.* v. *N.K. Firodia*, [1971] 41 Comp Cas 1. See also *Mannalal Khetan* v *Kedarnath Khetan*, [1977] 47 Comp Cas 185.

of the Board of Directors of the company. The law must be amended to prevent such occurrences.

In all the situations described above, the ambiguity arises because the "change in control" safety net for the shareholders has not been adequately spread by the code. For example, in the case of indirect takeovers by unlisted companies, providing evidence of collusion by the management will be a tough task for SEBI. Control is not exercised only through a 51% stake in the company, but also through shareholder agreements. Yet, defining control could well limit the application of the code. It is time for SEBI to re-examine the efficacy, merits and drawbacks of the takeover code, given the advent of the phenomenon of the hostile takeover into the Indian economy.