Majority Beware: Minority Rules!

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Squeeze-outs (popularly referred to as 'freeze outs' in some jurisdictions) in India of minority shareholders by the majority shareholders has always been a contentious subject. The debate has mostly been around two primary questions. First, on the fairness of the exit price given to the minority shareholders and second, a rather larger and more esoteric debate, on whether it is fair to obligate the minority shareholders to sell their shares even if they wish to hold on to them.

On the latter, the debate has been well settled by Section 395 of the Companies Act, 1956 ("Act") that provides for 'squeeze out' of the minority shareholders. However, due to the requirement of consent of 90% of the shareholders that are being squeezed out, Section 395 has seldom been used. However, underscoring the will of the majority, courts have allowed for selective reduction of capital under Section 100 of the Act, in terms whereof only the shares of certain minority shareholders were extinguished. Section 100 of the Act provides that the capital of the company may be extinguished in any manner whatsoever by way of a special resolution (75% majority of all shareholders present and voting (and not just minority shareholders)), subject to approval of the courts. There has been a debate on whether a squeeze out under Section 100 of the Act circumvents or contravenes the spirit of Section 395 of the Act, but that debate has been put to rest in Sandvik Asia Case, Elpro Case and others where the it has been settled that a minority of minority cannot be allowed to thwart the exit of the remaining minority shareholders, especially in an illiquid market.

On the former, fairness of the exit price has mostly been the subject of dispute as there are no statutory benchmarks. In case of listed companies, benchmarking is relatively easier due to the availability of the secondary market; fair value of unlisted shares is subjective and open to challenges. While decisions around fair valuation have usually been decided by the courts alone based on independent valuations there is no 'entire fairness' regime that has developed in the Indian context. In the US, for instance, courts ensure that 'entire fairness' is ensured while determining the exit price for the minority in statutory cash-out mergers. Based on case law precedents, exit price for the minority is usually negotiated by a special committee consisting of independent directors acting in the interests of the minority.

Companies Bill, 2012 ("Bill") seems to have taken a giant leap forward towards rationalizing the manner and mechanism of squeeze-outs in the newly introduced Section 236 of the Bill. The Bill proposes that a 90% shareholder of the company shall (and not may) offer to buy the shares held by the minority shareholders in the Company at a price not less than that set out in the valuation guidelines to be notified by the government ("Exit Valuation"). In such a situation, the Bill is ambiguous on whether the minority shareholders shall be obligated to tender their shares to the majority shareholder at the Exit Valuation. Interestingly, Section 236 of the Bill also allows the minority an option to make an offer to the majority shareholders to buy their shares at a price not lower than the Exit Valuation. Again the scheme of Section 236 is ambiguous, but it seems that acceptance of such an offer is likely to be incumbent on the majority shareholder. Essentially, Section 236 is ensured to the minority shareholders the moment 90% shares are held by one person, alone or together with persons acting in concert.

Section 236 also seeks to protect the interests of the minority of the minority in such squeeze out transactions and aims at plugging situations where the majority of the minority would negotiate a higher price for themselves. First, by stipulating all squeeze outs under Section 236 to the Exit Valuation, thereby allaying the possibility of the shareholder holding largest block of shares dictating the exit price as in case of delisting guidelines. Second, by Section 236(8) requiring that if 75% or more of the minority shareholders negotiate a higher price for their shares, then such additional compensation received by them shall be shared by them pro rata with the remaining minority shareholders.

Section 236 of the Bill seems to be a rational blend of Section 395 and Section 100 of the Act inasmuch as it provides for squeeze outs, even though it is inherently different from Section 100 as it provides for mandatory acquisition of shares (as contemplated by Section 395) as against extinguishment of capital (as contemplated by Section 100). Section 236 borrows from Section 100 the concept of special majority of the shareholders as a whole, and not majority of the minority as in case of Section 395 of the Act, and enhances the shareholder approval threshold from 75% to 90%. In doing so it rationalises Section 395 and facilitates an exit to the minority shareholders at a fair price without the intervention of the court. The efficacy of Section 236 will however depend largely depend on the Exit Valuation norms that are yet to be prescribed. Interestingly, Section 395 of the Act continues to find a place in the Bill in the form of Section 235.

(Alap Yadav and Ruchir Sinha also contributed to this article)