

M&A Hotline

October 24, 2013

SUPREME COURT LIMITS SCOPE OF WITHDRAWAL OF OPEN OFFER

- The Supreme Court applies principle of *caveat emptor* to investment acquisitions and holds that an investor should exercise due care and caution before investing.
- The Supreme Court holds that withdrawal of an open offer under the Takeover Regulations would be on limited grounds of impossibility, such as statutory impossibility. Economic hardship is not sufficient ground for withdrawal of an open offer.
- The discretionary powers of SEBI are limited while considering an application for withdrawal of an open offer.
- It is pertinent to note that though the court's interpretation was of Regulation 27 (d) under the Takeover Regulations of 1997, the same provision is also in the Takeover Regulations of 2011 and therefore, the expression "such circumstances as in the opinion of the Board merit withdrawal.", should be given the same interpretation.

INTRODUCTION

The Supreme Court of India ("**Supreme Court**") has ruled in a recent appeal¹ from the Securities Appellate Tribunal ("**SAT**") that the powers of the Securities and Exchange Board of India ("**SEBI**") under the SEBI (Substantial Acquisition of Shares and Takeovers Regulations) 1997 ("**Takeover Regulations**"), to permit withdrawal of an open offer made under the Takeover Regulations are limited and cannot be given a wide and expansive definition.

In this case, the Appellant, Nirma Industries, sought withdrawal of an open offer under Regulation 27 (d) of the Takeover Regulations on the ground that the promoters of the target company had committed a fraud and had embezzled funds. Nirma Industries applied to SEBI to allow the withdrawal of the open offer. The Supreme Court however rejected all the contentions of Nirma Industries and held² that an investing company is responsible for its own decision to invest and should carry out appropriate diligence. Further, the power of SEBI to pass an order for withdrawal of an offer under Regulation 27 (d) would be quite narrow and limited to circumstances of impossibility in the nature of circumstances stated in Regulation 27 (b) and Regulation (c).³ Although the Takeover Regulations have been replaced⁴, the observations of the Supreme Court in the context of impact of fraud and due diligence are extremely important.

BACKGROUND

In March 2002, the Promoters of Shree Ram Multi Tech Limited ("**SRMTL**") had borrowed Rs. 48,94,00,000 from Nirma Industries and pledged shares of SRMTL worth Rs. 1,42,88,700 (representing 24.25% of equity capital). In June 2005, when the debt was due, Nirma Industries called upon the promoters to repay the amount and when they failed to do so, Nirma Industries enforced the pledge.

The invocation of the pledge triggered Regulation 10 of the Takeover Regulations. Nirma Industries made a public announcement for the proposed open offer to acquire up to 20 % of the shares of the existing shareholders and published the offer price of Rs. 18.40, arrived at as per Regulation 20(4) of the Takeover Regulations.

In August 2005, Nirma Industries submitted a draft letter of offer to SEBI but also stated that "acquirers reserve right to withdraw the offer pursuant to Regulation 27 of the Takeover Regulations." Subsequently, it came to the knowledge of Nirma Industries that there were grave irregularities in SRMTL which were highlighted in the quarterly audit for June - September 2005. Subsequently a Special Audit Report was also commissioned and the Special Audit Report was released in parts and the final report was released on January 1, 2006 and was in public domain in March - April 2006. The Special Audit Reports confirmed these findings in the initial reports.⁵ In view of these developments, Nirma Industries sought to withdraw the offer through their Merchant Banker by way of letter dated September 22, 2006 ("**Withdrawal Application**").

SEBI, by way of their letter dated April 30, 2007 ("**Rejection Letter**"), rejected the application without hearing Nirma Industries in person, on the ground that the reasons for withdrawal were not justified and hence, SEBI would not exercise powers under Regulation 27 (d) (such circumstances as in the opinion of the Board merit withdrawal). SAT upheld the order of SEBI reiterating that grounds under Regulation 27 (d) were not made out. The scope for withdrawal of an offer under Regulation 27 (d) was argued before the Supreme Court.

CONTENTIONS OF THE APPELLANT

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Analysing SEBI's Consultation Paper

1. SEBI did not grant an opportunity of being heard while deciding the Withdrawal Application and the Rejection Letter was issued in violation of the principles of natural justice. Therefore, the Rejection Letter was therefore liable to be set aside.⁶
2. The Promoters of SRMTL had committed a fraud on Nirma Industries and as such this act of fraud had vitiated the transaction.⁷ Consequently, Nirma Industries ought not to be mandated to complete the transaction.
3. SEBI should be given wide powers on Regulation 27 (d)⁸;
4. SEBI ought to have followed a purposive interpretation of Regulation 27 (d) in view of the object for which withdrawal of an offer is sought;
5. Principles of *ejusdem generis* would not apply in interpreting Regulation 27 (d), since SAT had relied on *ejusdem generis* taking into account conditions in Clauses (b) and (c) of Regulation 27.

SUPREME COURT RULING

The Supreme Court rejected each of the contentions of the Appellant and upheld the Rejection Letter as being valid and binding on Nirma Industries. The Supreme Court held that principles of natural justice did not mandate that an audience of hearing was compulsory in all cases and in certain cases, even if the party was not heard in person, the order would be valid. The Supreme Court held that the promoters had not committed a fraud on Nirma Industries and therefore the argument of fraud was not available in the present case.

The Supreme Court rejected the contentions regarding exercise of powers by SEBI by holding that purpose and object of Takeover Regulations needed to be considered. After a detailed analysis of the Takeover Regulations, the Supreme Court noted that the purpose of the Takeover Code was to "ensure transparency in acquisitions of large percentage of shares in the target company."

The two important principles from the ruling are regarding the obligation to carry out due diligence and interpretation of Regulation 27 (d). The Supreme Court held that communication between Nirma Industries and SRMTL indicated that Nirma Industries was aware of various litigations and therefore could not plead ignorance of the litigation and the dangers of investment.⁹

On the interpretation of Regulation 27 (d), the Supreme Court held that, in view of the object of the Takeover Regulations¹⁰, the power to withdraw an offer must be interpreted in the limited context of the provisions of Clauses (b) and (c) and hence, the principle of *ejusdem generis*¹¹ must be applied.¹² The Supreme Court also rejected the contention of economic prejudice or economic impossibility or that it was just uneconomical. Therefore, while the Takeover Regulations does confer certain discretionary powers on SEBI, it would be in respect of impossible situations which are similar to situations in Clause (b) (statutory impossibility) and Clause (c) (death) of Regulation 27. Consequently, this would place a very limited scope of application for withdrawal of an open offer.

OUR ANALYSIS

By limiting the scope of applicability of Clause (d) of Regulation 27 and the discretion available with SEBI while considering an application for withdrawal, investors would have very limited ground for withdrawing an open offer. Although commercial hardship is not a ground for exemption from performance, prior to this judgment SEBI could have considered grounds on the basis of the power conferred on it under Regulation 27 (d). The Supreme Court has recognized the principle that powers conferred on an authority must be exercised in furtherance of the objectives for which the power has been conferred.¹³ In the context of Takeover Regulations, since the power is to ensure transparency and prevent abuse of the market, SEBI could have exercised such discretionary power consistent with the objects of the Takeover Regulations. Thus, in appropriate cases, economic hardship could have been allowed.

An important aspect which was not argued before the Supreme Court relates to the pledge transaction itself. For instance, Nirma Industries could have sought to distinguish their case as one relating to enforcement of a pledge rather than a case of a voluntary acquisition under a share purchase agreement. Although in the present case, it would have been difficult for Nirma Industries to sell the shares pledged, in a case, it is possible that rather than enforcing the pledge, a lender chooses to sell the shares rather than enforce the pledge and thus avoid triggering the Takeover Code 2011. Thus, by distinguishing the intention of the action of acquisition, it is arguable that Nirma Industries might have been able to show grounds for exercise of jurisdiction under Regulation 27 (d).

Although the Takeover Regulations have been replaced by the Takeover Code 2011, Regulation 23 (1) (d) of the Takeover Code 2011 is akin to and has the same expression as Regulation 27 (d) of the Takeover Regulations¹⁴, and therefore the principles highlighted in this judgment would also apply with respect to Takeover Code 2011.

The second important aspect that emerges from this ruling is the obligation that the Supreme Court has cast on investors in terms of conducting a due diligence. In view of the nature of information available in public domain, it is possible that the standard expected of an investor is too high for an investor to reasonably achieve. In view of the interpretation of Regulation 27 (d) and obligations of an investing company, due care and caution must be exercised and companies would have to ensure that there is appropriate due diligence in respect of the target company. In light of the observations of the Supreme Court with respect to right of hearing, it would also be important for companies to seek and insist on the right of personal hearing before any statutory authority.

— M.S. Ananth & Vyapak Desai

You can direct your queries or comments to the authors

¹ Civil Appeal No. 6082 of 2008 Nirma Industries and Anr. v. Securities and Exchange Board of India.

² (2013) 8 SCC 20, decided on May 9, 2013.

³ 27. (1) No public offer, once made, shall be withdrawn except under the following circumstances:-

(a) *****

(b) the statutory approval(s) required have been refused;

(c) the sole acquirer, being a natural person, has died;

(d) such circumstances as in the opinion of the Board merit withdrawal.

- ⁴ Securities Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations 2011 ("Takeover Code 2011").
- ⁵ The net worth was completely eroded and contingent liabilities were Rs. 263 Cr. as against Rs. 15 Cr. disclosed.
- ⁶ Canara Bank v. Debasis Das (2003) 4 SCC 557; ECIL v. B. Karunakar (1993) 4 SCC 727; Automotive Tyre Manufacturers Association v. Designated Authority (2011) 2 SCC 258.
- ⁷ S.P. Chengalvaraya Naidu v. Jagannath (1994) 1 SCC 1 and Ram Chandra Singh v. Savitri Devi (2003) 8 SCC 319.
- ⁸ Sahar India Real Estate Corpn. Ltd. v. SEBI (2013) 1 SCC 1.
- ⁹ The Supreme Court in fact held that, "Nonetheless any reasonable investor/group of investors/consortium would have come to a conclusion that investing in this entity would not be a prudent decision."
- ¹⁰ (a) ensure target company is aware of the substantial acquisitions,
(b) ensure that in the process of substantial acquisition or takeover, the security market is not distorted or manipulated,
(d) small investors are given option to exit,
(e) prevent speculation by abusing the provisions relating to acquisition of shares.
- ¹¹ The principle of *ejusdemgeneris* means of the same kind or nature, i.e., when general words follow specific words, the general word must be confined to the things of the same kind, as the specific words.
- ¹² Maharashtra University of Health Sciences v. Satchikitsa Prasarak Mandal (2010) 3 SCC 786; Kochuni v. State of Madras AIR 1960 SC 1080; Amar Chandra Chakraborty v. Collector of Excise (1970) 2 SCC 442.
- ¹³ This principle is a well settled principle of administrative law as held by the Supreme Court in Shri Rama Sugar Industries Ltd v State of Andhra Pradesh (1974) 1 SCC 534, Hindustan Tin Works Pvt. Ltd. v Employees of Hindustan Tin Works Pvt. Ltd. (1979) 2 SCC 80, Alcock, Ashdown and Company Limited v The Chief Revenue Authority AIR (1923) PC 138.
- ¹⁴ Clause 23 (1) (d) - such circumstances as in the opinion of the Board, merit withdrawal.
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