Corporate Governance in M&A Transactions

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The growing importance of M&A has coincided with a spurt in concerns over Corporate Governance issues. However, there has been little analysis of the clash between the two. In this essay, Mr. Varottil studies the anatomy of an M&A transaction through the lens of governance mechanisms, noting how pulls and pressures within a company affect the viability of a deal. He notes that 'mature and sophisticated' structures can minimize the risk of an M&A transaction. Further, he considers whether the existing legal framework in India allays fears of misgovernance, and suggests that there are several aspects that require reconsideration from both the regulators and the corporate sector.

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I. Introduction

This essay traverses two significant topics, that of corporate governance and mergers & acquisitions (M&A), each of which commands great attention on a stand-alone basis, having hogged the limelight in the business sphere at least for the last quarter of a century, if not more. However, less light has been shed on the intersection between corporate governance and M&A, at least in the Indian context. This essay focuses on what lies at the cusp of these two well-known phenomena.

Corporate governance and M&A enjoy a symbiotic relationship, mutually feeding off each other. *First*, M&A induces the necessary incentives in companies to enhance their governance practices. The concept of a market for corporate control suggests that poorly governed companies would automatically become targets for acquisitions, particularly in efficient markets which will accordingly impose a discount in the market price of the stock. The existence of such a possibility will, in itself, impel companies to boost their governance structures and practices, in order to avoid being taken over.[1] As one analogy, albeit infamous, goes: "It is like riding a tiger, not knowing how to get off without being eaten."[2] Even in a global context, the available evidence indicates that in cross-border M&A, the corporate governance regimes of all the companies involved tend to get elevated to reflect that of the company which has the highest standards, particularly if that were the acquirer or the resulting company from the M&A transaction.[3]

Second, the causative factors operate in the reverse direction as well, in that better corporate governance practices employed while undertaking M&A transactions enhance the value of the deal to the companies' shareholders as well as other stakeholders.[4] Corporate governance also acts as a set of checks and

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1 Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110 (1965); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1161 (1980-1981).

2 Letter dated January 7, 2009 from B. Ramalinga Raju, Chairman, Satyam Computer Services Ltd. to the Board of Directors, Satyam Computer Services Ltd.

3 Arturo Bris, Neil Brisley & Christos Cabolis, *Adopting better corporate governance: Evidence from Cross-Border Mergers*, 14 J. Corp. Fin. 224 (2008); Marina Martynova & Luc Renneboog, *Spillover of corporate governance standards in cross-border mergers and acquisitions*, 14 J. Corp. Fin. 200 (2008); Cong Wang & Fei Xie, *Corporate Governance Transfer and Synergistic Gains from Mergers and Acquisitions*, 22(2) Rev. Financ. Stud. 829 (2009).

4 Elijah Brewer III, William E. Jackson III & Julapa A. Jagtiani, *Corporate Governance Structure and Mergers* (Federal Reserve Bank of Philadelphia, Working Paper No. 10-26, 2010) *available at* http://ssrn.com/abstract=1666238.

balances that aims to prevent companies from entering into value-reducing deals.[5] This essay will deal with this set of mechanisms in some detail before commenting upon some of the legal trends in India.

II. Corporate Governance Mechanisms

An M&A transaction is a significant event in the life of a company. Although there are several economic and business drivers for why companies would embark upon M&As, concerns have been expressed about issues such as managerial hubris, overconfidence and the winner's curse that may motivate companies to enter into M&A deals that should have been avoided, or where they ought not to have paid a price so handsome.[6] These issues are magnified in competitive bid or auction situations where the acquirer's CEO are likely to display overconfidence in the value of the deal. Matters take on a more serious tone in cases where concerns of confidentiality and the demands of speed prevent a wider consultation of stakeholders, who will have no choice but to reconcile themselves with the decision of the CEO and the top-management team. A mature and sophisticated governance structure within these companies would certainly minimize the risk of failed M&As.

A number of well-established governance mechanisms operate in the context of M&A, both domestic and cross-border.

A. Board of Directors

To begin with the board of directors, reviewing the merits and disadvantages of an M&A transaction constitutes an important area of board decision-making.[7] In terms of the corporate governance environment, these are turbulent times indeed and never before have the actions of the board been subject to such strict scrutiny, given the lessons from the global financial crisis and a fair share of corporate governance scandals, both in India and elsewhere. A "rubber stamping" board is

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5 James K. Donaldson, *You Can Come Under the TARP, But First … The Bank of America – Merrill Lynch Merger Was a Failure of Corporate Governance*, 9 Fla. St. U. Bus. Rev. 21 (2010).

6 Donald C. Langevoort, *The Behavioral Economics of Mergers and Acquisitions*, 12 Transactions: Tenn. J. Bus. L. 65 (2011); Richard Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 J. Bus. 197 (1986).

7 Martin Lipton & Andrew J. Nussbaum, *Corporate Governance and Cross-Border M&A: Key Challenges and Responsibilities*, Third International Conference "Global Capital Markets and Corporate Governance: Quest for Global Standards", Moscow May 31-June 1, 2012, *available at* http://ssrn.com/abstract=2115535.

surely a thing of the past. A board must not only have acted, but must be seen to have acted, thereby lending credence to the actual process followed.

How does the board discharge the role of enhancing shareholder value? *First*, the board is called upon to provide strategic inputs. For example, whether the deal fits well within the company's overall strategy. Essentially, it is a sounding-board of sorts. This aspect is fairly well-understood. *Second*, and more importantly, the board performs a monitoring function. In any M&A transaction, the key questions the board must generally ask are: What are the findings of a due diligence conducted on the target? Have they been adequately addressed in the transaction structure and legal documentation? How has the valuation been arrived at? Is it fair to the shareholders? And so on and so forth. Reliance is usually placed on external advisors' reports in arriving at the board's own decision. In fact, it is good practice for boards to obtain independent advice on large and complex M&A transactions.

A related aspect is that the role and involvement of the board varies depending upon the type of company, particularly in the Indian context. While promoter-driven companies are clearly more aggressive and quick with decision-making on M&A transactions, companies with diffused shareholding that are professionally managed can be more process-oriented and bureaucratic. Board members carry an unenviable burden in both cases as they are either seen as facilitators if they support the deal or hindrances if they place checks and balances.

B. Risk Management

One area that is acquiring an increasingly important status as the monitoring role of a board (including in M&A transactions) is risk management. This is particularly the case in cross-border acquisitions where the acquirer will not only be subject to an alien legal regime, but also to a different culture. Companies acquiring overseas targets are presented with unique issues and unusual compliance risks.[8] For example, what are the environmental liabilities in a target incorporated in a jurisdiction which has a plaintiff-friendly regime for tortious claims and successor liability? Has the target company been in compliance with applicable legislation, particularly in sensitive areas such as anti-corruption? With multinational acquirers becoming increasingly conscious of compliance risks under statutes such as the Foreign Corrupt Practices Act (FCPA) and the Bribery Act, it is reasonable to

8 *See e.g.*, Cliff Wright & Brian Fenske, *Visionary Deal Strategies in an Ever-Changing M&A Market: Leading Lawyers on Conducting Due Diligence, Negotiating Representations and Warranties, and Succeeding in a Post-Recession Market*, in Aspatore, M and A Deal Strategies (2012).

assume that they would be willing to walk away from transactions where the target's governance is unclear from a corruption perspective. These are a matter of concern for global businesses, and understandably so.

C. Board Independence

Since an M&A transaction is crucial to a company, the monitoring function is required to be carried on in a dispassionate fashion. That is where board independence comes in. Since managers and controlling shareholders tend to have an interest in the transaction, either in terms of pecuniary interest or their emotional entanglement, independent directors are called upon to perform the role of a "watchdog". The role of the independent directors becomes even more significant in M&A transactions between related parties. Sound principles of corporate governance necessitate a greater role for either the audit committee (which substantially comprises independent directors), or even a separately constituted special committee of independent directors. This committee must meet separately in executive sessions to arrive at their views on the transaction in an impartial manner. The independent directors may even appoint their own set of advisors different from those appointed by the company. Although this trend in independently assessing M&A transactions from the point of view of minority interests has been gradually gaining traction in countries such as India, there is a need for greater acceptance and popularization of the process. The legislative process in India seems to be headed in that direction as well with comprehensive recognition of board independence in the Companies Bill, 2011. Whether that amounts to regulatory micromanagement of corporate boards or whether board independence is likely to be effective at all are grave issues, but that is beyond the scope of this essay.

D. Gatekeepers

External advisors perform a significant gate keeping role, and mitigate the cognitive biases of corporate decision-makers in M&A transactions.[9] Accounting firms and investment banks are called upon to provide fairness opinions with increasing regularity.[10] Even lawyers have been required to assume the role of trusted advisors to corporate managers and controlling shareholders who are

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9 Andrew Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583 (2010).

10 Joan MacLeod Heminway, *A More Critical Use of Fairness Opinions as a Practical Approach to the Behavioral Economics of Mergers and Acquisitions*, 12 TRANSACTIONS: TENN. J. BUS. L. 81 (2011).

constantly looking for different and better choices that enhance value and minimize risk.[11]

E. Shareholders and Activism

One of the key criticisms of the corporate governance framework is the lack of outside shareholder participation in decision-making,[12] particularly with reference to M&A transactions. Retail shareholders are apathetic due to the miniscule individual shareholding held by them. Institutional shareholders such as mutual funds have only been recently prodded by SEBI to take an active role in the decision-making on their portfolio companies.[13] Several Indian financial institutions that fall within the influence of the Government continue to hold large stakes in Indian companies, and they generate their own governance complexities. For example, their decision of whether to support or object to an M&A deal of a portfolio company may require the blessings of the government, where economic rationality runs the risk of being clouded by political compulsions. Institutions within the sphere of government control may necessarily face limitations as to the independence of their action.

On the flipside, however, India has recently witnessed the emergence of independent proxy advisors, of the kind that the US markets are familiar with.[14] These advisory firms are playing a major role in advising shareholders, particularly of the institutional variety, regarding the merits of individual corporate transactions such as M&As. Such activism among shareholders will be a new force to reckon with in the M&A markets that were hitherto devoid of shareholder aggregation mechanisms. Of course, there is a need to ensure that their participation is carefully measured so that shareholder activism does not go down the slippery slope of transforming itself to acquire the status of greenmail. Again, it boils down to identifying the right balance.

After expressing some of these more universal sentiments, this essay will briefly comment on the state of the law in India on M&A and the extent to which

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11 Marc I. Steinberg, *Counsel Conflict Dilemmas in Mergers and Acquisitions*, 47 S. Tex. L. Rev. 3 (2005).

12 Umakanth Varottil, *A Cautionary Tale of the Transplant Effect on Indian Corporate Governance*, 21(1) Nat. L. Sch. Ind. R. 1 (2009).

13 Securities and Exchange Board of India, *Circular for Mutual Funds: Role of Mutual Funds in Corporate Governance of Public Listed Companies* (March 15, 2010).

14 Bhuma Shrivastava, *Proxy Advisory Firms Give a Boost to Shareholder Activism*, The Mint (June 29, 2012).

it does, or does not, take into account corporate governance issues, primarily with a view to address the concerns of minority shareholders in listed companies. Transactions involving Indian companies can be divided into three broad categories, viz. (i) mergers, demergers and corporate restructuring; (ii) takeovers; and (iii) going-private transactions culminating in squeeze out of minority shareholders. All of these generate different types of governance issues, and this essay will touch upon each of them.

III. Mergers, Demergers & Corporate Restructuring

Mergers, demergers and other forms of corporate restructuring are usually effected through a scheme of arrangement that not only requires the approval of different classes of shareholders and creditors, but also the sanction of the relevant court of law. The provisions of the Companies Act, 1956, specifically sections 391 to 394, contain an elaborate framework to give effect to such schemes of arrangement. This framework has functioned quite well, and it has been used extensively by the corporate sector in India. Although many other countries in the Commonwealth too have similar provisions in their corporate statutes that deal with schemes of arrangement, a broad survey of corporate law in various countries would suggest that the utilization of these legal provisions in India to effect M&A transactions far exceeds that in those other jurisdictions. The Indian courts too have played a pioneering role in developing the jurisprudence on schemes of arrangement, by clearly laying down the parameters within which such schemes of arrangement may be initiated, approved by classes of shareholders and creditors and then accorded the sanction of the court. The landmark decisions of the Supreme Court in *Miheer Mafatlal*[15] and *Hindustan Lever*[16] have acquired the status of jurisprudential folklore in M&A.

The popularity of schemes of arrangement in India is understandable due to the powerful nature of a court-approved scheme. A court order sanctioning a scheme is often used as a brahmastra (a deadly weapon) to bind dissenting shareholders and creditors as also against third parties. This, however, also makes it susceptible to abuses by some who may use schemes of arrangement to achieve

15 Miheer H. Mafatlal v. Mafatlal Industries Limited, (1996) 87 Comp. Cas. 792 (SC) [Supreme Court of India].

16 Hindustan Lever Employees' Union v. Hindustan Lever Limited, AIR 1995 SC 470 [Supreme Court of India].

ends that are not entirely noble. The lawmaking process has taken cognizance of this vulnerability and has sought to impose greater restraints on the use of schemes. For instance, listed companies are now required to obtain fairness opinions from independent investment banks regarding valuation of the companies involved, and schemes of arrangement must now comply with applicable accounting standards (a constraint that had to be imposed to avoid schemes that were initiated purely as a form of financial reengineering).[17] These and other anti-abuse provisions have also been introduced in the Companies Bill, 2011 that is pending before the Parliament.

However, this addresses only a part of the concerns. For example, the standard of disclosures on schemes of arrangement is abysmal. While the Companies Act requires disclosure of all material facts,[18] the disclosures tend to conceal more than they reveal. The valuation report is merely a summary, without the accompanying details of the basis on which the valuation was arrived at. Although the new requirement of fairness opinions is meant to address this concern, it appears that the marketplace is still to comprehend the obligations that underpin the issue of fairness opinions. There is arguably an inadequate supply of specialist professionals who can issue credible fairness opinions with the required sophistication on complex M&A transactions.

Other forms of business restructuring that are effected through private arrangement rather than a court-based scheme raise greater issues regarding corporate governance. For example, transactions such as asset sales and business sales are carried out as contractual arrangements with minimal oversight of minority shareholder interests. Here, and in the absence of a specific governance framework imposed by law or regulation, the role of the boards of directors becomes somewhat crucial. This is more so when the transactions are carried out among group companies. It is too early to exorcise the ghosts of episodes such as the Satyam-Maytas transaction involving group companies, which have also become the subject matter of detailed study regarding the attention and involvement of boards in public listed companies. There is a crucial lacuna in corporate law in this area, and it relates to the inadequacy and lack of clarity in duties of directors on corporate boards. The Companies Act itself does not specify duties of directors, which is left to the domain of common law, and to be moulded by courts through judicial precedents. This is not unusual, and is in fact quite customary in leading common law jurisdictions. However, what makes India different is that courts

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17 Clauses 24(f) to (i), The Listing Agreement, clause 24 (f) – (i).

18 § 393, Companies Act, 1956.

have made insufficient use of common law to shape the duties of directors such as that of care, skill and diligence as well as duties that are fiduciary in nature. A survey of case law in India indicates that instances where common law duties have been applied to directors are few and far between. This is unlike other developed jurisdictions where robustness in the progression of judge-made common law has generated a sense of clarity and certainty in judging the conduct of directors on corporate boards, including in the backdrop of large M&A transactions.

IV. Takeovers

Moving on to takeovers, the position of the target's board in a takeover offer generates a different set of issues. This is because an offer is usually made by the acquirer to the other shareholders "over the top" of the board. Until recently, the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 provided for a passive target board in that context. The board could, at its option, make recommendations to shareholders, which was contrary to the position in several leading jurisdictions in the Commonwealth where boards are obligated to make recommendations to the shareholders regarding the takeover offer made. More recent developments seek to address this issue head-on and confer a more active role to target boards. The new set of regulations issued by SEBI, i.e. the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, requires boards to constitute a committee of independent directors to provide reasoned recommendations to the shareholders that would enable them to make their decision on whether or not to accept the offer.[19] The independent committee is also entitled to appoint external advisors such as investment banks, accountants and lawyers, at the expense of the target company. Once this approach works itself into the M&A sphere in India, it will introduce a sea-change in the way takeovers are undertaken in India, and make them less driven by acquirers and possibly the controlling shareholders.

Moving on to the issue of hostile takeovers, they provide a market for corporate control and operate as a corporate governance mechanism to keep incumbent management under check. What role is an Indian target's board expected to play in such a scenario? Can it build defensive mechanisms to protect the incumbent board and management? How is the board to assess and measure shareholder value and thereby demonstrate a proper discharge of its duties? An analysis of the SEBI takeover regulations leaves open the possibility for hostile takeovers, as Indian

19 Reg. 26(6) – (7), SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011.

boards have minimal powers to build takeover defences in the wake of a hostile offer. Frustrating actions against takeovers are not permitted without the prior approval of the shareholders,[20] which is somewhat similar to the position in the UK,[21] but further distant from the position in the US (in Delaware) where boards are conferred with greater flexibility in building defences against hostile takeovers.[22] At present, the debate on hostile takeovers may appear somewhat academic because most Indian public listed companies have controlling shareholders that make a hostile takeover a near impossibility.[23] However, given the gradual thrust towards greater liquidity in the Indian stock market and the ongoing dilution of promoter shareholding that have been occasioned by regulation that mandates a minimum public float in listed companies,[24] the hostile takeover debate is probably lurking in the shadows. The role of target boards in that situation requires a more nuanced approach. For example, one may turn to the role shaped by the Takeover Code in the UK and directors' common law duty *"to act for proper purpose"*,[25] as well as the jurisprudence in Delaware on the board's role in the shadow of a takeover.[26] The Indian approach, whether regulatory or judicial, needs to be developed before hostile takeovers become the hard reality in India too.

V. Squeeze Outs

The final transaction-type, i.e. squeeze out of minority shareholders produces significant corporate governance issues, particularly straining the relationship between the controlling shareholders and the minority shareholders. In India, courts have generally been taking a view that favours squeeze out of minority shareholders through schemes of arrangement under section 391 and schemes

20 Reg. 26(1) – (3), SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011.

21 Rule 21.1, Panel on Takeovers and Mergers, *The Takeover Code*, rule 21.1.

22 *See e.g.*, Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 Yale L. J. 621 (2003).

23 Shaun Mathew, *Hostile Takeovers in India: New Prospects, Challenges, and Regulatory Opportunities*, Colum. Bus. L. Rev. 800 (2007).

24 Clause 40A, The Listing Agreement read with Rules 19(2)(b) and 19A of the Securities Contracts (Regulation) Rules, 1957.

25 Howard Smith v. Ampol Petroleum, [1974] AC 821 [Privy Council]; Hogg v. Cramphorn, [1967] Ch 254 [High Court (Chancery Division)].

26 *See e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 183-84 (Del. 1986); Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48 (Del. Ch. 2011).

of reduction of capital under section 100 of the Companies Act.[27] Although that position is somewhat clear as a matter of law, squeeze out transactions are often found to be under scrutiny if the price offered is challenged before courts. Given that a squeeze out effectively involves an expropriation of minority shares, corporate governance demands that the transaction measure up to the dual standards of fairness in process and fairness in price.[28]

As squeeze outs intensify the conflict among shareholders, being the controlling shareholders and the minority, they touch upon aspects that are at steep divergence from the principles governing directors. Shareholding in a company is associated with property rights,[29] entitlements, powers and privileges while directorship denotes fiduciary duties and responsibilities. Hence, a controlling shareholder cannot possibly suffer from any conflict of interest in a company law sense. Such a shareholder may vote at general meetings even on transactions in which it is interested, with a minority squeeze out being one such. A proposal by SEBI to the Ministry of Corporate Affairs to introduce the concept of an "interested" shareholder who should be disallowed from voting on a related party transaction will, if accepted, signify a paradigm shift in the approach.[30] Moreover, company law does not foist controlling shareholders with duties (such as fiduciary duties). As a result, they do not owe any duty either to the company or to the minority shareholders. Although some jurisdictions have embraced the concept of a duty owed by controlling shareholders to minority shareholders at least in exceptional transactions such as squeeze outs,[31] there is no such move in the Indian context. It is not known if any proposal in that direction will muster enough momentum to see the light of day in the near future, but it is important to ensure that such a radical departure is confined to exceptional situations such as related-party transactions involving the controlling shareholders or to squeeze outs of minority shareholders.

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27 Sandvik Asia Ltd. v. Bharat Kumar Padamsi, 111(4) Bom L.R. 1421 [Bombay High Court]; Reckitt Benckiser (India) Ltd., 122 (2005) DLT 612 (Del) [Delhi High Court]; In re Elpro International Limited, [2009] 149 Comp. Cas. 646 (Bom) [Bombay High Court].

28 The U.S. courts follow an entire fairness standard that was enunciated in Weinberger v. UOP Inc., 457 A. 2d 701 (Del. 1983).

29 § 82, Companies Act, 1956.

30 SEBI Press Release, "Recommendation to MCA on related party transactions" (7 February 2011).

31 *Supra* note 28.

VI. Conclusion

In sum, giant strides have been taken in the evolution of a legal regime that engenders M&A transactions, both domestic as well as cross border. Similarly, the corporate governance framework too has progressively acquired strength. However, there continue to be areas at the intersection of these two regimes that merit further attention of the regulators, the legal process and the corporate sector itself.

This essay has only been able to scratch the surface of this vast topic with a set of issues that merit greater depth. But, it concludes with the hope that its broad framework will provide sufficient momentum for an ongoing discourse.