THE NEW TAKEOVER CODE : POISED TO TAKE-OFF

*Anil Suraj**
*P.K. Prabhat**

INTRODUCTION

There would be fewer divorces if the husband tried
as hard to keep his wife as he did to get her.

Rob Prewitt

With the wind of liberalisation blowing across the vast economic expanse of the country the environment is becoming more conducive to economic freedom and less protectionism. This is one among several developments which has led to the widespread increase in takeovers and rarely does a day pass, without an announcement of a takeover. It is in this scenario that the new takeover code assumes great importance.

In a market driven economy where free competition should thrive without relying on the protective hand of bureaucratic intervention, it is important that such critical processes as Substantial Acquisition of Shares and Takeovers, which can significantly influence corporate growth and contribute to the wealth of the economy through rational allocation and optimal utilisation of resources, take place within the orderly framework of regulation.

A committee was therefore set-up by Securities and Exchange Board of India (SEBI), under the chairmanship of Justice P.N. Bhagwati, former Chief Justice of India, to review the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1994 (hereinafter referred to as SEBI code). The terms of reference of the committee are the following:[1]

a) To examine the areas of deficiency in the existing regulations, and

b) To suggest amendments in the regulations with a view to strengthening the regulations and make it more fair, transparent and unambiguous and also to protect the interest of the investors and of all parties concerned in the acquisition process.

The committee, after examining the principles, practices and regulatory framework governing takeovers in as many as 14 countries, proposed seminal

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* II Year B.A., LL.B. (Hons.), NLSIU.

1 Para IX of the preface of the new takeover code (hereinafter new code).

changes having far reaching impact on different players of the economic system which needs to be examined.

SALIENT CHANGES

The following are the important changes that are ingrained in the new code by the committee:

1. There was no provision regarding consolidation of holdings in the SEBI code, but this has been adequately dealt with by the committee. The new code envisages the consolidation of holdings by an existing shareholder, holding not less than 10% of the voting rights, should be allowed.[2]

2. The SEBI code stated that the consideration shall be payable in cash or by exchange of shares. The new code stipulates that the consideration payable at the option of the shareholders, in cash or by exchange of shares or by exchange of and/or transfer of secured instruments with a minimum of 'A' grade rating.[3]

3. Upfront deposit in an Escrow account was not required in the SEBI code, whereas, the new code requires the acquirer to deposit upfront 10% of the total consideration in an escrow account. It also allows conditional bid (offer) subject to checks and balances.[4]

4. Acquisition of shares by the acquirer during offer period is permitted in the new code, except in case of conditional offer. The time schedule for each event in the takeover process has also been specified.[5] The SEBI code was ambiguous about this.

5. The SEBI code has no restriction on the induction of the acquirer or his representatives in the Board of Directors of the target company during offer period, whereas new code regulates that the acquirer or his representatives will not be inducted in the Board of Directors of the target company.[6]

6. The new code has, to an extent, relaxed the stipulation for the minimum shares to be acquired. The SEBI code has laid down 20% of the total shares as minimum for acquisition. The proposed code stipulates that the minimum shall remain to be 20% of total shares, but if the acquirer is prohibited from making an offer for 20% due to the operation of any other law in force, SEBI may permit an offer of less than 20%.[7]

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2 Chapter III, Regulation 10 of the new code.

3 Chapter III, Regulation 18 of the new code.

4 Chapter III, Regulation 28(1) of the new code read with Regulation 22(9) & (10).

5 Chapter IV, Regulation 34 of the new code.

6 Chapter III, Regulation 22 of the new code.

7 Chapter III, Regulation 21(1) of the new code.

7. As per the SEBI code the acquirer was not required to submit letter of offer to the stock exchanges. The new code requires the acquirer to send a copy of the letter to all the stock exchanges where the share of the target company are listed, within 14 days of the public announcement.[8]

8. The SEBI code has laid down that the acquirer shall appoint a merchant banker. The new code has further stipulated that the appointed merchant banker should not be a group company or an associate of the acquirer or the target company.[9]

9. SEBI code requires the prior approval for revision of offer, but it has been done with by the new code. However unlike SEBI code, the new code allows only upward revision of prices and number of shares to be acquired, and any change in other terms is not permitted. The changes have to be effected within three days prior to the date of the closure of the offer.[10]

10. SEBI code is applicable only to takeovers through acquisition of shares or voting rights of the target company, whereas, the new code is applicable even to takeovers through acquisition of control of a company, irrespective of whether or not there has been acquisition of shares or voting rights.[11]

IMPLICATIONS ON CORPORATE HOUSES

The new code, at first glance, looks like a typically complicated bit of Indian rule-making. Through the new code, SEBI wants to make takeovers, including hostile takeovers, much easier (as it will no longer have to protect the rights of the minority shareholders). This may cause the downfall of "Corporate empires". It provides a way to the families that control Indian business to be replaced by more widely held companies or even by corporate raiders. It is a warning to dynasties such as the Tatas, Birlas, Thapars to restructure their business if they have to survive. Presently, these corporate families, e.g. Tatas, who have an average stake of 15% in all the 70 companies the Tata empire embraces, could exploit the leniency of company law, which makes it simple to control subsidiaries through very small shareholdings. The new code also forces the Indian companies to be more transparent.[12] It tightens the definition of companies liaising illegally in concert,[13] and compels the buyers of the privately quoted investment companies to make public offers for quoted subsidiaries. If put into practice in right earnest, the families' dominance will gradually become a thing of the past.

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8 Chapter III, Regulation 22(2) of the new code.

9 Chapter III, Regulation 13 of the new code.

10 Chapter III, Regulation 26 of the new code.

11 Chapter I, Regulation 2(1)b of the new code.

12 Chapter IV, Regulation 40 of the new code.

13 Chapter I, Regulation 2(1)d of the new code.

IMPLICATIONS ON SHAREHOLDERS

The Escrow account is one feature which is unique to the Indian case, and has been incorporated keeping in mind the recent fiascos in some takeover bids. Shareholders found that after accepting the offer, the acquirer either turned his back on them or did not have the money to pay for the shares. However, the new framework envisages the operation of an Escrow account, which would ensure that in case of default, the acquirer pays a heavy penalty.[14]

The fear of takeovers will lead to better shareholder information dissemination. Equality of treatment and opportunity to all shareholders, fair and truthful disclosure of all material information by the acquirer in all public announcements and offer documents, regulation that no information is to be furnished by the acquirer and other parties to an offer exclusively to any group of shareholders, availability of sufficient time to the shareholders for making informed decisions, are the other benefits the shareholders enjoy in the new code.

Notwithstanding all these benefits, the shareholders are inconvenienced by the existence of one feature. If number of shares offered for sale are more than the shares agreed to be acquired, acceptance will be proportional. This is detrimental to the interest of the shareholders, because this closes the exit route for balance shares of those shareholders who have no confidence in the new management. It would, at the same time, be very unreasonable to compel the acquirer to make an offer for the entire paid up capital of the company.

IMPLICATIONS ON INVESTORS

The new code requires:- a) A potential bidder, who acquires shares or voting rights which would entitle him to more than 5% of shares, shall disclose the aggregate of his shareholding or voting rights in that company;[15] b) That an offer be open for a minimum of 21 days for competitive bids;[16] c) A bidder to deposit 10% of the offer amount in an Escrow account.[17] The more the regulations for a takeover, the lesser are the benefits that accrue to a naive investor. The investor will gain more when an active takeover market creates more value. Another deficiency of the regulations is that it limits the set of investors who can participate in corporate control transactions relating specifically to financially weak companies.[18]

Thus, erecting far fewer regulatory road-blocks against takeovers will help the average naive investor, and not them as the general perception is.

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14 Chapter IV, Regulation 45(2) of the new code.

15 Chapter II, Regulation 7(1) of the new code.

16 Chapter III, Regulation 24(7) of the new code.

17 Chapter III, Regulation 28(1) of the new code.

18 Chapter IV, Regulation 37 of the new code.

UNGUARDED PITFALLS

The committee may have spent more than a year in preparing a comprehensive code, nevertheless, there are certain pitfalls which necessitates immediate correction.

1. Under Regulation 22(7), an acquirer cannot make fresh market purchases during the period an offer is open for acquisition of shares. Considering that the formalities of a takeover offer can take upto 4 months, the guideline limits the flexibility of the acquirer, while at the same time allowing others to buy form the market and dump stock to the acquirer at a higher price.

2. Under Regulation 2(1)d,[19] there is no logical basis for "deeming" institutional investors, foreign or domestic, to the persons acting in concert, governed as they are by their respective charters, and have independently constituted decision-making boards. The irony is that latest Finance Bill has itself increased the limit for mutual funds and Foreign Institutional Investors (FIIs), to 10% in a company. Now, thanks to SEBI, a motive is automatically imputed to purchases by FIIs and mutual funds. This means that, even a normal investment decision runs the risk of being misconstrued as an attempt to takeover.

3. Regulation 11(1)[20] seems to be tilted in favour of large holdings as an acquirer with 25% can buy 2% more without attracting the provisions of the takeover code. On the contrary, one who acquirers 9.99% stake has to perforce make a public offer for another 20%, if he has any intention of buying any more.

4. Under Regulation 3(2), *inter se* transfers of shares among Indian promoters are excluded from the ambit of takeover regulations. Provided that each of the transferers and the transferees holding not less than 5% in the company, that to for a period of 3 years.

5. Regulation 6(4) of the code, makes it mandatory for all listed companies to send quarterly disclosures to all stock exchanges where the shares are listed, the names and addresses of the promoters and/or person(s) having control over the company, details of those shares and their total holding as a group.

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19 It reads "Person acting in concert" comprises (1) Persons who, for a common oabjective or purpose of substantial acquisition of shares or voting rights or gaining control over the target company, pursuant to an agreement or understanding directly or indirectly co-operate by acquiring or agreeing to acquire shares or voting rights in the target company or control over the target company.

20 It reads "No acquirer who together with persons acting in concert with, has acquired, in accordance with the provisions of the law, not less than 10% but not more than 25% 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 twelve months, unless such acquirer makes a public announcement to acquire shares in accordance with the regulation."

6. Under Regulation 22(8), any person(s) representing the acquirer, and being directors on the Board of the target company will have to be excluded from all matters concerning or relating to their public offer. It seems to be an impractical proposition, as key persons representing the acquirers will generally be directors in the target companies, and will naturally have to be involved in the matters relating to public offers.

7. Regulation 21(1) limits the acquirer's flexibility to acquire a smaller block of shares at any particular time, which may be relevant in terms of cash flows from time to time on the availability of adequate stock.

8. Under the Regulation 24(6),[21] in the event of acquirer not fulfilling his obligations, the money deposited in the Escrow account has to be transferred to the investors' protection fund of regional stock exchange of the target company. It is contended that a "would-be" acquirer must have an exit route with SEBI's approval to take care of material events not in the acquirer's control, for instance, an earthquake destroying the target company's plant.

CONCLUSION

In this modern era where there has been a frenetic boom in company floatations and restrictions placed by the monopolies Act (MRTP) on large holdings been removed, takeovers or acquisitions of companies have become a virtual reality. In order to dominate the national economy as well as to face foreign competition acquisition of undertakings is the most effective weapon in the armoury of the entrepreneurs.

Undoubtedly, takeovers will be more frequent in the future and it is therefore desirable to have a code which will be equitable to all the parties, flexible enough, to deal with complexities and at the same time will be able to protect investors' interest. The code does provide many plugs but it has several loopholes and pitfalls which need to be remedied before it takes off.

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21 It reads "Upon fulfilment of all obligations by the acquirers under the regulations, the merchant banker shall cause the bank with whom the Escrow amount has been deposited to release the balance amount to the acquirers."