LEGAL AND BUSINESS FACTORS AFFECTING HOSTILE TAKEOVERS: AN ANALYSIS

Written by ***Aesha Anurag Shah***

3rd Year BBA LLB Student, Jindal Global Law School, Sonipat, India

ABSTRACT

There is a pervasive presumption regarding the Takeover Code in India (Substantial Acquisition of Shares and Takeovers Regulations, 2011) that it is biased towards the incumbent management. It is incorrectly said that the Takeover Code is there to prevent hostile takeovers in companies. However, on an inspection of the provisions, it is revealed that it is not so. The Takeover Code merely provides a regulatory framework for the adherence of proper procedure for both- the acquirer and the target company. Only a fair ground is provided by the Takeover Code so that the acquirer can attempt the takeover and the target company can defend itself, all while trying to maintain the best interests of the company. At this stage, possible defences are studied to peg any biases in their applicability or inapplicability in India. It is also revealed that the reasons for sparse takeover activity are beyond the legal and the regulatory frameworks and can be found within the business environment and the shareholding pattern in the country. Lastly, recent amendments are studied to determine the latest stance of the legal and regulatory framework towards hostile takeovers.

INTRODUCTION

Since the 1991 economic liberalization in India, the booming Mergers and Acquisitions ("M&A") activity in the country has mainly consisted of friendly covenants. Surprisingly, merely a couple of M&As from them have been endeavours of hostile takeovers. And only a very negligent number out of those attempts have resulted in a successful takeover of a publicly listed company[i]. Practitioners of corporate law and investment banking interviewed for this paper gave one main underlying reason for the low rate of hostile takeover attempts, successful or not. The reason given is that the regulatory environment and more specifically the provisions of Substantial Acquisition of Shares and Takeovers Regulations, 2011 ("the Takeover Code") favour the promoters. Some literature on the same is based on a similar understanding[ii]. However, based on a few scholars[iii] and my analysis for this section, I disagree with the given reason while providing a balanced understanding of the current scenario of hostile takeovers and how they have and can take place and be prevented.

For this section, firstly, the Takeover Code has been dissected to inspect whether there is a bias towards the incumbent management which prevents hostile takeovers. Secondly, the market fluctuations, business environments and shareholding patterns that in effect influence the occurrence of hostile takeovers have been determined and studied. Lastly, some of the defences available to the company against hostile takeovers are explained and compared with other jurisdictions for their applicability in the Indian context. The defences have been mentioned to probe whether the validity of a particular defence in India is advancing the interests of the incumbent management or not.

DISSECTION OF THE TAKEOVER CODE

Mahesh Kumar Thambi in his paper, 'Indian Takeover Code: In Search of Excellence'[iv] segregates the M&A and takeover activities post-independence into three waves. The first wave can be observed to be between the 1980s and early 1990s, when there was negligible or no regulation for takeovers. The takeover, friendly or hostile, was merely based on buyer-seller negotiations. The second wave began after the economic liberalization in India. This was a period filled with M&A activities and hostile takeover attempts. Replacing the Foreign Exchange Regulation Act (FERA), deconstructing the licensing regime and an increased access

to foreign funds fuelled the proliferation of M&A and takeovers during this period. The third wave is what is going on today. In the third wave, there is an increase in the number of companies, the complexity of corporate structuring, dealings with foreign companies and individuals coupled with a less restrictive framework for Foreign Institutional Investment ("FII") to permeate the Indian financial market[v]. Thus, there is a rising prevalence and importance of banks, corporate legal practitioners, and other experts during the period for M&A and takeover activities. Such a complicated setup also requires intricate regulations to secure and preserve transparency, minority shareholder protection, integrity of the financial markets and fairness in case of hostile takeovers (or any other M&A activity). For ensuring the aforementioned, the Takeover Code is not only instrumental in India but all over the world[vi]. It is a common mistake that the Takeover Code has been enacted to prevent hostile takeovers.[vii]

The Takeover Code does not favour either the acquirer or the target company in the process. It only provides both the parties with the processes and regulations to effectively deal with the takeover process. There is no unassailable hindrance for hostile takeovers that is positioned by the Takeover Code as it is today. In fact, if the 2011 Code is compared with the 1997 Code, the regulations in the former pave a wider way for hostile takeovers to occur. In the new Takeover Code, acquirers have the autonomy to hold 25% of voting rights[viii] of the target company before they prompt the requirement of an open offer as compared to 15% in the old Code[ix].

For creeping acquisitions, that is when the shareholder of a company can gradually purchases shares to increase their shareholding without requiring any disclosure like the open letter, the bracket has been increased to 25-75% of voting rights[x]. This means that an acquirer who already has 25% voting rights or more, can acquire 5% additional voting rights[xi] every financial year until they hold 75% of voting rights. This allows the acquirer to quietly establish a majority stake through negotiations with the other shareholders without inviting the scrutiny or a battle with the incumbent management that an open offer often invites. But the method of creeping acquisitions can also be utilized by the members of the incumbent management to increase their shares to combat or prevent any takeover plans. The 2011 Takeover Code also raised the offer size permissible for the open letter offers from 20% to 26%[xii] which allows the acquirer to take over the company more expediently.

While I have claimed in the previous paragraphs that the Takeover Code does not favour the promoters or the incumbent management, it would be erroneous to construe the paragraphs to mean that the regulatory framework, through the Code, embraces or promotes hostile takeovers. The Takeover Code provides the acquirers with neutral regulations that assist in keeping the interests of the minority or public shareholders intact and also in implementing a systematic and fair route for a hostile takeover. If the Takeover Code had to promote hostile takeovers, the regulations would have been drafted to allow the acquirer to purchase an increased percentage of voting rights without any obligation of an open offer or a regulation of the offer price.[xiii]

It is interesting to note that market experts had highlighted a robust hostile takeover activity after the increase of limit from 15% to 25% of voting rights for the trigger of open offer requirement[xiv]. Economic Times declared that 480 companies, out of the 3000 companies analysed, are at a risk of a hostile takeover[xv]. However, this fear of an immense rise of hostile takeovers did not translate into reality. This is yet another evidence for the neutrality of the provisions of the Takeover Code. Instead of the Takeover Code, the reasons outlined in the upcoming section are responsible for low hostile takeover events in the country.

REASONS FOR SPARSE HOSTILE TAKEOVER ACTIVITY

One of the main reasons for a limited hostile takeover activity in India is the concentrated shareholding pattern and control of the company in the hands of the founding family.[xvi] Usually the ownership is vested in the hands of family members and acquaintances only.[xvii] In such a scenario, company shareholding is impenetrable by hostile takeovers as the family or acquaintances are not going to give away any of their shares to acquirers, no matter how high the price offered is. A similar case is portrayed by patterns of shareholding world-wide. For 1999, the latest year for which such data is available, 64% of large firms in 27 countries examined have a concentrated shareholding[xviii]. Studies as recent as 2017 show that such a pattern is still conspicuous in emerging markets such as India, Brazil, and China.[xix] It can be argued that the Takeover Code should have taken the concentrated shareholding pattern prevalent in India and pave way for an increased takeover activity. However, that would leave the businesses having a less concentrated shareholding pattern in a volatile position and

jeopardize the interests of the company. Moreover, it is not possible or reasonable for the Takeover Code to restrict the concentration of shareholding in the companies. The maximum shareholding that one can have has already been capped by SEBI and putting more restrictions on the same would only conflict with the autonomy of the management.

Also, the fact that M&A activity has significantly increased in India despite the low rate of hostile takeovers, proves that synergistic agreements[xx] between companies have been worked out. It is not prudent to neglect a chance of combining the resources of two companies to work for the increased benefit of both and instead going for a hostile takeover battle that might take more than a year with a negligent success probability.

Another possibility highlighted by some scholars is that hostile takeovers do not occur frequently due to "India's currently favourable economic climate".[xxi]Even though the same scenario is no longer true today, given the slowdown and the pandemic, the claim does hold some merit in justifying previous patterns of scarce hostile takeovers. This is because when the companies have a high market capitalization, because of growth at record prices, a hostile takeover becomes "a very costly affair"[xxii] and thus does not take place. When the mentioned claim is coupled with the fact that Indian markets are extremely volatile[xxiii], it might get difficult to come up with a reasonable hostile takeover bid and align it with the fluctuating prices.

DEFENCES AGAINST HOSTILE TAKEOVERS

One of the most controversial defences used in the U.S. is the "poison pill" defence. Poison pill (or a shareholder's rights plan) is when a company tries to dilute its shares by offering shares to the existing shareholders at a substantially discounted price. Apart from selling shares for a cheaper rate to the shareholders, many techniques of poison pill defence exist.[xxiv] However, for the purpose of the paper, the form discussed suffices. In 2000, Yahoo feared a hostile takeover by Microsoft and as a result allowed the board to issue 10 million new shares in case of an open offer by the acquirer. But the poison pill defence cannot be utilised in India. Regulation 26(2) of the Takeover Code prohibits the issue of fresh securities once there is an open offer, except in cases where the issue or allotment of such securities or convertible securities took place before the open offer.[xxv] Also, SEBI ICDR (Issue of Capital and Disclosure Requirements) Regulations, 2018, places restrictions on the discount rate that can

be offered on issue of shares. Hence, a substantial rate of discount would not be possible.[xxvi] The impossibility of a poison pill in case of Indian companies, gives a fair chance to the acquirer for the hostile takeover.

Another defence strategy used in U.S., but is not possible to use in India, is the staggered board defence. Staggered board defence is implemented by ensuring that only a third of the board of directors can be changed every year. This would make it difficult and gradual for the hostile acquirer to completely change the board for effective control in the target company. Section 169 of the Companies Act, 2013 gives the right to the company to remove shareholders by way of a vote. The right to remove directors which is granted by the statutes cannot be taken away by way of an amendment in the bylaws of the company in India.

Defences popular in the U.S. such as the Pac-man and White Knight are available to Indian target companies as well. A Pac-man defence is when the target company tries to alarm the acquirer by attempting to take over the acquirer's company. However, the target company is often smaller in comparison to the acquirer's company which would make such a defence impossible. The White Knight defence is when the target company or a friendly investor or the promoter of that company makes an offer to the public that is more enticing than the acquirer's offer.[xxvii] Such an act is permitted by the Takeover Code under Regulation 20 and the offer is known as a "competing offer". In the case of Great Eastern Shipping Company Ltd, Mahindra & Mahindra stepped in as the "white knight" that prevented its hostile takeover by Renaissance Estates.[xxviii] In a similar hostile takeover battle, ITC tried to acquire its rival, East India Hotels. But, before ITC could do so, Reliance Industries entered as a "white knight" and acquired about 18.53% of shares[xxix].

In spite of the aforementioned two defences, the most functional defence in India is a dominant stake of the promoter in the target company.[xxx] This makes the company takeover-proof. It is the same strategy which is carried out by groups like Birla[xxxi] and Tata Sons[xxxii] in their companies. Also, the most public listed companies in India have already safeguarded themselves from hostile takeovers as a result of dominant shareholding of the promoter in the company. Table 1 at page 27 reveals that in March 2021, on an average the promoters controlled 49.3% of shares in BSE 500 companies.

CURRENT REGULATORY CHANGES AFFECTING HOSTILE TAKEOVERS (during the outbreak of COVID-19)

The changes made in the Takeover Code recently in 2020[xxxiii], keeping in light the outbreak of COVID-19, will possibly prevent hostile takeover activity in the financial year 2020-21. Three separate amendments have been legislated in June and July of 2020. In the first amendment, a proviso to Regulation 3 (2) of the Takeover Code has been added[xxxiv]. This proviso increased the annual limit for creeping acquisition of voting rights from 5% to 10% only for the financial year 2020-21. But the increased limit for creeping acquisitions is meant only for promoters acquiring shares in a preferential issue. Also, controllers like the promoters, who have already acquired voting rights more than 25% but less than 75%, without attracting an open offer obligation are not permitted to purchase more voting rights by way of voluntary open offers until the completion of 52 weeks. However, this condition which has been provided in the proviso for Regulation 6, has been relaxed for the financial year 2020-21. It is pertinent to note that the 2020 amendment was published by the Securities and Exchange Board of India ("SEBI") to provide a smooth path for the company to raise funds from the promoters. The promoters will not be obligated to publish an open offer and the company will be able to deal with any liquidity crunches that it faces during the economic recession in the pandemic[xxxv].

These are incumbent management-friendly measures and are necessary during the pandemic because companies are more susceptible to hostile takeovers as their businesses and market values dwindle.[xxxvi] Here also it is important to emphasize that there is no special inclination made towards the incumbent management by the Takeover Code for the financial year 2020-21. The Amendment only tries to set-off the advantage that the acquirer has over the target company as a result of the devastating business environment for most firms during COVID-19.

Fearing hostile takeovers of Indian companies by Chinese investors, the government in April 2020 altered its Foreign Direct Investment Policy ("FDI") to block automatic FDI from bordering countries. The rule mandates government approval before any investment done by an entity from a border-sharing country[xxxvii]. This policy change has been made to curb opportunistic and foreign hostile takeovers in the wake of COVID-19, when the companies are facing a strenuous time due to the imposition of lockdowns and a recessionary economy.

In my opinion, blocking neighbouring countries from investing automatically does not mean that the possibility of hostile takeovers is negated. Hostile takeovers by entities of other foreign countries and the domestic ones is still a possibility. In fact, the probability of such takeovers has increased now in the wake of COVID-19, more than ever. The plunging of share prices in the Indian markets[xxxviii] will lead to a low market capitalization of companies and hence make a hostile takeover bid affordable for certain large companies with resources. Also, as the companies would be functioning in a limited capacity at this time, employing rapid changes to guard themselves against hostile takeovers might get onerous. Even the authorities responsible for approvals and scrutiny like SEBI, National Company Law Tribunal ("NCLT"), etc., would not be operating at full capacity[xxxix]. This paves way for acquirers to exploit the situation and initiate a hostile takeover.

CONCLUSION

On a close analysis of the Takeover Code, business patterns, and environment, it is uncovered that there is no inherent bias favouring the incumbent management or the acquirers. While certain provisions of the Takeover Code, availability of few defences and other legal framework may seem to amplify the chances of a hostile takeover, it is balanced against the concentrated shareholding patterns omnipresent in Indian countries. At the time of inspecting a bias, it is pertinent to understand that a hostile takeover is not an evil that needs to be thwarted by the legal and regulatory framework in a country. The attempt by Swaraj Paul, a London based industrialist, to acquire Escorts Ltd and DCM in 1980s led to the rise of a nationalist sentiment against hostile takeovers. This, and the concept's name, gave hostile takeovers a bad start. However, hostile takeovers by well-managed companies can be beneficial for shareholders.[xl] Many incumbent managements in certain companies callously utilize scarce funds and reward the shareholders poorly. In such a case, a lurking threat of an outsider ready to take away control is a boon to develop a competitive spirit that forces the management to shape up.

ENDNOTES

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