Is the Focus on Minority Shareholders Justifiable?

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A much talked about regulatory dilemma is that of balancing the rights of minority shareholders against the principle of shareholder democracy. On closer examination, this regulatory dilemma is not as serious as it might appear at first sight. In many ways, the very term shareholder democracy represents a misguided analogy between political governance and corporate governance. Unlike political governance, corporate governance is primarily contractual in nature, and corporate governance is at bottom a matter of enforcing the spirit of this contractual relationship.

It is important to bear in mind that the relation between the company and its shareholders and the relation between the shareholders *inter-se* is primarily contractual in nature. The memorandum and articles of association of the company constitute the core of this contract and the corporate laws provides the framework within which the contracts operate. The essence of this contractual relationship is that each shareholder is entitled to a share in the profits and assets of the company in proportion to his shareholding. Flowing from this is the fact that the Board and the management of the company have a fiduciary responsibility towards each and every shareholder and not just towards the majority or dominant shareholder.

Shareholder democracy is not the essence of the corporate form of business at all. Shares are first and foremost ownership rights - rights to profits and assets. In some cases (non-voting shares for example) that is all there is to it. In other cases, shares also carry some secondary rights including the control rights - rights to appoint the Board and approve certain major decisions. The term shareholder democracy focuses on the secondary and less important part of shareholder rights. Corporate governance ought to be concerned more about ownership rights. If a shareholder's ownership rights have been trampled upon, it is no answer to say that his control rights have been fully respected.

The fundamental principle defining operation of shareholders democracy is that the rule of majority shall prevail and are deemed to be fair and justified while overshadowing the minority concerns. However, it is also necessary to ensure that this power of the majority is placed within reasonable bounds and is not abused resulting in oppression of the minority. Adequate protection of shareholders and the business are the foundations for growth. Shareholders' rights are set out in the articles of association and Statutory provisions in this regard have also been specifically provided under the Companies Act, 1956 ("CA 1956"), which is being replaced by the Companies Act, 2013 ("CA 2013").

Despite the fact provisions have been in place under the CA 1956 to protect the interest of the minority shareholders, the minority has been incapable or unwilling due to lack of time, recourse or capability- financial or otherwise. This has resulted in the minority to either let the majority dominate and suppress them or squeeze them out of the decision making process of the company and eventually the company. CA 2013 has sought to invariably provide for protection of minority shareholders rights and can be regarded as a game changer in the tussle between the majority and minority shareholders. Various provisions have been introduced in CA 2013 to essentially bridge the gap towards protection and welfare of the minority shareholders under CA 1956.

The word 'minority' has not been defined under the Companies Act though in ordinary parlance 'minority' means persons who hold relatively less number of shares compared to other shareholders in the company. To determine a 'minority', 10% criteria in case of companies having share capital and 20% criteria in the case of other companies is provided for in the CA, 1956. CA 1956 provides for various provisions dealing with situations wherein rights of minority shareholders are affected and the same can be divided into two major heads, i.e., (a) oppression and mismanagement of the company; and (b) reconstruction and amalgamation of companies.

CA 1956 provides for protection of the minority shareholders from oppression and mismanagement by the majority under Section 397 (Application to Company Law Board for relief in cases of oppression) and 398 (Application to Company Law Board for relief in cases of mismanagement). Oppression as per Section 397(1) of CA 1956 has been defined as 'when affairs of the company are being conducted in a manner prejudicial to public interest or in a manner oppressive to any member or members' while the term mismanagement has been defined under Section 398 (1) as 'conducting the affairs of the company in a manner prejudicial to public interest or in a manner prejudicial to the interests of the company or there has been a material change in the management and control of the company, and by reason of such change it is likely that affairs of the company will be conducted in a manner prejudicial to public interest or interest of the company'. Right to apply to the Company Law Board in case of oppression and/or mismanagement is provided under Section 399 to the minority shareholders meeting the ten percent shareholding or hundred members or one-fifth members limit, as the case may be. However, the Central Government is also provided with the discretionary power to allow any number of shareholders and/or members to apply for relief under Section 397 and 398 in case the limit provided under Section 399 is not met.

On the other hand, CA 2013 provides for provisions relating to oppression and mismanagement under Sections 241-246. Section 241 provides that an application for relief can be made to the Tribunal in case of oppression and mismanagement. Section 244(1) provides for the right to apply to Tribunal under Section 241, wherein the minority limit is same as that mentioned in CA 1956. Under CA 2013, the Tribunal may also waive any or all of the requirements of Section 244(1) and allow any number of shareholders and/or members to apply for relief. This is a huge departure from the provisions of CA 1956 as the discretion which was provided to the Central Government to allow any number of shareholders to be considered as minority is, under the new CA 2013 been given to the Tribunal and therefore is more likely to be exercised.

Further, by way of Section 245, CA 2013 has introduced the concept of class action which was non-existent in CA 1956. It provides for class action to be instituted against the company as well as the auditors of the company. The Draft Companies Rules allow for this class action to be filed by the minority shareholders under Clause 16.1 of Chapter-XVI (Number of members who can file an application for class action). On close reading of Section 245 of the CA, 2013, it can be seen that the intent of the section is not only to empower the minority shareholder and/or members of the company but also the depositors. Unlike Section 399 of CA 1956 which provides for protection to only shareholder/members of the company, Section 245 of CA 2013 also extends this protection to the class of depositors as well. While 'member has been defined in the CA 2013 as including the subscriber to the memorandum of the company, shareholders and person whose name is entered in the register of members; definition for depositor is not provided under CA 2013. Further, section 245 does not empower the Tribunal with discretionary power to admit/allow any class suit wherein class of members or depositors are unable to comply with the minimum number of members/depositors requirement to be laid down in the Companies Rules.

With respect to minority shareholder rights at the time of reconstruction and amalgamation of companies, CA 1956 under Section 395 states that transfer of shares or any class of shares of a company (transferor company) to another company (transferee company), has to be approved by holders of atleast nine-tenths (9/10) in value of the shares whose transfer is involved within four months after the offer has been made by the transferee company. Herein it is important to note that consent of 90% (ninety percent) shareholders is required, which is referred to as majority. The section further provides that within two months after the lapse of the aforementioned four months, the transferee company shall give a notice to any dissenting shareholders expressing its desire to acquire their shares. Herein, the term 'dissenting shareholder' is defined under Section 395(5)(a) as including shareholder who has not assented to the scheme or contract and any shareholder who has failed or refused to transfer his shares to the transferee company in accordance with the scheme or contract. As the ninety percent (90%) shareholders in this section are referred to as majority, the remaining ten percent (10%) dissenting shareholders can be referred to as minority. The section further goes on to provide that once the notice is provided to the dissenting shareholders, unless the dissenting shareholders make an application to the Tribunal within a month of such notice, transferee company shall be entitled to the shares of the dissenting shareholders and such shares shall be transferred to the transferee company. If the transferee already owns ten percent (10%) or more of such shares then the scheme needs to be approved by shareholders holding ninth-tenth (9/10) in value and being three-fourth (3/4) in number of the shareholders holding such shares. In such a case, the dissenting shareholder ought to be offered the same price as the other shareholders. However, this section has seldom been used and instead recourse has been to Section 100 of CA 1956 to eliminate the minority. Section 100 provides that the capital of the company may be reduced in any manner whatsoever by way of a special resolution i.e. assent of seventy-five (75%) shareholders present and voting subject to approval of the courts. This section ignores minority shareholding to the extent that special resolution does not reflect the intention of the minority shareholders.

To counter these shortcomings, CA 2013 has provided for Section 235 (Power to acquire shares of shareholders dissenting from scheme or contract approved by majority) and 236 (Purchase of Minority Shareholding). Section 235 is corresponding to Section 395 of CA 1956 and provides that transfer of shares or any class of shares in the transferor company to transferee company requires approval by the holders of not less than nine-tenths (9/10) in value of the shares whose transfer is involved and further the transferee company may, give notice to any dissenting shareholder that it desires to acquire his shares. Section 235 makes it mandatory for the majority shareholders to notify the company of their intention to buy the remaining equity shares the moment acquirer, or a person acting in concert with such acquirer, or group of persons becomes the registered holder of ninety per cent (90%) or more of the issued equity share capital ofa company. It further provides that such shares are to be acquired at a price determined on the basis of valuation by a registered valuer in accordance with such rules as may be prescribed.

CA 2013, in addition to minor improvements to certain provisions of CA 1956 has also introduced new provisions affecting the reconstruction and amalgamation procedures. Such as CA 2013 vide Section 235(4) in respect of 'Dissenting Shareholders' provides that the sum received by the transferor company must be paid into separate bank account within the specified period of time as against the provision mentioned in Section 395(4)of CA 1956 which lacked clarity on this aspect and as per CA 2013, Section 236 (1) and (2), the Acquirer on becoming registered holder of ninety percent (90%) or more of issued equity share capital shall offer minority shareholder for buying equity shares at the determined value. Section 236 (3) of CA 2013 has also provided the minority with an option to make an offer to the majority shareholders to buy its shares; and Section 236 (5) of CA 2013 requires the transferor company to act as a transfer agent for making payments to minority shareholders.

The new Companies Act,2013 has given a lot of powers to minority shareholders, but the one creating ripples in the corporate sector is that promoters, who are majority shareholders, cannot vote in special resolutions in cases of related-party transactions. The new rules under Section 188 say any related-party transaction that is not done in the ordinary course of business and is not at an arm's length will need approval of minority shareholders by way of a special resolution. But, shareholders who are related or interested parties in the transaction will not be able to vote in resolutions relating to payment of brand fees or management fees to majority shareholders. Under the previous Companies Act, minority shareholders' approval or consent was not necessary for entering into related-party transactions. As a result, a majority of shareholders could go for transactions with themselves or related parties as they deemed appropriate. There will now be the much-needed checks and balances to protect minority shareholders, especially in companies where promoters continue to hold a majority of shares and even subsidiaries of multinational companies where the foreign parent holds a majority of shares.

Besides the above, CA 2013 has sought to empower the minority shareholders in corporate decision making also. Section 151 of the CA 2013 requires listed companies to appoint directors elected by small shareholders, i.e. shareholders holding shares of nominal value of not more than twenty thousand rupees (INR 20,000/-). Here, it is important to note that small shareholders are different from the minority shareholders as small shareholders are ascertained according to their individual shareholding which should be less than twenty thousand rupees (INR 20,000/-); whereas minority shareholders/shareholding is collectively ascertained and regarded as having non-controlling stake in the company. However, small shareholders can be included in and/or regarded as minority shareholders by virtue of their small shareholding amounting to non-controlling stake in the company.

While empowering the minority/small shareholders in the decision making process, the CA 2013 endeavours to further its present provisions to safeguard the interest of minority shareholders through appointment of independent directors. The 'Code of Independent Directors' provided pursuant to Section 149(8) in Schedule IV of the CA 2013, provides that independent directors shall inter alia work towards promoting the confidence of minority shareholders.

Upon careful examination of the provisions of the CA 2013 it can be ascertained that legislative intent in CA 2013 is to safeguard the minority interest in a more comprehensive manner. Thus, after comparing both CA, 1956 and CA, 2013 it can be concluded that the proposed changes are very much useful to the minorities as it gives clear picture for the same. However, it not only requires proper implementation upon addressing the present lacunas but also requires instigating confidence in the minority shareholders with respect to the institutional and regulatory mechanism which ensures that interest of minority shareholders shall be given due consideration. Nevertheless, the effort in the new Act to empower the minority shareholders is commendable.

Minority shareholders had a few major victories in 2014, but 2015 will have its new share of challenges. The concepts discussed hereinabove empower India Inc. investors with new mechanisms for the minority protection. The new amended regime would require more engagement from both sides. Company boards will have to be more conscious of the rights of minority investors and should guide the management to communicate to them the rationale behind key resolutions before these come up for voting. The onus on minority investors, especially institutions, is bound to go up because their inaction could be costly for investee companies. It is important for management to open communication channels with large minority investors. The ability of minority shareholders to take control of board resolutions to protect their interests rather than those of a few shareholders and management, and veto actions they deem detrimental to the long-term interests of the company and themselves, is set to play a major role in improving corporate governance.

However, the provisions relating to NCLT, SFIO, and class action suit have not been notified, and the actual implementation is yet to be tested. The mechanisms aim to check the abuse of power by directors but there are no substantive standards which will guide the process of investigation by NCLT or SFIO. Perhaps, the relevant ministry and departments will collectively come forward and provide an appropriate framework. In the meantime, increased caution has to be exercised by the board in its functioning. Proper maintenance of records, registers and pro-active participation in board meetings will help directors to avoid personal liability. Actual impact will be apparent only gradually. As of now, the picture promises a happy investor!