Ejecting The Unwilling Minority Shareholder

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Striking a bargain for an exit with an unwilling minority shareholder is usually a challenge and does turn out to be a painstakingly arduous task if litigated by a reluctant minority stakeholder. In unlisted companies, the majority shareholder may be driven by a variety of reasons to squeeze-out the minority such as for obtaining greater operational flexibility (and smoother decision-making) or to limit information flow to a minority shareholder.

Undoubtedly, squeezing-out of the minority has often been viewed as an abuse of powers by opportunistic majority shareholders. Historically, balancing the rights and flexibility of the majority shareholders (who control decision making by virtue of their shareholding) against the protections provided to the minority investors, has been a challenging task given the conflicting set of interests. This issue has witnessed substantial debate and also prolonged litigation.

Courts have in general stayed away from interfering with the commercial rationale of a squeeze-out provided the it fits within the legal framework and is fairly priced. However, disagreements surrounding the valuation of a squeeze-out are common and often contested.

Existing Framework

Under the existing regime, pursuing a minority squeeze out requires the majority shareholder to consolidate 90% of the equity shareholding before forcing out the minority at a fair valuation. That said, shoring-up shareholding maybe a challenging exercise (especially in companies with high valuation) given that substantial cash infusion is required. Nevertheless, for a determined majority, the key attraction of this option is that the judicial interference can be avoided, unless the minority contests its dilution as oppression or challenges the fairness of the squeeze-out valuation.

The other route for minority squeezing-out entails selective capital reduction wherein the company pays-off identified shareholders and subsequently cancels the shares held by them. Therefore, the squeeze-out is funded by the company itself as opposed to the majority shareholder. However, in addition to a super majority shareholder approval (i.e. 75% vote of members present and voting), this also requires the approval of the jurisdictional national company law tribunal (NCLT) which does stretch the timelines. As a practical matter, the shareholders of a company having a negative net worth may not be able to take benefit of this route.

New Mechanism

Another mechanism for a potential squeeze out of the minority has been recently introduced under the Companies Act, 2013.

In contrast to the abovementioned mechanisms (which will run in the parallel to this new regime), this avenue marks a significant relaxation from the earlier threshold of consolidating 90% equity shareholding and permits those with 75% shareholding to approach the NCLT for buying out the minority at a fair price. The application is to be accompanied with a valuation report and a confirmation that 50% of the aggregate sale consideration for the acquisition has been deposited in a separate bank account operated by the company.

The valuation report is required to determine the sale consideration which must be the highest of (a) acquisition price of the company's shares in any transaction effected in the preceding year; or (b) fair value which must take into account valuation parameters which are customary for the company's industry including return on net worth, book value of shares, earning per share, and price earning multiple of the industry.

While this process too has its own limitations (especially in terms of time and costs) given NCLT's involvement, nevertheless, it allows the majority to avoid direct and probably prolonged engagement with an unwilling minority by presenting an option to directly approach the NCLT for a forced buyout.

Balancing the Imbalance: Re-assuring the Minority

Evidently, squeeze-out may take the form of oppression if the pricing is unjust and therefore, it is indeed significantly re-assuring that the NCLT has been tasked with the duty of overseeing and granting approval under the new mechanism, which act as a deterrent to those looking to unfairly tweak the valuation exercise. This does bolster sentiment and is a step-further in the right direction towards instilling confidence in the minority shareholder who is an integral constituent of a healthy market. A failure on this front could seriously impede capital raising and investment by those seeking to acquire a smaller stake.

A key takeaway is that in case of minority investments, adequate contractual safeguards need to be baked into the shareholders' agreement to fetter the ability of the majority shareholder from taking any such steps. An oversight on this front at the time of investment may, going forward, prove to be costly for the minority shareholder.

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