INDIRECT ACQUISITION UNDER THE TAKEOVER CODE: THE FAIRNESS-EFFICIENCY SPECTRUM AND LESSONS FOR REGULATION

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ABSTRACT

One of the main features of the Indian takeover regulation regime is the protection of minority shareholders, which may deter merger and acquisition activity. In particular, this is true for "indirect acquisitions," which are purchases of upstream companies that ultimately change the person or individuals running a downstream company. Indian law mandates that a takeover bid be made for all such indirect purchases, regardless of whether the purchase had any influence on the initial agreement that resulted in it. This essay provides a critical evaluation of this position in light of the limitations it places on the Indian securities market and the impact it has on global merger and acquisition transactions. It analyzes Indian law in light of the strategies adopted by different foreign jurisdictions by employing the conceptual framework of a "fairness-efficiency spectrum," which classifies the relative weight that a jurisdiction gives to the concerns of minority shareholder protection (fairness) and the promotion of merger and acquisition activity (efficiency). It offers suggestions for modifying India's indirect acquisition strategy in order to better balance the many challenges based on these procedures.

I. INTRODUCTION

In early 2017, Linde AG ("Linde") and Praxair, Inc. ("Praxair"), two leading companies in the industrial gas industry, declared that they had entered into a definitive agreement to merge their operations. The merger would result in their unification under a common holding company, forming the largest supplier of industrial gases globally. During the regulatory review of the merger across different jurisdictions, a distinct challenge emerged in India. The Securities and Exchange Board of India (SEBI), the nation's securities market regulator, determined that the consolidation resulted in a change of control for the publicly listed Linde India Limited ("Linde India"), which is owned by Linde through several intermediary entities. As a result, an offer had to be made to Linde India's shareholders to acquire their outstanding shares. The merging entities sought to contend that the requirement for an 'open offer' was not relevant to them; however, this argument was rejected on a technicality. The BOC Group Limited (a subsidiary of Linde), Praxair, and other 'persons acting in concert' would eventually have to address the regulatory challenge of submitting a takeover bid for what seemed to be a minor entity in a merger of global importance[2]. This was merely one example among many where large corporations engaged in mergers and acquisitions were required to make offers for the outstanding shares of relatively minor downstream Indian entities. Similar

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[2] *LINDE INDIA LIMITED_Post Offer Ad_3 October 2019.pmd*, (Oct. 4, 2019),

to how Linde dwarfed Linde India, Indian companies owned by foreign entities generally constitute a small portion of these larger organizations. This scenario has prompted questions about the necessity of such offers for seemingly insignificant entities. The Takeover Regulations Advisory Committee ("Achuthan Committee") looked into this matter, which ultimately shaped the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 ("Takeover Code"). A survey conducted by the Achuthan Committee of listed Indian companies with foreign parent companies found that the average market capitalization, net worth, and net sales of these Indian firms were only 5.4%, 1.8%, and 2.1%, respectively, compared to their foreign parents. Of the 35 companies examined by the Achuthan Committee, only three had a market capitalization exceeding 20% of their foreign parents, and none exceeded 15% of their parents' net worth or net sales[3]. This poses an interesting challenge for Indian securities market regulation—frequently, the ultimate owners of Indian listed companies shift in transactions where acquiring control over such a company is, at most, a minor consideration. Consequently, as we will explore in this article, the relevance of the Indian aspect in global transactions, or the underlying intent, often carries little significance in Indian takeover regulation. A decade after adopting this approach, numerous practical questions remain.

In straightforward terms, takeovers are transactions in which one or more parties aim to gain control over a company, usually by buying its shares. Statutes governing takeover regulation in India, enforced through the Takeover Code, oversee these transactions. As we will explore in Part I of this article, these regulations are designed, at least in theory, to facilitate the orderly conduct of takeovers while protecting minority shareholders during changes in control. A fundamental aspect of Indian takeover regulation is the 'mandatory takeover bid'—a stipulation that anyone who acquires control of a company must make a general offer to purchase its outstanding shares at the best available price, which must be equal to or higher than the price paid for the shares that conferred control.

Control over a 'target' company does not necessarily need to be acquired directly through the purchase of shares or rights. It can also be obtained by acquiring an intermediary (termed the 'primary acquisition' in this article) that already has control over the target, thereby allowing for control through that intermediary (known as the 'indirect acquisition'). For instance, consider company A, which owns a 60% stake and has a controlling interest in company B. If you were to acquire company A, you would also obtain the rights linked to its 60% stake in B, effectively granting you control over B. Such 'indirect' acquisitions are subject to the Takeover Code, even if there is no change in the shareholding of the listed company itself. Under the provisions of the Takeover Code, all such acquisitions trigger mandatory takeover bid requirements, irrespective of the intent behind the primary acquisition.[4] Since 1997,

[3] *Microsoft Word - Document6*, (July 19, 2010), https://www.sebi.gov.in/sebi_data/attachdocs/1287826537018.pdf.
[4] *Sebi*, Measures to Strengthen Equity Index Derivatives Fr (May 17, 2024), https://www.sebi.gov.in/legal/regulations/may-2024/securities-and-exchange-board-of-india-substantial-acquisition-of-shares-and-takeovers-regulations-2011-last-amended-on-may-17-2024-_69218.html.

indirect acquisitions have been identified as potential triggers for mandatory takeover bids.[5] the Takeover Code is noted by some as having cemented the law on the matter, laying a detailed and transparent framework for how such acquisitions are treated.[6] Since this legal change, numerous mandatory takeover bids have been conducted due to indirect acquisitions. Over the last three fiscal years, 8.33% of all public announcements for mandatory takeover bids have involved indirect acquisitions. Despite this, there is a notable absence of academic literature analyzing India's approach to takeover regulation, even though such regulations could considerably hinder merger and acquisition activities. This article offers a critical examination of the regulation of indirect acquisitions in India and suggests alternative models for achieving these goals.

Part I delineates the primary rationales for takeover regulation, which are categorized into 'efficiency' and 'fairness' considerations. It argues that an overemphasis on fairness may adversely impact efficiency. Building on this premise, Part II explores how various jurisdictions around the world have approached indirect acquisitions along a fundamental 'fairness-efficiency' spectrum, illustrating how their selected methods either promote or detract from these considerations.

Part III provides an in-depth analysis of India's approach to indirect acquisitions, tracing its development along the fairness-efficiency spectrum over time. Acknowledging that Indian law currently occupies one extreme of this spectrum, Part IV calls for reform based on the principle of comity and offers recommendations for future action.

II. OBJECTIVES OF TAKEOVER REGULATION

Two primary rationales are frequently cited for takeover regulation: 'efficiency' justifications and 'fairness' justifications. The former asserts that takeovers, as a vital element of the 'market for corporate control', enhance market efficiency by motivating management to secure the highest possible price for a company's shares, or risk being overtaken by another entity. The latter rationale emphasizes that takeover regulations are crucial for ensuring fair treatment of minority shareholders, allowing them to exit the company during a management change under terms comparable to those received by shareholders transferring control to the new management.

However, as we will explore, particularly concerning mandatory takeover bid requirements, these considerations can be at odds with one another. While such requirements strengthen minority shareholders' rights during a change in control, they can also diminish efficiency by increasing the costs associated with these changes. Therefore, crafting takeover legislation necessitates a careful balancing act—maximizing shareholder protection while minimizing the regulatory burden on merger and acquisition activities.

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[5] *A Guide to SEBI's Substantial Acquisition of Shares and Takeovers Regulations 2011*, Patrons Legal Blogs (Mar. 28, 2024), https://patronslegal.com/blogs/a-guide-to-sebis-substantial-acquisition-of-shares-and-takeovers-regulations-2011/.

[6] *INDIAN UPDATE – New Takeover Regime Provides Clarity for Indirect Acquisitions in India and Overhauls Old Regime – XBMA*, (Dec. 20, 2022), https://xbma.org/indian-update-new-takeover-regime-provides-clarity-for-indirect-acquisitions-in-india-and-overhauls-old-regime/.

Markets are generally perceived to have a disciplining effect on producers, as consumers tend to favor attractive products while avoiding those that are less appealing. In a similar vein, many believe that securities markets regulate management, with investors favoring well-managed companies that sustain high share prices and shunning those that are poorly managed. As Henry Manne first suggested in 1965, this interplay creates a 'market for corporate control,' driving company managements to compete to maintain high share prices.[7] Takeovers are essential to the functioning of markets for corporate control. Bidders frequently seek out companies with low share prices due to mismanagement. The possibility of a takeover motivates management to work as efficiently as possible, keeping the company's share price high enough to deter potential acquirers. If current management fails to achieve this, takeovers offer a chance for new leadership to come in and potentially improve the company's performance.[8] In this context, takeover regulations can be essential by promoting the orderly conduct of takeovers and reducing unnecessary interference from entrenched management.[9] As a result, the G20 and OECD promote the effective functioning of markets for corporate control to enhance corporate governance, highlighting the necessity of well-defined rules and procedures for takeovers.[10]

However, the takeover regulation model implemented by India[11] is best suited for jurisdictions where share ownership is widely dispersed, enabling outsiders to more readily take control of a company. For a range of historical, structural, and cultural reasons,[12] India has a particularly stagnant market for corporate control, with a substantial majority of its companies being dominated by family business groups.[13]

This creates a challenge for the governance of listed Indian companies. With shareholdings primarily concentrated among founders and their families, managements have limited accountability to public shareholders[14] In such a setting, takeover rules haven't done much to foster a market for corporate control. Although required takeover bid regulations have been a part of Indian legislation since 1990, hostile takeover attempts have been few and far between in the report of the Justice P.N. Bhagwati Committee ("Bhagwati Committee"), which led to the creation of the Takeover Code 1997 (prior to the Takeover Code), they were considered as a means of promoting the takeover market. It appears that this had little impact. In actuality, between 1997–1998 and 2014–2015, more than half of all takeover offers were

[7] Manne, Henry G. "Mergers and the Market for Corporate Control." *Journal of Political Economy*, vol. 73, no. 2, 1965, pp. 110–20. *JSTOR*, http://www.jstor.org/stable/1829527. Accessed 20 Oct. 2024.
[8] https://www.econlib.org/library/Enc/MarketforCorporateControl.html.
[9] (Dec. 22, 2013), https://hummedia.manchester.ac.uk/schools/law/main/research/MSLR_Vol2_11(Okanigbuan).pdf.
[10] https://www.oecd-ilibrary.org/docserver/9789264236882-en.pdf?expires=1729400041&id=id&accname=guest&checksum=C82D33EA35BB654BB6E834B9DCB76F31.
[11] (Jan. 28, 2011), https://law.stanford.edu/wp-content/uploads/2017/04/HILJ_52-1_Armour_Jacobs_Milhaupt.pdf.
[12] *The Emerging Market for Corporate Control in India: Assessing (and Devising) Shark Repellents for India's Regulatory Environment*, The Emerging Market for Corporate Control in India https://journals.library.wustl.edu/globalstudies/article/id/706/.
[13] https://repository.nls.ac.in/cgi/viewcontent.cgi?article=1083&context=nlsblr.
[14] *Sebi*, Report of the Committee on Corporate Governance (Oct. 20, 2017), https://www.sebi.gov.in/reports/reports/oct-2017/report-of-the-committee-on-corporate-governance_36177.html.

made by incumbent owners looking to combine their holdings.[15]

Some analysts contend that India's takeover regulations improve the position of existing owners because they haven't produced any noteworthy takeover activity. Bidders are less inclined to attempt to take over companies covered by the Takeover Code because of the additional cost of needing to file a takeover bid. It forces the acquirer to get the money required to purchase a substantially greater number of shares than they had originally intended, on top of the costs related to the takeover bid process itself. Instead of creating a market for corporate control, these criteria end up being unintentional takeover defenses when the increased expenses start to threaten the economic viability of a takeover.[16] Similar issues have arisen in other jurisdictions with highly concentrated corporate shareholding.[17]

Fairness

According to the various organizations that have affected the development of Indian takeover legislation, the primary rationale for the law is the need to ensure equity and equal opportunity for all shareholders.[18] The concept of a compulsory takeover bid originated with the City Code on Takeovers and Mergers in the United Kingdom (the "City Code"), which was based on this premise.[19] A "control premium," or higher price, is often offered to shareholders who sell a "controlling block" of shares since these shares together give a purchaser control over the company. Takeover bids remove this advantage by giving every shareholder an equal opportunity to sell their shares on the terms associated with the sale of the controlling block. The control premium is dispersed among shareholders by requiring such a bid, ensuring that no share of the company is worth more than others just because it is a part of a controlling block.[20]

Furthermore, in the event that a company's management changes control, statutory takeover bid rules give shareholders the opportunity to escape. This type of exit opportunity is required since a change in control may also mean a change in the company's policies, and it might be challenging for a shareholder to leave on comparable terms later on if the company's policies alter in a way that would be harmful to their interests. In the event of a takeover bid, minority shareholders must decide whether they believe the management provided by the acquirer would increase the value of the company's shares above the premium the acquirer is proposing. Unless the answer to such a question is in the affirmative, it becomes a reasonable decision for the shareholder to leave the company.[21] Shareholders are, therefore, likely to stay in the case of value-enhancing takeovers, while exiting in the case of value-reducing takeovers.

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[15] https://law.nus.edu.sg/wp-content/uploads/2020/04/011_2015_Umakanth_Varottil.pdf.

[16] Varottil, Umakanth. "COMPARATIVE TAKEOVER REGULATION AND THE CONCEPT OF 'CONTROL.'" *Singapore Journal of Legal Studies*, 2015, pp. 208–31. *JSTOR*, http://www.jstor.org/stable/24872278. Accessed 20 Oct. 2024.

[17] https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1321&context=jbl.

[18] *Microsoft Word - Document6*, (July 19, 2010), https://www.sebi.gov.in/sebi_data/attachdocs/1287826537018.pdf.

[19] https://lup.lub.lu.se/luur/download?func=downloadFile&recordOId=1555449&fileOId=1563662.

[20] Luttmann. "Changes of corporate control and mandatory bids" ideas.repec.org/a/eee/irlaec/v12y1992i4p497-516.html. Accessed 20 Oct. 2024.

[21] "Equal opportunity rule vs. market rule in transfer of control: How can private benefits help to provide an answer?" ideas.repec.org/a/eee/corfin/v23y2013icp88-107.html. Accessed 20 Oct. 2024.

Striking a Balance

Due to the previously described issues, takeover regulation in economies like India is not always advantageous and necessitates a careful balancing act between ensuring the protection of shareholders' interests and maintaining a strong market for corporate control. Although mandatory bid requirements have been lauded as a net advantage for shareholders, it is important to carefully analyze the barriers they impose to a change in ownership of a company. Because of the significant degree of shareholder concentration in the Indian market, there is little room for mistake in reaching this equilibrium.

Maintaining this equilibrium is particularly important when the acquisition is indirect. Such acquisitions are started by an offer for control of a separate company upstream, not the target company. This influences how fairness and efficiency considerations need to be made. The market for corporate control is further hampered in these cases by mandatory bid requirements, which impose a regulatory penalty on control changes that are less directly tied to the firm that made the offer. Additionally, stockholders are less likely to be impacted by an upstream acquisition. Because an acquirer who had no intention of taking over a company in the first place is less likely to do so, this is especially true when an indirect acquisition is only incidental to the primary acquisition.

Due to these considerations, direct purchases are treated quite uniformly over the world, while indirect takeovers do not show similar convergence. As evidenced by the many ways that various jurisdictions have evolved their methods, there is a lack of worldwide consensus over how to manage indirect purchases. We shall look at these models in the next chapter.

III. APPROACHES TO INDIRECT ACQUISITIONS

In controlling indirect purchases, nations all over the world have attempted to find a middle ground between two opposing causes. On the one hand, minority shareholders shouldn't be left in the dark if indirect acquisitions subsequently prove to be a pretext to buy a company (repeating the fairness issue). However, excessive regulation must be avoided to prevent it from completely stifling merger and acquisition activity (echoing arguments of efficiency). As we'll see later, countries like New Zealand have also taken into consideration the third principle of international "comity," which is to respect other countries' policies by making sure that their laws don't impose an excessive burden on cross-border trade.

Plotting the approaches of various countries to indirect acquisitions along a crude "fairness-efficiency" spectrum can be done with these factors in mind. We divide the methods we examine into three general categories for convenience: "efficiency-heavy," "balanced," and "fairness-heavy."

Efficiency – Heavy Models

The efficiency end of this spectrum includes nations that do not include indirect purchases in their statutory takeover bid requirements. Some outliers, like the United States of America, have no rules for mandatory takeover bids at all, regardless of the type of acquisition. Even within more conventional legal frameworks, some nations offer exceptions to indirect purchases under certain conditions in order to keep mandatory takeover bid requirements from becoming unduly onerous.

For instance, when someone acquires direct or indirect control of more than 20% of a company's vote, Australian regulations typically call for a mandatory takeover offer. They do, however, include controls to make sure that these processes don't become unduly onerous. When an acquirer purchases a company as a secondary acquisition after purchasing a publicly traded company, these takeover offer regulations are not applicable. As a result, even while the existence of intermediary companies usually does not protect an acquirer from a compulsory takeover bid, attempts at a merger or acquisition are not impeded by various takeover bid restrictions. To stop them from being abused, the Australian Takeovers Panel can declare some transactions' conditions "unacceptable," denying them the benefit of such exemptions.

Structuring mandatory bid requirements in this manner ordinarily ensures that any merger or acquisition transaction triggers a maximum of one takeover bid. This potentially leads to situations where minority share- holders do not necessarily have an exit option, signalling that fairness con- cerns do not always warrant the imposition of too significant a regulatory burden. To avoid shareholder harm, however, the Australian model creates a safeguard in the form of the oversight of the Takeover Panel, which may mandate a takeover bid in case greater protection is warranted.

Balanced Models

Many jurisdictions refer to this intermediate ground as the [22]"chain principle."Provisions of the chain principle, which are found in the takeover legislation of Singapore, Hong Kong, the United Kingdom[23], and Hong Kong, and emphasize how someone who gains control of one firm may indirectly gain control of another company as a result of that control. According to each of these clauses, such circumstances will only result in mandatory takeover bid requirements if one of two conditions is satisfied: either the second company is "significant" in relation to the company that the person directly acquired, or the acquisition of control over the second country was a major driving force behind the upstream transaction.

This strategy strikes a balance between the need to prevent merger and acquisition activity from becoming unduly complicated and the rights of shareholders to an exit option by clearly outlining both the necessity of takeover bids and examples of incidental indirect acquisitions without giving precedence to either. This establishes an obligatory takeover bid as the standard, in contrast to the Australian model, which calls on the regulator to actively prevent transactions when shareholders would be left stranded. On the other hand, it guarantees that a regulator cannot target such transactions by limiting the exception to cases where an indirect acquisition is only incidental.

Fairness- Heavy Models

Regardless of whether the firm was a major component of the original acquisition, a number of jurisdictions choose to enforce a takeover offer for indirect acquisitions. For example, the European Union ("EU") mandates that its member states impose mandatory takeover bid restrictions on individuals who directly or indirectly acquire control of listed

[22] https://nysba.org/WorkArea/DownloadAsset.aspx?id=22351

[23]https://www.mas.gov.sg/-/media/mas/resource/sic/the_singapore_code_on_take_overs_and_merger_24-january-2019.pdf

companies.[24] For indirect acquisitions, no exemptions or relaxations are recommended. The majority of major jurisdictions, including France[25], Germany, Italy[26], and the Netherlands, have included provisions pertaining to takeovers in their own domestic laws, but they do not specifically provide any exemptions for indirect acquisitions. This is despite the fact that EU member states are allowed to choose how the directive applies to their own jurisdiction. This is also the case in India, as we will discover in the next chapter.

Interestingly enough, however, domestic authorities in many of these jurisdictions have the power to grant exemptions in the case of an indirect acquisition. For instance, a forced takeover bid may not be necessary if the Autorité Des Marchés Financiers, the French financial markets regulator, finds that a company being acquired indirectly does not constitute "an essential asset" of the company being acquired in the primary acquisition.[27] With this approach, a country can ensure the highest level of security for its owners while retaining the adaptability to permit circumstances in which there is no risk of harm to shareholders.

Indirect Acquisitions in India

In the last chapter, we created a fairness-efficiency spectrum that illustrates how various jurisdictions address indirect purchases and related problems at various points along the spectrum. The development and trajectory of indirect acquisition laws in India will be examined in this chapter. As we shall see, the majority of Indian jurisprudence on indirect purchase falls on the fairness end of this range.

Both a quantitative trigger, which happens when an individual's shares or voting rights in a company surpass specific thresholds, and a qualitative trigger, which happens when an individual gets "control" over a company, are the primary causes of mandatory takeover bids in India. An act of "acquisition," whether it be of control or the ability to vote, is necessary for both sets of triggers.

Sometimes, though, neither of these triggers is triggered right away. For instance, the Linde-Praxair agreement did not alter the entities that owned shares in Linde India or the number of shares they held. No company bought any Linde India stock directly. The people who would eventually run Linde India were altered by the underlying international transaction, though, as can be shown by looking at the several levels of organizations that operate above it and how its immediate shareholders exercised their rights in it. The combination of the upstream firms would result in Linde losing its position of effective control over Linde India.

In addition to direct purchases of shares, voting rights, and control, the Takeover Code also defines an indirect change in voting rights or control as a "acquisition." Such an indirect acquisition has the same legal impact as a direct acquisition of a business, and if it meets the requirements for control or voting rights, it may result in a required takeover bid duty.

In our "fairness-efficiency" paradigm, India's stance on indirect purchases under the Takeover Code is unquestionably fair. However, things haven't always been this way. In

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[24] *Directive*, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32004L0025.
[25] *Article 234-2 into force since 30/06/2014*, (June 30, 2014), https://www.amf-france.org/en/eli/fr/aai/amf/rg/article/234-2/20140630/notes.
[26] *Microsoft Word - REFERENCE LEGISLATION*, (Apr. 13, 2017), https://www.delonghigroup.com/sites/default/files/reference-legislation.pdf.
[27] https://www.amf-france.org/en/eli/fr/aai/amf/rg/article/234-9/20160101/notes

reality, India's takeover laws did not initially take indirect acquisitions into account. This concept gained traction in legislative and judicial discourse as the body of Indian legislation pertaining to takeover regulation developed. When the necessity for a mandatory takeover bid for indirect purchases was incorporated into Indian law in 1997, substantiality became a consideration in assessing whether an indirect purchase would result in a takeover offer. Only then did India adopt its current, equity-oriented approach. We shall look at this trajectory in the following sections of this chapter.

IV. CONCLUSION

The takeover laws in India may restrict the flow of acquisition activity unless they are adjusted to make things as easy as possible for potential acquirers, given the high costs of compliance. Control fights are already difficult due to the significant concentration of shares in Indian firms. The system as a whole may suffer from any additional constraints on this type of activity. For example, the high transaction costs may discourage international investors from making investments in India. This is particularly important given the current administration's focus on encouraging more foreign investment. As a part of a wider global civilization, India must embrace the economic policies of its international competitors and ensure that it doesn't hinder international financial activity without legitimate cause.

If we were to achieve these objectives, we would need to modify our existing paternalistic regulatory approach to corporate activity control. Liberalizing our indirect purchases policy would be a crucial first step in this direction. The purpose of this essay is to offer a framework for implementing such a change. We propose strategies that preserve the prominence that minority shareholders now have under Indian law while lowering the regulatory costs related to mergers and acquisitions. Without unjustly hurting small investors through mergers and acquisitions, we think striking this balance will enable the Indian economy to grow more efficient.