THE WARNING OF AN AMBUSH: DISARMING AND APPEASING ACTIVIST SHAREHOLDERS

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ABSTRACT

This paper attempts to establish that the unprecedented instance of a rise in shareholder activism in India may lead to unprecedented consequences as well. It argues that intervening minority shareholders may pose a threat to the control of the management over corporate decisions. As a reaction to this threat, the directors may adopt strategies that, in the garb of benefitting the company, help them in retaining control. This paper points out two strategies that might be adopted by them. Preferential allotment, which disarms the intervening shareholders at the very beginning by diluting their stakes and voting powers. The other is appeasement of the shareholder body at large by increasing leverage, making risky investments and decreasing cash holdings which in turn have negative credit market reactions. This paper aims to act as an invitation for lawmakers and scholars to deliberate upon a problem that can be anticipated for the near future.

Keywords: *Shareholder activism, creditors' protection, minority shareholders, director's duty, preferential allotment.*

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I. Introduction

WHERE THERE has been a delegation of decision making, it is naturally assumed that a situation of conflicting interests will arise.[1] The decision-maker, if not subjected to control and obligation, legal or moral, will end up acting in favour of furthering his interests, leaving the delegator in an extremely vulnerable position. In the corporate world, this scenario can easily

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[1] John Armour, Henry Hansmann *et.al.* "Agency Problems, Legal Strategies and Enforcement" (2009) (Harvard John M. Olin Discussion Paper Series Number 644).

be observed in the functioning of a company. The shareholders are the owners of the company, and they delegate the management of it to the Board of Directors[2]. Based on their expertise, experience, access and position, the Board of Directors are always at an advantage; meanwhile, the shareholders are left subjected to the decisions taken by them. Especially in a country like ours, with concentrated shareholding and negligible separation of ownership and management[3], the minority shareholders become the ultimate victim of this tyrannical exercise of power.[4] At this juncture, it is the responsibility of the legislators to step up and protect the minority shareholders.

The Companies Act of 2013 was drafted keeping this vulnerability in mind.[5] It is no secret that throughout India's corporate history, being a minority shareholder in a company has not been a bed of roses.[6] This history is also tainted by the tendency of these shareholders to remain passive. They have been infamous for taking no action to protect their interest in the company, rather opting for the *'Wall Street Walk'*- that is selling their shares in the stock market - if they are not happy with the management or share prices.[7]

But if passivity still exists among shareholders in India, then how is it possible that it may become a threat to the strong class of creditors? The answer to this question is based purely on events that have taken place in the past few years. Section III of this paper substantiates that the trend of shareholder passivity is subsiding, giving way for a new trend of active intervention.

The whole concept of shareholder activism is unprecedented but extremely important for India.[8] It is crucial to establish it as unprecedented at this juncture, as then it becomes obvious that it may have unforeseen consequences, as well. This paper intends to bring a possible negative consequence into scholarly and legislative attention. It aims to establish a relationship

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[2] One must not forget that shareholders are owners of the company in a limited sense. It is true that they contribute to the finance of a company but they have little control over its day-to-day functioning and their debts cannot be satisfied using the assets of the company.
[3] N. Balasubramanian and R.V. Anand, "Ownership Trends in Corporate India 2001-2011 Evidence and Implications" *IIM Bangalore Working Paper No.419*, 2014, *available at*: Corporate Ownership Structures in India (iimb.ac.in) "Concentrated ownership and control is the predominant shareholding pattern in India. Over the eleven-year study period from 2001-2011, controlling shareholders have further entrenched themselves by substantially increasing their holdings" .
[4] *Supra* note 1 at 1.
[5] The Companies Act, 2013 (Act 18 of 2013).
[6] Umakanth Varottil, "The Advent of Shareholder Activism in India" 1 *Journal on Governance* 584 (2012). Additionally, the cases of *Sandvik Asia Ltd.* v. *Bharat Kumar Padamsi* (2009) 92 SCL 272 (Bom) and *In Re: Elpro International Ltd.* (2008) 86 SCL 47 (Bom) show the hesitation of the courts to step in and protect the minority shareholders in case of a minority squeeze out.
[7] *Ibid.*
[8] *Ibid.*

between the growing interventions of shareholders in the management of a company, the threat it poses to the power of the directors, their response to the same and the negative impact such response may have on the interest of present or potential creditors. Additionally, it also describes a disarming strategy that the directors may engage in to nullify the looming threat of losing power. This strategy is that of preferential allotment and amplifies the agency problems between the management and the shareholders and between majority and minority shareholders.[9]

Section 166 (2) of the Companies Act of 2013[10], taking a pluralistic approach, even though without doubt, puts the company at the foremost of a Director's priorities, manages to touch upon a few classes of stakeholders whose interest may be considered in day-to-day decision making. However, the board has tended to prefer shareholders in a situation of conflict over any other stakeholder.[11] In the light of this, what happens when these shareholders, who are already habitual of preferential treatment[12], actively intervene with the powers that the management holds?

It can be inferred that the shareholders cannot usurp the powers of the directors as was held in the case of *John Shaw and Sons* v. *Shaw*[13]; however, it is important to point out that the new Companies Act stipulates certain mechanisms that the shareholders can use when the management is not performing to meet their satisfaction. Under section 180, there are certain restrictions on the powers of the Board, mostly in the form of shareholder approval.[14] Along with this, sections 241[15] and 245[16] also give them the power to subject the company and the board to litigation. These are not to usurp the power of the board but to put reasonable restrictions on it. It is, therefore, best for the directors to remain in harmony with the shareholders if they want the company to function smoothly.

[9] *Supra* note 1 at 1.
[10] *Supra* note 5, s. 166 (2).
[11] Mihir Naniwadekar and Umakanth Varottil, "The Stakeholder Approach Towards Directors' Duties Under Indian Company Law: A Comparative Analysis" *NUS Centre for Law and Business, Working Paper Series 16/03*, 2016. "*While section 166 (2) of the 2013 Act at a superficial level extensively encompasses the interests of non-shareholder constituencies in the context of Directors' duties and textually adheres to the pluralistic approach, a detailed analysis based on interpretation of the section and the possible difficulties that may arise in its implementation substantially restricts the rights of stakeholders in Indian companies*."
[12] *Ibid.*
[13] *John Shaw & Sons (Salford Ltd.)* v. *Shaw* (1935) 2 KB 113.
[14] *Supra* note 5, s. 180.
[15] *Supra* note 5, s. 241.
[16] *Supra* note 5, s. 245.

Once activism starts, the directors might see minority shareholders as a threat to their own power.[17] Frequent disagreements resulting in delayed or unfavourable decision making might force the directors into a battlefield for regaining control. Their war would be against minority shareholders, and their strategies would be that of disarmament of minority shareholders or appeasement of the shareholder body as a whole. Disarmament will be through a preferential allotment, and the process of appeasing may consist of actions like increasing the leverage of a company or excessive dividend distribution or buying back of shares in order to take back as much control as they can.[18] These measures, at face value, appear to benefit the shareholders in the short term, but as a matter of fact, may harm the company and its creditors in the long run.

The second part of this paper is a comparative analysis about the ESV Model that the English lawmakers had adopted while drafting section 172 of the Companies Act of 2006[19], *vis-a-vis* the approach that Indian lawmakers took while drafting section 166 (2)[20] of the new companies act along with the attitude of preference that the Indian Directors have adopted.[21] The third part substantiates that Indian shareholders are following a new trend of intervention in the powers of the management that is contrary to the popular belief that corporate governance in India is still the victim of passive shareholders.[22] This forms the basis of this paper and is followed by the fourth part, which talks about the response of the directors trying to disarm the activist shareholders and the amplification of agency problems. The fifth part describes the alternative appeasement mechanism along with the negative credit market reactions that it may cause.

II. The road not taken: A preferential attitude towards shareholders

This section is where the unspoken understanding of the board to prefer the shareholders over other stakeholders is questioned. One may argue that this statement is not relevant as far as

[17] As minority shareholders start taking stances against the decisions of the directors. This point has been further exemplified in Part 3 of the paper which shows companies like Raymond Group, the Tata Group and Fortis healthcare have faced opposition from minority shareholders

[18] Felix Zhiyu Feng, Qiping Xu, *et. al.,* "Caught in the Crossfire: How the Threat of Hedge Fund Activism Affects Creditors" 64 *Journal of Empirical Finance* 128 (2021), *available at:* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2716929 (last visited on Oct. 2, 2021).

[19] The United Kingdom Companies Act, 2006 (c.46), s. 172.

[20] *Supra* note 11 at 3.

[21] *Ibid.*

[22] "Boosting Shareholder Activism in Corporate India", *Live Mint* (June 1, 2018), *available at*: https://www.livemint.com/Opinion/pmfj3Ug7d0BYVd6YW4QXgP/Boosting-shareholder-activism-in-India.html (last visited on Oct. 3, 2021).

Indian corporate law is concerned given the fact that section 166 (2) of the Companies Act of 2013 exists:[23]

> A director of a company shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for the protection of environment.

A surface reading of this section gives the idea that Indian lawmakers wanted the directors to protect the interests of other stakeholders in the company. However, it is claimed that despite this, the Indian directors still show a trend of preferring the shareholders above all stakeholders.[24] To understand this better, the most vital questions in this debate are - should directors consider the interests of the shareholders only, or should they also consider other stakeholders' interests?[25] Is Indian Corporate Law on a road it did not take as far as the interests of other stakeholders are concerned?

These questions can be answered through a comparative study of English and Indian law as they highlight the two different approaches that can be used to answer the first question.

The English lawmakers took the Enlightened Shareholder Value (ESV) approach, while the Indian lawmakers took the Pluralist one. Even though they took two different roads, both of them reached the same destination, which is preferring shareholders over other stakeholders.[26]

It is an accepted fact that the shareholders are not mere investors. They bear the highest risk.[27] The creditors enjoy prime concern the minute insolvency is declared.[28] The equity shareholders come at the very bottom of this priority list[29]. In this scenario, they cannot opt for selling their shares and walking away as their shares become worthless, leaving them no option but to stay

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[23] *Supra* note 5, s. 166 (2).
[24] *Supra* note 11 at 3.
[25] AA Berle, "Corporate Powers as Powers in Trust" 44 *Harvard Law Review* 1049 (1931); E. Merrick Dodd, "Corporate Managers Trustees?" 45 *Harvard Law Review* 1145 (1932). This has been significant in the famous Berle-Dodd Debate with Berle arguing that companies must have responsibility only to shareholders and Dodd advocating that companies must be accountable to other stakeholders as well.
[26] *Supra* note 11 at 3.
[27] N. Balasubramanian, *Leading from the Top: Directors Who Make the Difference* (Random House India, 2013).
[28] The Insolvency and Bankruptcy Code, 2016, s. 53. Section 53 of this act creates a priority list also known as the waterfall mechanism, which attempts to organize the distribution of assets of an insolvent company with Secured Creditors on top and Unsecured Creditors coming a close second.
[29] *Supra* note 28 at 5.

and wait to see if anything is left for them to redeem. Since they bear the maximum risk, they should also be able to enjoy the maximum profit.[30]

This conception is the central notion of the ESV model, where the shareholder enjoys the position of topmost priority until and if at all the company reaches the stage of insolvency. The underlying assumption here is that the power to make managerial decisions is delegated by the shareholder to the Board of Directors.[31] However, this does not mean that the board has to disregard the interest of other stakeholders deliberately[32]. The board can consider their interests but only as long as such consideration ultimately enhances the value of the shareholders in the long run. The Pluralist Model, on the other hand, prescribes that looking after the interests of the stakeholders should be the aim of the Board as an end in itself and not just as means to enhance shareholder value.

The roots of both these models can be traced back to almost a century-old debate[33]. Starting back in the 1930s, two American lawyers, Adolf A. Berle and E. Merrick Dodd, got into a very public debate about the accountability of the management of a company. The former believed that the management's accountability lies solely with the shareholders, while the latter advocated that it lies with the shareholders and the society in which they operated.[34] As this remained largely unresolved, two contradicting opinions formed following this debate as the concept of 'Corporate Social Responsibility' *(hereinafter* 'CSR'*)* came about. First is the CSR Good Governance view that relates good corporate governance with social responsibility[35]. It entails that a firm that can be called socially responsible already engages in profit maximization behaviour.[36] This views shareholder value maximization and stakeholder's interests as congruent and not parallel concepts.

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[30] *Supra* note 27.

[31] Reinier Kraakman, John Armour, *et. al., The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford University Press, 2009).

[32] *Supra* note 6 at 2.

[33] *Supra* note 25 at 5.

[34] Allen Ferrell, Hao Liang, *et. al.*, "Socially Responsible Firms" *ECGI Working Paper Series in Finance 432/2014, 2014.*

[35] A. Edmans, "Does the Stock Market fully Value Intangibles? Employee Satisfaction and Equity Prices" 3 *Journal of Finance Economics* 621 (2011).

[36] *Ibid.*

The view, which contrasts the one above, is largely based on a strongly worded article by Milton Friedman in 1970, claiming that – "*businessmen who talk of social responsibility are nothing but unwitting puppets of intellectual traditions*."[37]

This unresolved trend has resulted in the two approaches mentioned above. India did take the route that Dodd was suggesting, but it is argued that it remains the approach only on paper as far as certain stakeholders are concerned.[38]

One may argue that this is misleading as rule 34 (2) (f) of the SEBI LODR Regulations obligates a company to submit a Business Responsibility and Sustainability Report.[39] This report articulates the approach of the company with respect to shareholders and all other stakeholders. These reports are within public access and may affect the price of shares in a sentimental market. This means that the market itself forces a company to adopt a pro-stakeholder approach.[40] Also, if a company contravenes the requirement of the report, they are held in violation of clause 55 of the listing agreement, which can lead to the de-listing of their shares from the stock market. But it is important at this juncture to point out that this report is a mandate for the top 1000 companies only.[41] All other companies fall outside the purview of this rule but within the purview of analysis of this paper.

The British Parliament incorporated the ESV Model into section 172 of the UK Companies Act of 2006.[42] They expressly rejected the Pluralist approach and drafted the current law as: "A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard to…"

The way that this section has been drafted, hints at a distinct hierarchy between shareholders and other stakeholders. The fact that the director 'must act to promote the success of the

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[37] Milton Friedman, "A Friedman Doctrine: The Social Responsibility of Business is to Increase its Profits" *New York Times* (Sept. 13, 1970), *available at*: https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html (last visited on Aug. 23, 2021).

[38] *Supra* note 11 at 3.

[39] Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations 2015, rule 34(2)(f) "*for the top [one thousand] listed entities based on market capitalization, business responsibility report describing the initiatives taken by them from an environmental, social and governance perspective…*"

[40] For example, if a company is not keeping up with standards of pollution control, they may be at risk of closure or penalty. Any shareholder would hesitate to invest in a company at such threat.

[41] *Ibid.*

[42] *Supra* note 19 at 4.

company and its shareholders while having 'regard' for the interests of other stakeholders, shows that the benefit of others must be a means for ultimately enhancing shareholder value.[43]

Section 166 (2), as mentioned above, is based on the pluralist model. One must note that this section did not look like this since its genesis in 2008.[44] This draft was based on the recommendation of the Irani Committee Report, which adopted the 'have regard to' approach similar to that of the English Law.[45] Paragraph 11.77 of the Twenty-First Standing Committee Report on Finance[46] read as follows: "Specific reference for duty of directors towards shareholders, employees, environment and community should be given."

This shows that the lawmakers had intended for the law to be a positive duty on the directors and not a mere enabling provision.[47] This has to be read in a combination of the specific context that India was going through at that time, along with its history of socialism. The Satyam Scam had recently shaken the Indian Corporate law to its core, and the effects of the incident were evident in the law-making process that came after.[48] The legislators were overly cautious when it came to the protection of all stakeholders while drafting the 2013 Act. The journey of Socialism that the country had seen, on the other hand, highlighted the unequivocal zeal of the lawmakers to protect the stakeholders.[49]

Despite this clear intention of protection, the gap between text and practice rendered the new law practically useless, and the problem majorly lies in the implementation of the law.[50]

Once again, the section states that[51]:

> A director of a company shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best

[43] *Supra* note 11 at 3.
[44] The Companies Bill 2008 (Bill 57 of 2008), s.147 (2). "*A Director of a company shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole and in the best interest of the company*."
[45] Jamshed J. Irani, "Report of the Expert Committee on Company Law" (Ministry of Corporate Affairs, 2005). "*Certain basic duties must be spelt out in the act itself – (c) have regard to the interest of employees etc*."
[46] Standing Committee on Finance, "21st Report on Companies Bill" (Ministry of Corporate Affairs, 2009).
[47] It was actually the recommendation of the Institute of Company Secretaries of India that made the lawmakers take the Pluralist.
[48] HT Correspondent, "Satyam Scam: India's Biggest Accounting Fraud", *Hindustan Times,* Apr. 9, 2015, *available at*: https://www.hindustantimes.com/business/satyam-scam-all-you-need-to-know-about-india-s-biggest-accounting-fraud/story-YTfHTZy9K6NvsW8PxIEEYL.html (last visited on Aug. 24, 2021) *"the fake accounts were shown not only to the shareholders but also other stakeholders who also suffered due to the scam."*
[49] *Supra* note 11 at 3.
[50] *Ibid.*
[51] *Supra* note 10 at 3.

interests of the company, its employees, the shareholders, the community and for the protection of environment.

First and foremost, the section conditionalizes the consideration of the interests of other stakeholders.[52] There can be two interpretations of this text. First, which promotes the Pluralist view, says that a director must act to promote the objects of the company 'and in the best interests of the company and other stakeholders; 'and being the operative word here. It recommends that both the interests of the company, its members and other stakeholders are important. On the flip side, another interpretation, which became a part of the concluding remarks of the Standing Committee Report,[53] was that the main duty of the directors is to promote the objects of the company during which the interests of shareholders and stakeholders must be taken into account, but the primary duty remains to promote the objects of the company.

Secondly, the vagueness of the language in the section renders it quite difficult to identify the party to whom the duty of care lies. It has been given to the public in general, which makes it difficult to implement practically.[54] Given these factors, it is highly unlikely that action can arise from this section. Moreover, this section should be read in light of the Business Judgement Rule as well.[55] This rule creates a presumption in favour of the directors. So, if a stakeholder files a class-action suit against the company and directors under section 245 of the new Companies Act, the burden of proof is initially on the plaintiff to prove that the Director was acting in self-interest and not in the interest of the company. This leaves the stakeholder to meet a stringent threshold before claiming personal harm, as the burden of proof will shift to the director only when such a threshold is met. Other than this, section 245 is also limited to members and depositors and leaves out other stakeholders of its purview. One can say that shareholders can then file a case on behalf of other stakeholders like creditors under section 241, but what happens when their interests are clashing? As a result, India has been facing a trend where shareholders are in a better place when compared to other stakeholders, enjoying a deliberate or unknowing preference by the management.

The ideal situation would have been where the directors place all stakeholders in the company on an equal platform. One can understand this through the concept of 'horizontal equity' in

52 *Supra* note 11 at 3.
53 *Supra* note 46 at 8.
54 *Supra* note 11 at 3.
55 *Cede* v. *Technicolour* (1993) 634 A.2d 345.

taxation. The concept of horizontal equity[56] becomes relevant in taxation as it justifies the fact that people with a similar level of income and assets should be taxed equally. Within the realm of corporate law, it may be useful in suggesting that people who contribute equally to the working of a company should also enjoy equal preference.

This is not to say that the environment and the community should be ignored. It is a mere suggestion to be able to equate creditors to shareholders, which can be quite constructive in an environment where companies prefer debt financing over equity financing. The next question that may arise is why the preferential attitude towards debt financing? Equity financing, as opposed to debt financing, takes away at least some part of control over the company from the majority stakeholder. In a country where family shareholding is the norm, giving up control can become an issue, the solution to which is debt financing.

III. A series of fortunate events: The rise in shareholder activism

The Indian corporate history is witness to the fact that shareholders with minority stakes in a company rarely take an interest in its management. They mostly remain at the periphery of the shareholder circle, and the moment they feel that the company is not acting according to their preferences, they sell their stake and exit.[57] Given the pattern of concentrated shareholding in India, the reason behind this behaviour has to be the futility of being active. When a minority shareholder knows that they have very few ways in which they can express themselves, be heard without prejudice and influence decision making, they lose all motivation to fight the management and choose to exit the company altogether.

The advent of the 2013 Companies Act and the amendments and additions to it have tried to create more room for the voice of a minority shareholder, which is mostly overlooked otherwise. Two major provisions which have empowered the minority shareholders are section 241 and section 245 of the Companies Act, 2013. Section 241 and section 245 provide for minority shareholders to approach the National Company Law Tribunal if they feel that the management has wronged them or the company as a whole. In day to day working of a company, it falls on the Board of Directors to initiate litigation if the company is facing a legal issue. Through section 241, shareholders have been empowered to initiate litigation on behalf of the company, in case it is the Board of Directors themselves who are evading the law or the

[56] The Meaning of Income Tax, *available at*: https://www.britannica.com/topic/income-tax/The-meaning-of-income#ref592184 (last visited on Aug. 24, 2021).
[57] *Supra* note 6 at 2.

corporate standards set by it.[58] Before this, such action existed in the Indian corporate jurisprudence in the form of common law, and it was the Companies Act of 2013 that condensed it into a statute.[59] Though there are specific qualifications listed in section 244, which one must fulfil before applying under section 241, there is a unique and unprecedented feature widening the statute's scope. Section 244 states that the Tribunal can, upon application, dismiss all or any of such qualifications, analyzing facts on a case to case basis.[60] But it is important to note that in suits initiated under section 241, the company itself is at the forefront of victims. Section 245, on the other hand, has made room for class action suits, where the minority shareholder can demand remedy for the loss caused to him personally.

At this juncture, it is important to point out that despite provisions like these, it is believed that Indian minority shareholders continue to remain dormant.[61] But before coming to a final conclusion on this point, one cannot ignore the following data, which is evidence of a change in this trend.

The year 2017 is considered as a turning point in the dormant behaviour of the Indian minority shareholders.[62] What was this series of fortunate events?

The Raymond Group

In March 2017, minority shareholder Vishal Patel, in a very valiant attempt, publicly accused the high officials of the company of misappropriating funds.[63] He published a letter, addressed to the accused officials, the board of directors and the auditors of the company in Business Standard, a very popular business daily, in which he claimed that Rs. 186 Crore from the funds of the company had been used to construct a property in Mumbai which was now the family home of the promoters.[64]

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[58] *Supra* note 15 at 3.
[59] *Supra* note 6 at 2. Exceptions were established in the case of *Foss* v. *Harbottle* which stipulated that in certain circumstances shareholders could file derivative action on behalf of the company.
[60] *Supra* note 5, s. 244 - "*Provided that the tribunal may, on application made to it in this behalf, waive all or any of the requirements specified in Clause (a) or clause (b) so as to enable the members to apply under Section 241*".
[61] *Supra* note 6 at 2.
[62] Kunal Mehta and Puneet Rathsharma, "Shareholder Activism in India: Has it been successful?", *Economic Times*, Apr. 11, 2018, *available at*: https://cfo.economictimes.indiatimes.com/news/shareholder-activism-in-india-has-it-been-successful/63715712 (last visited on Aug. 3, 2021).
[63] Soumya Gupta, "Raymond Minority Shareholder Alleges Misuse of Funds", *Live Mint*, Mar. 2, 2017, *available at*: https://www.livemint.com/Companies/nH0cHXSGjLn3oWBYzaCBfL/Raymond-minority-shareholder-alleges-misuse-of-funds.html (last visited on Aug. 3, 2021).
[64] *Ibid.*

In the letter[65], he also stated that, "the minority shareholders were and are kept in complete darkness about the commercial aspect of some projects which defeats the basic corporate governance norms required to be followed by the company." This was an unprecedented public stand taken by a minority shareholder, holding the promoters liable.

The activism in Raymond did not stop here. In June of the same year, a proposal to sell JK House to the Promoter's family at a substantial discount was put in front of the shareholders as a part of a tripartite agreement between the company and occupants of JK House.[66] This proposal was overwhelmingly rejected by a total of 97.67 per cent of votes against the sale.[67] This can be considered as evidence of the shareholders actively making decisions against the promoters.

Religare Enterprises Limited

In September of 2017, India Horizon Fund, a minority shareholder of the Religare Group, filed a suit against the board of the company on the grounds of oppression and mismanagement.[68] The petition stated "irrational and fraudulent management of funds of the company by the promoters and the board of directors and frequent and unexplained write-offs by the company and its subsidiaries" as a reason to file the suit.[69] They demanded a complete dissolution of the board and the management, along with a forensic audit of the company's financials.[70]

Though this suit ultimately could not succeed because India Horizon did not meet the 10 per cent threshold of section 244 of the companies Act,[71] it can surely be construed as an active attempt by a minority shareholder to hold the high officials liable.[72]

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[65] *Ibid.*
[66] "Raymond Shareholders Reject Sale of JK House to Promoter Singhania Family", *Live Mint*, Jun. 6, 2017, *available at*: https://www.livemint.com/Companies/mLoL7HdMf7B7cSDF8TWzXL/Raymond-shareholders-reject-sale-of-JK-House-to-promoter-Sin.html (last visited on Aug 3, 2021).
[67] *Ibid.*
[68] Deepali Gupta, "Religare Institutional Shareholders Move Court Seeking Ouster of Board", *The Economic Times*, Sept. 14, 2017, *available at*: https://economictimes.indiatimes.com/markets/stocks/news/religare-institutional-shareholders-move-court-seeking-ouster-of-board/articleshow/60504013.cms (last visited on Aug 3, 2021).
[69] *Supra* note 68 at 12.
[70] *Ibid.*
[71] *Supra* note 5, s. 244 (1) (a) "*in the case of a company having a share capital, not less than one hundred members of the company or not less than one-tenth of the total number of its members, whichever is less, or any member or members holding not less than one-tenth of the issued share capital of the company, subject to the condition that the applicant or applicants has or have paid all calls and other sums due on his or their shares*".
[72] "Religare Enterprises Shareholder Resolution Case: NCLT Refuses Relief", *Financial Express,* Sept. 16, 2017, *available at*: https://www.financialexpress.com/market/religare-enterprises-shareholder-resolution-case-nclt-refuses-relief/857400/ (last visited on Aug. 3, 2021).

Alembic Pharmaceuticals Limited

In July 2017, Unifi Capital Limited, a minority shareholder of one of the oldest pharmaceutical companies in India, proposed to nominate a small shareholder's director to the Board of Alembic.[73] This was the first time that section 151[74] of the new Companies Act was invoked in such a manner.[75] The proposal was rejected by claiming that it was an artificial and unnecessary intervention; most of its supporters came together in a matter of days and that the independent directors of the company were fully equipped to take care of the interests of all shareholders.

Tata Group

This is perhaps the most popular shareholder conflict that has come to light in recent years. The conflict is between the Tata Sons and its minority shareholder Shapoorji Pallonji Group who has a stake of almost 18 per cent in the business.[76] Cyrus Mistry, from the minority shareholder group, was appointed as chairman of Tata after Ratan Tata announced his retirement in the year 2012. He was ousted from his position in the year 2016 after a clash of opinion with the promoter and majority shareholder Ratan Tata.[77]

He objected to his illegal removal by filing an appeal in the NCLT in Mumbai, which dismissed his petition with derogatory comments on his attempt.[78] The matter went to NCLAT in December 2019, where Justice Mukhopadhaya observed that the behaviour of Tata Sons' Board of Directors was 'prejudicial' and 'oppressive' towards the minority shareholders. They ordered the reinstatement of Mistry as the chairman.[79]

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[73] Reeba Zachariah, "Board Seat: Alembic Junks Small Shareholder Plea", *Times of India*, Jul. 29, 2017, *available at*: https://timesofindia.indiatimes.com/business/india-business/board-seat-alembic-junks-small-shareholder-plea/articleshow/59815348.cms (last visited on Aug 3, 2021).
[74] *Supra* note 5, s. 151 "*A listed Company may have one director elected by such small shareholders in such manner and with such terms and conditions as may be prescribed*."
[75] *Ibid.*
[76] K. Satish Kumar, "Cyrus Mistry Saga: The Story of Minority Shareholder Protection", *CNBC TV18*, Dec. 20, 2019, *available at*: https://www.cnbctv18.com/legal/cyrus-mistry-saga-the-story-of-minority-shareholders-protection-4907031.htm (last visited on Aug. 3, 2021).
[77] *Supra* note 76 at 13.
[78] *Ibid.*
[79] *Ibid.*

Despite a judicial order of reinstatement in his favour, Mistry has refused to resume his chairmanship. However, one of his statements to the press becomes particularly important in this context.[80] He said:

> I will however, vigorously pursue all options to protect our rights as a minority shareholder, including that of resuming the thirty-year history of a seat at the Board of Tata Sons and the incorporation of the highest standards of corporate governance and transparency at Tata sons.

This was quite a powerful decision and statement in the face of concentrated shareholding patterns and promoter-driven corporations in India. Recently, the court has given the decision in favour of the Tata Group. However, it must be noted that a review petition has been filed in that regard which exemplifies the increasing zeal of the minority shareholders to stand against the majority and the management.[81]

Fortis Healthcare Limited

In February 2018, Fortis Healthcare was presented with a situation of a takeover by the Munjal and Burman family when co-founders Malvinder and Shivinder Singh stepped down from the Board of Directors.[82]

The shareholders were aware that there were higher bids on the table, other than the Munjal-Burman one, and despite that, the company accepted a lower bid.[83] In the act of resistance and revolt, the shareholders voted Brian Tempest, who was one of the allies of the Singh brothers, out of the Board of Directors. The vote of removal had an 88 per cent majority.[84]

Finally, in July 2018 it was a Malaysian Company, IHH Healthcare, won the takeover bid, buying a 31 per cent stake in Fortis.[85] They immediately allotted Rs 4000 Crores to the Indian Company and put Rs. 3400 Crores in Escrow, to initiate an Open offer, buying another 26 per

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[80] ET Bureau, "Not Pursuing Chairman's Post, But Will Protect Rights as a Minority Shareholder, says Mistry", *The Economic Times,* Jan. 5, 2020, *available at*: https://economictimes.indiatimes.com/news/company/corporate-trends/not-pursuing-chairmans-post-but-will-protect-rights-as-a-minority-shareholder-says-cyrus-mistry/articleshow/73108886.cms (last visited on Aug. 3, 2021).

[81] Deb Chatterjee, "Tata vs. Mistry: Shapoorji-Pallonji Group files review petition in SC" *Business Standard,* Apr. 26, 2021, *available at:* Tata vs Mistry: Shapoorji-Pallonji group files review petition in SC | Business Standard News (business-standard.com) (last visited on Aug. 3, 2021).

[82] *Supra* note 22 at 4.

[83] *Supra* note 22 at 4

[84] *Ibid.*

[85] Teena Thacker, "Fortis Investors Move SEBI over Delay in IHH Open Offer, Seek Interest", *Live Mint*, May 22, 2019, *available at*: https://www.livemint.com/companies/news/fortis-investors-move-sebi-over-delay-in-ihh-open-offer-seek-interest-1558546133265.html (last visited on Aug. 3, 2021).

cent stake in Fortis.[86] This Open offer suffered a massive delay which was objected upon by the minority shareholders. They moved to the Securities and Exchange Board of India to force IHH to pay them interest for the delay, also requesting directions for IHH to resume the open offer tendering process as soon as possible.[87]

It must be noted that the unfortunate fates that some of these attempts met ultimately cannot be ignored, but a clear change in the attitude of the passive Indian minority shareholder must be noted. Shareholder activism in India may have a long way to go, but it is inevitable in the current atmosphere.

IV. The sword of preferential allotment

When a faction faces a hostile attack by another, usually one of the first strategies to stop the attack is disarmament. Based on this idea, it is proposed that directors may first try to dilute the power that minority shareholders possess. Such dilution is possible through preferential allotment stipulated in section 62 (1) (c) of the Companies Act.[88]

Through this, the directors take a more offensive approach rather than a defensive one.[89] Preferential allotment refers to the offer of equity shares, fully convertible debentures/partly convertible debentures or other security convertible into equity to a select person or a group of persons.[90] This proposed attempt at dilution includes the issuance of equity shares to majority shareholders only, deeming them the select group of persons as per section 62. Unlike the Rights Issue, the preferential allotment has no mandate of issuing shares in proportion. The proviso to rule 13 (1) of Company (Share Capital and Debenture) Rules encapsulates the phrase 'one or more exiting members only.[91] This, by necessary implication, can refer to a situation where shares are issued to certain members within the company without maintaining any mandate of proportionality.

As a result, the voting rights and shareholding of the minority are diluted. Since the shareholding stands diluted, instituting actions against the directors or rejecting their decisions

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[86] *Ibid.*
[87] *Ibid.*
[88] *Supra* note 5, s. 62(1)(c) "*to any persons, if it is authorized by a special resolution, whether or not those persons include the persons referred to in clause (a) or clause (b), either for cash or for a consideration other than cash…*".
[89] *Supra* note 88 at 15.
[90] The Companies (Share Capital and Debentures) Rules, 2014, r. 13 (1) Explanation (ii).
[91] *Ibid. "Provided that in case of any preferential offer made by a company to one or more existing members only…".*

becomes more burdensome in this scenario. The minority shareholders are then tempted to leave the company instead of trying to overcome the burden and holding it accountable.

What is happening here is not just the weakening of the intervening minority but also the strengthening of the controlling majority. This forebodes that even in future, the minority shareholders might face further subjugation not only by the management but also by the majority shareholders. This strategy of the directors kills two birds with one stone. While on the one hand, the Directors can dilute the threat posed by the minority, on the other hand, they can pacify and appease the majority, securing a large number of votes in their favour. Among the three agency problems that are identified in corporate governance[92], this strategy amplifies the first two that are between the management and the shareholders and between the majority and the minority shareholders.

One may argue that to allow preferential allotment of shares, a special resolution by way of a general meeting[93] is required, and minority shareholders would never pass such a resolution, especially during a context of intervention. The fact that Indian jurisdiction has a concentrated shareholding pattern becomes relevant here. Due to the majority of the votes being in the hands of few individuals who will become the beneficiaries of preferential allotment, such a special resolution may be passed without hassle.

What solution does the minority have for this? The immediate answer is section 241 and section 245.[94] However, one must understand that shareholder activism may be on the rise, but it still hasn't overcome all the obstacles in its path.[95]

The first obstacle these minority shareholders have to surpass is the qualification criteria for applying under sections 241[96] and 245, which requires cooperation among a large number of minority shareholders.[97] This challenge is amplified due to dilution. The next obstacle will be

[92] *Supra* note 1 at 1. The first stems from the relationship between the management and the shareholders. The second engages with the dynamic of majority and minority shareholders and the third describes the complex relationship between the company's stakeholders at large.
[93] *Supra* note 88 at 15. "*For the purposes of Clause (c) of subsection (1) of section 62, if authorized by a special resolution passed in a general meeting shares may be issued by any company by way of a preferential offer…*"
[94] *Supra* note 15 and 16 at 3.
[95] *Supra* note 6 at 2.
[96] While a suspension of the requirements under section 241 is possible, it must be noted that it is a discretionary power in the hands of the court and may require a certain standard of proof from the minority shareholder.
[97] S. 241 requires 100 members of the company or not less than one-tenth of the total number of its members, whichever is less or they should be members holding not less than one-tenth of the issued share capital. S. 245 requires 5 percent of its members whichever is less or members holding at least 2 percent of the company's share capital.

the business judgement rule, which, as mentioned above, puts the initial burden of proof on the minority shareholders to prove a case against the director.[98] Only once the court is satisfied that there may be wrongdoing on the part of the directors, can the burden of proof shift to them.

Once such a shift happens, the case may come under the purview of the 'proper purpose test'. The directors may try to show an alternative purpose for which preferential allotment was undertaken to rebut the fact that the allotment served the purpose of dilution. This case will be slightly more complicated than the Indian precedent of *Dale Carrington*[99] as it may have both proper and improper purposes involved. Here the court has to rely on the decision in *Eclairs Case*[100], which never clarified a general standard. They will have the option of applying two tests established therein; the 'primary purpose test' or the 'but for' test. The former entails that out of multiple purposes, if the primary reason to undertake an action was improper, then that action fails to meet the mandate of proper purpose.[101] On the other hand, the 'but for' test claims that one must look at the reason without which any such action would not have been undertaken at all. If that reason is improper, then the action under question will meet the same fate.[102]

Given the absence of a clear precedent in Indian jurisdiction, the ambiguity in Eclairs and the subjective nature of the proper purpose test, the court may rule either way. However, the atmosphere of intervention by a minority before the allotment might be helpful in proving that the allotment was undertaken for dilution.

The possibility of failure in court and the negative publicity that comes with litigation, having the potential to plummet share prices, might force the directors to opt for an alternative approach to retaining power. This alternative is the of appeasing the shareholder body as a whole which may have negative consequences for the directors.

V. Creditors: Caught in the crossfire

The rise in shareholder activism is a much welcome event after a long history of shareholder passivity and undemocratic corporate decision making.[103] However, when one takes a more

[98] *Supra* note 55 at 9.
[99] *Dale and Carrington Pvt. Ltd* v. *P.K. Prathapan* (2005) 1 SCC 212.
[100] *Eclairs Group Ltd.* v. *JKX Oil and Gas* (2015) UKSC 71.
[101] *Ibid.*
[102] *Ibid.*
[103] *Supra* note 6 at 2.

holistic view of this phenomenon, it is quite obvious that not all members of the corporate society will look upon it as a positive occurrence.

The chain reaction

In all companies, efficiency necessitates the delegation of authority to manage the business to a specialized management team, that is, the Board of Directors.[104] However, this enjoyment of efficiency comes at a cost which is the risk of the agent acting for his benefit at the expense of their principal.[105] In legal language, this problem is referred to as 'agency problem' and when a shareholder delegates management to a director, they are always at the risk of being subjected to undemocratic decision making.[106]

In India, particularly in the atmosphere of concentrated shareholding, minority shareholders are at immense risk. Often, they find themselves in a position where they are left out of the decision-making process by the sheer futility of their voting rights.[107] This is the starting point of the chain reaction – undemocratic decision making.

As explained in the above sections, initially, this was followed by the minority shareholder taking the 'wall-street walk.'[108] This meant that usually, they would sell their shares in the secondary market and exit the company. But with a change in that trend along with the support of the new Companies Act and stricter corporate governance standards, now the shareholders have every incentive to intervene and hold the decision-makers accountable actively.

Assuming that this trend continues to rise, one can easily discern that soon enough, the directors and the majority shareholders will begin to perceive such intervention as an active threat to their monopoly over decision making. In a climate of rejected resolutions, pending litigations and demands for nominee directors, there is very little they won't do to pacify this threat and remain in power. For them, this kind of intervention is impossible to ignore and, at the same time, too intimidating to tolerate.

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[104] J.E. Parkinson, *Corporate Power and Responsibility: Issue in the Theory of Company Law* (Oxford University Press, 1995).
[105] *Ibid.*
[106] *Supra* note 1 at 1.
[107] This futility emanates from the first two agency problems *i.e.,* between the managers and shareholders and between the majority and minority shareholders. It is easy to ignore the voices of the minority in a concentrated shareholding.
[108] *Supra* note 6 at 2.

The next question that arises in this context is: What will then be their next step to nullify the threat? Among other strategies, one of them is appeasement.[109] This appeasement may take various forms like increasing leverage, share repurchases, more dividends etc.[110] The Board of Directors will be so focused on pacifying intervening shareholders that they may lose sight of other stakeholders who will suffer as a result. This is where the chain which started from undemocratic corporate decision-making ends.

Protection of creditors

Corporate creditors are the only non-shareholder stakeholders that every company law protects.[111] The reason behind this protection stems from a unique risk that corporate creditors face, which is the power of the shareholders to manipulate limited liability.[112] In India, the Insolvency and Bankruptcy Code, under section 53, creates a waterfall mechanism that places the creditors of the company at the top of the priority list when assets of the company are being used to pay off remaining debts once liquidation begins.[113]

Along with this, in the Companies Act itself, there are various measures stipulated for their protection. It is unnecessary to multiply examples of such sections for this paper, as none of them gives the creditors the power to stop what may happen to them once appeasement starts.

One may argue that section 245, in particular, empowers a creditor to sue a company for personal injury caused.[114] It is true that section 245 is broader than section 241 and allows more entities to sue and to be sued.[115] However, this remedy is also of a limited nature. First and foremost, only depositors can sue under section 245, and they would require a co-operation between at least 5 per cent of the company's total depositors or one hundred of them, whichever is less or co-operation among members to whom 5 per cent of the total debt is owed.[116] This in itself is a major qualification to achieve, and unlike in section 244, no waiver of such a mandate is possible under section 245.[117] Other than this, there needs to be wrongdoing on the part of

[109] *Supra* note 18 at 4.
[110] *Ibid.*
[111] *Supra* note 31 at 6.
[112] *Ibid.*
[113] *Supra* note 28 at 5.
[114] *Supra* note 16 at 3.
[115] This is true by virtue of the fact that under s. 241 only members of a company can file, while under s. 245 members and depositors can file for litigation. In s. 241 only the Directors can be sued on behalf of the company, while under s. 245 the company, the directors, and the auditors can be sued.
[116] *Available at*: https://www.mca.gov.in/Ministry/pdf/AmendmentRules1_08052019.pdf (last visited on Aug. 23, 2021).
[117] *Supra* note 71 at 13.

the directors or auditors for creditors to initiate litigation. For instance, signing risky deals at the insistence of shareholders cannot be grounds for litigation under section 245 even though it may be harmful to the interest of the creditors. They have no say in such matters until it is too late and the company has already reached insolvency.

Another strong argument that can be made against this stance involves nominee directors. A creditor may appoint his nominee to the Board of Directors to safeguard his interest. This is made possible by the new Companies Act under section 161(3)[118]. A nominee director should ensure that the Board of directors does not make any decisions contrary to the interest of the appointing creditor. This argument can be diluted by raising questions about the efficiency of such nominee directors.

The efficiency of nominee directors

a. Conflict of Interest

A nominee director is appointed to the board of directors by one specific stakeholder, usually a shareholder or a creditor. This may cast a shadow on their allegiance to the company as one may argue that by virtue of their appointment, they are bound to favour their nominator in a situation of conflicting interests. It also begs the question of who should they owe the utmost duty of care? A nominee director is thus, in a very precarious position. If they ignore the interests of the company, they breach their fiduciary duty, and if they ignore the interests of their nominator, they may lose their trust.

The English law laid the basis of the jurisprudence that Indian courts have followed in this regard. The case of *Percival* v. *Wright* [119], is where the English Court established the fiduciary duty of a director to his company. In *Percival*, some shareholders sold their shares to the directors of the company, willingly and at a fair market price. Later, the directors sold these shares at a higher price than at what they were bought and made a significant profit.

The shareholders sued the directors claiming that the negotiations of a deal that would have had them sell shares at a higher price were deliberately hidden and that the directors had made a profit at the cost of the shareholders, breaching the fiduciary duty owed to them. The court held in favour of the directors and clarified that a fiduciary duty is owed by the directors solely to the company and not to its shareholders. This case elucidates that the primary duty of a

[118] *Supra* note 5, s. 161 (3) *"Subject to the articles of a company, the Board may appoint any person as a director nominated by any institution in pursuance of the provisions of any law for the time being in force…".*
[119] *Percival* v. *Wright* (1902) 2 Ch 421.

director, any director executive or non-executive, is only to the company and not to an individual shareholder.

Although it may seem that this case is then sufficient to answer the question of ultimate allegiance but more than clarifying the position, this makes the water murkier.[120] Take note of a situation where a shareholder explicitly states their trust in a director to find a buyer for shares. Despite this, the director goes ahead and executes a transaction where ultimately the shareholder suffers. This then becomes a case of an implied agency, and the director may be held liable for breach of trust. The nominee director is this trusted director on the board of a company.

The position was clarified in the case of *Scottish Cooperative Wholesale Society* v. *Meyer*[121], where Lord Justice Denning acknowledged this precarious position of the nominee director. He expressly held that in such cases, the primary duty of the nominee director remained towards the company.[122]

He made a similar comment in the case of *Boulting* v. *ACTT*[123] , stating that,

> There is nothing wrong with a director being nominated by a particular shareholder to represent his interests so long as the director is left free to exercise his best judgment in the interest of the company which he serves. But if he is put upon terms that he is bound to act in the affairs of the company in accordance with the directions of his patron, it is beyond doubt unlawful.

The case of *Aes Opgc Holding (Mauritius)* v. *Orissa Power Generation*[124] upheld the same standard for Indian Nominee Directors in the year 2005. The court first described the problem briefly by stating that[125]: "Conflict of interest would arise when a person owes allegiance to two or more persons or entities and is then placed in a situation to take a decision which would affect the interest of all those to which or whom, he owes allegiance."

As far as the fiduciary duty of the Indian Nominee Director was concerned, the court stated that[126]:

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[120] *Coleman* v. *Meyers* (1977) 2 NZLR 225.
[121] *Scottish Cooperative Wholesale Society* v. *Meyer* (1959) AC 324.
[122] *Ibid.*
[123] *Boulting* v. *Association of Cinematograph, Television and Allied Technicians* (1963) 2 QB 606.
[124] *Aes Opgc Holding (Mauritius)* v. *Orissa Power Generation* (2005) 3 CompLJ 139 CLB.
[125] *Ibid.*
[126] *Ibid.*

> If a director of a company is placed in such a situation, either he should recuse himself or he is duty bound to take the decision which would be in the interest of the company, failing which he will be in breach of his fiduciary duties. It is more so in the case of nominee directors when there is a clash of interest between the company and their nominators.

This may affect the efficiency of a nominee director as he may fail the very purpose he was nominated for, which was looking after the interests of his nominator.

b. Internal Backlash and Risk of Agency Problems

Both Independent Directors and Nominee Directors are non-executive directors and are not charged with day-to-day affairs and management of the company. Rather, they have a supervisory role in maintaining the standards of corporate governance. It is important to point out that even independent directors, like the nominee directors, are outsiders to the internal ecosystem of a company because they are selected from a data bank maintained by the Ministry of Corporate Affairs and do not belong to the organisation itself. Due to a concentrated shareholding pattern, any outside interference in matters of running the company is bound to meet resentment, the consequence of which is that the companies often fail to acknowledge the value of the input these directors bring to the firm. The line of difference between the two stems from the fact that Independent Directors have very specific duties to carry out, which are protected by the statute itself.

This can be elucidated with the help of an example from the new Companies Act. Section 177(2) of the 2013 Act[127] mandates Independent Directors on the Auditing Committee, and this enables them access to the financials of the company.[128] There is no similar law granting Nominee Directors such integral access. When they are to check the financials of the company, they are under an obligation to conduct their own due diligence. Often such attempts may be met with hostility by other board members, as it may be perceived as unnecessary interference. This will ultimately affect the efficiency of a nominee director.

Contrary to this situation, at another end is a friendly bond between the nominee director and other directors. This, too, can be harmful to the nominator. Section 149 (11) of the Companies

[127] *Supra* note 5, s. 177 (2) *"the Audit Committee shall consist of a minimum of three directors with independent directors forming a majority".*
[128] *In Re: Ramel Industries Ltd.* v. *State of West Bengal* (2013) 122 SCL 258.

Act stipulates that an independent director cannot hold office for more than two consecutive terms and provides for a three-year cooling-off period before the director can offer his services to the same company again.[129] The reason behind such precaution is that the lawmakers did not want the Independent Directors to develop a personal interest in the company and build long term relationships with insiders who may foster this type of interest. If any such bond is allowed to perpetuate, it may result in agency problems between the shareholders and the management, with independent directors colluding with other directors to act to the detriment of shareholders. Also, this prevents a relationship of absolute trust between them, condoning which may lead to the detriment of corporate democracy. It is vital for an independent director to always remain sceptical of the actions of other directors, in the absence of which their efficiency is compromised.

The perils of a nominee director having personal relationships within the company can be seen in one of the most important cases in corporate law that is the *Needle Industries case*.[130] The facts of this case were such that a foreign company, having a subsidiary in India, appointed a representative on the board of the subsidiary. This representative, Mr. Sanders, developed an immense relationship of trust with the India Chairman of the subsidiary. Due to this, when Mr. Sanders duly received a notice of a Board meeting scheduled for April 6, 1977, where one of the agendas was 'policy Indianization', he decided not to attend the meeting. Following this, another meeting was held on May 2, 1977, to further dilute the stake of the holding company to less than 40 per cent to comply with FERA requirements.

Mr. Sanders received the notice of this meeting on the day it was scheduled and later in the court; he contested that this meeting was illegal on the grounds of insufficient notice.[131] The court rejected his claim and upheld the dilution.

As a result, due to his immense relationship of trust with the Chairman of the subsidiary company, Sanders did not attend the first board meeting and was rendered helpless when prejudice was caused to his nominator. These are the types of relationships that the law should aim to avoid, and the requirement for a cooling-off period becomes imminent.

c. *Confidentiality*

[129] *Supra* note 5, s. 149 (11).
[130] *Needle Industries (India) Ltd.* v. *Needle Industries Newey (India) Holding Ltd*. (1981) 3 SCC 333.
[131] *Ibid.*

In a sentiment-driven market, any and all information is price sensitive and can significantly affect the stock prices, if leaked. All directors are under an obligation to protect any such information, keeping it within the company. A nominee director in such a situation is put in a peculiar spot.

As discussed above, they have a dual allegiance, and this can lead to the illusion of having a right to pass on information to their nominator. The ability of a nominee director to maintain the privacy of the company's internal affairs is always a matter of concern for the other board members. In the case of *Bennetts v. Board of Fire Commissioners*[132], the court held that: "A board member must not allow himself to be compromised by looking to the interests of the group which appointed him rather than to interests for which the board exists."

In light of the above information, it is clear that even a nominee director is bound by the stringent fiduciary duty that he owes to his company. Whenever it is a choice between the interests of a nominator and the interests of the company as a whole, the nominee director is legally bound to choose the company. This puts a shadow on their efficiency and allegiance to the nominator, who, for this paper, is assumed to be a creditor of the company.

How can shareholder activism affect creditors?

While the creditors may be a thoroughly protected class in the corporate society, the effectiveness of this protection is mostly limited to the stage of insolvency or grave violations by the management.[133] Day to day decisions that may negatively affect a creditor is still completely out of their purview. One may argue that this is the general risk that a creditor consents to, when they invest in a business. While it is true that not having a say in day to day decision making is otherwise fair as the decisions made are for the benefit of the company as a whole, but in a situation where the directors are particularly employing sketchy tactics to remain in power by appeasing intervening shareholders, it becomes a matter of concern.

a. *Increasing the Financial Leverage of a Company*

[132] *Bennetts* v. *Board of Fire Commissioner of New South Wales* (1976) 87 WN (NSW) 307.
[133] *Supra* note 11 at 3.

Enhancing shareholder value has traditionally been the main objective of any company and its management.[134] Despite arguments and legislation to the contrary, the shareholders still enjoy a preferential attitude. In a climate of preference and active intervention, enhancing shareholder value further is a great tactic to pacify the threat of losing control.[135] The purpose behind any shareholder buying shares is mainly to earn a profit on those shares. Directors may believe that the reason shareholders are intervening is to ensure that all of them get as much profit as possible. So, if the company makes a very high profit in the short term, shareholders will have no reason to intervene in the decision-making process.

However, very high profits in the short term usually equate to riskier investments. Putting the shareholder at greater risk in this scenario by generating funds through equity will be counterproductive. The company will then take the route of debt financing and shift the risk of investment from shareholders to creditors. Increasing financial leverage means adding debt to the capital structure.[136] Usually, the output of highly leveraged firms[137] is in extremes. The profits might soar high, but at the same time, even the losses are greatly amplified.[138] The wealth distribution will be in a way that the shareholders enjoy the profits, but the creditors bear the losses.

The advocates of debt financing in such a scenario will put forth an argument that the creditors are secured through collateral, but what about Operational creditors? They have no say in such decisions. By the time they realize that the investments were to their detriment, the company will have reached the stage of insolvency where it may or may not be able to pay the operational creditors their due. As companies approach insolvency, shareholder incentives to siphon away value or gamble on risky projects grows rapidly.[139]

b. The decrease in Cash Holdings

[134] P. Saravanan "Leverage Can Help Executives Give Shareholders A Better Deal", *Financial Express*, Jul. 7, 2015, *available at*: https://www.financialexpress.com/industry/banking-finance/leverage-can-help-executives-give-shareholders-a-better-deal/96084/ (last visited on Aug. 24, 2021).
[135] *Supra* note 18 at 4.
[136] *Supra* note 136 at 26.
[137] High leveraged company in this case will mean a company having a significant amount of the capital structure as debt.
[138] *Supra* note 31 at 6.
[139] *Supra* note 31 at 6.

The major cash holding account of any company is its Free Reserve. 'Free Reserves' is defined in section 2 (43) of the Companies Act, 2013.[140]

The definition itself depicts its main purpose, which is the distribution of dividends to the existing shareholders. In the process of appeasement, it goes without saying that along with riskier investments, directors would want to distribute higher dividends to pacify the intervening shareholders further. The only reserve that can be used for the distribution of dividends is a company's free reserve.[141] This then implies that while undergoing the process of appeasement, the free reserves of a company are in a weakened state. Now, if the pacification does not end at higher dividends, further appeasement would also require funds.

Flowing from the claim above is the question of where is the funding required? The answer is the issuance of bonus shares and buybacks. While both strategies appear to be quite contrary to each other, they can prove to be useful in the appeasement mechanism.

Section 63 of the Companies Act, 2013 stipulates the rules for the issuance of bonus shares to existing shareholders. While the company would be reluctant to add new shareholders to their corporate structure, they would issue more shares to the existing ones to pacify them. Clause (1) of the section gives an exhaustive list of funds that can be used for the issuance of bonus shares[142]:

> *(1) A company may issue fully paid-up bonus shares to its members, in any manner*
>
> *whatsoever, out of—*
>
> *(i) its free reserves;*
> *(ii) the securities premium account; or*
> *(iii) the capital redemption reserve account*

The first two funding option for the issuance of bonus shares is Securities Premium Account and Free Reserves. As discussed above, out of them, free reserves are not in a healthy state and thus, diminish further.

One may argue that sub-section (2) of section 63 puts certain restrictions on such issuance. Two of such restrictions are relevant in this context. Clause (b) requires the approval of

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[140] *Supra* note 5, 2013, s. 2 (43).
[141] *Supra* note 5, s. 123 (1) "*Provided also that no dividend shall be declared or paid by a company from its reserves other than free reserves*."
[142] *Supra* note 5, s. 63 (1).

shareholders in a general meeting.[143] It can be said with certainty that shareholders who supposedly will get more control in the company and higher dividends are eager to approve a resolution of bonus shares. Clause (c) ensures that the company has not defaulted in payment of any debt securities, which can be seen as indirect protection of creditors.[144] However, one must note that the anxiety of the creditor in this situation is regarding future payments and not the ones made in the past. The company might be able to make payments on debt securities before it has made the issuance of bonus shares but may not be able to pay it after that.

If pacification by enhancing shareholder value does not work, the next logical step would be to take away the voting rights of intervening shareholders altogether. Repurchasing shares would be a very effective way to regain control of the company. But how will the company fund this share repurchase?

Section 68 of the Companies Act of 2013 is the stipulated law as far as buybacks are concerned.[145] There is a specified clause that restricts funding buybacks[146]:

> *Notwithstanding anything contained in this Act, but subject to the provisions of sub-section (2), a company may purchase its own shares or other specified securities*
> *(hereinafter referred to as buy-back) out of—*
> *(a) its free reserves;*
> *(b) the securities premium account; or*
> *(c) the proceeds of the issue of any shares or other specified securities…*

This suggests that a buyback of shares can be funded only by three means – (1) Free Reserves (2) Securities Premium Account (3) proceeds of the issue of other securities, which must be different from the ones being repurchased.[147] As noted above, Free Reserves are already draining, and now repurchase of shares puts a major shadow on their chance of survival. Even

[143] *Supra* note 5, s. 63 (2) (b) "*it has, on the recommendation of the Board, been authorized in the general meeting of the company*."
[144] The Companies Act, 2013, s. 63 ss. (2) (c) "*it has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it*."
[145] *Supra* note 5, s. 68 (1).
[146] *Ibid.*
[147] *Supra* note 147 at 28.

if the company decides to use the proceeds of the issue of other securities or the Securities Premium Account, the cash holding of the company is still decreasing significantly.

The loss of assets through riskier investments and cash-holdings through bonus shares and buybacks becomes a major cause of concern for the creditors. The ability of the company to pay the creditors back without default, both before and after insolvency, decreases significantly.[148] In a normal course of business, when the risk of default increases, the firm increases its holding of liquid assets in response.[149] But since this whole mechanism is aimed at appeasing shareholders, with the increase in the probability of a defaulting payment, the firms continue to lose money. An added consequence is the fact that the Credit Rating of such a firm falls rapidly. Credit Rating measures the ability of the company to pay back debts. Once this starts falling, potential creditors of the company are in a tough spot, creating negative consequences for the credit market as a whole.

VI. Conclusion and Suggestions

This paper began with the idea that shareholders enjoy an unfair preference over other stakeholders, even though, on paper, the law is quite contrary. This was followed by the data, which claims that the previously passive shareholders have now started harbouring sentiments of activism. Due to this, the Board of Directors might fear losing control over decision making and adopt certain actions which may have a larger consequence for the market as a whole.

The two arrows they have in their quiver are disarmament and appeasement. Both can harm the corporate governance regime in the country as disarmament may be harmful to minority shareholders, while appeasement is detrimental to creditors.

Disarming is the issuance of shares to a few select individuals, attempting to dilute the shareholding of the minority and appeasing the majority. While this may be one of the ways to obliterate the threat of activism, they may also try appeasement of the shareholder body as a whole by increasing leverage, issuing more dividends, making bonus issues and when all fails, buying back security to regain control. These appeasement actions might make the creditors

[148] *Supra* note 18 at 4.

[149] Viral Acharya, Sergei A. Davydenko, *et.al.,* "Cash Holdings and Credit Risk" *Rock Centre for Corporate Governance at Stanford University Working Paper Number 123*, 2012.

lose trust in their investment. This has the potential to plummet future investments as well, creating negative consequences for the credit market as a whole.

This paper aims to raise certain new questions. In summary, they are as follows:

1. Can creditors be placed on an equal pedestal as the shareholders by virtue of their contribution to the company and in light of the concept of horizontal equity?
2. Can the tool of preferential allotment pose a challenge to the rise in shareholder activism?
3. What may be the consequence of shareholder activism for other stakeholders of the company? Will it always be positive?
4. How can the efficiency of nominee directors be improved, specifically in light of the internal backlash they may face or the agency problems that might arise?

Since this paper aims for lawmakers and scholars to deliberate upon a potential problem, the following suggestions and pointers may prove to be useful as initiating points to find a solution to this potential problem that India might face.

Similar to the concept of a credit rating agency, an agency to rate the stakeholder engagement and relationship maintained by a company may prove to be useful. A public report of such an agency would automatically ensure market control over such engagement. A better relationship with minority shareholders may potentially add to the value of the company by painting a stakeholder friendly picture.

The paper points out that the law regarding preferential allotments allow the majority shareholders to issue shares in their name, effectively diluting the powers of the minority. Additional disclosure requirements and proportional share distribution to democratically decided shareholders may help in shielding the minority from the sword of preferential allotment.

These questions and suggestions, if deliberated upon by scholars and legislators, may prevent the anticipated collapse of both corporate democracy and the credit market.