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ENTRENCHMENT PROVISION: A BOON FOR MINORITY SHAREHOLDERS

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ABSTRACT

In an attempt to boost up the growth of the Corporate sector,Government has brought new Companies Act, 2013 superseding old Companies Act, 1956.New Provisions have been inserted in the Act and one of which is"Entrenchment provision" in Articles of Association which provides for article being altered if restrictive conditions are met or complied.The objective of this study is to explore the term Entrenchment with reference to its objectives & effectiveness. As there is old saying, 'good law but bad implementation'meaning laws are good but there is always a mismatch between good laws and their implementation. As Entrenchment provision provides strong footing for minority shareholders but its implementation may become contrary to the aim of protecting the rights of the minority shareholders. In India, there is concentrated ownership with promoters and findings of earlier research underline them as dominant shareholders who exercise control at the expense of minority shareholders.The study reveals how entrenchment provision can expropriatethe rights of minority shareholders.

Key words: Entrenchment, Majority and minority, Concentrated ownership

I.INTRODUCTION

The UK was one of the first nations to establish rules for the operation of the companies. From the United Kingdom, we devised and evolved the Indian company law. The Companies Act, 1956 has been reviewed and it brings in law new amendments and new terminology. Specifically, changes are aligned with an aim to improve and fulfil the changes of economic restructure and business environment. The new Companies Act, 2013 has replaced nearly a six decade old Companies Act, 1956 and the government insisted that new law should address the concerns raised by various stakeholders.The reason for amending such a law is to bring effective and escalatingprovisions so that the constructive objective is achieved. Moreover, they fill the various lacunas present in the law. The Companies Act, 2013 comes in to existence on 29th August 2013 after receiving the President's assent.

Thereare significant changes in the Companies Act, 2013 which include provisions relating to governance, compliance and enforcement, disclosure norms, auditors, mergers and acquisition and new concepts of one-person company, small companies, dormant companies, class action suits, corporate social responsibility has been included. Each change brings its own importance in the law.In the companies Act, 2013 there is one more

insertion of the provision which is called entrenchment provision. Entrenchment provision is provided in the law inSection 5(3), 5(4) and 5(5) of the Companies Act, 2013 that is included in Articles of Association. An entrenchment provision makes the current level of provisions more difficult to follow for the coming period. These provisionshave been added in the law to give strength to the minority party so as to not allow voluntary decisions in the company until the consent of such mediocre party is available if given in the entrenchment provision in Article of association. It is true that company is formed to create wealth for the persons who create it and who invest their funds. Promoters are the person who create the company and who is likely to invest major part of their capital in the formation and there are some shareholders who invest their funds to create wealth in the near future. There are certain situations in which majority shareholders will try to impose their decisions on others and affecting the rights to have a say on matters which are relevant to the minority shareholders. These issues raise the problems of agency which affects the corporate governance of the company which is needed for the reputation and performance of the company.Thus,considering such problems, the Companies Act, 2013 incorporated Entrenchment provision to give a helping hand to minority from the peril of shareholder majoritarian. In this study, we encapsulated the implications of entrenchment provision and its effectiveness in the law.

II. REVIEW OF LITERATURE

Review of the literature is important because it covers all the previous researches and sets the platform of the current research. **Kabra,Suyog (2015)** in his article entitled as 'Entrenchment clause in Article of Association', explains the procedure of incorporation of entrenchment provision in Articles after incorporation and concluded that it is more positive for joint venture and private equity investors and it provides strong footing for minority interest. K**hunteta,Shubham(2016)**in his article entitled as'Decoding the Entrenchment clause as provided by the CompaniesAct, 2013'made an attempt to explain the concept and instances of entrenchment provision and brief a note on penalty amount which is applicable according to Section 450 of the Act and according to Section 451 for the subsequent breach of provision. Kumar, Vijay (2015) in his article **'Entrenchment Clause-Question mark on validity'** tries to explainwhat is Entrenchment andwhether the Companies Act, 1956 provided for entrenchment clause or is it an introduction made in the Companies Act, 2013.**Bebchuk, L.,Cohen, A. andFerrell, A. (2008)**in their article**'What Matters in Corporate Governance?'** investigated and explained the relative importance of 24 provisions followed by Investor Responsibility Research Centre and explained Entrenchment index by considering only six provisions which are staggered boards, limits to shareholder by-laws amendments, poison pills, golden parachutes, supermajority requirements for mergers and charter amendments. **CS Pingle,Gaurav (2015)** in his article entitled **"Concept of Entrenchment in Companies Act"**explains what is entrenchment in Companies Act,1956 and in Companies Act, 2013.In this study, there is an explanation of the entrenchment on the basis of its disadvantages also and how entrenchment leads to expropriation of minority shareholders and impacts the corporate governance of a company. The study is an attempt to exploratory research which is based on the information collected from various secondary sources such as Act, Rules, Guidelines, Research papers available online, various websites, newspaper articles.

III. OBJECTIVE OF THE STUDY

[1] To know what is Entrenchment in Indian and U.K. Context.

[2] To find reason of Introduction and effectiveness of Entrenchment provisions

[3] To analyse the entrenchment provision on the expropriation of minority shareholders.

[4] To understand the impact of entrenchment on corporate governance.

IV. ENTRENCHMENT PROVISION IN INDIAN CONTEXT

The term entrenchment has not been defined in the Companies Act, 2013. This provision comes in to force on 1st April, 2014. The dictionary meaning is as follows:(1) to apply additional legal safeguards;(2) to place (someone or something) in a very strong position that cannot easily be changed; Therefore, 'entrenchment' means an addition of provision which makes certain amendments either more difficult or cumbersome by way of procedure, checks and safeguards.

V. ENTRENCHMENT PROVISION IN THE COMPANIES ACT, 1956

The Companies Act, 1956 did not have a specific provision on entrenchment. The additional legal safeguards and checks and controls were recognised through judicial judgements. In one of the landmark judgments in V B Rangaraj v. V B Gopala Krishnan, the Supreme Court laid down the law that private agreement between shareholders would not bind the company unless the Articles of association of the company provide for such restrictions. Therefore, it was necessary to include the shareholder's agreement in AOA for ensuring the enforceability of shareholder's agreement. If for some reason, it was notimbibed in the AOA, then such agreement was not binding on company/its shareholders.

VI. ENTRENCHMENT PROVISION IN THE COMPANIES ACT, 2013

Sub-sections (3) to (5) of section 5 contain provisions related to entrenchment and the same aresummarised as:

[1] AOA may contain provisions for entrenchment for giving an effect that the specified provisions of AOA may be altered only if conditions or procedures as are more restrictive, are met or complied with.

[2] Entrenchment provisions shall only be made either at the time of incorporation of a company, or at the time of amending AOA.

[3] Amendment of the AOA of private company (relating to 'entrenchment') can be effected only if the same is agreed to by all the members of the company.

[4] Amendment of the AOA of public company (relating to 'entrenchment'), can be effected only upon passing of a special resolution.

[5] Where the AOA contain provisions for 'entrenchment' (whether made on formation or by AOA amendment), the company is under an obligation to give notice to the Registrar of Companies (ROC).

[6] Entrenchment clauses are not enforceable if they are against the companies Act, 2013 or Memorandum of Association.

VII. ENTRENCHMENT PROVISION OF U.K. COMPANIES ACT, 2006

As per Section 22 of Companies Act, 2006 of U.K contains the Entrenched provision of the articles that are as follows:

(1) A company's articles may contain provision ("provision for entrenchment") to the effect that specified provisions of the articles may be amended or repealed only if conditions are met, or procedures are complied with, that are more restrictive than those applicable in the case of a special resolution.

(2) Provision for entrenchment may only be made—

(a) in the company's articles on formation, or

(b) by an amendment of the company's articles agreed to by all the members of the company.

(3) Provision for entrenchment does not prevent amendment of the company's articles—

(a) by agreement of all the members of the company, or

(b) by order of a court or other authority having power to alter the company's articles.

(4) Nothing in this section affects any power of a court or other authority to alter a company's articles.

VIII. REASON FOR INTRODUCTION OF ENTRENCHMENT PROVISION

With the entrenchment provision, criteria is to prevent subsequent amendments, once it is adopted which makes some portion of law irrevocable except in cases of assertion of rights. Entrenchment provision are included in AoA at the discretion of the company but once it is adopted they have to be complied. In some cases, it is justified as it protects the rights of minority from the majority of concentrated ownership. The Entrenchment clause makes certain amendments either more difficult or impossible. Entrenchment can be used as a mechanism of corporate governance as it protects the interest of the minority shareholder. Generally, articles are by laws or rules which govern the management in order to achieve the objectives which is defined in the memorandum. It is the article with in which the company has to perform hence enormous caution must be taken. If it is prescribed in the entrenchment clauses of article of association that the certain decision needed the consent of the minority, the decision cannot be approved, without the consent of the minority. This means that it provides a special privilege to minority consent. Majority always enforce their decision on company but with entrenchment provision prevents the creation of legal autocracy. Now minority members can force majority to appraiseof their views in decision making.

According to Rule 10 of the Companies (incorporation) Rules 2014 where the articles contain the provisions for entrenchment, the company shall give notice to the Registrar of such provisions in Form INC – 2 or Form INC – 7, as the case may be, along with the fee as provided in the Companies (Registration offices and fees) Rules, 2014 at the time of incorporation of the company. These forms are related to incorporation of One Person Company and Company other than One Person Company, respectively.Form INC – 2 asks whether Articles are entrenched or not and Number of Articles to which provision of entrenchment shall be applicable. The form also asks for details of entrenched articles; Article number and contents. Entrenched Articles are also required to be attached with the Form INC – 2. There is similar provision in Form INC – 7.Where the articles of an existing company altered to include entrenchment, the notice of entrenchment shall be filed in Form MGT – 14 within

thirty days from the date of entrenchment of the articles, as the case may be, along with the fee as provided in the Companies (Registration offices and fees) Rules, 2014.Form MGT – 14 is related to filing of resolutions and agreements to the Registrar pursuant to Section 94(1) and 117(1) of the Companies Act, 2013.

IX. EFFECTIVENESS OF ENTRENCHMENT PROVISION

Before coming in to the effect of the entrenchment provision the procedure of appointment of board of directorswere through a simple majority vote thereby dispossessing the right of the minority shareholders to place even a single director on the Board. Now with the effect of entrenchment provision in Article of association thatinserts a clause which deprive the majority from exercising such power. Entrenchment provision stow article of association in a heftyposition. Let's take an example AB ventures is a private equity fund subscribes 15% of equity fund in PQR limited. PQR can do certain transactions without taking the consent of AB which are associated with their affirmative rights which are given to any private equity investor. If POR ltd approach any Bank for loan, they go through with the article of association and ask consent of the AB ventures. Now in this case the remaining 85% holders by passing a resolution removes the affirmative rights from the article than AB ventures do not have control over PQR ltd. If at the time of investment by AB venture if they ask PQR ltd to include entrenchment clause in the article that can be allowed that any affirmative rights of PQR will only be done with the consent of AB ventures which means somewhere it strengthens the position of minority.

X. EFFECT OF ENTRENCHMENT PROVISION ON EXPROPRIATION OF MINORITY SHAREHOLDERS RIGHTS

Usually Shareholders denotes a person who holds some shares in a company. Mostly Companies has two types of shareholders one is majority shareholders who owns and hold more than half of the company's shares and minority shareholders who have below 50% ownership incompany's shares and who does not have exert control over the company. Majority shareholders are mostly the promoters of the company and it is contemplating that they have controlling voting power in the company.For the persuasiveworking of the company it is egalitarianismthat there is a balance between the rights of the majority and minority shareholders. Companies Act, 2013 has sought to provide protection of minority shareholders and act as a game changer in the scuffle between the majority and minority shareholders but still there were some glaring lacunas in the existing provisions of the law.As we discussed earlier about the entrenchment provision which strengthen the position of minority shareholders but one should also consider the negative repercussions of the entrenchment provision.

Companies having concentrated ownership structureweakens the governance mechanisms and increase the probability of minority shareholder's expropriation. High ownership concentration in the hands of few has always been create a problem in emerging economies.Concentrated ownership has been an important feature of the Indian private sector since decades. Ownership structure may arise the problem of Principal-Principal conflict refer to the conflict between two classes of principals i.e. controlling shareholders and minority shareholders which is distinct from principal-agent conflicts. In the era of emerging economies ownership and control are concentrated in the hands of controlling shareholders as such they are able to use their voting power

to decide who sits on the board of directors and who is appointed in the management of the company. As discussed earlier, the effectiveness of the entrenchment provision, which is to strengthen the position of minority shareholders but this provision remains ineffective if applied by the controlling shareholders for their own benefit. Article of association is a document which prescribes the rules and by-laws for the management of the company including information about the general meetings, board of directors, proceedings about the courts and details on voting rights.

Controlling shareholders can amend the Article of association and insert the clause which are beneficial to only controlling shareholders and apply the tactics in their favour so that they are able to redirect or consume corporate resources in a way that provide benefits to only controlling shareholders and not to others i.e, minority shareholders. With this they will extract private benefits of control by forcing decisions and which leads to expropriation of minority shareholders. Company having concentrated ownership structure, the promoters were the controlling shareholders of the company and they have number of majority votes associated with their shareholding in the company and if they altered their article by laying down the conditions for which majority of votes is required than its becomes easier for them to pass every resolution even without giving significance to the consent of the minority shareholders. In a similar situation if a company lays down the condition in its article that every resolution require the assent of its nominee director only than the power remains only in the hands of the nominee director and the votes of the minority shareholders does not count for this.

All the above activities exercised by controlling shareholders leads to the expropriation of the rights of the minority shareholders with the objective to use the company resources for private benefits, for related party transactions, to retain control and for tunnelling activities. The safeguards provided by the entrenchment raises a number of legal issues about their validity like can a Public company grant special privileges to its promoter in terms of voting power by amendment of article of association with regards to entrenchment provision? By having a special voting power by majority against wisdom of minority provided by entrenchment clause is valid? Thus,entrenchment provision if not applied in the strict sense of law than leads to expropriation of minority shareholder's rights.

In the case of Tata Sons limited which is the holding company of the Tata group which holds shareholdings in the Tata group companies. Tata Sons is held by philanthropic trusts endowed by Tata family members which holds 66% of the equity capital of Tata Sons. The biggest of two are Sir Dorabji Tata Trust and Sir Ratan Tata Trust. In 2012 the Cyrus Mistry whose father has presently held 18.5% in Tata Sons was appointed as chairman of the Tata Sons. On 9th April the Tata Sons moved seven resolutions to amend its articles by passing resolutions in extraordinary general meeting which curtails the power of the chairman.

By amending the Article 121A the lists of items have been provided which needs the board approval which includes:

- A five year strategic plan which lays down the strategic path of Tata Sons, along with its business and investments. Any alterations to any this strategic plan required board approval.
- An annual business plan which would be granular in nature and disclose debt, cashflows, investments and return ratios. Again, any changes to this needed board approval.
- The borrowing programme which covered raising new debt or refinancing of existing debt.

- Any proposed investment by the company in stocks, shares, immovable property or bonds exceeding Rs 100 crore, if not already approved in the annual plan.
- Any change in the capital structure of the company.
- Any sale, pledge or encumbrance of any rights by the company or over its shareholding in any Tata company.
- Any matter affecting the shareholding of the Tata Trusts or rights conferred by the AoA of the Tata companies.
- Nomination of a representative from Tata Sons to exercise voting rights at the shareholder meetings of Tata companies, particularly if the vote is on matters concerning capital raising, incurring of debt, divesting or acquisition of any undertaking.

With introduction of Article 121B any director of Tata Sons could ensure a discussion, provided the board was given 15days prior notice and article said it is mandatory for the board to take up such matter for consideration and vote at the next board meeting held.One of the amendments was a resolution that allowed the Dorabji Tata Trust and Sir Ratan Tata Trust 'acting jointly' to nominate one-third of the prevailing number of directors on the Board. The AoA also allowed the two trust to remove or replace any of its nominee directors. The resolutions specified that both Trusts will appoint the directors together. In case of dispute the view of majority of the trustees will prevail. In August 2016, the Trust nominated Amit Chandra to the board of the Tata Sons, while Vijay Singh and Nitin Nohria was on the board since 2014.

An amendment to Section 105 of AoA conferred power on the chairman or managing director '**only by way of prior board resolutions'.** Prior to the amendment, the powers could be conferred on chairman without board resolutions with in defined boundaries.Another important amendment of article 121 which deals with the manner in which resolution is passed by the Board. It introduces a clause that '**affirmative vote of the majority of the directors appointed pursuant to Article 104B**' would be needed for any resolution to go through. This step effectively shifted control in favour of the Tata Trust. Article 104B dealt with the appointment of nominee directors of Tata Trust on the Board of Tata Sons. This means that majority of nominee had to approve every board resolutions.In the above case the amendment in the Article of association requiring assent of only a majority of Trust nominated members instead of all members. This means that resolutions require only nominee's approval and no othermember's approval. Article were amended to conferred power on chairman only by way of board resolution prior to which it is conferred without board resolution which indicates the adherences to board consent only.

Another case of the Infosys company where Article of association is amended which brings in provision of the Buy-back of the share and revision in the compensation of Chief operating officer and whole time director. On this N R Narayan Murthy said "**given the current poor governance standards at Infosys, the targets for variable pay may not be adhered to, if the board wants to favour a top management person." (Economic Times)**

Amendments of articles must be in the genuine interest of the company and cannot be designed for the need of few shareholders only. It does not mean that it must be agreed by all the shareholders, but it cannot be used by

majority to discriminate between majority and minority. You cannot amend the articles to give preference only to a specific group of shareholders

Since no specific penalty or punishment is prescribed for infringement of section 5, general penalty suggested under Section 450 of the Act is applicable. Accordingly, the company, as well as its officer, who is in default or such other person shall be punishable with a fine up to Rs.10, 000/-. For continuing offence, they are punishable with a further fine up to Rs.1, 000/- for every day after the first during which breach continues.It may be noted that for a second or a subsequent breach of the provision of this section, if made within a period of three years, then the company as well as its officer who is in default shall be punishable under Section 451 with twice the amount of fine in addition to any imprisonment provided for the offence.

XI. IMPACT ON CORPORATE GOVERNANCE

Corporate Governance is the system by which companiesare directed and controlled. Main objective of the corporate governance mechanisms is to safeguard the expropriation of minority shareholders, equal treatment of all the shareholders, transparency in board process and independence of board and accountability towards shareholders. If there is expropriation of the rights of the minority shareholder's than it affects the corporate governance of a company. Now a days' corporate governance receives attention because of the importance for the healthy growth of the companies and after having a plethora of corporate scams in recent times. Effective Corporate governance is a key factor in determining the integrity and efficiency of a company and presupposes the protection of minority shareholders.Corporate governance ensures the equitable treatment of all the shareholders and protects the rights of the shareholders'. It ensures the shareholders participation in corporate decision such as nomination and election of board members and approve and participate in decisions making of the company. Corporate Governance ideally protect the interest of all the investors from the manager and majority shareholders.

According to the Article of association some powers may be exercised by the directors and certain other power may reserve for the shareholders for the General meeting. Generally, decisions are taken by considering the majority votes. If by altering the Article of association there is inclusion of clause that deprives the right of minority shareholder from voting may affect the corporate governance of that company. If there is any conflict between majority and minority shareholders where dominant shareholders monopolize the company's funds to serve their private benefits by amending the article of association,this give rises to the corporate governance abuses in India. Thus, policy makers crafted law in the efficient manner so that no one can take the advantage of that gaping loopholes. The Companies Act, 2013 introduces some new provision in the law for the protection of the minority shareholders but they remain ineffective if they are not implemented in a bona fide manner.The Entrenchment Clause, however, needs to be in accordance with the Memorandum of Association of the Company and the Companies Act, 2013. Any entrenchment Clause which is against the provision of Companies Act, 2013 or Memorandum of Association is void and unenforceable. The additional safeguard provided by the Entrenchment Clause will raise number of legal issues about their validity. Whether the validity of Entrenchment Clause can be tested on the grounds of reasonableness is a moot question. For example-

- Whether any Clause in the Articles of Association which grants special rights in terms of voting or veto power to a minority group against the wisdom of majority of shareholders is valid or is such clause against the very basis of corporate democracy of one share one vote and that all shares rank paripassu

Can a public listed Company by virtue of entrenchment Clause grant special privilege to its Promoters in terms of voting powers on Amendment to Articles of Association?

Entrenchment Clause as defined supra requires registration with Registrar of Companies. Any clause in Articles which grants veto right to Banks or Venture Capital Investor on issues/proposal of Company like raising of capital, sale of undertaking of the Company etc. are not entrenchment Clauses and are mere clauses regulating the business decision making of the Company.

Therefore, at last, it can be said that the government by incorporating the entrenchment provisions in the Companies Act, 2013 gave the breath to live to the minority and vulnerable people and power to negotiate fearlessly with the majority in their interest, although these provisions are discretionary on the part of the company. However, the minority shareholders due to this incorporation into the Companies Act of this provision can insist and bring on the ground the majority to concede with the minority and truly stand to the utmost duty, i.e., "Fiduciary duty" of the majority to minority.

XII.CONCLUSION

It is well established fact that company's AoA is an important document, though not written in stone, need can arise for any alteration or addition of provisions protecting the respective rights and interest of stakeholders in the company.Government of Indiaassimilated the entrenchment provision in Companies Act, 2013 in Article of Association making certain amendments restricted to compliance of certain conditions. But by virtue of amendments in article the law cannot allow to grant special privileges to the promoters in terms of voting power. But with the entrenchment provision in the article certain conditions can be lay down which provides exercise of power by majority shareholders only. In this case it is concluded that with entrenchment provision the amendments of articles can be made with an objective so that it allows the majority to expropriate the rights of the minority shareholders and which adversely impact the corporate governance of the company. It is recommended that these provisionsneeds to be effectively implemented by both minority and majority shareholder in the interest of the company and for all the stakeholders.

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