

Jumping buyback hurdles in India

As the Indian economy continues to slump, companies are looking to carry out share buybacks to preserve the value of their stock.

On February 10 2009, GSS America Infotech's board approved a buyback. And the week before, Indiabull, Kilburn and ICI India announced they were also buying back stock from shareholders. They are not alone - 23 companies are in the process of buying back a portion of shares from their investors, including Reliance Infrastructure, Bosch and DLF.

The reasons for such a strategy are clear: It reflects management's confidence and illustrates to investors that the company is solvent.

But the process is not always smooth under Indian law.

Firstly, ambiguity surrounds the enforceability of the exit right in buying back a put option. Depending on how the Securities Contracts Regulation Act (SCRA) is interpreted, a put option could be considered a legal spot delivery contract or an illegal forward contract. If seen as the latter, the buyback's success would be unlikely.

The SCRA does not address what type of contract a put option is. A recent Bombay High court judgment ruled that a put option is a forward contract, which counters an earlier high court decision that it is a spot delivery contract. The opposing perspectives accentuate the contract status vagaries of a put option and lawyers are calling for reform.

"Amendments to the SCRA or a clarifying circular by the Securities and Exchange Board of India (Sebi) to this effect would be useful, especially in the prevailing market conditions," says Amrita Singh, the head of fund investments at Nishith Desai Associates.

Mr. H. Jayesh, founder partner of Juris Corp feels similarly, "The SCRA does need amendments, but not so much because it is out-of-date but rather because of previous piecemeal amendments that have resulted in a hodge podge."

"Given enforceability concerns, one has to build in risk mitigants and fall backs, and evaluate the choice of governing law, dispute resolution forum and venue accordingly," he adds.

A buyback requires three-quarters approval of the majority to consent by way of a special resolution. But shareholders who hold over 25% of a company's share capital

can veto the special resolution and block the buyback.

Singh thinks that transaction documents should stipulate that majority shareholders must vote and ensure that at least 75% of them vote in favour of a resolution for the buyback of shares.

Juris Corp partner Vandana Sekhri highlights another problem: determining a fair

shares to the management or promoter of the company.

A company is also limited to funding its buyback from only three specific resources: free reserves, a fresh issue of shares of a different class or its securities premium account. If its funds are settled in other resources, the company may not be able to complete the buyback.



Easier than buying back shares

price for the securities that will be sold after a buyback.

The transfer of shares of an Indian company from a non-resident to a resident must be at a price which is lower than the valuation carried out by the independent auditors and statutory auditors. This pricing mechanism very often becomes a hindrance in the investor being able to recover the return on its investments.

The law states that the buyback of shares should be equal or less than 25% of the aggregate of the total paid-up capital and the free reserves of the company.

But companies cannot use more than 25% of their paid up capital or free reserves to do a buyback, especially when a shareholder has been guaranteed a significant return on its investment.

To circumvent this potential pitfall, Nishith Desai senior lawyer Archana Rajaram recommends implementing the buyback in phases where the maximum number of shares are bought back in one financial year and the remaining shares outstanding are bought in the next financial year.

Alternatively, the shareholder may be given a put option to sell the remaining

Lawyers recommend drafting the transaction documents to force the company to raise funds through a fresh issue of different shares or sale of assets.

The proceeds of these sales should be transferred to the company's free reserves. "The shareholder can be given the right to veto any debits from the securities premium account with a corresponding obligation on the company to ensure that the account is maintained so as to make a buyback possible on agreed terms," says Singh.

Other problems can appear if shareholders who do not have the right to exit through a buyback start tendering their shares during the buyback process.

This may limit the resources and ability of the company to complete the buyback of those shareholders' shares who do have the buyback exit right.

To guard against this, Rajaram advocates restricting other shareholders from tendering their shares after the letter of offer has been issued by the company. "The company should ensure that such restrictions also extend to new shareholders," she adds.

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