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NCLAT rejects scheme of amalgamation based on unfair valuation report and exchange ratio

NCLAT rejects the scheme being convinced that exchange ratio is based on guesswork and disregards methodology stated in valuation report

Facts:

The NCLT had approved the scheme of arrangement (Scheme) which inter alia provided for amalgamation of First Transferor Company and Second Transferor Company (Transferor Companies) into the Transferee Company. The said order of NCLT was challenged by the shareholders of the Transferor Companies before the NCLAT inter alia alleging that the Scheme was against the interest of minority shareholders.

Submissions of the shareholders:

- The valuation report was not prepared by a Registered Valuer and was unfair for the following reasons:
  - It considers book value of shares of Transferor Companies instead of their intrinsic value based on asset valuation method as derived by the merchant banker.
  - The intrinsic value of shares of Transferor Companies was significantly higher compared to their book value since the Transferor Companies owned substantial shareholding in a listed company whose net worth was INR 50 Billion and market capitalisation was INR 175 Billion (please refer below table).

(in INR)

Transferor company	Book value per share	Intrinsic value[1] per share
First	173.38	20,677.11
Second	280.51	14,885.22

  - Accordingly, the exchange ratio was unfair to the public shareholders (please refer below table).

Transferor company	No. of equity shares of Transferee Company
First	4 equity shares of INR 100 each for every 907 shares of INR 10 each
Second	5 equity shares of INR 100 each for every 1541 shares of INR 10 each

[1] As per valuation carried out by a Merchant Banker

- Even the public shareholders of Transferor Companies whose shares were rounded off to zero, the repayment of capital would be made as per book value of such shares as against their intrinsic value.
- Certain shareholders alleged that they were not served with notice convening the meeting of shareholders of Transferor Companies to approve the Scheme and that the Transferor Companies misrepresented that such notice was served to all their respective shareholders.

Submissions of the Transferor Companies:

- Valuation was based on market value approach. The valuation should not be questioned for the following reasons:
  - The objecting shareholders have not cited any fundamental error in valuation but have merely contended that valuation should have been done using the intrinsic value. No reason has been suggested for using such method.
  - The intrinsic value derived by the merchant banker followed the guidelines issued by SEBI for providing exit at time of delisting.
  - Use of intrinsic value was not justified as none of the Transferor Companies was a non-going concern.
  - Even listed shares of reputed companies trade at considerable discount to intrinsic value.
- The objecting shareholders own less than ten percent of shareholding. Accordingly, as per proviso to Section 230(4) of the Companies Act, 2013 (the Act), such shareholders are not entitled to oppose the Scheme.
- The notice of shareholders meeting was served to all shareholders individually as well as in form of public notice published in newspapers.

Question of Law:

- The question that arose before the NCLAT was whether the exchange ratio proposed by the Transferor Companies was fair and equitable?

Ruling of NCLAT:

- Based on evidence of service of notice provided by Transferee Company, the NCLAT was convinced that the notice was served to the objecting shareholders.
- The NCLT is duty bound to ensure that all procedures are followed and the Scheme is equitable and is not prejudicial to any class in spite of the fact that such class may not comply with the threshold of ten percent of shareholding required for objecting to the Scheme.
- In respect of valuation report the NCLAT observed as follows:
  - The valuation report does not provide any basis for arriving at the exchange ratio.
  - No details regarding valuation of each share of Transferor Companies has been provided in the valuation report. In absence of such details, the valuation report is not helpful to the stakeholders whose interest could be impacted by the Scheme.
  - In absence of necessary diligence as mentioned above, the NCLAT ruled that the valuer had adopted a cavalier approach in carrying out the valuation.
  - In view of such serious compromise in process of valuation, the exchange ratio stated in the valuation report is not credible and is based on guesswork.

- Accordingly, the NCLAT held that the Scheme could be termed as not being fair to all stakeholders. The Scheme was rejected by the NCLAT with order of costs of INR 10 Lakh on the Transferee Company.

Conclusion:

The NCLAT has favorably considered the objections of the minority shareholders on the valuation approach adopted by the valuer while determining the exchange ratio. The NCLAT has also held that the NCLT is duty bound to consider the submission of minority shareholder(s) to ensure that all procedures are duly followed despite the fact that such shareholders do not own ten percent of shareholding. The ruling of NCLAT could lay down a significant precedent that while approving the Scheme the NCLT would be required to ensure the fairness of valuation process and also look into details of valuation methodology adopted to value shares of companies involved. It may be advisable for companies involved in a Scheme to maintain strong documentation to justify the methodology adopted as well as the assumptions underlying the valuation process.

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