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*Analysis*

# Threat of valuation litigation in Public M&A – Carlyle-PNB Effect!

## Key Takeaways

- SEBI floor price prescription in case of fund raises should not automatically dislodge directors' duty to exercise independent judgment and maximise shareholder value
- Target boards to proactively consider appointing an independent banker and running a robust auction process for capital raises
- Investors should strategise for high stakes valuation litigation by shareholders failing which the entire transaction could be potentially derailed

Unsuccessful sale processes, struggling lender, fund-raise and tender offer, vigorous activism, enhanced scrutiny of board responsibilities and litigation, terminated fund raise process and finally a rights issue – or, in three words, PNB Housing Finance (PNBHFL). In what could be a landmark turn of events for India, the PNBHFL saga has shown glimpses of what sophisticated M&A in the West typically entail. While there are various sub-themes to the entire episode, this piece focuses on three key questions which will arguably shape the M&A litigation sphere in the next decade – is a SEBI-prescribed historical price indicative of the fair value of a company? What are the duties of the board of directors while approving a majority sale? And finally, will PNBHFL be the starting point for the growth of appraisal rights litigation in India?

## Background

Last year, a PE consortium led by Carlyle announced the majority acquisition of PNBHFL – a publicly listed housing finance lender. The consortium agreed to invest ~USD 550 million into PNBHFL through a primary infusion to acquire a controlling stake, which in-turn triggered a mandatory tender offer. The consortium's entry price was at 0.7x of PNBHFL's book value, ~50% lower than the IPO listing price and ~75% lower than the stock's lifetime high in 2017. However, the deal price was in full compliance with the minimum pricing condition mandated by India's takeover regulations. To make things interesting, the stock price nearly doubled within days of the deal being announced, leading to claims from proxy advisors and minority shareholders that the company was being sold at a significantly cheaper value. SEBI, in possibly an unprecedented action, stalled the shareholder vote to approve the proposed sale based on a procedural aspect under company law which is commonly disregarded. SEBI also issued notices to the directors asking them to explain why action must not be initiated against them for violation of their duties. On appeal, the SAT (appellate tribunal) passed a split verdict. Eventually, while the matter was pending before the Supreme Court, PNBHFL withdrew the preferential allotment entirely. Now, after many months, PNBHFL is back in the news – to raise funds through a rights issue.

## M&A Valuation and Directors' Duties

Under Indian takeover law, a tender offer to acquire majority control cannot be launched by an investor below a floor price. The floor price is mainly a function of how the stock has traded historically. The key issue however is whether the SEBI prescribed floor price is indicative of the 'fair value', or is it just a minimum price intended to protect public shareholders?

For better context, most deals in the unlisted space are struck after examining various valuation metrics that are relevant to the target (eg: DCF, market-comparable etc.). Many intangible elements such as management's expertise, regulatory landscape and technological advancements are considered before zeroing down on the right value.

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Logically, one could argue that listed company boards should also adopt a similar approach before approving share issuances. However, if the open market values the stock lesser than the perceived potential, an equally compelling argument can be posited that no further scrutiny is required beyond the SEBI mandated floor price. What then is the duty of the board in such a situation?

Under Indian company law, directors are duty bound to apply independent judgment, exercise diligence and maximize value for all the stakeholders. In fact, countries like the US specifically oblige directors (through statute) to achieve the highest possible price for shareholders in a takeover, based on reasonable decision making. Viewed in this context, directors can no longer assume that mere compliance with the SEBI floor price prescription will discharge their overarching statutory and fiduciary duties. The term 'duty' carries a much wider legal connotation than that of an 'obligation' – where the test is whether the directors have exercised all efforts to obtain the best possible price and not just the basic obligatory price required under law.

Therefore, during a fund raise, appropriate price discovery processes and the pros and cons of every offer should be carefully deliberated by the board before deciding the way forward. Ideally, for any large sale, directors should proactively appoint an independent banker and conduct a robust bid process to identify the correct benchmark price. Also, companies in certain segments (eg: public undertakings) are typically undervalued because of various intrinsic and extrinsic reasons. In such cases, directors should examine a combination of all the different valuation methodologies (income-, market- and asset-based) before arriving at a base price range. The methodologies adopted by the valuer and the weightage given to each should also be disclosed for public scrutiny. Businesses are evolving rapidly with the advancement in technology, and it is impractical to specifically legislate for every corner-case scenario. Given the high stakes involved, directors are expected to don a more active role and walk the extra mile to ensure that the best governance standards are adhered to.

## Appraisal Litigation

The PNBHFL episode also brings to the fore a very important litigation tool in the hands of public shareholders/ SEBI – appraisal litigation. Simply put, appraisal litigation is a method for dissenting shareholders to receive a fair market value if they perceive that a corporation has been undervalued in a takeover. While India does not have a statutory appraisal regime unlike other jurisdictions such as the US, the PNBHFL litigation almost resulted in the same outcome.

Historically, Indian courts have held that valuation is a matter of 'business judgment' and is generally beyond judicial scrutiny. However, recent years have witnessed a stark change – with SEBI re-examining and even increasing open offer prices based on shareholder grievances/ push by proxy advisors (as in the case of Federal Mogul

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India). PNBHFL is yet again a sobering reminder of SEBI's power to intervene in matters concerning takeover valuation in order to protect the interests of public shareholders. With the increasing focus on the rights of minority shareholders, activist shareholders are less likely to rollover simply because the majority is in favor of a transaction. Acquirers should be mindful that there are sufficient avenues for shareholders, under both corporate and securities laws, to pursue valuation litigation and one can only expect this to rise in the days to come.

Indian public markets have seen a tectonic shift over the last decade, with PEs and sovereign wealth funds investing large amounts of capital. Simultaneously, SEBI is becoming progressively vigilant, and the overall activist ecosystem is growing to be significantly effective. Given this background, it is paramount for investors and corporations to meticulously strategize every aspect of an investment – starting from press and shareholder management to potential litigation scenarios – before launching an open offer. Even a slight technical flaw has the potential to entirely derail a huge transaction, as seen with PNBHFL. The litmus test therefore of every corporate action will be the highest standards of governance and as the proverbial expression goes, governance starts where mere legal compliance ends!

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