VOLUME 4 | ISSUE 2

INTERNATIONAL JOURNAL OF ADVANCED LEGAL RESEARCH

DEMYSTIFYING ENTRENCHMENT IN CORPORATE GOVERNANCE: A CALL FOR MANDATED PROVISIONS

- Shubham Goyal[1]

Synopsis:

This article asserts that to safeguard the interests of minority shareholders, corporate governance should require entrenchment requirements. Sections 5(3) and 5(4) of the Companies Act 2013 **(CA)** are ineffective because they are optional. To maintain shareholder value and company integrity, a required application is suggested.

Keywords: Entrenchment Provisions, Corporate Governance, Minority Shareholders, Mandatory Implementation.

The Articles of Association (**AOA**) comprise the rules, regulations, and bylaws for the internal management of a company's affairs. Although any provision of the AOA can be amended through a special resolution (i.e., it should get at least three times the number of votes cast against it by members, if any), the 2013 Companies Act introduced entrenchment provisions in Sections 5(3) and 5(4). The term "*entrenchment*" is not defined anywhere in the act, but it refers to the adoption of a clause that, through procedures and checks, makes certain amendments either more difficult or impossible.

The entrenchment clauses are considered to be of great importance because they were added to create a barrier against the majority shareholders' arbitrary decision-making power by giving minority shareholders a voice in decisions that affect them and are vital to their interests. However, the establishment of the entrenchment provisions is not obligatory. Section 5(3) of the

[1] Student at O.P. Jindal Global University

Companies Act states, "*The articles **may** contain provisions for enforcing....*." In this context, the word may indicate that the statute has left the implementation of the entrenchment clauses up to the discretion of the companies. Companies are therefore free to adopt or reject this provision. This clearly shows the power/authority of the companies to not adopt the entrenchment clause. This choice makes this provision almost useless as even though the provision is created, its implementation can be regulated by the companies as per their benefits.So, according to me, the entrenchment clause should be made mandatory, as its optional application runs counter to its purpose and renders it nearly ineffective in protecting minorities.

In the absence of entrenchment provisions, power will be centralized among the majority shareholders of a company. The majority of promoters and non-promoter shareholders will have the power to reject any amendment to the articles containing entrenchment or any other resolution that conflicts with their interests. Promoters of Adani Wilmar, for instance, hold approximately 88% of the shares. Therefore, they already have a special majority if they want to amend an article to their advantage without an entrenchment clause. However, if the provision of entrenchment is mandated, decisions will be made that are in the best interest of both the minority and majority shareholders. Companies would now require a higher percentage than 75% to amend their articles. A system of checks and balances between majority and minority shareholders will be maintained as the amendment of articles becomes more stringent. For instance, the minority would be able to block any decision to amend the AOA that ran counter to their interests, even if the required entrenchment provision set the bar at 85% or 90%. It will prevent improper behavior and reduce the likelihood of power concentration. Each side would have veto power over the other, and the firm would need to balance the interests of both sides to obtain the necessary votes to amend the articles. This would act as a counterbalance.

The mandatory use of entrenchment provisions is also required because the oppression of minority shareholders by majority shareholders violates the provisions of company law. Section 241 of the 2013 Companies Act, which addresses detrimental and oppressive acts of majority shareholders, also supports the mandatory application of entrenchment provisions. In *S.P. Jain v. Kalinga Tubes Ltd.***(Kalinga)**, the court stated that the word oppression used in Section 241 should be the result of the majority shareholders misusing their majority voting power to treat the company and its affairs as if they were theirs, to the disadvantage of the minority shareholders. In a recent case involving *Cyrus Investments Pvt. Ltd. vs. Tata Sons Ltd. & Anr.***(Cyrus)**, the

Supreme Court reaffirmed this judgment as a precedent. The optional use of the entrenchment clause would likely increase the likelihood that this oppression of minority shareholders would occur. Therefore, if entrenchment clauses were required, minority shareholders would not be oppressed in the first place. In addition, other provisions of the 2013 Companies Act and SEBI Regulations also safeguard the interests of shareholders. To protect their interests, shareholders can engage in shareholder activism to bring about desired changes in the company's operations. As a result, minority shareholders are protesting decisions made by management that they believe are unfair to them.Minority shareholders now have a voice in how businesses are managed, including opposing pay raises for CEOs and thwarting promoters' efforts to sell stakes. Minority shareholders, for instance, prevented Vedanta's promoters from delisting the company in 2020. The promoters proposed to acquire the public shareholders' 40% stake for Rs. 87.25 per share. The cancellation of the event was necessitated by a minorty shareholders' demands for Rs. 236-320.Whereas these provisions aim to empower minority shareholders and protect their interests, the optional use of entrenchment provisions diminishes their influence. Optional usage allows majority shareholders to make decisions in their best interests without using entrenchment provisions. Therefore, the optional application of the entrenchment provision has a significant impact on the statute and SEBI's efforts to protect minority interests, and this provision should be applied mandatorily.

Numerous individuals believe that the mandatory application of the entrenchment clause would make the operation of a business cumbersome and inefficient. But according to me, just as all Indian citizens are part of this country, so too are all shareholders of a company. The concept of checks and balances underpins democratic governance and maintains the interdependence of the three pillars of democracy. If a country as large as India can function while protecting the interests of minorities and oppressed communities, then a company (which is a much smaller entity) can also function effectively while taking minority shareholders' opinions into account. According to Praveen Raju, Partner at Spice Route Legal, shareholder activism may result in short-term value depletion, but it would result in accountability, good corporate governance, and the creation of long-term shareholder value. He continued to say that it is only natural for controlling management to assert their right to run corporations as they see fit, but such checks and balances are necessary to ensure their vigilance. We can say that the organization's decision-making process may become sluggish due to entrenchment provisions. But, as shareholders can

file complaints against oppression, this alternative is still preferable. In addition to having a significant impact on the company's operations, legal proceedings about such complaints can also have a substantial impact on the company's reputation and goodwill. Therefore, the use of mandatory entrenchment clauses is the superior option.