SEBI'S EVOLVING REGIME ON ACQUISITION OF CONTROL: FROM SUBHKAM VENTURES TO THE BRIGHTLINE TEST

Paridhi Srivastava[1]

INTRODUCTION

In India, the law governing the acquisition of shares, voting rights and control of listed companies is laid out in the takeover regulations framed by Securities and Exchange Board of India (hereinafter referred to as "SEBI"), known as the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 (hereinafter referred to as "The Takeover Code"). The takeover code mandates the requirement of an open offer in case where the acquisition of shares or voting rights entitle the acquirer to more than 15% of the voting rights in the target company (as contained in Regulation 10 of the Takeover Code). The Takeover Code also invokes the mandatory requirement of an open offer not only in cases of share acquisitions, but also in cases where there is an acquisition of "control" (as contained in Regulation 12 of the Takeover Code).

When financial investors, such as private equity investors and venture capitalists, make an investment of more than 15% in listed companies, they are required to mandatorily make an open offer for acquisition of shares under Regulation 10 of the Takeover Code. As per the deal structure, such investors are entitled to certain rights in the target company such as the ability to appoint nominee director or an observer or certain supermajority or veto rights in order to ensure that the company does not undertake certain actions without the prior approval of their investments.

However, SEBI soon began invoking the requirement of open offers to be made under Regulation 12 of the Takeover Code as well. SEBI claimed that such investors were deemed to have obtained "control" over the target company by virtue of the rights to which they were entitled to under the deal transaction documents. The acquisition of "control" of listed companies had always attracted a lot of premium. The interpretation of the term control has been a contentious matter.

[1] 4th Year, B.A., LL.B (Hons.) Student at NALSAR University of Law, Hyderabad, India.

This Paper will analyse the important judicial decision in the Subhkam Ventures case on the interpretation of "control" along with the SEBI notification in 2011 Takeover Regulations compared with the latest SEBI Discussion Paper released on March 14th, 2016.

SUBHKAM VENTURES CASE STUDY

This case involves the deal between MSK Projects (India) Ltd. (hereinafter referred to as the "Target Company") and Subhkam Ventures Private Ltd. (hereinafter referred to as the "Subhkam Ventures"). Target Company was a public company listed on the Bombay Stock Exchange. On October 20, 2007 the Target Company issued and allotted 44, 55,000 fully paid up equity shares of Rs. 10 each on a preferential basis, which represented 19.91 per cent of the equity share capital of the Target Company. Subhkam Ventures was allotted 40, 00,000 shares, acquiring 17.9 per cent of the post preferential issue of equity share capital of the Target company. The allotment was made in pursuance of a special resolution passed by the shareholders of the Target company under section 81(1A) of Companies Act, 1956 in an extra-ordinary general meeting held on August 27th, 2007.

Subhkam Ventures triggered the open offer under the Takeover Code. Since Subhkam Ventures acquired more than 15 per cent of the voting rights in the target company, it invoked Regulation 10 of the Takeover code. In observance of regulation 10, Subhkam Ventures made a public announcement of an open offer to acquire 45, 77,572 equity shares of the target company from its public shareholders. As on the date of such public announcement, Subhkam Ventures and persons acting in concert with it held 24.26 per cent of the equity share capital of the target company. This attracted Regulation 18 of the Takeover Code as per which the acquirer, in this case Subhkam Ventures, was required to file with SEBI a draft letter of offer through its merchant bankers containing the required disclosures. In accordance with the rule, Subhkam Ventures filed this draft letter of offer under Regulation 10 within 14 days from the date of public announcement through Collins Stewart Inga Private Ltd., the merchant banker to the open offer. According to this draft letter of offer issued in accordance with the takeover code, Subhkam Ventures sought to acquire more than 20 per cent of the voting rights of the target company from its public shareholders. The contentious issue in this deal was whether the shareholder and share subscription

agreements (hereinafter referred to as the "agreement") executed between Subhkam ventures and the target company gave Subhkam Ventures "control" over the target company, thereby attracting an open offer under Regulation 12 of the Takeover code?

It is important to note that a clause in the draft letter expressly stated that the intention of Subhkam Ventures was to be a mere financial investor such that the acquisition will not result in a change of control of the company, thereby implying that Subhkam Ventures would not be in control of the target company. However, SEBI was of the view that certain clauses in the agreement (particularly clauses 5 and 9) give ample powers to Subhkam Ventures in terms of affirmative rights by which it could exercise control over the target company. The merchant banker continued to reiterate that Regulation 12 could not come in the picture as there was no change of control as envisaged, emphasizing that Subhkam Ventures was merely a financial investor and could not be termed as a promoter of the company. Disregarding this view, SEBI it directed Subhkam Ventures to revise the offer document to reflect that the open offer was being made under Regulations 10 and 12 (change of control) under the Takeover Code.

SEBI's order was appealed against by Subhkam Ventures before the Securities Appellate Tribunal (hereinafter referred to as "SAT"). What needs to be examined is whether Regulation 12 got triggered when Subhkam Ventures acquired 24.26 per cent of the equity share capital of the target company?

Regulation 10 and 12 of the Takeover Code:

Regulation *10. No acquirer shall acquire shares or voting rights which (taken together with shares or voting rights, if any, held by him or by persons acting in concert with him), entitle such acquirer to exercise fifteen per cent or more of the voting rights in a company, unless such acquirer makes a public announcement to acquire shares of such company in accordance with the regulations.*[2]

[2] Regulation 10, Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997. Available at: http://www.SEBI.gov.in/acts/tkreg.html#reg%2010. (Last Accessed: 12th July, 2016).

Regulation 12. *Irrespective of whether or not there has been any acquisition of shares or voting rights in a company, no acquirer shall acquire control over the target company, unless such person makes a public announcement to acquire shares and acquires such shares in accordance with the regulations."*[3]

Regulation 10 applies where the acquirer by virtue of his acquisition exercises 15 per cent or more voting rights in a company. Regulation 12 applies when an acquirer acquires control over the target company irrespective of whether or not there has been any acquisition of shares or voting rights in that company. While both the regulations can be triggered simultaneously, they can also apply independently in a different set of circumstances.

SAT laid down few general principles on what constitutes "control" in such a situation. It makes a noteworthy distinction between proactive power (positive control) and reactive power (negative control).

The term "control" has been defined in Regulation 2(1) (c) of the Takeover Code to

"include the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner."[4]

This an inclusive rather than an exhaustive definition. It has the following distinct and separate features:

1) Right to appoint majority directors; or

2) Ability to control the management or policy decisions by various means referred to in the definition.

It is similar to Black's Law dictionary's definition of control – "The direct or indirect power to direct the management and policies of a person or entity, whether through ownership of

[3] Regulation 12, Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997. Available at: http://www.SEBI.gov.in/acts/tkreg.html#reg%2010. (Last Accessed: 12th July, 2016).

[4] Regulation 2(1)(c), Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997. Available at: http://www.SEBI.gov.in/acts/tkreg.html#reg%202. (Last Accessed: 12th July, 2016).

voting securities, by contract, or otherwise; the power or authority to manage, direct, or oversee."[5]

According to this definition SAT held that, control is a proactive and not a reactive power. By proactive power, it means a power by which the acquirer can command the target company to do what he wants it to do by taking the initiative to create or control a situation. On the other hand, a reactive power is where the acquirer is can only prevent the company from doing what it wants to do. The acquirer is only reacting rather than taking an initiative, thereby it does not amount to control.

The determining factor, therefore, is whether the acquirer is the driving force behind the company and the one providing motion to the organisation. If this is satisfied, he is in control, but not otherwise. Control in this sense implies "effective control".

In order to establish control, SEBI referred to various clauses in the agreement.

1. Clauses 3.2(c) and 7.2 of the agreement which empowers Subhkam Ventures to appoint a nominee on the Board of Directors of the target company. SAT is of the view that this clause does not in any way imply that Subhkam Ventures has acquired control over the company. It is a reasonable ground between the parties that out of the Board of directors, Subhkam Ventures would get the right to appoint one nominee of its own the board. Power to appoint one nominee director of Subhkam Ventures on the board can by no stretch of reasoning imply that Subhkam Ventures has acquired the power to exercise control over the affairs of the target company or control its board of directors. That single nominee would merely be a microscopic minority and having no veto powers.

2. Clause 4.1 of the agreement which was a conventional standstill provision having a limited purpose of ensuring that in the time between the signing of the agreement and the actual investment of funds, the investor does deviate from the basis on which the decision to invest had been made. SAT was of the view that such a clause did not demonstrate the acquisition of control upon making the investment, as it was only a temporary provision which ceased to operate from the date of allotment of shares to Subhkam Ventures it could not be regarded as conferring control on it.

[5] Black's Law Dictionary (9th ed. 2009).

3. Clause 7.7 of the agreement provides that the presence of Subhkam Ventures nominee director is essential to constitute the quorum of the board meeting of the target company. SAT notes that the absence of the nominee director would only have the effect of adjourning the matter for two weeks after which the directors present would constitute the quorum.

4. Clause 7.3 of the agreement gives the investor director the right to be a member of any committee of the board and to vote in all meetings of such committees. SAT does not think that such a clause confers any control upon Subhkam Ventures. The object of the clause was that the investor would be aware of even those developments made at the committee level instead of at the board level.

5. Clause 9 sub clauses (a) to (o) which provides Subkham Ventures with supermajority rights in terms of Subhkam Ventures' nominee director obtaining an affirmative vote on the board while deciding fundamental corporate matters of the company, such as amendment to Memorandum of Association and Articles of Association, change in share capital, amalgamation, winding up, etc. SAT found that even though these matters were fundamental corporate matters, they did not cover day to day operations of the company. Such veto rights are provided to ensure the maintenance of standards of good corporate governance and protection of the interest of the investor. More importantly, SAT was premised on the fact that the veto right is only a negative right and does not allow the investor to carry out these actions on its own, thereby stressing on the investor's inability to carry out any positive acts rather than on the nature of the matters themselves that are on the list on which he has a veto right.

Based on the examination of the above relevant clauses, SAT concluded that the affirmative rights conferred on Subhkam Ventures in those clauses are not sufficient to amount to acquisition of control under the Takeover Code so as to attract Regulation 12 of the code, as control under the code is a proactive and not a reactive power. SAT set aside the SEBI order.

The SAT order set to rest an issue that had caused a great amount of consternation amongst investors and their advisors. It came as a relief for financial investors that customarily seek protective provisions in their transaction documents without the fear of unintended consequences of becoming the controller of the target company. The decision allows for the

conferral of a wide variety of supermajority rights without putting the investor in control in the sense of the term under the Takeover Code.

However, an appeal against the SAT order taken up by the Supreme Court in November 2011 which disposed off the matter without a decision on the question of law. According to the Supreme Court, the question of law on what constitutes "control" under the Takeover Code had become infructuous due to the change in factual circumstances. The Supreme Court disturbed the equilibrium by effectively nullifying the broader implications of the SAT order in the following words:

"Keeping in view the above changed circumstances, it is in the interest of justice to dispose of the present appeal by keeping the question of law open and it is also clarified that the impugned order passed by the SAT will not be treated as a precedent."

The Supreme Court accepted the out-of-court settlement between SEBI and Subhkam Ventures and specifically stated in its order that the question of law (i.e., whether negative control amounts to control) remains open and that the SAT decision would not be considered precedent.

The Supreme Court ruling that the SAT decision would not be considered as precedent has cleaned the slate and brought the interpretation of the term "control" back to its ambiguous position. In the meanwhile, SEBI brought an amendment to the erstwhile Takeover code in 2011 raising the trigger limits for the open offer to 25 per cent from the previous 15 per cent, however the definition of the term "control" remained unchanged and ambiguous. SEBI may therefore continue to apply its interpretation of negative control as acquisition of control to trigger the mandatory open offer obligations under the Takeover Code.

Under the 2011 Takeover Code, investors may acquire up to 24.9 per cent of a listed company without invoking the mandatory open offer requirement under the code. The definition of control under the 2011 regulations remains the same as that which was subject to litigation in the Subhkam Ventures case. In the absence of a clear Supreme Court decision and the benefit coming from the SAT decision in the Subhkam Ventures case, special or minority protection rights that may be obtained by an investor have to be reviewed on a case-by-case basis. Each veto right secured by the investor under the transaction documents would have to be reviewed in terms of the commercial parameters underlying such right, as well as

its impact on the general management and policy decisions, in order to determine whether such right would constitute 'control'.[6] Therefore, since the Supreme Court was silent on the question of law, SEBI will have to depend on the facts of each case, and the investors can hope that the law will be constituted in other cases, where the SAT decision can be cited for persuasive value, if not having any binding value.[7]

SEBI DISCUSSION PAPER ON "BRIGHTLINE TESTS FOR ACQUISITION OF 'CONTROL' UNDER SEBI TAKEOVER REGULATIONS"

After the SAT ruling and the subsequent decision of the Supreme Court left a gap in the law, SEBI recognized the need for negative control for private equity and venture capital investors. It realized that the need for clarity on the implications of 'negative control' is imperative. Any clarity on this issue from the regulators could boost the confidence of the private equity and venture capital investors in undertaking much needed large investments in listed companies.

As a consequence, on 14th March 2016, SEBI released a discussion paper on "Brightline tests for acquisition of 'control' under the Takeover Code. Post the 2011 amendment, the Takeover regulations provide that an acquisition of more than 25 per cent of the substantial shares or voting rights of the target company would require the acquirer to make an open offer to the public shareholders of the target company. The Bhagwati committee, however, left the definition of "control" unchanged and ambiguous, putting the onus on SEBI to decide whether there has been an acquisition of control based on the facts of each particular case. It is clear that the acquisition of control over a target company is straightforward in cases of acquisition of shareholding or voting rights. But in cases involving accrual of rights in the contractual agreements, it is very complex to determine the acquisition of control and it requires a close examination of the facts and circumstances of the case. Therefore, the nature of the definition of "control" under the code is principle based and not rule based. However,

[6] Amarchand Magaldas Suresh & Shroff, Insight: Analysis of Recent Developments in Corporate Law, December 5, 2011. Available at: http://aibi.org.in/InsightIssueDec2011.pdf. (Last Accessed: 26th March, 2016).
[7] *Ibid.*

the application of these principles to the facts of cases has led to a multitude of opinions leading to several litigations.

The existing inclusive definition of the term "control" in the takeover code finds its roots in the Justice P N Bhagwati Committee Report on Takeovers in 1997 which had recommended such a definition to serve the purpose of indicating the circumstances when the regulations would be triggered, even when there has been no acquisition of shares, such that SEBI would not be in an uncharted sea in investigating whether there has been a change in control.[8]

The Takeover Regulations Advisory Committee set up under the chairmanship of Mr. C Achuthan, was of the view that a holding level of 25 per cent voting rights permits de facto control. The existence or non-existence of control over a company is to determine as a question of fact, or at best a mixture of question of fact and law, based on the facts and circumstances of each case. Acquisition of de facto control and not only de jure control should trigger the requirement of an open offer. The Committee recommended that the definition of "control" be modified to include the "ability" in addition to the "right" to appoint majority directors or to control the management or policy decisions to constitute control.[9]

The discussion paper proposes two methods to redefine control.

- **Framework for Protective Rights –** SEBI seeks to clarify the position regarding negative control, i.e., protective rights which typically confer veto rights to a non-majority substantial shareholder, would not be taken to imply acquisition of "control" under the Takeover code. It proposes to amend the framework of protective rights and exclude certain business decisions taken by an entity from coming within the ambit of the "control" definition. It lays down illustrative situations where negative control or protective clauses in a shareholders' agreement will not be regarded as "control". SEBI places reliance upon the SAT ruling in the Subhkam Case that "negative control is not control". Some of these rights which have been excluded are decisions such as the appointment of chairman if he is just a nominee of the investor and does not hold any executive position, appointment of an observer who does not

[8] Justice P N Bhagwati Committee Report on Takeovers. Available at: www.SEBI.gov.in/commreport/bagawati-report.html. (Last Accessed: 26th March, 2016).

[9] Report of the Takeover Regulations Advisory Committee under the chairmanship of Mr. C Achuthan. Available at: http://www.SEBI.gov.in/cms/SEBI_data/attachdocs/1287826537018.pdf. (Last Accessed: 26th March, 2016).

have any voting or participation rights, exercising agreements specified by lenders, if such rights are customary to the lending business and the lender has granted a loan strictly on a commercial basis, and veto or affirmative rights in matters that are not part of the ordinary course of business or involve governance issues would be considered as protective rights and not constitute control.

- **Adopting a numerical threshold –** SEBI proposes to define "control" in the SEBI Takeover code to mean 1) the acquisition of 25 per cent of the voting rights; or 2) the right to appoint a majority of non-independent directors to the board of the target company. This threshold limit follows from the Companies Act which provides that a special resolution requires three-fourths majority, therefore an investor holding more than 25 per cent will be able to block special resolutions. It must be noted that Regulation 17 of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 mandates that at least one-third of the Board of Directors shall comprise of independent directors where the chairperson of the board is a non-executive director, and that at least half of the board shall comprise of independent directors where the listed entity does not have a regular non-executive chairperson. Thus there would be a large number of companies where a large number of members are independent, therefore the right to appoint majority directors would not have much significance in such cases. Therefore, an entity having the right to appoint majority of non-independent directors may be considered to be in control of the company.

It is also quite likely that the list of protective rights in option 1 would be read literally by the regulators as well as practitioners, who may tend to think that all that is not falling within the list may be falling on the other side of the brightline, and therefore may be construed as control. It is only an indicative list, thereby the acquisition of other rights would have to be determined on the basis of the facts and circumstances of each case. However this approach may lead to complexities in assessment and ambiguity in interpretation. In case of option 2, acquisition of control through other means such as special rights would not amount to acquisition of control under the Takeover Code. However, it would bring greater certainty and much needed clarity in the assessment of acquisition "control". If the proposal is accepted, India would be following several other countries in moving from a de facto approach towards control to a de jure approach. Such a de jure or objective approach, also

known as the "Brightline test" provides greater certainty. However, this move towards a more objective, voting control based approach comes at a time when several information technology sector companies have demonstrated that voting controls and the ability to derive economic benefits may be completely dissociated.[10] However, while option 2 provides for a more objective, brightline test to ascertain control, there can be issues in cases where the investee company is short on funds, in distress of which it sells or issues shares to an investor, the investor may still hold less than 25 per cent of the shareholding or remain below the director threshold, though still have affirmative votes in a range of matters that will tantamount to control but would fall outside the purview of the Takeover Code, because the definition as per this option precludes de facto control. While the investor might take the driver's seat and exercise control over the company's policies, it would amount to "effective control" as contemplated in the Subhkam Ventures case.

Both the options represent a defining step towards greater predictability, clarity and certainty in the regime of control under the Takeover code. SEBI has invited recommendations, suggestions and public comments on its two proposals in order to guage the opinion of the public which proposal to be adopted.

[10] "Choosing between a blurred line and a brightline", India Corporate Law Blog, March 21st 2016. Available at: indiacorplaw.blogspot.in/2016/03/choosing-between-blurred-line-and.html. (Last Accessed: 26th March 2016).