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Decoding Control giving special reference to Shubkam Ventures Pvt. Ltd vs. SEBI

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Introduction:

The term 'control' has two connotations- *de jure* control and *de facto* control[1]. When a person exercises control over the management and affairs of the company because of holding a majority or substantial stake in the company, it is said to have *de jure* control. When the control is exercised irrespective of whether the entity has majority shareholding of the company or its ability to appoint KMPs , then there is *de facto* control. In Kamat Hotels vs SEBI[2] the interpretation of control came up before SEBI. It had to decide whether there exists an acquisition of control by the noticees after entering into an agreement which confers them certain rights which would trigger an open public offer under the Takeover Code, 1997. The court held that "It is apparent that the scope of the covenants in general is to enable the Noticees to exercise certain checks and controls on the existing management for the purpose of protecting their interest as investors rather than formulating policies to run the Target Company"

Facts of the case:

1. M/s Subhkam Ventures (I) Private Limited is the appellant and was formerly known as M/s Subhkam Holding Private Ltd. This company triggered the open offer under the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997.
2. The entity merged into the appellant and because of the same, all the rights and obligations arising out of the open offer, vested with the open appellant.
3. The appellant is an 'acquirer' under the Takeover Code.
4. The Board of Directors of MSK Projects (target company) on 20th October, 2007 held a meeting in which it issued and allotted 44,50,000 fully paid up equity shares of Rs.10 each on preferential basis representing 19.91% of the equity share capital of the target company.
5. The appellant acquired 40,00,000 shares valuing upto 17.90% of post preferential issue of equity capital.
6. This allotment was made after a special resolution was made by the shareholders of the target company under S. 81(1A)[3] of the Companies Act, 1956.
7. On October 20, 2007, a share subscription and shareholders agreement was executed and this agreement governs the investment made by the appellant (referred to as 'the agreement' henceforth).

[1] Evolution of the Definition of 'Control' under Indian Laws and Regulations by Zia Mody and Varoon Chandra
[2] WTM/GM/EFD/DRAIII/20/MAR/2017
[3] Section 81 (1A) of the Companies Act, 1956

8. The agreement clarifies that the appellant is only a financial investor in the target company and is not a promoter and that the appellant will not acquire control and management of that company for any reason.
9. As the acquisition was more than 15% of the voting rights. The Regulation 10 of the Takeover code was triggered and a public announcement for an open offer to acquire 45,77,572 equity shares of the target company from its public shareholders. The announcement was made on October 24, 2007. As on that date, the appellant held 54,23,000 equity shares of the target company valued upto 24.26% of its equity share capital.
10. Regulation 18 of the Takeover code requires the acquirer to file a draft letter within 14 days with SEBI.
11. Clause 3.3.3. of the draft letter states that "The Acquirer is merely a financial investor and this acquisition will not result in a change in control of the Company and therefore, the Acquirer will not be in control of the management of the Target Company."
12. The Board directed that the offer document be revised to make sure that Regulation 10 and 12 is complied.
13. After some exchange between the parties, the Manager, Corporation Finance Department, Division of Corporate Restructuring of the respondent letter dated 28th April 2008 coveted some comments under Regulation 18(2)[4] of the Takeover code.
14. It was claimed that clauses 5 and 9 of the agreement gives ample powers to the appellant over the target company. Changes for the same was proposed by the appellant.
15. The board directed the appellant to abide by the comments offered on 28th April 2008 and also the subsequent comments offered on 13th June 2008.
16. Aggrieved by the decision of the board, the appellant filed an appeal before the Tribunal. The order was set aside and reverted back to the board directing it to pass a fresh order complying with the law and also giving reasons for the same. The board reiterated the earlier decision by giving reasons.
17. An appeal was filed under Section 15T[5] of the SEBI Act, 1992.
18. The appellant contended that it did not acquire control over the target company and therefore Regulation 12 does not apply and the appellant has rightly made an open offer under Regulation 10. It added that it is a financial investor in the target company and it only wants to protect its investments through the clauses in the agreement and has no intention to exercise control over the target company.
19. The board on the other hand contended that the clauses of the agreement makes it clear that the acquirer has control over the target company and therefore Regulation 12 of the Takeover code will apply so that proper disclosures are made to the shareholders in order to help them to make an informed decision. 'Control' includes some responsibilities and obligation which the appellant does not want to be burdened with.

[4] Regulation 18(2) of the Takeover Code, 2011
[5] Section 15T of the SEBI Act

Issue:

1. Whether Regulation 12 got triggered when the acquirer 24.26% of the equity shares of the target company?
2. Whether the subscription and shareholders agreement executed between the appellant and target company gives control over the target company to the appellant.

Analysis:

Before making such decisions, it is important to refer the provisions of Regulations 10[6] and 12[7] of the Takeover code.

Regulation 10: "***Acquisition of fifteen per cent or more of the shares or voting rights of any company.***

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."

Regulation 12: "***Acquisition of control over a company.***

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 public
announcement to acquire shares and acquires such shares in accordance with the regulations."

Regulation 10 applies when the acquirer through acquisition exercises more than 15% of the voting rights in a company whereas Regulation 12 will apply when there is acquisition of control irrespective of whether acquisition of shares or voting rights in that company.

The word 'control' is defined under the Takeover code in Regulation 2(1)(c)[8] as follows:

"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."

SEBI provided a consultation paper on March 2016[9] in which the definition of 'control' under Takeover Regulations was amended as:

"(a) the right or entitlement to exercise at least 25% of voting rights of a company irrespective of whether such holdings give de facto control and/or

(b) the right to appoint majority of the non-independent directors of a company".

This is not yet implemented.

This definition is an inclusive definition and not exhaustive. The control of management or policy decisions could be by virtue of shareholding or management rights or shareholder agreement or voting rights or in any other

[6] Regulation 10 of the Takeover Code, 2011
[7] Regulation 12 of the Takeover Code, 2011
[8] Regulation 2(1)(c) of the Takeover Code, 2011
[9] https://nishithdesai.com/generateHTML/4792/4

manner. Control is a proactive power and not a reactive power. In a company managed by the board, it is the board of directors that is in control. When an acquirer has the power to appoint the majority of directors, then it is obvious that the acquirer will control the company by controlling its management and policy decisions. The test is whether the acquirer is in the driving seat. If the answer is in affirmative, then he would be in control of the company. Control means effective control.

The Deputy General Manager of the respondent Board has referred to various clauses using which it has come to a conclusion that the appellant has acquired control over the target company. The following clauses were referred by the Board:

1. CLAUSE 3.2(c)- This clause enables the appellant to appoint its nominee on the Board of Directors of the target company. The SEBI Appellate Tribunal decided that there is no control acquired through this clause. It is common for a board of directors of a target company to have 10 directors including the nominee of the appellant. The acquirer has the right to appoint one nominee director who will be a microscopic minority with no veto powers or control over the affairs of the country. The reason for the appointment of nominee director is to protect its provisions as it has made a huge investment and is interested in ensuring that the objects of the target company does not get deviated.

2. CLAUSE 4.1- The target company and its promoters agreed that between the signing of the agreement and the allotment of shares to the appellant under the agreement, the target company would not change its basic contours. This clause deals with covenants. This is a conventional 'standstill' provision which aims at ensuring that "between the signing of the agreement and the actual investment of funds into the target company, the latter shall not deviate from the basis on which the decisions to invest have been made." If there is any material change during this period, the appellants can treat it as a breach of agreement and will also serve as a reason for termination of the agreement. It will cease to exist after expiration of the investment. The SEBI Appellate Tribunal held that this does not amount to acquisition of control.

3. CLAUSE 7.2- This clause gives the appellant the power to appoint its nominee on the Board of Directors of the target company. But this was clarified while dealing with Clause 3.2(c) and was decided that these provisions do not confer any control.

4. CLAUSE 7.3- The agreement through this clause gives the investor director the right to become a member of any committee of the board and to vote in these committee meetings. The tribunal held that this does not give any control to the appellant. The object of this clause is to assist the investor in keeping up with the developments in the company as what would be done at the board level is done at a committee level.

5. CLAUSE 7.7- The presence of the investor director to constitute quorum for board meetings. This clause provides that 3 directors will constitute quorum of the meeting. And out of those 3, one will be the investor director. In a board meeting, where there are more than 3 directors present, the investor director will always be the minority and will have no veto power. The Clause 7.7 has to be read with Clause 7.8. According to this clause, if adequate quorum is not present, then the meeting "shall be adjourned by a a week at the same place and same time and in the adjourned meeting the directors then present shall constitute the quorum except that they cannot

consider and vote on matters enumerated in clause 9 which deals with protective provisions." The tribunal held this clause does not result in effective control.

6. CLAUSE 9: Great emphasis was laid down under this clause by the respondent to contend that the provisions of this clause confer control to the appellant. This clause puts the appellant in a position to influence major policy decisions of the target company. It was also contended that the appellant will have veto rights on crucial matters related to policy decisions which will result in acquisition of control. The clause 9 reads as follows:

" PROTECTIVE PROVISIONS:

The parties hereby agree that until such time as the Investor equity shareholding in the Company does not fall below 10% of the paid equity share capital of the Company, the affirmative vote of the Investor Director shall be required in a meeting of the Board (or any committee thereof) in respect of any of the following matters:

a) any amendment of the Memorandum and/or Articles of the Company;
b) any consolidation, subdivision or alteration of any rights attached to any share capital of the company or any of its subsidiaries, any capital calls on shareholders;
c) any redemption, retirement, purchase or other acquisition by the Company of any Shares of the company;
d) approval of the Annual Business Plan and any deviation, revisions therefrom;
e) the sale or disposition by the Company of any its assets, except for sales of assets:
(i)which are in the ordinary course of business; or
(ii)if outside the ordinary course of business, which, during any Fiscal year of the Company, have a fair market value of less than Rupees One Crore only;
f) the making of any loan or advance by the Company to any Shareholder or any third party, or the entry by the Company into any guaranty, indemnity, or surety contract or any contract of a similar nature in favour of or for the benefit of any Shareholder or any third party outside the ordinary course of business, of a value in excess of Rupees Two Crores;
g) the acquisition by the Company through subscription, purchase or otherwise, of the securities of any other body corporate;
h) to create any lien or to lease, mortgage, charge, pledge, licence any assets, rights, titles, intellectual property etc. of the Company or its Subsidiaries valued in excess of 5% of the networth of the company;
i) the conduct by the Company of any business other than the Business and/or the acquisition of any assets not related to the Business;
j) any amalgamation, splitting, reorganization or consolidation of the company (or any Subsidiary thereof);
k) to alter the composition and strength of the Board or to delegate the authority or any of the powers of the Board to any individual or committee;
l) the winding up, liquidation or dissolution of the Company;
m) incurrence of indebtedness in the Company in excess of 5% of the networth of the Company other than as approved in the Annual Business Plan;
n) appointment of key officials of the Company e.g. CEO, COO, CFO, CS or of equivalent designation and the determination of their remuneration and powers;
o) any capital expenditures in excess of 5% of the networth other than as approved in the Annual Business Plan;

p) any authorization, creation, grant, issue, allotment redemption of any Shares or convertible instruments of any class, debentures or warrants, grants, options over Shares, or approval

of the terms of a public issue by the Company, or approval or disapproval of any transfers thereof, except as provided under this Agreement;

q) filing of all offering materials to be utilized in connection with any public offering of shares of the Company;

r) any strategic alliance/joint venture proposal to be entered into by the Company;

s) approval of the annual financial statements, distribution of profits and coverage of losses of the Company and its Subsidiaries;

t) transactions with affiliates;

u) incorporation of subsidiaries, the acquisition of interests in any company or business or to acquire or sell shares, debentures, bonds or other securities/instruments in any company;

v) to settle, compromise or abandon any legal or arbitration proceedings, claims, actions or suits relating to the Company involving sums exceeding Rupees One Crore in respect of anyone such claim, action or suit or cumulatively exceeding Rupees One Crore in respect of claims, actions

and/or suits in a Fiscal Year;"[10]

The tribunal held that the sub-clauses only meant to protect the interests of the acquirer/appellant. The tribunal agreed that the protective provisions are only to ensure standards of good corporate governance and to protect the interests of the shareholders. The clauses 9(a) to 9(o) do not discuss about the day to day operations of the company and therefore does not control the management or policy decisions of the target company. In the case at hand, the target company prepares an Annual Business Plan and the same must be approved by its Board of Directors where the appellant is a minority. If after approving the plan, the target company wants to deviate from the plan, an affirmative vote from the appellant is essential. The tribunal held that this clause only enables the appellant to protects its interests and investments. The affirmative vote of the appellant is required for the appointment of key officers of the target company. The tribunal held that "Affirmative vote of the investor in these matters is necessary for protecting its investment".

The tribunal concluded that the appellant has not gained control over the target company. The Regulation 12 was not triggered because of the agreement.

[10] CLAUSE 9 of Agreement between the Acquirer and the Target Company.