

Corpsec Hotline

January 22, 2010

'VETO RIGHTS NOT CONTROL', CLARIFIES SECURITIES APPELLATE TRIBUNAL

The Securities Appellate Tribunal ("SAT") has recently passed an order in *Subhkam Ventures India Private Limited v. SEBI*¹ ("Subhkam Case") clarifying that veto rights (right to veto certain actions proposed to be undertaken by the company) do not constitute 'control' under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 ("Takeover Code").

Subhkam Case - Factual Background

Subhkam Ventures India Private Limited ("Acquirer") had acquired more than 15% in MSK Projects (India) Ltd., ("Target") triggering the requirement of making a public offer (an offer to acquire at least 20% of public shareholding) under Regulation 10² of the Takeover Code. After the draft letter of offer stating that the Acquirer is merely a financial investor and that the acquisition would not result in a change in control was filed with SEBI, further information was sought from time to time. The Acquirer continued to emphasize that the acquisition would not lead to a 'change in control' under Regulation 12. Finally, pursuant to further exchange of communication, SEBI directed that the offer document be revised to reflect that the open offer was being made under Regulation 10 as well as Regulation 12 (change in control). As a result, the Acquirer ultimately filed an appeal with SAT□□□□□□.

The relevance of 'control' under the Takeover Code

Prior to a discussion on SEBI and SAT's views on 'control', the relevance of the term 'control' under the Takeover Code is to be understood.

The requirement of making an open offer under the Takeover Code is triggered not only on the acquisition of shareholding beyond prescribed thresholds but also pursuant to any acquisition or change in 'control' (regardless of acquisition of any shares). While the former is comparatively straightforward, the latter has always raised various uncertainties especially in light of the broad and inclusive definition of 'control'.³ Consequently, certain arrangements customary in private equity investments (such as veto rights etc.) have always been open to regulatory scrutiny (i.e., on whether such arrangements constitute 'control').

What is 'control'?

To determine whether the Appellant had acquired control, various clauses of the share subscription and shareholders agreement executed between the Acquirer, the Target and the promoters of the Target were analyzed.

A summary of the analysis has been tabulated below.

#	SEBI	SAT
1.	Power of the Acquirer to nominate its director on the board results in control.	1 nominee out of 10 directors cannot confer control. The nominee is merely to keep the Acquirer apprised of developments in the company.
2.	Standstill provisions (covenants of the Target and the promoters not to undertake various actions between signing of the agreement and allotment of shares to the Acquirer) indicate control exercised over the Target.	Merely a transitional provision. Since the clauses cease to operate on allotment of shares, it cannot be regarded as conferring control on the Acquirer.
3.	Acquirer's board nominee required to constitute quorum reflects that the board of the Target cannot approve any actions without the Acquirer.	Subsequent clauses provide that if adequate quorum is not present, the matter would be adjourned by a week where the directors then present would constitute the quorum (except for the reserved matters which will not be dealt with by the directors unless the Acquirer's nominee is also present)
4.	Actions that require the Acquirer's affirmative	Such veto rights are meant only to protect the

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consent indicate that the Acquirer would be in a position to influence major policy decisions of the target by virtue of its 'affirmative vote'.	interest of the Acquirer and the investment made by it. Specifically analyzed the various veto rights (including amendments to Business Plan, charter documents of the company etc.) and finally held that such rights are merely indicative of the fact that the Acquirer wants to protect its investment and that the basic structure of the company is not altered without its consent.
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According to SAT, 'control' is a proactive and not a reactive power. Thus, power by which an acquirer can only prevent a company from doing what the latter wants to do is by itself not control. SAT went on to state that it is conventional for financial investors to protect their investment and, indeed, the target company itself from the whims and fancies of the promoters who manage the target company.

Pursuant to analyzing all the clauses referred to by SEBI, SAT finally concluded that none of the clauses individually or collectively demonstrates control.

Relevance

Financial investors ("FIs") such as private equity and venture capital investors typically seek various protective provisions in the investment documents executed with the investee company. Among the most sought after protections is the right to veto certain actions that the company proposes to take.

Until SAT's recent order, there has been much ambiguity as to whether such veto rights constitute 'control' under the Takeover Code. The order thus brings much relief to financial investors who have been uneasy about seeking such rights in listed companies for fear of triggering the requirement to make an open offer and also the implications of being regarded as persons in 'control' over the company.

Conclusion

The good news is that a precedent on the issue of veto rights has finally been set. However, given the importance of this issue, it is possible that SEBI appeals against SAT's order before the Supreme Court of India. Further, the possibility that SEBI may continue to pull up FIs for certain rights granted under a shareholders' agreement cannot be ruled out.

1 Appeal No. 8 of 2009 decided on 15.01.2010

2 Regulation 10 titled "Acquisition of 15% or more of the shares or voting rights of any company" reads: 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 (15%) 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.

3 Regulation 2(1) (c) of the Takeover Code defines the term as follows: "control" shall 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.

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