Balancing SEBI Regulations in Overseas M&A

In 1997, the Securities and Exchange Board of India began regulating M&A activity with the Takeover Code. The advent of a globalized economy since the code was introduced brings certain consequences to Indian companies that are targeted for takeovers by foreign companies. Priti Suri examines one possible case to highlight certain ambiguities, and makes suggestions as to how companies should proceed.

By Priti Suri
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India is poised to become one of the world's economic superpowers. Companies around the world are making their best efforts to benefit from India. In an address at the World Economic Forum in Davos in January 2005, India's commerce minister Kamal Nath commented: "The question for CEOs the world over is no longer 'should my company go to India' but rather 'can my company afford not to be India?'"

India has become such a strategic destination for big multinational companies that it has given an impetus to M&A. However, the game of M&A has its own set of rules. In order to govern the issues emanating from acquisitions of listed companies in India, the capital market regulator, the Securities and Exchange Board of India (SEBI), formed the Takeover Code, or *Substantial Acquisition of Shares and Takeovers Regulations, 1997*. As with the rules governing acquisitions elsewhere, the Indian Takeover Code is a complicated set of instructions. SEBI's aim is to protect the common investor. In order to provide a level playing field and to ensure that the strong do not devour the weak, the Code provides an exit route to existing shareholders in case of substantial acquisition of shares or change in management control.

In a globalized environment, the ripples of a merger or acquisition overseas may also affect India. SEBI will scrutinize the deal if the merger affects an Indian listed company. By using a hypothetical case, what are the repercussions of the merger of two foreign companies on a listed Indian company in light of the Takeover Code?

Hypothetical case

Two foreign companies, X and Y, execute an agreement for a global merger outside India. To implement the proposed merger, company X will establish a holding company which, in turn, will form a wholly-owned subsidiary (WOS). This WOS will merge with Y. Company Y holds controlling interest in YY, another foreign company. Consequently, the surviving company, XY, post-merger, will retain a controlling interest in YY. All these steps will occur outside India.

YY holds more than 75% of the current subscribed equity share capital as well as the controlling interest in a listed Indian company (AB). Company YY's pre-merger position regarding company AB is such that its nominee directors control AB's board and, therefore, AB is indirectly controlled by Y's management.

Assumptions post-merger are that changes may occur in the:

(i) corporate name of the surviving company XY, which may percolate to AB, or

(ii) board of directors of YY, such that new nominee directors indirectly controlled by XY (as opposed to Y) will manage AB.

In the aforesaid circumstances, will the Takeover Code be triggered? There are two possible situations, namely:

(i) post-merger, the constitution of AB's board does not change, or

(ii) post-merger, the constitution of AB's board does change.

Applying the Takeover Code to M&A has been a contentious issue, and revolves around four different regulations under Chapter III. Of the four regulations, three pertain to the circumstances when the Code is triggered, requiring a prior public announcement, while the fourth provides an exception to applying those three regulations. The regulator's orders on matters regarding the application of the exception have swung from allowance to denial.

It is essential to analyze the circumstances that trigger the Takeover Code, making a public announcement mandatory. This essentially happens in two situations; when there is an acquisition of shares beyond a threshold limit, or when there is a change in control over the management of the target company. Regulations 10 and 11 address the issue of acquiring shares, while Regulation 12 deals with acquiring control.

Acquisition of shares

Chapter III discusses in depth the circumstances in which the Takeover Code is triggered regarding acquisition of shares or voting rights (here, the term "shares" implies shares with voting rights). Acquisition of shares by the acquirer would also include acquisition by those acting in concert, if any, with the acquirer. Regulation 10 and 11 provide different limits on the acquisition of shares and, when those thresholds are exceeded, a public announcement becomes essential. Given the lengthy process of a public announcement and its consequential impact on the timing of any transaction, many companies explore the necessity of making an announcement at all.

Regulation 10 describes a substantial acquisition of shares for which a public announcement becomes a pre-requisite. Under this regulation, any acquisition of shares by an acquirer enabling it to exercise more than 15% voting rights in the target company requires a prior public announcement stating the intention to acquire shares in the target company.

Regulation 11 deals with the consolidation of holdings, and is targeted at two situations—firstly, where an acquirer holds shares between 15% and 55% and wishes to acquire further shares in the same company and, secondly, where an acquirer has acquired 55% or more but less than 75% of a company's shares or voting rights, and still intends to increase its shareholding further. In the former situation, for an acquisition of more than 5% of the shares, a prior public announcement is required. Thus, if a shareholder holds 51% of the shares and wants to acquire another 4%, Regulation 11 will not be attracted. In the second scenario, an acquirer is forbidden to acquire any additional shares in the company without a prior public announcement.

The explanation for Regulation 11 has clarified that, for the purposes of Regulations 10 and 11, acquisition means and includes:

(i) direct acquisition in a listed company to which the takeover regulations apply, and
(ii) indirect acquisition by virtue of the acquisition of companies, whether listed or unlisted, in India or abroad.

Acquiring control over management

Lawmakers have very clearly segregated shareholding from control over management. A person with a majority stake may not necessarily have control over the management of a company. The difference between the two may be found in the definition of 'control' in the Takeover Code itself.

The term 'control' has been defined under Regulation 2(1)(c), although the definition is not exhaustive but inclusive in nature. It includes the "right to appoint majority of the directors or to control 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".

Control over management need not necessarily be backed by majority voting rights or shares. Many companies are managed by professionals who have very little shareholding, but the shareholders rest their faith in management and allow them to perform their functions autonomously. Also, at times, the shareholding in the company is so scattered and multi-polarized that a person, despite having a small shareholding, but with the tacit consent of other shareholders, may acquire control over the company.

Regulation 12 deals with gaining control over the target company, irrespective of whether any shares or voting rights are acquired. In such a case, unless an acquirer makes a public announcement to acquire shares, he cannot acquire control over the management of the target company. Under this regulation, an acquirer shall be one who acquires, directly or indirectly, control of the target company, by virtue of the acquisition of companies, whether listed or unlisted and whether in India or abroad. No matter how control is acquired, it shall lead to a public announcement resulting in an open offer to acquire shares in accordance with the regulation.

The proviso to this regulation, however, exempts such an acquirer from making a public announcement if change in control takes place after a special resolution passed by the shareholders of the target company in a general meeting (this requires three times the number of votes in favour of the resolution versus votes cast against it). The objective of this regulation is to circumvent hostile acquisitions and, by virtue of a special resolution, the shareholders of a target company have an opportunity to approve the acquisition by the acquirer.

Public announcement

The mechanism of an open offer via a public announcement is an issue that has generated significant controversy. Under the Takeover Code, a public announcement is made by a merchant banker on behalf of the acquirer in newspapers disclosing the latter's intention to acquire a certain number of shares of the target company, as may be permissible under law. According to Regulation 14(4), in the case of an indirect acquisition or change in control, a public announcement is to be made in the newspapers by the acquirer within three months of the consummation of such a merger/acquisition, or change in control, or restructuring of the parent company holding shares, or control over the target company in India.

Disclosure in the public announcement includes the identity of the acquirer, offer price, number of shares to be acquired from the public, purpose of acquisition, future plans of the acquirer, if any, regarding the target company, change in control over the target company, the procedure to be followed by the acquirer in accepting the shares tendered by the shareholders, and the period within which all formalities pertaining to the offer would be completed. A public announcement is made to ensure that the shareholders of the target company are aware of the proposed transaction; they can then choose whether or not to exercise the exit opportunity available to them. The maximum stipulated time period permissible for completing the entire procedure is 120 days, starting from the date of the open offer until the sending of the final report by the merchant banker to SEBI. Practically, the whole procedure takes around 75–90 days, depending on the efficiency of the merchant banker.

Exception under Regulation 3

Regulation 3 provides for various exceptions to applying the Code. Regulations 10, 11, 12 do not apply to a rearrangement or reconstruction, formulated under any law, Indian or foreign.

Regulation 3(1)(j)(ii) states: "Nothing contained in regulation 10, 11 and 12 of these regulations shall apply pursuant to a scheme of arrangement or reconstruction including amalgamation or merger or demerger under any law or regulation, Indian or foreign."

This exception has attracted a lot of controversy and has been misused by many corporations. From the rulings of SEBI and the Securities Appellate Tribunal (SAT), it seems that the exception enshrined in the Takeover Code does not provide blanket cover to all mergers and amalgamations, and the regulatory authority has the right to scrutinize the scheme.

In the decided case of Ray Ban Sun Optics, both SEBI and SAT disallowed the exemption under Regulation 3(1)(j). Bausch and Lomb USA and Luxottica executed an agreement providing for Luxottica to purchase Bausch and Lomb's eyewear business. Bausch and Lomb had an Indian subsidiary. Execution of the agreement would have meant that the management control of the Indian business would change hands, thereby making a public announcement a necessity.

The agreement was later amended to provide a "merger clause" in order to circumvent the requirement of public announcement and application of Regulation 10, 11 and 12. Many contentious issues were involved and the matter was taken up by SEBI and SAT. It was held that, for the purpose of the Takeover Code, a subsequent change in the terms of the agreement would not transform Luxottica's acquisition into a merger and prevent making a public announcement.

The Takeover Code was triggered when the purchase agreement itself was concluded. Though the merger may have been valid under the applicable foreign law, it was not allowed as an exception under Regulation 3(1)(j), since Luxottica's initial intent was to acquire the business (and thereby control) and not to enter in a scheme of rearrangement. The matter is now sub-judice before the Supreme Court of India.

SEBI or SAT have not always disallowed exemptions—there have been instances when the acquirer has successfully qualified as an exception. In the case of Eaton Corporation, SEBI had disallowed the exemption but SAT reversed the SEBI order.

In this case, there was a merger under the laws of the State of Ohio, US Eaton Corporation's direct subsidiary, Eaton Industries, was merged overseas with Aeroquip-Vickers. The surviving company Aeroquip-Vickers became the subsidiary of Eaton Corporation. After the merger, the names of the subsidiaries of Aeroquip-Vickers were also changed. There was an Indian listed company, Vickers System International (VSIL), in which Aeroquip Vickers had indirect control through its wholly owned subsidiary. SAT, in its order, held that the case involved global restructuring—Eaton Corporation gaining control of VSIL was a fallout of the merger and, hence, should be exempted from the Takeover Code.

There is ambiguity when applying Regulation 3(1)(j). As a matter of practice, SEBI does scrutinize the agreement to ensure that there is no change in control over an Indian listed company in the garb of a merger.

Case Study

Coming back to the case study, it has to be seen how the provisions of law discussed above impact the outcome of the merger in the two given situations. It is essential to determine whether the transaction comes within the purview of substantial acquisition of shares. There is no acquisition of 75% of the shares of AB by XY from YY, which will continue to hold the shares in AB. Regulations 10 and 11 of the Takeover Code will not be triggered, as the transaction is a merger in an offshore jurisdiction whereby AB's eventual management would possibly be different.

The two assumptions need to be scrutinized in the light of Regulation 12.

What is the probability of making a public announcement or open offer subsequent to the merger:

(i) if there is no change in AB's board of directors, and

(ii) if there is a change in the board.

Assumption (i)

If YY's board is not reconstituted, there should not be any reason to believe that there is a change in control, despite the merger between X and Y and the creation of XY, since YY still holds 75% of the shares in AB and AB's board remains unchanged. Thus, there is no change in control of AB after the merger.

Assumption (ii)

When AB's board is reconstituted, it can be argued that change in management control has taken place. Normally, Regulation 12 would apply, making an open offer by a public announcement necessary. However, in view of the fact that this is an overseas merger, the exception under Regulation 3(1)(j) would apply and there would be no need for an open announcement. There is no change in control, because there is no change in the shareholding pattern of AB and YY still holds 75% of AB's shares. Any appointment of directors to AB's board must be with the consent of YY, which has the controlling stake in AB. AB's management shall also be governed by YY because of the 75% shareholding.

Though it may again seem as if the exemption under 3(1)(j) would have an overriding effect, there have been precedents where SEBI has denied the exemption, mostly because it found that a merger of the holding company of the target company, or even the holding company's holding company, with another company has come down to acquiring shares of the target company or reconstituting its board or changing the shareholding structure of the target company. SEBI may scrutinize the whole transaction and perceive a change in the board as a change in control.

It is also pertinent to consider why acquirers tend to avoid making an open offer via a public announcement. Acquirers seek exemption under Regulation 3 as it helps to minimize the cost of the transaction since the process of making an offer involves merchant bankers and is not really cost-effective. Further, it takes less time to close the transaction.

Conclusion

Recent trends show ambiguity as to when an exception under Section 3 (1)(j) can be successfully sought. SEBI has a tendency to view global mergers strictly, particularly to assess whether there are any hostile takeovers, directly or indirectly, and if potential acquirers can indirectly harm the interests of a company's shareholders. Given the volatile trends in the Indian capital market, SEBI's tendency is to make every transaction related to shares fair and open and prevent suppression or fraudulent practices by the majority shareholders or the management in key areas such as change in management control, without giving an opportunity to minority shareholders (generally, the public).

Therefore, as a matter of practice to avoid uncertainty, it is a common practice for acquirers to make an open offer instead of applying for an exemption from making a public announcement, thereby avoiding the future risk of any claim against the new management by other shareholders.

Of course, in certain cases, companies can seek an exemption from making a public announcement. A detailed application is required to be made to SEBI, which, in turn, refers it to the Takeover Panel. The application is decided on the panel's recommendations.

In the above hypothetical facts, YY needs to take a pragmatic and practical approach and avoid a show cause notice issued by SEBI for not following the Takeover Code. It may be more realistic to weigh the cost and time of defending the transaction before the quasi-judicial and judicial authorities versus the cost of an open offer. Whichever direction the balance of scales tilts should ideally be the most practical approach.

About the Author

Priti Suri is the proprietor of PSA. Priti has two decades of experience, in three continents, in diverse areas of international commercial law; mergers and acquisitions and possesses a general corporate background. Her focus is on company, commercial, joint ventures, mergers and acquisitions, technology transfers and arbitration and litigation.

Early litigation exposure in India provided her with knowledge of contentious issues that arise in business contracts. Subsequently, pursuant to an LL.M. degree in the US, she also added to her knowledge as an exchange visitor under the ABA's International Legal Exchange program and worked at law firms in the US. As an associate lawyer, she assisted in diverse areas of commercial law, including extensive work in ICC and AAA arbitrations exceeding values of $200-500 million for clients in the energy and telecom sectors.

Her early exposure to international transactions and professional experience in US and Europe has given her a flexibility to interact easily with clients from all jurisdictions. She was also appointed as "Special Counsel" to the State of Ohio, Office of Attorney General, in relation to advice on India related litigation matters. During the early 1990s she was based in Paris, first as an associate and subsequently as a partner of a law firm, where she represented several clients of the firm in numerous cross-border transactions. Priti has also prepared detailed documentation, in French, analyzing global tenders between French multinationals and state entities including various governments in South-East Asia and Africa.

In February 1997, she returned to India to set up the practice in New Delhi. Priti has and continues to represent several clients in a broad spectrum of industry ranging from automobiles, defense, energy, information technology, infrastructure, pharmaceuticals and telecommunications. She has served as lead counsel in numerous joint ventures, mergers and acquisitions (stock and assets acquisitions and sale of businesses) including in an investment in India for one of the world's largest steel conglomerates where the total value was in excess of $900 million. Priti's experience includes counseling clients in negotiations and restructuring commercial transactions between European/American/Asian multinationals and government/corporations in India. She steered to conclusion several projects where the value was in excess of $200-$500 million including setting up of a satellite for hand-held mobile communications. Over the years, Priti has supervised projects on inward investment approvals and follow-up with the Indian government regulatory authorities. Her experience includes counseling a European MNC, with a presence in 65 countries and a yearly turnover of $10 billion, on its Indian investment options including structuring and securing approvals from the regulators in a record time of less than 3 weeks. She has worked closely with senior management of the firm's clients and her representations have involved general corporate advice, listing issues, private equity matters and structuring mergers and acquisitions, both for listed and unlisted companies, between American/Indian corporations and European/Indian corporations in various sectors.

Priti's multi-lingual skills [she communicates in French, English, Hindi and Punjabi (native language)] have proved to be very useful in bridging cultural barriers. She has also represented the firm at various national and international seminars in India/Europe/US and spoken on cross-border investments in India. She has also co-authored articles published in the Illinois Bar Journal and authored a chapter titled "Criminal Procedures in the Use of Agents in India" in a book titled "International Trade: Avoiding Criminal Risks" edited by William H Hannay and published by Butterworths Legal Publishers in USA in fall 1991. Her other publication includes an article on "Enforcement of foreign awards in India: Simplification under the 1996 Act", published in the "*Asian Dispute Review*" by Hong Kong International Arbitration Centre. Recently Priti has also authored to and edited two books "*Open Source and the Law*" (the first book on the subject in India) and "*FDI Notifications: An Anthology*" published by LexisNexis Butterworths, India.

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