

APRIL 2017

CONTROL AND INVESTOR PROTECTION RIGHTS UNDER THE SEBI TAKEOVER REGULATIONS

1. INTRODUCTION

The Securities Exchange Board of India (“SEBI”), in a recent order dated March 31, 2017, in the matter of Kamat Hotels (India) Limited (the “SEBI Order”) has clarified that protective covenants or rights in favor of an investor in the company are in the nature of checks and controls rather than formulating policies to run the company.

2. BRIEF BACKGROUND

2.1 Clearwater Capital Partners (Cyprus) Ltd. along with Clearwater Capital Partners Singapore Fund III Private Limited (the “Investors”) had subscribed to foreign currency convertible bonds issued by Kamat Hotels (India) Limited (the “Company”). The Investors converted the foreign currency convertible bonds to equity shares of the Company, thereby, increasing their shareholding in the Company to 32.23% and requiring an open offer to be made as per the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (the “Takeover Regulations”).

2.2 The draft offer letter for the open offer was shared with SEBI which observed that the Investors had acquired control of the Company in view of certain clauses in the inter-se agreement executed among the Company, its promoters and the Investors (the “Investment Agreement”) which necessitated making a public announcement pursuant to regulation 12 of the Takeover Regulations. Accordingly, SEBI directed that:

- (i) appropriate disclosures in relation to violation of regulation 12 of the Takeover Regulations, as prescribed, should be made in the offer letter; and
- (ii) the offer price should be revised to be the higher of the price calculated by either the trigger of control pursuant to the investment agreement or the control pursuant to the conversion of the foreign currency convertible bonds.

The offer letter, which was finally shared with the public, contained all observations made by SEBI *except* the disclosures required under regulation 12 of the Takeover Regulations. Instead, it was stated in the offer letter that the Investors were aggrieved by the observations made by SEBI and would challenge it before the Securities Appellate Tribunal (the “SAT”).

2.3 Pursuant to the above statements, the Investors went ahead with the open offer and filed an appeal before the SAT (Appeal No. 21 of 2013). The SAT disposed of the appeal by its order dated February 12, 2014 and observed that:

“In the circumstances, without expressing any opinion on the merit of the case, we permit SEBI to issue show cause notice, to Appellant, if they choose to do so, regarding the direction contained in the communication dated November 30, 2012 and consequences for noncompliance of those directions. If SEBI issues show cause, then Appellant (Investors) would be at liberty to file reply. Thereupon SEBI shall pass final order after giving an opportunity of hearing to the Appellant (Investors)”.

- 2.4 SEBI thereafter issued a show cause notice stating that the provisions of the Investment Agreement, including:
- (i) the requirement to obtain the prior approval of the Investors for undertaking certain actions in the Company;
 - (ii) the ability of the Investors to restrict the promoters and the company from entering into certain agreements; and
 - (iii) a right to appoint a director on the board of directors of the Company,

were indicative of the right of investors to control the policy decisions of the Company which amounted to *control* defined under the Takeover Regulations. Therefore, not making the required disclosures as required by SEBI in the offer letter resulted in the open offer being in violation of the Takeover Regulations and other relevant SEBI regulations.

3. LAWS APPLICABLE

- 3.1 Regulation 12 of the Takeover Regulations provides that making of a public announcement for open offer is mandatory in cases where an acquirer acquires shares in a company beyond the prescribed limit or when a person acquires control over a company.
- 3.2 The Takeover Regulations recognizes that control in a company can be acquired even without acquisition of shares. The term '*control*' has been defined under the Takeover Regulations as:

"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 shareholder agreements or voting agreements or in any other manner..."

4 THE SEBI ORDER

- 4.1 While deciding on this matter, SEBI referred to the case of *Subhkam Ventures (I) Private Limited v. SEBI* (Appeal no. 8 of 2009 decided on January 15, 2010) (the "**Subhkam Case**") and observed that the disputed rights under the Investment Agreement were similar to the provisions of the agreement in question in the Subhkam Case which were interpreted by the SAT as *not* triggering control under the Takeover Regulations. The scope of the covenants under the Investment Agreement were observed to be general in nature to enable the Investors to exercise certain checks and controls on the existing management for protecting their interests. The Investment Agreement had also expired on July 31, 2014 and therefore was no longer binding on the promoters of the Company.
- 4.2 SEBI observed that the Investors had publicly disclosed SEBI's observation on acquisition of control under regulation 12 of the Takeover Regulations with riders as the Investors intended to challenge such statement on merits, which the Investors challenged after the open offer.
- 4.3 SEBI further observed that the offer price determined by the Investors took into account the price which the shareholders would have obtained if the Investment Agreement were to be held as acquisition of control under the Takeover Regulations.
- 4.4 In view of the points set out above, SEBI held that the charges alleged against the Investors under the show cause notice issued by SEBI were not maintainable. Accordingly, the show cause notice was disposed off.

IndusLaw View:

The SEBI Order is a welcome measure for private equity investors, who generally prefer to have certain investor protection matters in the nature of positive or negative covenants in the target company.

However, it should be borne in mind that the Investors, in the present case, had several other contributing factors in their advantage, such as the expiry of the Investment Agreement, offer of best price to public shareholders and adherence to the directions of SEBI in its offer letter by them.

This SEBI Order also does not set out an exhaustive list of rights which will not amount to control and has not gone into a comprehensive analysis of why the investor protection rights set out in the Investment Agreement did not amount to control.

Therefore, prospective investors should be careful and take a conservative approach and provide minimal protection rights which are not controlling in nature while investing in listed companies.

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