BRIGHTLINE TEST FOR CONTROL: EXPLORING ITS EFFICIENCY

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INTRODUCTION

The issue as to what constitutes 'control' has over the decades become somewhat technical in nature and has befuddled regulators, acquirers, target companies and shareholders with respect to its application as a trigger for the Mandatory Disclosure or Mandatory Bid Rule ("MBR"). Under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 ("Takeover Regulations"), a number of compliances and mandatory disclosures are required to be made by an entity which exercises 'control' in a public listed company. Investors dodge such compliances by structuring their investments accordingly. However, disputes are bound to arise due to the ambiguity surrounding the issue of control.

The term 'Control' with respect to the Takeover Regulations has led to a host of issues due to the inconsistency and vagueness in its definition. The uncertainty of precedence and uniformity as ascertained by regulators such as SEBI, CCI and IRDAI is the reason why the proposed discussion paper has been put forth for feedback. Companies need to feel assured that if a particular case was handled by a regulator in a certain manner, then the other regulators would also handle similar cases in the same manner.

The issue of 'What amounts to control?' has been one of great contention and numerous litigations. The latest attempt to streamline litigation and judicial response to "control" was the Securities Exchange Board of India's (hereinafter SEBI) proposal of a Brightline Test for determining acquisition of control.

Generally speaking, a Brightline Test or a brightline rule refers to *"an objective rule that resolves a legal issue in a straightforward, predictable manner. A bright-line rule is easy to administer and produces certain, though, arguably, not always equitable results"* thereby

ensuring certainty and consistency upon application. Applied in the control paradigm, a Brightline Test thus seeks to develop a framework devoid of ambiguity in determining control, through introduction of numerical thresholds. SEBI however dismissed the said proposal, stating that a Brightline Test could be "prone to misuse”.

The Discussion Paper by SEBI aimed to clear issues of indirect takeovers and put to rest the controversies surrounding the issue. This paper starts by looking at the concept of ‘Control’ under current Takeover Code and tries to analyze the proposed bright line test introduced and the reasons for its dismissal and to to bring definitional clarity in control.

CONTROL UNDER TAKEOVER CODE, 2011 AND HISTORY OF JUDICIAL RESPONSE TO CONTROL

In the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, ‘Control’[i] has been defined 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 shareholders agreements or voting agreements or in any other manner”*

The above-mentioned definition under Section 2(1) (e) of the Takeover Regulations has broad contours and is contingent on the facts and circumstances of each case, which results in multitude of opinions and thus a number of litigations due to the inconsistent views. Multitude of opinions may give rise to different assessments on the amount of control over a listed company and lead to significant litigation.

In **Rhodia S.A. v. SEBI**[ii], SAT ruled that Rhodia, albeit not being a shareholder, was in a position to control the affairs of Danube, the step-up parent company of the target in India. From the facts of the case it appears that SAT had inferred Rhodia’s ability to control the affairs of Danube not only due to the contractual veto rights vested with Rhodia on all major matters such as payment of dividend, acquisition or disposal of assets and issuance of securities but also due to the other conditions surrounding the case. Rhodia funded Danube and also completely controlled the bid placed by Danube’s wholly owned subsidiary for the acquisition

of the target company in UK. Based on all of the above it is not very tough to come to the deduction that Rhodia did have an ability to control the affairs of Danube. It will be misplaced to read the Rhodia S.A. decision to mean ‘a veto right over significant corporate transactions of the company amounts to an ability to control that company’.[iii] It can be undoubtedly inferred that Rhodia exercised a degree of control over the company well past its affirmative veto rights.

In the case of **K. Sreenivasa Rao v. SEBI**[iv], it was held that when an acquirer acquires the control over a target company, there is the obligation to make a public announcement on the acquirer who agrees to buy.

In **Re NRB Bearings India Ltd**[v]., SEBI stated acquirer’s veto rights over amendments to the organizational documents, declaration of dividends, alteration in share capital, entry into JVs, technology transfer etc. did not amount to control since the foreign acquirer had only nominal representation on the target company’s board.

Contrary to the ruling in Rhodia, in **M/s Subhkam Ventures Pvt. Ltd. V SEBI**[vi], Subhkam Ventures (I) Private Limited acquired more than 15% shares in MSK Projects Limited (“MSK”), the target company. Subhkam made the public announcement of open offer under Regulation 10 and filed a draft letter of offer with SEBI, which then mandated the acquirer to state in the letter of offer that the offer is being made under Regulation 12 as well. This is because of the reason that the subscription and shareholders agreement entered into among Subhkam, the promoters and target Company enclosed protective provisions in favour of Subhkam. As the issue remained disputed, the acquirer preferred an appeal to SAT. SAT started off by laying down some general principles on what constitutes “control” in such a situation involving a financial investor.

The emphasis was laid down to the distinction being made between proactive power (positive control) and reactive power (negative control). The ruling of the SAT was as follows: - *“we are clearly of the view that none of the clauses therein taken individually or collectively demonstrates control in the hands of the appellant. In this view of the matter Regulation 12 does not get triggered and the Board was not justified in making the appellant incorporate this regulation in the letter of offer.”*

In **M/s. Clearwater Capital Partners Ltd. v. SEBI**[vii], it was held affirmative voting rights granted to Clearwater amounted to handing over control over the target company. Even if the court considers the affirmative voting rights not to be controlling the day to day management

Or policy decisions, SAT has held that if these affirmative voting rights relate to the 'structural and strategic decisions' it would still constitute control.

In **Century Tokyo Leasing Corporation/Tata Capital Financial Services Limited**[viii], the CCI held that affirmative rights relating to annual budget, annual business plan, exit and entry into lines of business, appointment of management or other strategic business decisions would be considered control.

There are also a couple of contemporary issues wherein interpretation of the term 'control' has been involved. In **In Re: Jet Airways Ltd**.[ix], preferential allotment of 24% shares of Jet to Etihad was to be made. The issue was whether 24% shares allotted to Etihad would amount to control over management and policy decisions of Jet. SEBI held that rights acquired by Etihad do not result in change in control and do not attract Reg. 2(1) (e) read with Reg. 4 of the Code. The way ahead in terms of an ultimate judicial determination of the issue is definitely not clear. Judicial decisions may be helpful in setting out broad parameters or principles for determining control, it may not be the finest method for determining recurring explanatory issues on what may constitute 'control'. Ultimately, SEBI may need to consider issuing guidelines on how control should be assessed in the context of specific rights.

BRIGHTLINE TEST FOR CONTROL: AN ANALYSIS

The SEBI "Discussion Paper on Brightline Test for Acquisition of 'Control' under SEBI Takeover Regulations" seeking to put an end to this ongoing controversy was seen as a welcome step in the takeover regime in India. It was thought that a Brightline Test, being objective and clear in nature, would assist the judiciary in developing a consistent response to litigation surrounding 'control'. SEBI ultimately dismissed the test due to certain shortcomings.

One of the options suggested by SEBI in its Discussion Paper on Control proposed to define control 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."[x]

The discussion paper asserts the need of a Brightline Test and and it cites experiences of several jurisdictions and according to the paper, majority of these jurisdictions have a *de jure* measure of control.[xi] The discussion paper also shows how different laws in force in India interpret 'control' differently which subsequently leads to different conclusions in issues with same factual matrix. This in turn leads to ambiguities, making the adoption of objective standard contextually appropriate. The objective standard approach can reduce the ambiguities in determining whether control over target has been acquired or not and can provide clarity on the issue to a great extent but it has its own shortcomings which are grave in nature.

The threshold of 25% which has been proposed by SEBI should take into account the pattern of shareholding in Indian jurisdiction and should not be seen as an absolute figure. The corresponding quantitative trigger for control should be kept at a low level in jurisdictions with dispersed shareholdings as opposed to high trigger in concentrated shareholdings.[xii] Thus, the 25% trigger proposed by the SEBI itself seems problematic since it may prove to be illogical and "counterintuitive" since shareholdings in India are largely concentrated.[xiii]

The primary shortcoming of the 25% acquisition of voting rights in the Brightline Test for control lies in its own certainty.[xiv] Investors, assisted by their lawyers and bankers can evade the Brightline rule if there is a fixed numerical threshold.[xv] As a consequence, this would preclude them from making a mandatory open offer, thus damaging the interests of the minority shareholders who may seek a favourable exit opportunity to no avail.

The Brightline Test proposed in the Discussion Paper also disconnects the threshold required to launch a mandatory open offer from de facto control. In other words, while the acquirer company may stay below the threshold to make an open offer, it may exercise de facto control owing to the shareholding structure of the target company or through derivative instruments. A Brightline Test ignores such realities of control, and in adopting an approach grounded in legal formalism often operates to the detriment of the minority shareholders. The underlying rationale of the threshold required to make an open offer, viz., the equality of opportunity to the minority shareholders would thus suffer irreparable damage due to such disconnection.

Hence, a situation wherein an acquirer attains 24.9% of the voting rights in the target company (with no other similar shareholder), but still retains de facto control over the target company due to the pattern of shareholding of the target company cannot be disregarded.[xvi]

In fact, if the acquirer is in a position to exercise de facto control, it would be prudent and beneficial for him to stay below the open offer trigger.[xvii] Since, he is below the Brightline threshold he would not be reuired to make a mandatory open offer but yet could exercise a great degree of influence over the target company's management and policies. Once again, this requirement of a mandatory open offer would violate the basic aim of the Takeover Regulations (of furnishing an opportunity of exit to minority shareholders, in case of displeasure with the acquirer and his policies).[xviii]

In United Kingdom, there has been noticeable trend of acquirers avoiding the open offer regulations by not only remaining under the Brightline trigger of 30% but also through the usage of investment instruments of a complex nature, or of dexterous structuring strategies; a feature also seen in other jurisdictions and India should learn a lesson from their experience.[xix] For instance, it would not be altogether unrealistic to envisage a situation where the acquirer invests in a percentage of shares, a shade below the open offer requirement and then through the adoption of positions in derivative instruments, use swaps and options to fulfil the deficit in percentage. An option vests in a party the right to purchase or sell the underlying asset on a particular point in time in the future at a decided price. A swap on the hand refers to the exchange of two financial instruments. [xx]

Subsequently, the acquirer is also empowered to skirt disclosure requirements by discreetly obtaining positions (a position refers to a binding commitment to purchase or transfer a financial instrument. These positions may be long, or short) and then launching a surprise voluntary offer on the target company's Board.[xxi] Further, the numerical Brightline proposed by the SEBI could also impede the interests of not only promoters, but also companies/firms managed professionally existing in sectors highly dependent on capital. In such capital-intensive segments of the market, the investors, although exceeding the threshold, would not desire to undertake the responsibilities associated with acquisition of control over a company.[xxii]

With regard to the appointment of a majority of non-independent directors, the question of whether an acquirer would be deemed to be in 'control' of the target company would turn on the usage of „and/or" in the Discussion Paper. If the 'and' is employed, that could be circumvented by acquirers by staying below the 25% Brightline, but having the right to appoint a majority of non-independent directors by virtue of the shareholding structure of the target, or through covenants.

On the other hand, if the 'or' criteria is employed, using the 'right to appoint' test solely, would take us back to the definition of control as already envisaged in Regulation 2(e), thus making it redundant. It could also result in a number of professional investors, like venture capital funds who wish to stay outside the net of 'control' being caught in it. Thus, instead of introducing objectivity, it would again be a subjective determination of whether or not the acquirer (here, the fund) actually exercises control over the company.

SEBI's proposal of fixing the Brightline for open offer obligations at 25% cannot possibly be enforced as a universal rule in every circumstance due to the complicated nature of facts which may arise in the future, and would not exclude the possibility of future uncertainties arising. The decoupling of the open offer trigger with de facto control endangers the underlying philosophy of the Takeover Regulations, that is, equality of opportunity to the minority. However, while it is undoubted that a greater degree of certainty would be infused in the Indian takeover regime, the opportunity cost of doing so is forsaking the exit rights of the minority stakeholders. Coupled with the capability of the acquirers to evade the open offer obligation by staying below the prescribed threshold and so on, as seen abroad, the consequences of a Brightline Test are highly problematic. In a Brightline Test, equity is sacrificed at the altar of certainty and predictability.

RESOLVING THE PROBLEM: A POSSIBLE WAY FORWARD

(a) Definitional Clarity by Harmonization of Regulations:

SEBI attempted to clear the definitional uncertainty by proposing the Brightline Test. The Discussion Paper proposed an 'either/or' test in which control would be determined by fulfilling either of the two criterion which basically are either breaching the threshold of 25%

voting rights or possessing the right to appoint majority of independent directors. This is particularly important as the 'or' test would classify the breach of the numerical threshold as control keeping the subjectivities aside. However, the breadth of the definition of 'control' that is inferred from the wholesome reading of Regulation 3 with Regulation 4 and 2 (e) is discarded due to the objective nature of the test.

According to Regulation 2 (e), a person is said to be in control if (i) he has right to appoint majority of (non-independent) directors, or (ii) he controls the management or policy decisions. The Regulation further stipulates that control can be acquired by agreements and there is no necessity of acquisition of shares. The Takeover Regulations makes it mandatory for the acquirer to make an open offer when it acquires 25% of the shares under Regulation 3. Notably, Regulation 3 does not speak of control, and regardless of the fulfilment of condition (i) and (ii) under Regulation 3, it mandates an open offer. This is at best a general compliance with the mandatory bid rule for substantial acquisition of share that is taken to be at the heart of the Takeover Code. However, acquisition of substantial shares does not always mean gaining control. Regulation 4, adopting a similarly broad phraseology as the definition under Regulation 2 (e) mandates an open offer regardless of shareholding.

However, the express distinction of an open offer prompted by acquisition of substantial shares and acquisition of control is discarded by the Brightline Test. It selectively reads Regulation 3 as 'control' and leaves out the expansive definitions under the other two provisions and is in clear discord with the scheme of the Takeover Regulations and betrays the express distinction laid by the framers itself between 'substantial acquisition of shares or voting rights' and 'acquisition of control'.

This distinction is however recognized by the Discussion Paper and it and remarks, *"In India, the Companies Act recognizes any holding in excess of 25% as the threshold at which special resolutions can be blocked. Further, the threshold for substantial acquisition under the Takeover Regulations is 25%. It would, thus, be appropriate that 25% may also be specified as the threshold level for trigger of control in Indian listed companies"*.

This patently flawed logic ignored the protective role and active role in control, and ostensibly discards the difference between and conflates substantial acquisition of shares with control to propose the Brightline test. This would result in absurd conclusions when the larger shareholder

holds 74% of total shares. The other shareholder would clearly have a decisive role to play in controlling the management or policy decisions while the owner of 26% of voting rights would not even be a joint owner.[xxiii] Can there be control of the company by two different persons at the same time? Who is to be held liable as the controller of the company in case of dispute and non-compliance? Gaining control is a higher threshold than merely acquiring substantial shares.

Therefore, such acquisition of shares should not and possibly would not confer 'control' upon the shareholder, despite breaching the limit that the Brightline Test lays down. The discussion paper proposed a test that is inconsistent with the intention of the framers of the Takeover Regulations because it laid down a strictly objective Brightline Test and did not take into consideration the subjective nuances of the meaning of control.

The proposal for the Brightline Test has been scrapped after extended consultations and the definition as provided under the Takeover Regulations is still being followed. Hence, the ambiguity that was perpetuated by the Supreme Court decision in Subhkam Ventures[xxiv] (and a prudent reading of the later Kamat Hotels case) still persists. Now if SEBI decides to resolve the ambiguity surrounding the meaning of control, it should take into consideration the interplay between Regulation 3, Regulation 4 and the broader definition as provided under Regulation 2 (e) of the Takeover Regulations, 2011.

The presumption of control should not exist against the shareholder merely because the threshold provided under Regulation 3 is triggered. The idea of active/positive control is implicit within the definition of control under Regulation 2 (e) thereby only including such rights that require a proactive action on the part of the acquirer to constitute control. Therefore, merely breaching the threshold without holding any right to influence the management or policy decisions and holding only certain rights for protection of one's own interest should not confer control upon the acquiring shareholder. The trigger under Regulation 4, which specifically applies in the case of control, should not be conflated with the general rule of an open offer by breaching the numerical threshold of 25% shareholding under Regulation 3.

Such an approach will help reap the benefits of a flexible approach of a qualitative idea of control while significantly reducing uncertainty among the shareholders.

(a) Reintroducing the Whitewash Provisions:

Often, major transactions may involve the acquisition of large number of shares, usually not through the shares held by existing shareholders but through the issue of new shares, when the intention of the acquirer might not be to gain control. In such circumstances, the obligation to make an open offer could be waived through the approval of the existing shareholders. This exemption, referred to as a 'whitewash' is based on the rationale of the primacy of shareholder's interest to decide whether to take the benefit of the exit opportunity provided or to consciously renounce it.[xxv] Whitewash, however is outside the purview of the Takeover Regulations, 2011. The provision to allow a whitewash existed in the erstwhile regime of the Takeover Regulations, 1997 under Regulation 12 wherein the rule of open offer could be dispensed with, if a '*special resolution is passed by the general meeting'*.

However, the provision applied specifically to exempt triggering of mandatory open offer in case large number of shareholders acquiesced to such change. The TRAC committee viewed such a selective application of the provision only to situations wherein there was a change in control but not to situations of acquisition of substantial shares as an anomaly.[xxvi] After exploring several possibilities of retaining the provision of a whitewash in the new Takeover Regulation by internalizing international practices, the Committee concluded it would be wise to dismiss the thought on account of absence of '*robust regulations on proxy solicitation*'.[xxvii] Proxy solicitation is often considered to be problematic, as it is perceived to be a mode of stifling dissident shareholders by using company funds.[xxviii] The large shareholding pattern by promoters in India is seen with suspicion as they allow the misuse of proxy solicitation.

However, instead of looking at the possibility to encourage diversified shareholding, scrapping the whitewash mechanism altogether in order to wait for the Indian market to ripen is similar to misplaced notions of hoping that the problem would get solved automatically.

Whitewash provisions are definitely not a new concept. Whitewash provisions have been incorporated by jurisdictions like UK and Singapore in their respective takeover regimes. However, these provisions cannot be blindly imported to India without customizing them to the ground realities here. For example, in Singapore, for the whitewash waiver to be valid, the requirement is an up vote by a simple majority.[xxix] However, since company shareholding in India is consolidated by promoters, usually members of the same family, and is not diffused,

the minority shareholders are exposed to greater vulnerability if the requirement is merely a simple majority. Therefore, it is proposed that the threshold be increased.

Further, keeping in mind that protection of the minority shareholders interest is at the core of the Indian takeover regime, a figure as low as say, 10% minority shareholders could object to the waiver and place an application to SEBI to deny such waiver unless the minority shareholders' interests are paid attention. Such provisions to safeguard minority shareholders' interests when the majority attempts to bulldoze their way through are already in place in the Companies Act, 2013. For example, even when a special resolution is successfully passed in regards to variation of shareholders' rights under Section 48 of the Companies Act, 2013, 10% of the dissenting shareholders can apply to the Tribunal to have the variation cancelled.

This approach strikes a balance between the autonomy enjoyed by the company in its affairs while keeping the minority interests safe. The provision from the UK Takeover Code to put forth an independent expert's opinion before the voting for waiver takes place could be transplanted to Indian law to reinforce the safety of shareholders by helping them make an informed decision.[xxx]

The author believes that the introduction of whitewash provisions could facilitate additional clarity on the contours of 'control'. Further, the shareholders would be empowered to differentiate between the triggering of an open offer under Regulation 3 merely by breaching the cap of 25% shareholding and a change of 'control' mandating an open offer under Regulation 4. The additional regulatory burden on the SEBI would also thereby be reduced through such clarity. Even in a scenario wherein 'control' has changed hands, the mechanism would allow the shareholders to decide whether they would like to continue under the changed circumstances. This could also contribute towards the aversion of a chilling effect on transactions that are purely geared towards extending support in times of financial distress, and in scenarios where the investment is being provided by the party that has limited funds and cannot bear the onerous burden of acquiring additional shares in fulfilment of the obligation of an open offer. Therefore, a need to reintroduce whitewash provisions are manifest, of course, with additional policy measures to ensure that the provision is not misused to defeat the interests of minority shareholders.

CONCLUSION

The lacunae present in the contemporary legal regime, owing to the dismissal of the proposed Brightline Test has sought to be addressed in this project. This project seeks to assist in the development of a broader framework that the SEBI should keep in mind while determining the acquisition of control on a (necessarily) case-by-case basis. This framework could achieve definitional clarity by harmonizing Regulations 2(e), 3 and 4 of the Takeover Regulations, 2011 and re-introducing the whitewash provisions, present in the former (although in a different form) Takeover Regulations 1997.

Introducing a Brightline Test would require a selective reading of control and would ignore the textual interplay between Regulation 2 (e), 3 and 4 of the Takeover Regulations, 2011. Further, the regulators should consider reintroducing the whitewash provisions, which are consistent with the democratic principles that allow the shareholders to decide their fate and working of their organization.

A rigid and objective standard of the Brightline would increase the scope of unwarranted interference in the internal working of the organization and subvert the idea of shareholder primacy. However, the measures proposed above are by no means exhaustive and must be supplemented by additional policy measures to ensure a robust takeover regime in India, conducive to acquisitions. Control, by its very nature is a dynamic concept, and an objective test would not suffice therein. Only by developing a broader framework of principles, can consistency and clarity merge in the interaction of the regulator and the stakeholders with the Takeover Regulations.

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