MAJMUDAR & PARTNERS
INTERNATIONAL LAWYERS
LEGAL EXCELLENCE SINCE 1943

# UNSECURED LENDING TRANSACTIONS CAN AMOUNT TO AN ACQUISITION OF CONTROL OF A LISTED COMPANY – A CRITIQUE

In India, under the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (the "**Takeover Regulations**"), there exists a mandatory tender offer regime for acquisition of listed companies. Under this regime, both, the acquisition of a substantial shareholding stake (25%) and the acquisition of "control" are treated equally, and require the acquirer to make an open offer to the public shareholders. Currently, under the Takeover Regulations, the test to determine what constitutes change of "control" is principle-based and is defined to include:

- the right to appoint a majority of the directors; or
- the right 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, management rights, shareholders or voting agreements, <u>or in any other manner</u>.

Recently, the Securities and Exchange Board of India (the "**SEBI**") passed an order in the matter of the indirect acquisition of control of New Delhi Television Limited ("**NDTV**") by Vishvapradhan Commercial Private Limited ("**VCPL**") pursuant to a lending transaction. This update critiques the SEBI's order on interpretation of "control" under the Takeover Regulations.

### *Background*

As of December 2008, the promoter group of NDTV, a public listed company, included Prannoy Roy and Radhika Roy (collectively, the "**Promoters**"), along with RRPR Holding Private Limited ("**RRPR**"). On July 21, 2009, RRPR and the Promoters availed a loan of INR3.5 billion (approx. US$51.47 million) from VCPL (the "**Loan**"), and consequently, entered into a loan agreement (the "**Loan Agreement**") and two (2) call option agreements with VCPL's affiliates (the "**Call Option Agreements**"). The Loan was unsecured, interest-free and for a term of ten (10) years from the drawdown date.

### *VCPL's rights under the Loan Agreement and the Call Option Agreements*

Under the Loan Agreement, the following rights were granted to VCPL:

- Convertible warrants were issued by VCPL with a right to convert into 99.99% equity shares of RRPR at any time during the tenure of the Loan or thereafter, without the consent of the Promoters (the "**Conversion Option**");
- VCPL had the right to purchase 100% equity shares of RRPR from the Promoters at par value (the "**Purchase Option**");
- VCPL had the right to appoint at least one (1) out of three (3) directors of RRPR;
- Certain corporate actions relating to RRPR and NDTV required prior consent of VCPL, including any changes in NDTV's constitution or capital structure; and

- The Promoters and their affiliates were required to exercise their voting rights in RRPR and in NDTV, collectively, in order to ensure that the Loan Agreement and the Call Option Agreements were given full effectivity.

Further, under the Call Option Agreements, VCPL's affiliates had an option, but not an obligation, to purchase the shares of NDTV from RRPR at a pre-determined price of INR214.65 (approx. US$3.16) per share (the "**Call Options**"). The Call Options were not linked to the repayment of the Loan and could be exercised even after the repayment of the Loan. Additionally, the following rights were granted to VCPL:

- The Promoters and RRPR were prohibited from selling or transferring the shares of NDTV held by them to any third party for a period of five (5) years from the date of the Call Option Agreement without the prior written consent of VCPL.

- The Promoters were prohibited from investing in any business similar to NDTV's business, financially or otherwise.

***Order of the SEBI***

<u>Based on a conjoint reading of the terms of the Loan Agreement and the Call Option Agreements, the SEBI concluded that the parties had entered into a lending arrangement to guise the acquisition of control of NDTV</u>. Listed below is the SEBI's reasoning for its order.

- The SEBI, while citing provisions of the Loan Agreement, observed that the Conversion Option and the Call Options were not limited in time, but could be exercised even after the repayment of the Loan. The SEBI rejected VCPL's argument that the rights given under the Loan Agreement and the Call Option Agreements would cease to be effective upon full repayment of the Loan, and therefore, were protective rights or collateral to the Loan given by VCPL to RRPR.

- The Conversion Option and the Call Option were independent of each other and both these options could be exercised by VCPL, as a result of which VCPL could potentially acquire a 52% equity stake in NDTV, i.e., by indirect acquisition of 99.99% of RRPR and by direct acquisition of 26% of NDTV. <u>In our view, it is pertinent to note that the Conversion Option and the Call Option were options to acquire control in the future and were not exercised as on the date of the SEBI order. Call options and convertible instruments are very common, and if these are interpreted to mean acquisition of "control," it will be very difficult to negotiate financing or shareholding arrangements without triggering the Takeover Regulations</u>.

- The fact that the Call Options were not contingent on default in payment of the Loan and were completely independent of the Loan Agreement has been construed by the SEBI to mean that regardless of whether the Call Options would be exercised, 26% shares of NDTV were "earmarked" from the word go for VCPL or its affiliates. <u>In our view, this opinion does not find merit from a corporate law standpoint, as there is no concept of earmarking of shares or even acquiring a beneficial interest in shares by virtue of grant of a call option</u>.

- The right of first refusal and the non-compete obligations of the Promoters and RRPR in the Call Option Agreements further indicate acquisition of control by VCPL over NDTV. The SEBI noted that these rights were found in share purchase agreements and shareholders' agreements, but not in conventional loan documents. In our view, the parties to an unsecured loan transaction are free to negotiate any collateral that they deem fit. This can be in the nature of physical assets or other intangible rights.

- The purchase price paid for the exercise of the Call Options would have to be used by RRPR to repay the Loan. Therefore, any subsequent monies paid by VCPL or its affiliates would be routed back to VCPL under the guise of repayment of the Loan. Further, the purchase price required to be paid upon the exercise of the Call Options was significantly higher than the market price of NDTV as on the date of the Call Option Agreements. Again, in our view, the parties should be free to agree on the commercials of a transaction, and this should not affect the legality of the transaction.

- The requirement of the Promoters and their affiliates to exercise voting rights to ensure that the Loan Agreement and the Call Option Agreements are given full effect implied that concurrence of VCPL would have to be taken into account for any decision and not just for the veto rights mentioned in the Loan Agreement. We are unable to agree with this view as the Loan Agreement merely provides that the Promoters and their affiliates will exercise their voting rights to give "full effect" to the Loan Agreement and the Call Option Agreement. This means that the transactions specified under these documents would be enabled by voting appropriately, as for example, voting in favour of taking on record the transfer of shares of RRPR in case of exercise of the Purchase Option. The SEBI has extended this to mean that VCPL would have a say in all decisions of RRPR and NDTV.

- As per the charter documents and financial statements, VCPL was not engaged in lending activities and did not have the financial capability to advance huge amounts. In our view, even if VCPL was not authorized to engage in lending activities, the consequence would be that the lending transaction could be held to be *ultra vires* its charter documents. However, this argument cannot be used as a basis to conclude that the loan transaction was an acquisition arrangement.

- As the collateral for the Loan was the direct and indirect interest in NDTV, there were no protective rights for repayment of the Loan in case of erosion of market value of NDTV. This is not in line with typical financing transactions. Once again, our view is that parties should be free to agree upon the commercials of a transaction, and regulators must refrain from intervening on these issues unless found to be in contravention of law.

***Our Comments***

Over the years, the definition of "control" under the Takeover Regulations has posed to be a problem as there are a number of different opinions on whether a particular action results in acquisition of "control." Previously, the issue of "negative control" pursuant to veto rights which do not result in a say in the day-to-day affairs and the business of a company was widely discussed, but there is no finality on this issue yet. Despite numerous industry representations, the SEBI has declined to adopt a rule based definition for "control" leaving investors in limbo.

Our views on interpretation of "control" by virtue of veto rights have been discussed in our articles.

The SEBI's order in this matter adds further confusion to the "acquisition of control" debate. It is very difficult to understand how future rights or options to acquire a stake can be deemed to mean acquisition of control as on the date of grant of the right or option. In fact, VCPL has stressed on this point that the rights under the Loan Agreement and the Call Option Agreements have not been exercised, and as such, they are mere "on paper" rights. However, the SEBI has disregarded this argument completely.

Further, a standard further assurances provision has been interpreted to mean control over the day-to-day affairs of the business of the company, despite there being a "negative" veto rights list in the documents. This goes to indicate that the SEBI's view on "control" is not consistent, and this does not augur well for investor confidence in India's securities regulator. We hope that the appellate authorities clarify this issue in the interests of both, the investors and the shareholders.