Legislative and regulatory update

TAXATION

Sub-contractors not a 'permanent establishment'

The Authority for Advance Rulings (AAR) has held that work independently performed by an Indian sub-contractor in its own factory does not represent a permanent establishment (PE) of a foreign company under article 5(2)(i) of the India-Germany tax treaty.

Pintsch Bamag, a German construction company, was awarded a contract by the Tuticorin Port Trust to design and install a navigational channel and fairway buoys for the Sethu Samudram ship channel project. Pintsch Bamag sub-contracted a major portion of the job to an Indian company, Asia Navigation Aids, and entered into supply contracts with other Indian companies.

Pintsch Bamag contended that it had no PE in India, as the staff it sent to India to work on the contract was there for only two months (at the time of installation and commissioning). This lay outside the time requirement of six months specified in article 5(2)(i). The tax authorities contended that the time resident in India should be calculated to include the activities of Asia Navigation Aids, which was performing tasks central to Pintsch Bamag's contract work. They also argued that the sub-contractor's workshop should be treated as part of a PE of the contractor. Such a definition would bring the duration of the contractor's work in India well beyond the stipulated six-month threshold.

The AAR found that the tax authorities' contention could only be upheld if the sub-contractor was treated as a dependent agent of the contractor.

The AAR also noted that the relationship between Pintsch Bamag and Asia Navigation Aids was more akin to one between principals than between an agent and sub-contractor. The authority held that the number of days spent by the sub-contractor at its factory should not be taken into account when computing the contractor's period of presence in India.

The AAR also observed that the activities undertaken during the preliminary stages of the project did not require the regular and constant presence of Pintsch Bamag's staff in India, and so did not bring a PE into existence.

The AAR relied on the earlier case of Cal Drive Marine Construction when discussing the interplay between the clauses of article 5. It observed that the determination of PE in this case would be under article 5(2)(i), thereby eliminating the application of general provisions under other clauses of article 5(2).

MERGERS & ACQUISITIONS

'Promoter' does not imply acquisition of control

In a recent adjudication order the Securities and Exchange Board of India (SEBI) held that the disclosure of acquirers as "promoters" in terms of regulation 8(2) of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 (the takeover code) does not in itself result in acquisition of control by the acquirers under regulation 12.

India Newbridge Investments, India Newbridge Coinvestments, India Newbridge Partners FDI and Maxwell (Mauritius) jointly purchased 2,250,000 equity shares (constituting 15.16% of the total equity capital) of Matrix Laboratories through preferential allotment according to an agreement dated 15 April 2004.

On 18 April 2004 the acquirers made an announcement in terms of regulation 10 of the takeover code. The acquirers' letter of offer clarified that they did not wish to acquire control of the target, and accordingly that regulation 12 did not apply to the open offer. The letter clarified that the post-open offer shareholding of the acquirers would be 40.46% of the total equity capital of the target.

On 28 August 2006 MP Laboratories (Mauritius) and Mylan Laboratories acquired 51.5% of shares from the promoters of Matrix Laboratories. The names of the acquirers appeared in the "promoter group" category of the target – that is, those having controlling or strategic holdings – in the letter of offer for the acquisition. This was also reflected in the shareholding pattern of Matrix Laboratories for the quarter ending on 31 December 2004.

SEBI noted that the acquirers' open offer in 2004 was made in terms of regulation 10, not regulation 12. It also alleged that the classification of the acquirers as part of the "promoter group" showed that the acquirers had obtained control of the target company on 31 December 2004, and had violated the takeover code's provisions by failing to make an open offer in terms of regulation 12 read with regulation 14(3).

The acquirers clarified that the target company had – at the suggestion of the Bombay Stock Exchange – included the acquirers with the "foreign promoter" category purely for the computation of a "free float" under the listing agreement. Consequently the acquirers filed declarations under regulation 8(2). The acquirers also pointed out that they only had restricted rights; they could appoint a maximum of three directors to the board, and had no right to nominate any officer or manager of the target.

The acquirers submitted that there had been no fresh trigger of any charging provisions of the takeover code after the open offer took place in 2004. Furthermore, the disclosure under regulation 8(2) was not supported by any material change such as an increase in the number of directors appointed by the acquirers, a change in management by the acquirers, a change in shareholdings or an amendment or rescinding of the shareholders agreement. In such circumstances, acquisition of control by the acquirers post-open offer cannot be established.

The adjudicating officer concluded that declarations under regulation 8(2) are merely an expression of the state of affairs, and do not effect acquisition of control by the acquirers unless coupled with some actual changes to that effect. Since there was no substantial evidence on record to establish that the acquirers gained control over target subsequent to the open offer, it was held that they did not violate regulations 12 and 14(3) of the takeover code.

Tribunal reaffirms relevant date for open offer price calculation

A recent order passed by the Securities Appellate Tribunal (SAT) in the matter of Goldstone Exports has reaffirmed the manner of calculation of open offer price under the takeover code in the event of conversion of warrants into equity shares.

Goldstone held 9.51% of the equity share capital of Goldstone Infratech (the target), a company listed on the Bombay Stock Exchange and the National Stock Exchange. At a meeting held on 25 January 2007 the target's board of directors considered a preferential issue of 15 million share warrants to Goldstone at a price of Rs22 per share warrant. The issue was approved by target's shareholders at an extraordinary general meeting held on 24 February and was concluded on 30 April.

At the expiry of tenure of the share warrants, the target's board of directors authorized conversion of share warrants and allotted 15 million resultant equity shares to Goldstone at a meeting on 29 October 2008. As a result Goldstone's holding in the target increased from 9.51% to 47.19%, triggering the open offer requirement under the takeover code.

On 4 November Goldstone announced an open offer to acquire 20% of the post-conversion equity share capital at a price of Rs23 per share payable in cash. The offer price was calculated with a reference date of 25 January 2007 – the date of the board meeting at which the preferential issue of share warrants was considered. This was challenged by SEBI, against which Goldstone filed an appeal with SAT.

SAT had to consider whether the reference date for determination of the open offer price under the takeover code should be the date of the board meeting at which the preferential issue of share warrants to Goldstone was considered (25 January 2007), or the date of the board meeting in which the share warrants were converted into underlying additional equity shares (29 October 2008).

SAT relied on two recent appeals on a similar issue, *Sohel Mallik v SEBI* and *Eight Capital Master Fund and Ors v SEBI*. In each of these cases SAT had held that under regulations 20(11) and 20(4)(c) the offer price should be determined with reference to the date of the board resolution that authorized the allotment of equity shares conferring voting rights.

Capital markets

SEBI proposes new securities guidelines

In a recent meeting SEBI proposed certain amendments to securities laws in India. The changes are intended to realign the takeover norms with market developments and to bring various pieces of legislation governing Indian capital markets in line with each other.

One proposal is to allow "anchor investors" for Indian depository receipts (IDRs). Anchor investors are qualified institutional buyers who commit to invest a fixed amount. Their involvement is valued by issuers as it boosts the confidence of other prospective investors.

In an attempt to encourage the issuance of IDRs and the listing of foreign companies on domestic bourses, SEBI has proposed to extend the scope of anchor investments to include IDRs issued by foreign companies. It is also proposed to reserve not less than 30% of all IDRs issued for retail investors, a move that will enhance liquidity.

The next proposal is to make the open offer requirements under the takeover code applicable to depository receipts (DRs) – that is, global depository receipts and American depository receipts. DRs currently remain exempt from the requirements until they are converted into underlying equity shares. It has generally been held that this position remains unchanged even when customary voting arrangements are entered into between depositories and DR holders.

SEBI now proposes that the exemption of DRs from the open offer requirement will apply only where DR holders remain passive investors, without any kind of voting arrangement with the depository banks on the underlying equity shares. The proposal does not address the potential consequences of this change for earlier DR issues, or whether it could lead to a "two-time trigger" of the takeover code.

A further proposed change concerns "creeping acquisition". Under the takeover code an acquirer is allowed to acquire 5% of a target each financial year if it holds between 15% and 55% of equity shares of the target. However, the law is currently silent as to whether an acquirer can exceed the 55% threshold by means of this creeping acquisition. SEBI proposes to clarify that an annual creeping acquisition limit of 5% is allowed provided that the post-acquisition shareholding and voting rights of the acquirer do not exceed 55% of the equity capital of the target.

Finally, SEBI proposes to extend the disclosure norms under the takeover code. It also proposes to require every scheme of arrangement or corporate restructuring exercise undertaken by a listed company to be in compliance with applicable accounting standards.

This is a mixed bag of proposals from SEBI. While the introduction of anchor investors for IDRs would be a welcome step, the proposed open offer requirement for DRs could be contentious, and may tend to deter foreign investors. This could make it hard for companies to complete their offerings, and so restrict their ability to mobilize foreign capital.

Trading in interest rate futures permitted

In a circular dated 28 August, SEBI introduced trading in exchange-traded interest rate futures (IRFs), which are standardized derivative contracts. IRFs differ from other derivative products only in the underlying security, which is a 10-year government security (G-Sec) rather than a stock.

SEBI has specified the following characteristics of IRFs, to be complied with by stock exchanges:

- a prescribed list of deliverable grade securities (DGSs) from which exchanges may select a basket of securities to underlie the IRFs;
- a maturity period for the DGSs of seven and a half to 15 years, calculated from the first day of the delivery month, with a minimum total outstanding stock of Rs100,000 million (US$2 billion);
- a contract size of Rs200,000 with a maximum maturity period of 12 months;
- a contract cycle of four fixed quarterly contracts (expiring in March, June, September and December);
- contracts to be settled by physical delivery of DGSs using the electronic book entry system of the existing depositories and the public debt office of the Reserve Bank of India;
- an interest rate of 7% for G-Secs; and
- a daily settlement price based on the last half hour weighted average price of the futures contract.

All foreign institutional investors (FIIs) registered with SEBI have been allowed to trade in IRFs. However, investments by FIIs in IRFs will be considered to be debt investments and will be subject to the applicable overall limits.

SEBI further requires that the total gross long (bought) position in cash and IRFs taken together should not exceed the individual permissible limit for investment in G-Secs. In addition, the total gross short (sold) position (for the purpose of hedging only) should not at any point exceed the investors' long position in G-Secs and IRFs.

The introduction of IRFs paves the way for innovative options in trading. As the underlying security is provided by interest rates rather than stocks, IRFs are a suitable tool for hedging, especially where large numbers of G-Secs are held. The process for calculating the daily closing price of IRFs is transparent. Finally, by opening the door for FIIs (including retail investors, fund houses and banks) to trade in IRFs, the market is further opened and liberalized, which is likely to be reflected in higher indexes.

INTELLECTUAL PROPERTY

Trademarks based on generic names harder to enforce

Cadila Healthcare, which owns the registered trademark Mexate, has lost a case filed against Wallace Pharmaceuticals. The unsuccessful action had aimed to restrain Wallace from using its registered trademark Mext.

Both companies use their trademarks as an abbreviation of methotrexate, a drug used to treat cancer. The following discussion of the case is based on media reports, as the judgment itself is not currently available.

In 2008 Cadila took action before Ahmedabad District Court, alleging that Mext was a confusingly similar abbreviation of its Mexate mark. Wallace responded that it had applied for the mark in 2002, and that Cadila had not raised any objection at that time. Subsequently, Wallace developed its brand and built a market for the product, besides regularly publishing its Mext trademark in medical journals and other magazines. Wallace also produced sales figures for the period 2003 to 2007 to demonstrate the extensive use of the mark.

The court noted that Cadila and Wallace were the registered owners of the marks at issue. Under sections 28(3) and 30(2) of the Trademarks Act, 1999, in cases involving two similar registered trademarks, use of one mark by one party cannot infringe the other party's mark. Accordingly, Cadila's infringement claim could not survive.

The court nevertheless considered the similarity between the two marks, taking into account the appearance of the two products, their packaging, price and other relevant factors. It observed that the overall appearance of the products was dissimilar. The court also observed that Mext and Mexate can be obtained only with a doctor's written prescription, and that as a result there was little chance of consumers being confused or deceived.

Under section 13 of the Trademarks Act, chemical elements or international non-proprietary names cannot be registered as trademarks. However, pharmaceutical companies have devised ingenious ways to overcome such restrictions. These include naming products based on the bodily organ that the drug is intended to treat, the principal ingredient of the drug and the name of the ailment. Such practices have given rise to numerous trademark infringement disputes, of which the present case is an obvious example.

It is clear that pharmaceutical companies should be cautious before deciding to establish and register trade names that are derived from the chemical or generic name. Though this move grants familiarity to the drug, it also risks diluting the proprietary distinctiveness of the trade name.

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