

M&A Hotline

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SECURITIES APPELLATE TRIBUNAL DECLARES NON-COMPETE FEE A SHAM!

In a recent ruling, International Paper Company v. Securities Exchange Board of India¹, the Securities Appellate Tribunal ("SAT") while adjudicating upon the legality of the non-compete fee under the SEBI (Substantial Acquisition of Shares and Takeovers), 1997 (the "1997 Takeover Code") has held that non-compete fee cannot be paid to shareholders who do not pose any competitive threat to the company after exiting, even if such shareholders are part of or related to the promoter group.

Global paper giant, International Paper Company, USA and its Singapore subsidiary IP holding Asia Singapore PTE Ltd. (collectively "Acquirers") entered into a Share Purchase Agreement with the promoters of Andhra Pradesh Paper Mill Limited ("Target") to acquire 53.46 per cent share capital of the Target at a price of INR 523/- per share. Additionally, the promoter group, comprising of twenty entities (seven individuals and thirteen companies) were paid a non-compete fee of INR 130.73 per share. The Target is involved in the business of paper and pulp manufacturing ("Business").

The acquisition triggered the open offer obligation under Regulations 10 and 12 of the 1997 Takeover Code, and hence the Acquirers made a public announcement to further acquire 21.54 per cent of the voting capital of the Target from the existing shareholders at an offer price of INR 544.20 per share, including INR 21.20 paid to the promoter group towards exclusivity fee. Subsequently, as per the requirements under Regulation 18 of the 1997 Takeover Code, the Acquirers filed the draft letter of offer with the Securities Exchange Board of India ("SEBI"). The dispute arose when SEBI ordered the Acquirers to revise the offer price from INR 544.20 to INR 674.93 i.e. by adding the amount of INR 130.73 to the offer price, being paid to the promoter group sellers as non-compete fee. SEBI's finding was primarily based on the ground that the non-compete fee was paid to some promoters who were not likely to pose any competitive threat to the Target after exiting.

CONTENTIONS OF THE PARTIES

SEBI's Arguments

- SEBI's primary contention was that in certain cases inclusion of non-compete fees can be a device to reduce the offer price payable to public shareholders. Therefore, it becomes essential for SEBI to examine whether the promoters receiving non-compete payments are capable of offering competition to the Target.
- The non-compete fee payable under the share purchase agreement was in furtherance of the covenants related to non-compete and confidentiality obligations. It was argued that confidential information related to the Business and affairs of the Target will be available with only such promoters who are involved in the management of the Target by handling its day to day affairs. A promoter who is not involved in the management and is associated with the Target only in its capacity as shareholder should not be put at a pedestal different from the public shareholders.
- SEBI's argument against payment of non-compete fee to Mr. Yogesh Bangur and Ms. Surbhi Bangur ("Individual Promoters"), was on the premise that they had no capacity to set up a competing Business as they were neither directors of the Target nor involved in its day to day Business. The Individual Promoters were considered part of the promoter group only because they were relatives of Mr. L.N. Bangur (the person who was actually in control of the Target). SEBI further argued that Mrs. Sheetal Bangur who was a director of the Target and involved in the day to day affairs of the Target was not paid any non-compete fee; thereby demonstrating the sham nature of the transaction.
- Similarly, the thirteen corporate promoter entities ("Corporate Promoters") were associated with the Target only in their capacity as shareholders and were not involved in the management of the Company. SEBI in its order had noted that the business of the Corporate Promoters was not similar to that of the Target. It was also contended that the constitutional documents of the Corporate Promoters did not include the Business

Arguments of Acquirers

The Acquirers challenged SEBI's findings on the following grounds:

- SEBI's finding that the Individual Promoters were not eligible to be paid non-compete fee was misdirected. The Acquirers argued that these two promoters by virtue of being shareholders of the Target and other corporate entities and associated with the management of the Target had acquired considerable knowledge about the Business and were therefore capable of competing with the Business.
- SEBI's finding that the Corporate Promoters were not entitled to non-compete fee, on the basis that none of the Corporate Promoters were in the same line of business was incorrect. It was argued that these Corporate Promoters by virtue of holding substantial shareholding in the Target and being involved in its Business and

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- operations for a substantial period of time had acquired confidential information regarding the operations of the Target. Thus, these entities were in a position to offer formidable competition after exiting.
- The Acquirers argued that even if some of the promoter group entities were not directly connected with the Business, it was nevertheless important to impose a non-compete obligation on them by virtue of these entities being closely connected with the shareholders/promoters of the Target.
 - The Acquirers also questioned the powers of SEBI to interfere with the payment of non-compete fee. Relying on SAT rulings in *Tata Tea Limited v. SEBI*², *Cementum IB. V. v. SEBI*³, and *E-Land Fashion China Holdings Limited v. SEBI*⁴, the Acquirers argued that SEBI should not interfere if the payment of non-compete is made in accordance with Regulation 20 of the 1997 Takeover Code i.e. it is less than 25% of the offer price.

SAT Order

SAT while directing the Acquirers to add the non-compete fees of INR 130.73 per share to the offer price payable to public shareholders, pronounced on the following issues:

1. SEBI's Power

- SAT relying extensively on its ruling in *Tata Tea* held that SEBI has the power to scrutinize the justification of non-compete fees, and if it is of the opinion that the non-compete fee is paid to a person who does not have the capacity to offer competition to the Target, then SEBI can direct the Acquirers to include the same in the offer price. SAT has emphasized on the point that the important criteria for payment of non-compete fees is whether the outgoing sellers are capable of offering competition to the business, solely or in association with third parties. The fact that the business was dependent on the outgoing seller is not relevant.

2. Payment of Non-Compete Fees

- To Corporate Promoters - SAT examined the validity of payment of non-compete fees to the Corporate Promoters by scrutinizing the material placed by the Acquirers before SEBI, including the nature of the business of these entities.⁵ While, acknowledging the common control of these companies, SAT held that such a connection can neither be an indicator of their involvement in the day to day Business nor it proves their capability to offer competition to the Target. SAT went on to say that the information provided by the merchant banker to SEBI does not prove the Corporate Promoters having access to information related to the Target. Commenting on the business of the Corporate Promoters, SAT held it does not put them in a position to offer competition.
- To Individual Promoters - On the issue of payment of non-compete fees to the Individual Promoters, SAT first pointed to the fact that the matter placed before them was insufficient to prove that the Individual Promoters were involved in the day to day affairs of the Target or were capable of competing with the Business of the Target. Hinting towards the sham nature of the non-compete fees, SAT noted that non-compete fee was not paid to Mrs. Sheetal Bangur, another family member Mr. L.N Bangur who was a director of the Target and involved in the day to day affairs of the Target whereas it was paid to the Individual Promoters who were not involved in the day to day affairs of the Target.
- Non-Compete and Confidentiality - SAT acknowledged the settled legal position that absence of confidentiality obligation would render the non-compete obligation ineffective. It refused to comment any further on this issue as the Acquirers, promoters group and the merchant bankers could not justify payment of non-compete fees on the basis of principles laid down in the earlier cases.

Based on the above, SAT upheld SEBI's view that the payment of non-compete fees was not justified and directed the Acquirers to add the non-compete fee to the offer price.

ANALYSIS

Regulation 8(7) of SEBI (Substantial Acquisition of Shares and Takeovers), 2011 ("2011 Takeover Code"), clearly provides that if the price paid for shares or voting rights or control of target company includes non-compete fees or control premium or any other payment, the same shall be added to the offer price. This change was made by SEBI to curb the practice followed under the 1997 Takeover Code by some of the promoters of receiving additional payment under the garb of non-compete fees thereby depriving the public shareholders of their rightful claim to get just price for their shares. As Justice Holmes famously said "the life of the law has not been logic; it has been experience" and hence the precedents laid down by SAT under the 1997 Takeover Code will continue to have persuasive value for similar cases under the 2011 Takeover Code.

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You can direct your queries or comments to the authors

¹Appeal No. 130 of 2011 decided on September 12, 2012.

²Appeal No. 136 of 2008 decided on September 15, 2009.

³Appeal No. 28 of 2008 decided on July 8, 2008.

⁴Appeal No. 27 of 2011 decided on May 24, 2011.

⁵The crux of the merchant banker's contention was that the Corporate Promoters by virtue of their long and continued association with the Target Company, had acquired comprehensive expertise of the business and had access to market information and industry connections, as a result of which they were capable offering competition to the business and causing irreparable harm to the Target Company.

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