BEFORE THE SECURITIES APPELLATE TRIBUNAL MUMBAI

Appeal No. 27 of 2011

Date of decision: 24.05.2011

E-Land Fashion China Holdings Limited
Walker House, 87 Mary Street,
George Town, Grand Cayman
KY1-90005, Cayman Islands. …… Appellant

Versus

Securities and Exchange Board of India
SEBI Bhavan, Plot No. C-4A, G Block,
Bandra Kurla Complex, Bandra (East),
Mumbai – 400 051. …… Respondent

Mr. Soli Cooper, Senior Advocate with Mr. Arka Banerjee and Mr. Aditya Mehta, Advocates for the Appellant.

Mr. Kumar Desai, Advocate with Ms. Daya Gupta and Ms. Harshada Nagare, Advocates for the Respondent.

CORAM : Justice N.K. Sodhi, Presiding Officer
P. K. Malhotra, Member
S.S.N. Moorthy, Member

Per : Justice N.K. Sodhi, Presiding Officer

The short question that arises for our consideration is whether the appellant is liable to pay to the public shareholders the non-compete fee that has been paid to the outgoing promoters of the company that has been taken over. Facts are not in dispute and these may first be noticed.

2. The appellant is a limited liability company incorporated and registered under the laws of Cayman Islands and has its corporate office in Hong Kong. On

October 15, 2010 it entered into a share subscription agreement with Mudra Lifestyle Limited – a company registered under the Companies Act, 1956 and it shall be referred to hereinafter as the target company. The promoters of the target company namely, Mr. Murarlilal Agarwal, Mr. Ravindra Agarwal and Mr. Vishwambharlal Bhoot (hereinafter collectively referred to as promoters) were also a party to this agreement. The appellant agreed to subscribe to 1,20,00,000 equity shares of the face value of Rs.10 each of the target company at a price of Rs.60 per share. On the same day that is, October 15, 2010 the appellant also executed a share purchase agreement with the promoters whereby it agreed to acquire their shares up to the higher of 1 crore equity shares or such number of equity shares as would, together with the shares subscribed to under the share subscription agreement, constitute 51 per cent of the share capital of the target company subject to a maximum of 1,24,75,139 shares at a price of Rs.75 per share inclusive of a non-compete fee of Rs.15 per share. The appellant also executed on the same day a shareholders agreement with the target company and the promoters to regulate their respective rights as shareholders of the target company and their respective responsibilities regarding the management and business of that company. Upon the consummation of the transactions described in the aforesaid three agreements, the shareholding of the appellant in the target company shall be a minimum of 51 per cent and a maximum of 67 per cent of the post equity share capital of the target company. Since the equity shares acquired by the appellant through the aforesaid agreements were in excess of 15 per cent of the voting rights in the target company, the provisions of Regulations 10 and 12 of the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 (hereinafter called the takeover code) got triggered. Accordingly, the appellant made a public announcement on October 21, 2010 to acquire up to 95,98,094 equity shares amounting to 20 per cent of the emerging voting capital of the target company at a price of Rs.60 per share. It is common case of the parties that the shares of the target company are listed on the Bombay Stock Exchange Limited (BSE) and the National Stock Exchange of India Limited and are frequently traded on both these stock exchanges and most frequently traded on the BSE. The appellant claims

that it determined the offer price of Rs.60 per share in terms of Regulation 20(4) read with Regulation 20(8) of the takeover code and that the said price is justified being the highest of all the four parameters prescribed in Regulation 20(4). As the payment of non-compete fee of Rs.15 per share paid to the promoters under the share purchase agreement is equal to 25 per cent of the offer price of Rs.60, the same was not added to the offer price in terms of Regulation 20(8) of the takeover code. After the public announcement, the appellant filed in terms of Regulation 18(1) of the takeover code a draft letter of offer with the Securities and Exchange Board of India (for short the Board) through its merchant banker, SBI Capital Markets Ltd. (merchant banker). While examining the draft letter of offer, the Board indicated to the merchant banker that it was inclined to add the non-compete fee of Rs.15 per share payable to the promoters under the share purchase agreement to the offer price in the light of the fact that the promoters after the acquisition continue as co-promoters with the appellant and queried as to why this should not be done. In response to the Board's query, the merchant banker and the legal advisors of the appellant met the officers of the Board to clarify as to why the non-compete fee should not be added to the offer price. It was pointed out that such an addition would be bad-in-law and contrary to the provisions of the takeover code and the earlier decisions of this Tribunal. The merchant banker then filed detailed written submissions before the Board in this regard. The Assistant General Manager, Corporation Finance Department, Division of Corporate Restructuring acting on behalf of the Board did not accept the plea of the merchant banker on behalf of the appellant and issued directions to the latter, the relevant part of which are reproduced hereunder:

> "4. Offer Price & Financial Arrangements
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> a. You are advised to add the non compete fee to the offer price in the instant open offer because of the following facts and circumstances:
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> i. Promoters are still continuing as promoters with the holding of 18.8% (post offer shareholding) with the certain rights and obligations.
> ii. The Promoters shall have the right to appoint 2 (Two) members on the Board of Directors of target company and 2 (Two) independent directors of the Target Company shall be jointly selected by the Promoters and the acquirer.
> iii. Promoters shall have the right to appoint 1(one) Joint Managing Director of the Target Company ("JMD"). The JMD nominated by

the Promoters shall be responsible for production and development.

iv. The Board shall not have the power to change the role, powers and duties of the Promoter JMD as stated above.

v. For a period of 3 (Three) years from the date of allotment of the Investor Shares to the Acquirer (the "Lock-in Period"), the Promoters shall not be entitled to transfer the shares held by them in the Target Company, without the prior written consent of the Acquirer, provided that this restriction shall not apply to the Free Flat Shares which shall be freely transferable by the Promoters subject to satisfaction of certain conditions.

vi. The Promoters have a right of first offer in any sale of shares by the Acquirer.

vii. The Promoters have a full tag along right or pro rata tag along right (as applicable) in any sale of shares by the Acquirer subject to the satisfaction of certain conditions.

viii. The Promoters have a put option on the Acquirer for a period of 6 (Six) months after the 3rd anniversary of the Completion Date whereby they may require the Acquirer to acquire all the shares held by them in the Target Company. This put option of the Promoters shall survive any termination of the SHA.

ix. The rights conferred on the promoters under the SPA along with the disclosure of the intention to be the co-promoters of the target company, exhibits that the promoters are still in the joint control of the target company. In such a scenario, it is not likely that the promoters would be willing to separate themselves from the target company and offer competition.

x. Therefore, you are advised to add the non compete of Rs.15/- to the instant open offer price of Rs.60/- and revise the open offer price to Rs.75/- (i.e. Rs.15 + Rs.60).

b. In view of aforesaid revised offer price vis-à-vis offer size (inclusion of non compete fee to the offer price), you are advised to update the escrow account as per Regulation 22(7) of Takeover Regulations.

……"

Feeling aggrieved by the aforesaid directions, the appellant has filed the present appeal.

3. We have heard the learned senior counsel on behalf of the appellant and Shri Kumar Desai, Advocate on behalf of the Board. Before we deal with the respective contentions of the parties, it is necessary to refer to the non-compete clause as contained in the share purchase agreement and the same is reproduced hereunder for facility of reference:

"6A. NON-COMPETE

6A.1 For a period which is the later of (a) 3(three) years from the Share Sale Closing Date, and (b) 2(two) years from the date upon which the aggregate shareholding of the Promoters falls below 5% (five) percent of the total Share Capital of the Company as on the Share sale Closing Date, (the "Non-Compete Period"), the Promoters hereby undertake to the Purchaser that they shall not, and shall

ensure that none of their Affiliates shall, singly or jointly, directly or indirectly, for their own account or as agent, employee, officer, director, consultant, or shareholder or equity owner of any other Person, engage or attempt to engage or assist any other Person (including their Relatives and non-dependant children) to engage in the Business.

6A.2 The Promoters further undertake that during the non-Compete Period, they shall give-up, part with and/or cease and desist from carrying on in India any activity or business which is same as that of the Business in India. During the Non-Compete Period, the Promoters undertake that any venture or investment, whether directly or indirectly, in the Business shall only be undertaken, carried on, implemented, or held through the Company or its subsidiaries, unless the Purchaser gives prior written consent to the Promoters to do otherwise.

6A.3 The Promoters undertake that during the non-Compete Period, they shall not divulge or disclose to any Person any information (other than information available to the public or disclosed or divulged pursuant to an order of a court of competent jurisdiction or required under applicable Laws) relating to the business, including but not limited to the identity of clients, finance, contractual arrangements, business or methods.

6A.4 The Promoters covenant and agree that during the non-Compete Period, they will not, directly or indirectly:

(a) attempt in any manner to solicit from any client/customer, except on behalf of the Company, business of the type carried on by the Company or to persuade any Person which is a client/customer of the Company to cease doing business or to reduce the amount of business which any such client/customer has customarily done or might propose doing with the Company whether or not the relationship between the Company and such client/customer was originally established in whole or in part through his or its efforts; or

(b) employ or attempt to employ or assist anyone else to employ any Person as an employee or a consultant (including the Key Employees) who is in the employment of the Company, or was in the employment of the Company at any time during the preceding 12 (twelve) months; or

(c) otherwise interfere in any manner with the contractual, employment or other relationship of any Person (including the Key Employees) who is in the employment of the Company, or was in the employment of the Company at any time during the preceding 12 (twelve) months.

6A.5 The Promoters acknowledge and agree that the above restrictions are considered reasonable for the legitimate protection of the business and the goodwill of the Company. The Promoters further agree that the Purchaser has agreed to invest in the Company and to acquire the Sale Shares from the Promoters relying on this covenant of the Promoters.

6A.6 In lieu of the Promoters' covenant under this Section 6A, the Parties agree that out of the total Purchase Price, Rs.15 (Rupees

> Fifteen Only) shall constitute the non-compete fee for each Sale Share acquired by the Purchaser from the Promoters."

It is not in dispute that the promoters continue to hold a minority stake of 18.87 per cent in the target company and by reason of the aforesaid agreements executed between the parties they have a right to appoint two members on the board of directors of the target company and two independent directors therein shall be jointly selected by the promoters and the acquirer. The promoters also have the right to appoint one joint managing director of the target company who shall be responsible for production and development. From these facts the Board has concluded that the promoters are still in joint control of the target company and it is not likely that they would offer any competition. It is strenuously argued on behalf of the appellant that the approach of the Board is wholly erroneous and contrary to law and that it is not justified in directing the appellant to include the non-compete fee in the price offered to the shareholders. It is urged that the outgoing sellers are capable of providing competition to the business as they have the managerial as well as financial resources to compete with the target company and that they could any time resign from the board of directors and offer competition to the target company which has been taken over by the appellant. The argument is that it is to avoid such an eventuality that the non-compete clause has been put in the agreement to prevent the promoters from offering any competition. Shri Kumar Desai, learned counsel for the Board, on the other hand, argued that the promoters are still continuing to hold a minority stake of 18.87 per cent in the target company and that they have two members on the board of directors and two independent directors that are jointly selected by the promoters and the acquirer. He further pointed out that the promoters also have the right to appoint one joint managing director who shall be in charge of production and development. He also referred to the agreements which give the promoters a right of first offer in any sale of shares by the acquirer. In view of these provisions contained in the agreements, the learned counsel for the Board contended that the promoters who are still in the joint control of the target company are not likely to disassociate themselves from it and offer competition to the target company and in this background the Board was justified

in advising the appellant to add the non-compete fee of Rs.15 to the open offer price of Rs.60 that has been offered to the shareholders. Having heard the learned counsel for the parties, we are clearly of the view that all the issues that are now sought to be raised by the respondent stand answered in favour of the appellant in an earlier decision of this Tribunal in Tata Tea Ltd. vs. Securities and Exchange Board of India and anr. [2010] 103 SCL 140. This is what the Tribunal has observed in that case -

> "6. The recommendations made by the Bhagwati Committee clearly recognize the legitimacy of the non-compete fee payable to the outgoing sellers. Regulation 20(8) based on these recommendations puts a cap on such payments so that an acquirer could not reduce the cost of acquisition through public offer thereby depriving the public shareholders of their legitimate dues. When examining the validity of the non-compete fee, the question to be addressed is whether the outgoing sellers are capable of providing competition to the business alone or in association with third parties and not whether the business was dependent on the outgoing sellers. When an acquirer takes over a business from the outgoing seller(s), it is obvious that the sellers have specific knowledge of that business and have access to and are in possession of crucial trade secrets of the target company which if disclosed or misused would be detrimental to and could cause irreparable harm to the target company and its continuing shareholders and by virtue of their association with that business, they (out going sellers) are capable of offering competition to the business being taken over. In such cases, it would be legitimate for the acquirer to enter into a non-compete agreement with the promoter sellers if he feels threatened by a lurking fear of competition from them. It is neither for the Board and not even for this Tribunal to analyse the threat perception of the acquirer. We are of the view that a non-compete agreement would then protect not only the target company but also its continuing shareholders. An acquirer has a right to protect his investment/business from competition by a seller of the business and this right is a long standing customary element in business sale transactions and is even recognised by law. Section 27 of the Contract Act recognises that non-compete agreements are not in restraint of trade if the restrictions placed are reasonable. The Law of Contract (Treitel, Sweet & Maxwell) 11th Edition at page 455 after relying on Connors Bros. Ltd & Ors. vs. Connors succinctly states the law as under:-
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> > "A person who sells shares in a company which he controls may covenant not to compete in respect of the business carried on by the company. Such a covenant may be valid if it was in substance the seller who, through his control of the company, carried on the business".
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> Again, the terms of the non-compete agreement have necessarily to be decided between the acquirer and the outgoing promoter sellers and based as they are, on business considerations, the Board and this Tribunal have no role to play. However, if they agree to fix the non-compete fee in excess of 25 per cent of the offer price as determined under sub-regulations (4) or (5) of Regulation 20 of the takeover code, the amount in excess of 25 per cent of the offer price shall be added to the offer price which shall be offered to all the public shareholders. It is common ground between the parties that in the case before us, the amount of Rs.3 crores which the appellant as the acquirer has agreed to pay to the promoters as

non-compete fee comes to Rs.9.64 per share which is only 6.96 per cent of the offer price as worked out under Regulation 20(4) of the takeover code. This is far less than the maximum prescribed by Regulation 20(8) and is in compliance with the takeover code. We are satisfied that this payment of non-compete fee is not an attempt on the part of the appellant to reduce the cost of acquisition to discriminate against the public shareholders.

7. We are also in agreement with Shri Janak Dwarkadas learned senior counsel appearing on behalf of the appellant that the payment and quantum of the non-compete consideration is based on strong business rationale. It is not in dispute that the target company is in possession of a unique source of water and is engaged inter alia in the business of sourcing, manufacture, bottling and distribution of natural mineral water and are owners of the "Himalayan" brand, a premium luxury brand of natural mineral water. It was rightly argued on behalf of the appellant that the knowledge and expertise of the promoters in managing and exploiting the said source is critical to the operations and the worth of the target company. The appellant as the acquirer is a new entrant to the business as a strategic player and hence it requires support and not competition from the promoters to realise its commercial objectives. It is not disputed that as on the date of the filing of the appeal, the appellant held 34.29 per cent of the equity share capital of the target company and being in control of the target company it was important for it to ensure that the promoters, who continue to hold a much smaller stake in the target company, do not compete with it in any manner. A reference to the non-compete provision which has been reproduced in the earlier part of our order would show that it is an obligation that binds not only the promoters but also their affiliates and, therefore, the obligations are quite extensive. A sum of Rs.3 crores has been paid as non-compete consideration to the seller promoters for not competing for a period of one year from the termination of the shareholders agreement executed on June 1, 2007 and it can be presumed that during this period the acquirer would stabilize in the business.

8. Shri Kumar Desai learned counsel appearing for the Board strenuously contended that the promoters are on the board of directors of the target company and hold a minority stake therein and, therefore, in the very nature of things they could not offer any competition to the business of the target company. According to the learned counsel, the appellant was not justified in paying non-compete fee to the promoters without paying the same to the public shareholders. Shri Desai referred to the judgment in Boulting vs. Association of Cinematograph, Television and Allied Technicians (1963) 2 QB 606 and urged that directors of a company act as its agents and cannot enter into engagements in which they have a personal interest conflicting with the interest of the company. He relied upon the following words of Lord Cranworth L.C. in Aberdeen Railway Co. vs. Blaikie Brothers which were quoted in Boulting's case (supra):-

> "The directors are a body to whom is delegated the duty of managing the general affairs of the company. A corporate body can only act by agents, and it is of course the duty of those agents so to act as best to promote the interests of the corporation whose affairs they are conducting. Such agents have duties to discharge of a fiduciary nature towards their principal, and it is a rule of universal application, that no one, having such duties to discharge, shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting, or which possibly may conflict, with the interests of those whom he is bound to protect."

> It is true that the directors of a company discharge a fiduciary duty and cannot allow their own interest to conflict with that of the company but such duties cease to exist the moment they resign from the directorship of the company. In the case before us, there is nothing to prevent the promoters from resigning from the directorship of the target company and setting up a rival business. It is with a view to safe guard against this possibility that the appellant as the acquirer entered into the non-compete agreement with the promoters with a view to protect the interest of the target company and its continuing shareholders. Equally, there is nothing that prevents the promoters from divesting their minority stake in the target company if that were to become necessary."

It is the case of the appellant which is not disputed by the Board that Mr. Murarilal Agarwal and Mr. Ravindra Agarwal are family members who were earlier promoters of Bombay Rayon Fashions Ltd. which was carrying on business similar to that of the target company. They separated from that company and promoted the target company and built it up as a strong competitor in the Indian textiles business with the assistance of Mr. Vishwambharlal Bhoot. The promoters have more than 20 years of experience in textiles business and have extensive knowledge of the market and intimate knowledge of the target company's business, employees, suppliers, customers, systems and technological know-how. In this background, they are capable of offering competition to the target company. The appellant, on the other hand, belongs to the South Korea based E-Land Group of Companies which has limited operating experience in the textile manufacturing industry in India. Having taken over the target company, it would like to take the benefit of the knowledge and expertise of the promoters in managing such a business in India and it is for this reason that they are being associated with the target company. In this background, we are satisfied that the promoters have the capability of building a strong business from scratch and as a result of their understanding of the market they have the ability to compete with the business of the target company. If they were to do that, it would neither be in the interest of the target company nor in the interest of its shareholders. We are further satisfied that the payment of non-compete fee in the instant case is not an attempt on the part of the appellant to reduce the cost of acquisition to discriminate against the public shareholders. The aforesaid observations made by the Tribunal in the case of Tata Tea Ltd. (supra) and also in the case of Cementrum IB.V. vs. Securities and

Exchange Board of India and anr. Appeal no. 28 of 2008 decided on July 8, 2008 squarely support the case of the appellant.

4. Before concluding, we may take note of an objection raised by the Board in its reply. It is stated that the impugned communication dated January 28, 2011 by which the observations of the Board were communicated to the appellant is not an 'order' within the meaning of Section 15T of the Securities and Exchange Board of India Act, 1992 (for short the Act) and, therefore, the present appeal is not maintainable. Since we have summarily rejected this objection in some earlier cases, the learned counsel for the Board wanted us to take note of this objection. After the public announcement is made, the acquirer is required to file with the Board a draft letter of offer to the public shareholders containing the requisite disclosures. This draft letter is filed under Regulation 18(1) of the takeover code. The draft letter of offer is then examined by the Board and it can require the merchant banker and the acquirer to make changes therein. If some changes are suggested, the acquirer and the merchant banker have no choice but to carry out those changes before sending the letter of offer to the shareholders. This is what the first proviso to Regulation 18(2) of the takeover code provides:

> "**Provided** that if, within 21 days from the date of submission of the letter of offer, the Board specifies changes, if any, in the letter of offer (without being under any obligation to do so), the merchant banker and the acquirer shall carry out such changes before the letter of offer is dispatched to the shareholders:
>
> Provided further that……"

The word '**shall**' used in the proviso leaves no room for doubt that whatever changes are suggested by the Board have to be carried out by the acquirer and his merchant banker and it is not open to them to ignore those suggestions. The word 'order' has been defined in Black's Law Dictionary (Sixth Edition) to mean **"a mandate; precept; command or direction authoritatively given; rule or regulation."** Since the changes suggested by the Board have to be carried out, the communication through which those changes are suggested is a command or a direction authoritatively given and, therefore, an order. There would have been merit in the objection raised by the

Board if it was open to the acquirer not to comply with the changes as pointed out by the Board. But that is not the position. We have, therefore, no hesitation to hold that the communication from the Board suggesting changes in the letter of offer is an order within the meaning of Section 15T of the Act and the person feeling aggrieved could always come up in appeal. The objection is overruled.

5. For the reasons recorded above, the appeal is allowed and the question posed in the opening part of our order answered in the negative. The impugned communication dated January 28, 2011, in so far as it directs the appellant to include the non-compete fee in the offer price, is set aside. The said fee shall not be included in the offer price. The appellant may now issue the letter of offer to the shareholders in accordance with law within the next two weeks from today. There is no order as to costs.

Sd/-
Justice N. K. Sodhi
Presiding Officer

Sd/-
P. K. Malhotra
Member

Sd/-
S.S.N. Moorthy
Member

24.05.2011
Prepared & compared by-ddg