Can pre-emptive, exit & negative control rights in SHAs create AEs?

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About the article: This article analyses whether under Transfer Pricing Regulations ('TPR') in India, a Financial Investor ('FI') (as opposed to a strategic investor) and the Portfolio Company would become Associated Enterprises ('AEs') on account of typical clauses inserted in Shareholders' Agreement ('SHA') entered into between them.

BACKGROUND OF SHA:

Shareholders' Agreement ('SHA') is essentially a contract between shareholders in a company, the purpose of which is to confer rights to and impose obligations on the shareholders over and above those provided by the Company Law. SHAs are not mandatory under Companies Act, 1956 and are binding only on the parties to the SHA as it is a contractual arrangement between the parties. SHAs provide contractual remedy to an aggrieved shareholder in the event of any breach of any covenant or representation by the other shareholder. This contractual remedy is available to a shareholder in addition to the statutory rights provided under the Companies Act, 1956, if the Articles of Association have been amended to incorporate the relevant provisions of the SHAs.

SHA is commonly entered into between FIs such as Venture Capital funds & Private Equity funds and the promoters when such FIs make investments in portfolio companies. The typical clauses inserted in such SHA are:

- *Right of First Refusal (ROFR):* It denotes an agreement between the existing shareholders whereby the shareholder wishing to sell to a third party must first offer the shares to the holder of ROFR. If the holders of ROFR do not buy these shares, the shareholder can then normally sell freely to a third party.
- *Right of First Offer (ROFO):* It is a variation of ROFR. The shareholder wishing to sell shall first offer the shares to the holder of ROFO and obtain a price therefrom for such shares. If third party offers a price more than the offer of holder of ROFO and the holder of ROFO does wish to purchase the shares at such price set by third party, then the shareholder wishing to sell is free to sell it to a third party.
- *Drag-along Rights (DRAG) and Tag-along Rights (TAG):* DRAG is an agreement between the shareholders, where the shareholder wishing to sell his shares to a third party has the right to drag all the other shareholders. TAG is the opposite i.e. the other shareholders have a right to tag along with the shareholder wishing to sell his shares to a third party.
- *Call option:* Call option gives its holder the right to buy a specified number of shares of the company at a predetermined price.
- *Put Option:* Put option gives its holder the right to sell a specified number of shares of the company at a predetermined price.
- *Veto Rights:* The investments made by FIs are generally characterized by a high degree of risk and therefore, to protect the value of their investments, FIs require that their consent be obtained before the Portfolio Company undertakes certain significant actions. Such matters are identified and agreed between parties to the SHA and a veto right is given to FIs for these "Reserved Matters".

APPLICABILITY OF TPR:

For applicability of TPR as prevalent in India, there needs to be satisfaction of two definite criteria:

I. Existence of an **International Transaction** as per provisions of Section 92B of Income Tax Act, 1960 ('ITA') (given the obvious satisfaction of definition of 'transaction' under Section 92F of ITA) and income arising therefrom;
II. Entering into such international transaction by two **Associated Enterprises** ('AEs') (as defined under Section 92A of ITA).

Let us examine each criterion one by one in the case of financial investments:

*I. Existence of an **International Transaction** as per provisions of Sec 92B of ITA and income arising therefrom:*

Keeping in view the restrictions under Foreign Exchange Regulatory framework in India and given the mandate of investments of most FIs, the transactions between such financial investors and the portfolio company are likely to be restricted to financial transactions viz. investment in share capital of portfolio company (i.e. equity shares and compulsorily convertible preference shares) & financing through loan (i.e. compulsorily convertible debentures) and resultant preference dividend/interest thereof. It is beyond doubt after the amendment made by Finance Act 2012 that the aforesaid transactions constitute an International Transaction under Section 92B of ITA[1].

*II. Entering into such international transaction by two **Associated Enterprises**:*

Meaning of AEs:

The meaning of expression 'Associated Enterprise' was introduced by Finance Act, 2001, alongwith introduction of TPR in India. Its meaning has been given in Section 92A of ITA which consists of two sub-sections. Section 92A(1) is reproduced below for ready reference[2]:

> *"Section 92A(1): For the purposes of this section and sections 92, 92B, 92C, 92D, 92E and 92F, "associated enterprise", in relation to another enterprise, means an enterprise—*
> *(a) which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or*
> *(b) in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise."* (Emphasis supplied)

When the section was first introduced into ITA, whereas Section 92A(2) specifically listed various categories and situations in which two enterprises would have deemed to become AEs, Section 92A(1) simply prescribed the criteria of direct or indirect participation in 'management' or 'control' or 'capital' of the enterprise for two enterprises to become AEs. Confusion therefore arose whether

[1] Whether income arises out of capital financing transactions or not has not been examined in this article since it is beyond the scope of this article and the matter is subjudice.
[2] Section 92A(2) has not been reproduced in entirety due to word limit placed on this article but clauses under this sub-section have been reproduced at appropriate places in this article.

two enterprises could become AEs for the purposes of TPR if they satisfied criteria laid down by Section 92A(1) independent of situations given in Section 92A(2) of ITA. Take for example, Section 92A(2)(a) specifically prescribes threshold of 26% shareholding with voting rights in the other enterprise for both enterprises to become AEs whereas as per Section 92A(1)(a), even shareholding with voting rights below 26% or shareholding without voting rights above 26% could imply that two enterprises could becomes AEs.

In order to remove this incongruity, a clarificatory amendment was introduced by Finance Act 2002 with retrospective effect interlinking both the sub-sections (1) & (2) while providing an explanation in the Memorandum to Finance Bill 2002 to the following effect:

> *"It is proposed to amend sub-section (2) of the said section to clarify that the mere fact of participation by one enterprise in the management or control or capital of the other enterprise, or the participation of one or more persons in the management or control or capital of both the enterprises shall not make them associated enterprises, unless the criteria specified in sub-section (2) are fulfilled."* (emphasis supplied)

Applying the Mischief Rule of interpretation, it becomes clear that the amendment was brought about to cure the defect or clear the air over ambiguity as prevalent in the prior provisions of Section 92A of ITA and therefore, the deeming provisions under Section 92A(2) are to be given importance in that light.

Examining effect of SHA clauses on AE relationship u/s 92A(2):

For the purposes of examining the effect of the above typical SHA clauses, let us first group them into three categories and subsequently examine them:

- Category 1 – Purchaser's Rights (ROFR, ROFO, Call Option): All the three aforesaid rights have been grouped here since they denote rights, the consequence of which could be to purchase additional shares in the Portfolio Companies and thereby result in an increase in the shareholding. Since these rights could effect a change in shareholding of FI in the Portfolio Company, only Section 92A(2)(a) would be relevant for determining effect of this category of rights on AE relationship. For ready reference, the sub-section is reproduced below:

  > *"Section 92A(2): For the purposes of sub-section (1), two enterprises shall be deemed to be associated enterprises if, at any time during the previous year,—*
  > *(a) one enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in the other enterprise; "* (emphasis supplied)

  Generally FIs hold minority stakes in Portfolio Companies and in most of the cases would be well below the threshold of 26% but they also hold the aforesaid rights, the exercise of which could cause them to cross the threshold shareholding. Under such circumstances, could possession of these rights be considered to give rise to deemed ownership at the hands of the financial investor so as to create AE relationship u/s 92A(2)(a)? The answer is negative since ROFR, ROFO and Call option simply denote rights but not an obligation on FI to exercise those rights. The word used in Section 92A(2)(a) is '*holds*' which denotes a factual reality and not a

possible reality. The same has also been explained by Bombay High Court in the case of *MCX*[3] which has been upheld by Supreme Court by dismissal of SLP[4] against the decision of the Bombay High Court. Bombay High Court stated that options constitute a privilege, the exercise of which depends upon the option holder's unilateral volition and that a concluded contract for sale and purchase of shares would come into existence only if the option holder exercises the option to purchase or sell shares. Similarly, Supreme Court in the case of *Vodafone International Holdings B.V.*[5] has also held that at the highest, options could be treated as potential shares and till exercised, they cannot provide any right to vote. Therefore, if FI shareholding is below the threshold level and even if it holds ROFR, ROFO and Call Option, these rights would not have any effect of creating AE relationship between FI and Portfolio Company.

- Category 2 – Seller's Rights (DRAG, TAG, Put Option): These rights have been grouped here since they denote rights, the consequence of which could be to sell existing shares held in the Portfolio Companies and thereby result in a decrease in the shareholding. Since DRAG, TAG and Put Option are rights similar in character to ROFR, ROFO, Call Option, the same conclusion could be arrived at in the context of Section 92A(2)(a) but conversely i.e. if FI shareholding in the Portfolio Company is above threshold of 26%, then by virtue of holding DRAG, TAG and Put Option, ipso facto it would not bring FI and Portfolio Company out of AE relationship.

- Category 3 – Veto Rights: Veto Rights could be granted for any kind of matter to be transacted related to the affairs of the Portfolio Company. The matter could be relating to any of the following or more:

  - appointment of executive director;
  - change in the number of directors of the company;
  - change in the maximum number of shares that the company is authorized to issue;
  - amendment, adoption or repeal of any of the company's articles;
  - making of any contract by the company outside of the ordinary course of business;
  - appointment of any person with an aggregate salary and/or perquisites in excess of a threshold amount per annum;
  - appointment of auditors;
  - material deviation from a budget or business plan;
  - declaration of dividends;
  - entering into of any partnership or joint venture with any other entity, etc.

  The consequence of granting Veto Rights to FI would be that a particular 'Reserved Matter' would need consent of FI in order to be effected. If FI does not grant its consent (i.e. vote by FI appointed director against proposed Board Resolution/vote by FI against proposed Shareholders' Resolution), then such 'Reserved Matter' cannot be effected (i.e. proposed resolution shall not pass through in the Board Meeting/Shareholders' Meeting).

[3] Writ Petition No. 213 of 2011
[4] Special Leave to Appeal (Civil) No.11738/2012
[5] 341 ITR 1

As explained above, Veto Rights are typically granted to minority investors in order to enable them to protect their interests in the company against other investors. By virtue of Veto Rights, FI has the right to only veto a resolution proposed by other shareholders and ipso facto, it does not grant FI the power to cause a resolution to be approved unless the consent of other shareholders too is obtained for that resolution to the effect of satisfaction of simple majority or special majority as may be required.

From the above perspective and keeping in view the limited nature of transactions between FI and Portfolio Company, only Section 92A(2)(e) would be relevant for determining effect of this category of rights on AE relationship. For ready reference, the sub-section is reproduced below:

> *"Section 92A(2): For the purposes of sub-section (1), two enterprises shall be deemed to be associated enterprises if, at any time during the previous year,—*
> *(e) more than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of one enterprise, are <u>appointed</u> by the other enterprise;"* (emphasis supplied)

In the context of Sec 92A(2)(e), since FI is typically a minority investor, under normal circumstances, by virtue of its shareholding, it would neither get the right to appoint more than half of the board of directors of the Portfolio Company nor get the right to appoint Executive Directors and consequently would not be in a position to 'appoint' either. Appointments of key personnel such as Executive Directors generally require consent of both FI and the promoter upfront while entering into the SHA and therefore could not be attributed solely to FI. Further, Veto Rights could be granted for an event of change in Executive Directors. It is well settled that deeming provisions creating legal fictions, especially in taxing statute have to be strictly construed[6]. Since Section 92A(2) is a deeming provision per se, the word '*appointed*' used in clause (e) to sub-section (2) to Section 92A has to be read to mean appointment in actuality by FI. As elucidated above, Veto Rights are basically negation rights and their exercise even recurrently (excluding the possibility of assumption of circumstances of a deadlock) by FI in the process of appointment of Executive Director to the governing board cannot result into an appointment by FI *de jure*, which is the requirement of Section 92A(2)(e). Therefore, grant/exercise of Veto Rights would not any bind FI and Portfolio Company into AE relationship.

Unsettling of importance attached to deeming provisions of Section 92A(2)?

In a recent ruling of Mumbai ITAT in *Sanchez Capital Services (P.) Ltd. v/s ITO*[7], the tribunal did not accept the contention of the appellant that sub-section (1) has to be read alongwith sub-section (2) of Section 92A of ITA. Relying on the memorandum explaining the provisions in the Finance Bill 2002, the appellant had argued that Section 92A(2) and 92A(1) are inter-related and unless the criteria specified in sub-section (2) are fulfilled, the two enterprises could not be considered as AEs because there is no threshold prescribed for shareholding in sub-section (1). The tribunal acknowledged that there was no AE relationship under sub-section (2) but ultimately remanded the

[6] Supreme Court decision in *CIT* v. *Keshavlal Lallubhai Patel* [1965] 55 ITR 637 (SC)
[7] 53 SOT 241

matter back to TPO to examine AE relationship under sub-section (1). It is to be noted that the ruling has not elaborately dealt with the appellant's contention of interpreting sub-sections (1) & (2) of Section 92A in jointly neither has it provided any reasons for rejecting the same. Under such circumstances, does the aforesaid ruling continue to serve as a precedent and is it permissible to follow the *ratio decidendi* of this decision or does it lose it binding precedence since it could be considered to have been passed *sub-silentio*? The Supreme Court in *State of UP v. Synthetics and Chemicals Ltd.*[8] has observed that a decision which is not express and is not founded on reasons nor it proceeds on consideration of issue cannot be deemed to be a law declared to have binding effect as is contemplated by article 141. It also referred to a previous Supreme Court decision in *B. Sharma v. Union Territory of Pondicherry*[9] wherein it was observed that a decision is binding not because of its conclusions but in regard to its ratio and the principles laid down therein. It therefore laid down that any declaration or conclusion arrived at without application of mind or preceded without any reason cannot be deemed to be declaration of law of authority of a general nature binding as a precedent. Therefore, assessees may have still the liberty to refrain from following the aforesaid ruling and continue placing reliance on memorandum explaining the provisions in the Finance Bill 2002 to determine AE relationship between two enterprises.

Interestingly, there is another ruling by Mumbai ITAT in the case of *Diageo India (P.) Ltd.*[10] which has given purposive interpretation to sub-section (1) to Section 92A and harmoniously interpreted both sub-sections (1) and (2) together. While interpreting sub-section (1), it observed that even as definition of AEs had crucial references to 'participation in management or control or capital' at some places, the precise scope of this expression had not been defined under the provisions of the ITA and it had previously not come up for judicial adjudication either. It eventually held that the true test of AE thus is control by one enterprise over the other, or control of two or more AEs by common interests, and such control is essentially an effective control in decision making process and therefore essentially all these three ingredients refer to *de facto* control on decision making. It further held that all clauses of deeming fictions set out in section 92A(2) are only practical illustrations of the manner in which this *de facto* control on decision making exists. It is to be noted here that the tribunal has not considered memorandum explaining the provisions in the Finance Bill 2002 while arriving at this conclusion and inspite of it, it has harmoniously interpreted both sub-sections of Section 92A. Would this decision be considered to have been rendered *per incuriam* since it has not taken into account the phrase 'For the purposes of sub-section (1)' so appearing at the beginning of sub-section (2) in the light of such memorandum?

Also, it may be appropriate to note here that such memorandum qualifies the expression 'participation in management or control or capital' by the phrase 'mere fact'. Therefore, would it imply that both sub-sections have to be satisfied simultaneously and if so, once we come to the conclusion that deeming fictions under sub-section (2) are purely manifestations of sub-section (1), then satisfaction of requirements of sub-section (2) automatically render provisions of sub-section (1) redundant.

[8] [1991] 4 SCC 139
[9] AIR 1987 SC 1480
[10] 47 SOT 252

There are hardly any other reported judgements in the context of AE relationship u/s 92A of ITA and till jurisprudence evolves on this topic, it would be futile to attempt to arrive at any conclusion.

Keeping in mind the harsh penalties prescribed u/s 271AA of ITA for non-reporting of international transactions (which do not give regard to the premise of lack of judicial opinion for applicability of AE relationship for not reporting such international transactions), a more practical approach would be to report international transactions between FI and Portfolio Company after examining whether AE relationship exists under Section 92A(1) independently. Nonetheless, it has been held in the decision of *Sanchez Capital Services (P.) Ltd.* (supra) that mere mention in the Form 3CEB of AE relationship alone would not be sufficient to treat the enterprises reported therein as AEs unless provisions of Section 92A are satisfied.

Examining effect of SHA clauses on AE relationship u/s 92A(1):

The foremost question to begin with the interpretation of the expression 'participation in management or control or capital' is whether we proceed to interpret each word separately or in a contextual manner in light of the decision rendered in the case of *Diageo India (P.) Ltd.* (supra).

All the three words have not been defined under ITA although an apparent inclusive definition of 'control' has been given under Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 ('Takeover Code') (and the same meaning has also been adopted under Companies Bill 2012 as passed by Lok Sabha). But, it would not be appropriate to refer to the definition of 'control' under Takeover Code for the purposes of ITA for two reasons: (a) interpretation of a provision with reference to provisions of another enactment is permissible when the two statutes are in *pari materia*[11] and ITA and Takeover Code are not statutes in *pari materia* since ITA is taxing statute and Takeover Code is a statue regulating securities market; and (b) since the definition of control is a legal fiction introduced under Takeover Code and legal fictions are only for a definite purpose and cannot not be extended beyond that legitimate field[12].

It has been held in the case of *Vodafone International Holdings B.V.* (supra) by Supreme Court that control and management is a facet of holding of shares and cannot be dissected from the shares. Although the ruling to this effect has been nullified by way of an express provision u/s 2(14) of ITA by providing that the right of control and right of management independently constitute 'property', it may be apt to adopt contextual and purposive interpretation in understanding the expression 'participation in management or control or capital' as has been adopted in the decision in case of *Diageo India (P.) Ltd.* (supra) since plain meaning of these words may not convey and may even defeat the intention of the Legislature. Therefore it seems apposite to adopt the meaning assigned to the expression 'participation in management or control or capital' as '*de facto* control on decision making' in the aforesaid decision. '*De facto* control on decision making' denotes factual control over the company and it is essentially a question of fact. It could be inferred from the circumstances surrounding the decision making exercise in the company and when a shareholder has the power to

[11] Supreme Court decision in Board of Muslim Wakfs v. Radha Kishan [AIR 1979 SC 289]
[12] Supreme Court decision in the case of Amarchand N. Shroff [48 ITR 59]

influence the decision making process directly or indirectly, such shareholder could be inferred to have '*de facto* control on decision making' in the company.

In this perspective, continuing with the grouping made before, examination is proceeded hereunder:

- Category 1 & 2 – Purchaser's and Seller's Rights: The conclusion arrived at under the analysis made for Sec 92A(2) would also hold good in case of examination of effect of these rights under Sec 92A(1) since none of these rights confer '*de facto* control' to FI over the Portfolio Company.
- Category 3 – Veto Rights: As explained above, Veto Rights are essentially negation rights which could be granted in a host of matters and FI needs to grant consent w.r.t. these 'Reserved Matters' for them to be passed. Therefore, even though FI would not have direct influence over the decision making process (because of its shareholding being in the minority), it would have indirect influence since practically FI would have the last say in the 'Reserved Matters' (excluding the possibility of assumption of circumstances of a deadlock) and it could exercise its special right of negation even when there is otherwise simple majority or special majority for passing a resolution under Board Meeting or a Shareholders' Meeting. Hence, going by the concept of '*de facto* control', grant of these Veto Rights could very well establish AE relationship between FI and the Portfolio Company.

The analysis presented under this article could therefore be summarized as below:

Type of right	Whether AE Relationship between FI and Portfolio Company?	
	Section 92A(2)	Section 92A(1)
Category 1 – Purchaser's Rights	Cannot create ipso facto	Cannot create ipso facto
Category 2 – Seller's Rights	Cannot negate ipso facto	Cannot negate ipso facto
Category 3 – Veto Rights	Cannot create ipso facto	Can affirm ipso facto

Bibliography

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