

Public M&A: JV's with exclusivity under SEBI's scanner – The Linde Case

Key Takeaways

- Independent Directors must pay closer attention to transactions with related parties. They should ask- are there any non-price factors that are not reflected in the transaction price? If yes, what is the value of these factors? Can they trigger the materiality threshold and need shareholder approval?

- Non-price factors could be a non-compete clause, especially crucial in case of hive-off or joint venture transactions (with non-compete from ListCo), and may need careful attention

- Test materiality by clubbing all related party transactions (RPTs) with a particular related party and not only those in the same contract or for the same purpose

Introduction

The recent SEBI order in Linde India Ltd ("**Linde**")[1] case has a clear message for independent directors – don't contend with management speak, especially while scrutinising RPTs (the SAT has currently granted a stay on procedural grounds without weighing in on the merits). The scrutiny must involve a thorough check of whether the transaction price has baked in all factors that could trigger materiality. In Linde's case, SEBI concluded, the independent directors failed to do so.

What Makes A Transaction 'Material'?

There's a clear brightline test - a transaction that meets either of the two criteria: (a) valued at more than INR 1,000 crore; or (b) more than 10% annual consolidated turnover of the company.

Once a transaction triggers either of these criteria, shareholder approval must be sought. The regulatory intent is that RPTs, while allowed, should be examined by uninterested parties to ensure fairness. This is ensured through two levels of approval – one, by the audit committee and two, by (unrelated) shareholders.

Pushing every related party transaction to a shareholder vote isn't optimal. Therefore, at the first instance the audit committee scrutinises these transactions and shareholders are only asked to vote on "material" transactions or "Material RPTs".

Part A – Linde's "Material" Position - The flip-flop: Must you club multiple transactions with the same related party even if they were not a part of the same 'contract'?

Linde, which wanted to enter into RPTs, first approached its shareholders since it was a Material RPT. When the shareholders rejected the RPT, it went ahead with the transactions by taking a call that shareholder approval was not required.

The company, citing three legal opinions, took a view that as long as the RPTs are not within a contract, or for the same purpose, the value of the transactions shouldn't be grossed up for the materiality test. For this, the company relied on a few words ("in a contract") in the Listing Regulations. For short, the opinion seems to be that "materiality" has to be tested on a contract by contract basis and that as long as there was no mothership contract or that the contracts were not for the same purpose, then multiple should not be clubbed together even if they are with the same related party.

[1] Securities And Exchange Board Of India Interim Ex Parte Order In Respect of Linde India Ltd, WTM/AB/CFID/CFID-SEC3/30299/2024-25

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A plain text reading of the regulations[2] suggests otherwise.

Definition of related party transaction (Reg 2(1) (zc)):

""*related party transaction" means a transaction involving a transfer of resources, services or obligations between:*

(i) a listed entity or any of its subsidiaries on one hand and a related party of the listed entity or any of its subsidiaries on the other hand; or

(ii) a listed entity or any of its subsidiaries on one hand, and any other person or entity on the other hand, the purpose and effect of which is to benefit a related party of the listed entity or any of its subsidiaries, with effect from April 1, 2023; regardless of whether a price is charged and a "transaction" with a related party shall be construed to include a single transaction or a group of transactions in a contract."

Definition of material related party transaction (Reg23):

"*The listed entity shall formulate a policy on materiality of related party transactions and on dealing with related party transactions 138[including clear threshold limits duly approved by the board of directors and such policy shall be reviewed by the board of directors at least once every three years and updated accordingly:*

Provided that a transaction with a related party shall be considered material, if the transaction(s) to be entered into individually or taken together with previous transactions during a financial year, exceeds rupees one thousand crore or ten per cent of the annual consolidated turnover of the listed entity as per the last audited financial statements of the listed entity, whichever is lower."

To test materiality, all transactions with a related party during a financial year need to be consolidated. Meaning, a company can't undertake smaller transactions with a related party to avoid triggering the materiality threshold, and in turn the shareholder approval requirement. The words 'in a contract' need to be looked at harmoniously with Reg 23 which requires that all transactions with the same related party be clubbed together rather than limiting it to transactions clubbed together in a contract. The definition of related party seems merely to confirm that a related party transaction can be a group of transactions in a contract, but does not preclude multiple contracts and the test for materiality again seems to just require that all transactions be clubbed, not only those within a single contract.

Hence, in our view there's no requirement for these transactions to be contained in a mothership contract. In essence, three main points emerge from SEBI's order:

[2] Securities And Exchange Board Of India (Listing Obligations And Disclosure Requirements) Regulations, 2015

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a. *Should transactions be contained in a contract* – No, they can either be contained in a contract or in several contracts or not be contained in any contract at all. The only requirement is a transaction (in its generic sense) to exist.

b. *Should unrelated transactions be clubbed together for the materiality test* – Yes, as long as they are with the same related party. The test exists to flag the conduct (i.e., whether it is a material RPT) while the purpose is judged by the shareholders. In short – the threshold test is plainly for the conduct and not the purpose.

c. *Should all transactions with all related parties be clubbed together for the materiality test* – No. The regulations are clear on the point that only transactions with that related party have to be clubbed. Even the SEBI interim order in the Linde case tacitly acknowledge this when it says "*all transactions with **a** related party*" have to be clubbed.

Part B: Must you value the non-compete? The Question Linde's Independent Directors Didn't Ask

Every transaction can have a price and a non-price value. There could be provisions in a contract which may not have a sticker price but could have an economic impact.

In the Linde case, it was a non-compete provision. Linde and its related party carved up products and market areas to avoid competition. In essence, a non-compete clause. The audit committee failed to account for the value of this non-compete while determining "materiality". SEBI found this to be a violation of the law.

A plain reading of the regulations suggests that merely because a price was not charged does not mean it must not be considered. For this, we will have to circle back to the intent of the law – i.e., anti-abuse. In fact, this intent is also well articulated in the regulations with the conspicuous mention of "*regardless of whether a price is charged*" in the definition of RPT.

SEBI's order makes it abundantly clear that boards must value contractual provisions to determine materiality. Merely looking at the sticker price of the transaction may also defeat the purpose of the law. If that position was taken, it would mean all transactions without a price would necessarily be non-material.

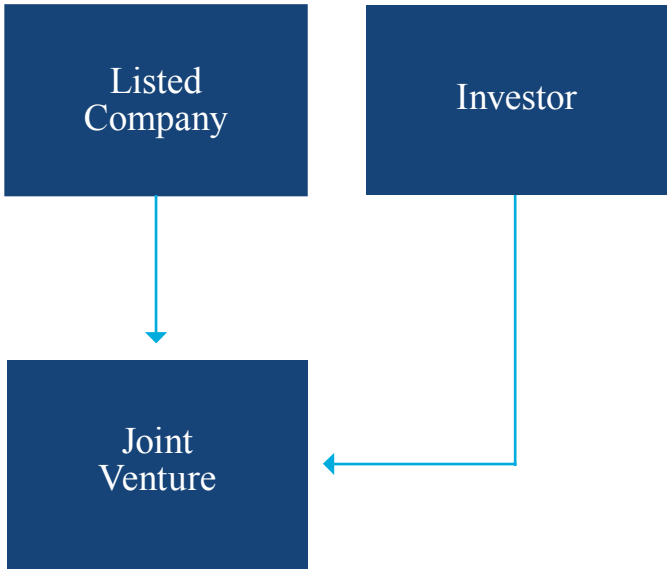
What's SEBI's Ask?

A contract necessarily involves a series of bargains, the sum total of which is usually reflected in the pricing. The regulator has a simple ask- boards must ensure that all non-price factors have been accounted for as well.

To illustrate, consider any joint venture of a listed entity. Usually, while setting up the joint venture company, the listed entity will also enter into a series of obligations (on supply of

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material, technology etc) but the most important part is usually "exclusivity" i.e., that the listed entity will not directly compete with the joint venture entity. This ensures alignment between the parties, and usually these separate units are set up so that a nascent business can be scaled up by partnering with either an investor or a strategic partner who only wants exposure to that line of business without buying into the larger interests of the listed company.



The regulations seem to require that the exclusivity clauses be valued. Though someone wearing a commercial hat could argue that the price of the transaction would have built in the cost of such clauses.

But should boards simply make this assumption and not even question the need for a valuation of such non-price factors?

The lodestar here is not whether the price has been considered but whether it has been considered fairly. For that purpose, the audit committee should not limit its review to a perfunctory matching of prices, but also ensure that the price charged is fairly reflected. This, after all, is the very essence of any anti-abuse mechanism – to identify and cure the mischief. Here, the mischief sought to be prevented is minority shareholders being adversely impacted by moving value out of the company. Clearly, a mere review of the contract price may not serve the purpose. While the independent directors at the audit committee are not expected to substitute the commercial judgment of the management, they are to at least seek out all the information before greenlighting RPTs.

SEBI has sent a loud and clear message to boards through this order - the duty to ensure minority shareholders are not short changed is not just a governance requirement but a regulatory one.

This perhaps starkly illustrates the need and the role of independent directors. They are to act as the adults in the room. Simply put, they are present to ask questions, sometimes uncomfortable ones, from a simple vantage point of a common shareholder – for instance, "the contract prevents us from selling wires to other companies for 2 years, have you considered the financial impact?".

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What could be the aftermath of this decision?

Such valuations haven't generally been the practice, and it does appear to be one of the first cases where the SEBI has asked for such valuation. This also gains importance given the increase in hive offs by listed companies in search of growth capital. Such decisions often result in a feeder structure where considerable value for shareholders is derived from the subsidiary/affiliate situated below the listed company. This also increases the role of independent directors in ensuring that when such business is moved a layer away from shareholders, that value is actually being created from the move. This entails them taking on more of an active role. If not of an enforcer, then at least that of a curious shareholder.

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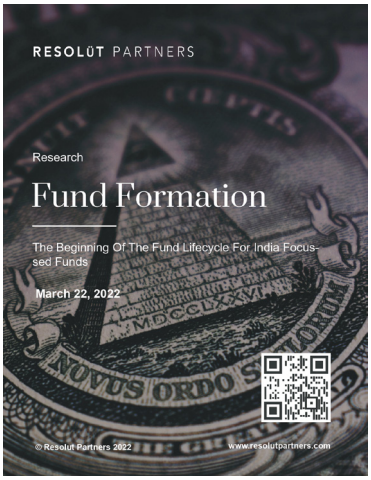
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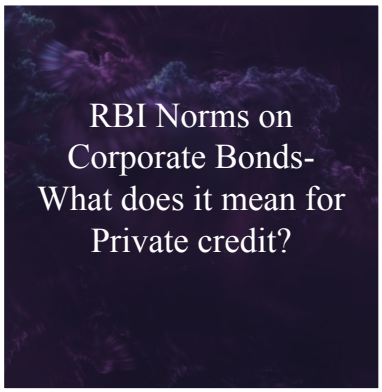






Bottom Line





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