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Revisiting Non-Compete Fee In Corporate Transactions

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Recently, merger of two major Insurance companies brought the whole issue of non-compete fee ("**NCF**") into limelight again. NCF is the fee paid to the promoters of target company in return of the assurance that they will not compete with the business of the target company for a certain period of time. On the face of it, there is nothing wrong with this fee, as it would not be advisable to acquire 'Apple' with out a commitment from Steve Jobs that he is not going to enter into the same line of business. After all, promoters have the knowledge and expertise in developing the company's business and non-compete restrictions are applicable only to them, not to the general public shareholders as a whole. However, problem arises when NCF is used as a disguise to cover the higher sale consideration paid to the promoter as compared to the consideration paid to the public shareholder.

The issue came up for consideration in the Achuthan Committee Report of the Takeover Regulations, the gist of whose recommendation are as follows:-

1. The public shareholders and the promoters are on the same footing and there should not be any discrimination between these two groups.
2. Preferential treatment in the form of NCF cannot be given to the promoter group as this was against the principle of shareholder equality.
3. Non- compete should flow to the entire shareholder body and not merely to a certain group of shareholders as they were in the nature of compensation for loss of potential value on account of sacrificed business of opportunities.
4. All shareholders shall obtain same exit price and that no preferential treatment is accorded to one set of shareholders over the others.

SEBI (Substantial Acquisition of Shares and Takeover Regulations) 2011 ("**SAST**") has implemented the recommendations of the Achuthan Committee Report, stating that any NCF paid to promoter group has to be factored in the open offer price paid to other public shareholders,[1] which essentially means that all shareholders obtain an exit at same price. Although, SAST does not completely prohibit NCF, it has ensured that all shareholders obtain the same exit price and no preferential treatment is accorded to one set of shareholders over the others.

While SAST put an end to NCF paid to promoters in take over, the restriction is not applicable to merger/demerger through scheme of arrangement ("**Scheme**") under the Companies Act, as the provisions of SAST is not applicable to court/tribunal driven merger/demerger Scheme. The following rationale can be given for providing a different treatment to Scheme as compared to SEBI regulated take overs:

1. The Companies Act prescribes an elaborate approval process for the Scheme. Unless the company obtains the requisite majority from shareholders, it can't go through with the Scheme. This kind of approval mechanism will itself ensure that no undue benefits are passed on to promoters.
2. The Scheme also requires the court/tribunal approval. Hence, unfair provision in the Scheme can be questioned before the court/tribunal where it comes for approval.

Though the above justification seems to be well founded, the transaction under consideration here exposed certain grave concerns arising out of the Scheme. The issue is aggravated by the fact that in mergers, such as the one we are discussing here, often the promoters don't exit and continue to be the shareholders of the resulting merged entity. Payment of NCF under such circumstances is quite debatable. On the wake of this controversy, SEBI seems to be considering extension of NCF restrictions to Scheme involving listed companies.

SEBI may justify its attempt on its mandate to protect public shareholder's interest. However, how far a regulator can go to this extend is seriously questionable. SEBI norms for Scheme applicable to listed companies[2] already provides that the Scheme would be valid only if the number of vote cast by the pubic shareholders in favor of the Scheme is at least twice the number of votes cast by public shareholders against it. This is in addition to the special majority requirement prescribed under the Companies Act. On the backdrop of such a vast majority required from public shareholders, how they will approve a Scheme if it is unfair to them? Further, the Scheme will go through the review of the stock exchanges and SEBI before submitting it to the court/tribunal for its approval. Hence, protecting the interest of the public shareholder is already embedded in the current regulatory system. SEBI's move to completely prohibit NCF can only be considered as a knee jerk reaction to the current merger controversy.

[1] Regulation 8 (7)

[2] Circular No. CIR/CFD/DIL//5/2013 dated 4th February 2013