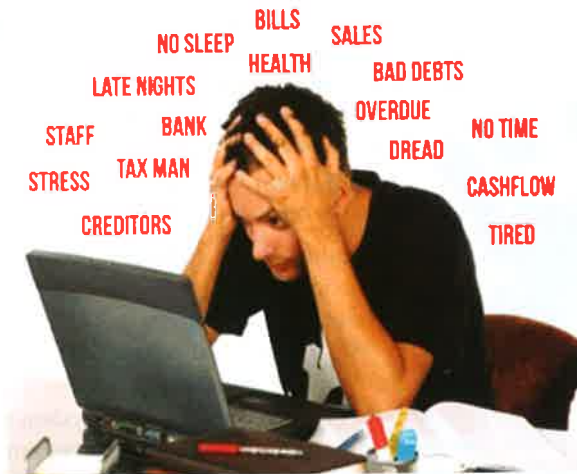


OUT OF CONTROL?

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Brief Summary: The term "Control" is one of crucial and a very strategic term in the Corporate Sector. It has been very widely defined in various corporate laws and also there are many case laws to further elaborate or clarify its definition. Here is an analysis of the definitions and to understand that whether the definition or the concept of "Control" has actually gone out of control?



In day to day working and also in strategic planning, a Professional comes across the term and concept of "Control". Few of the instances are the appointment of a Director in a Company, drafting the Articles of Association, drafting of Joint Venture Agreements, drafting of the Shareholders Agreement, finalizing Financial Policies, a listed company acquiring shares of other companies (listed or unlisted), Reporting and Disclosures requirements of the Accounting Standards and implications under the Income Tax Act.

The term is very widely defined in the Corporate Laws. Sometimes, we, as Professionals happen to think that whether the definition or the concept of "Control" has gone out of Control? Why is it so difficult to quantify / define "Control" Or Why can't we have one definition for the concept?

In this Article, I have analyzed the definition of "Control" by referring the Dictionary and corporate laws (existing and proposed):

(I) Blacks Law Dictionary:

- (1) Control (as Noun) - The direct or indirect power to direct the management and policies of a person or entity, whether through ownership of voting securities, by contract, or otherwise; the power or authority to manage, direct or oversee.
- (2) Control (as Verb) - To exercise power or influence over.

(II) The Companies Act, 1956:

Section 4 of the Companies Act, 1956 relates to the "Meaning of Holding Company and Subsidiary".

As per Section 4 of this Act, the companies ("S1 & S2") will be subsidiaries of company ("H") if:

- a) H controls the composition Board of directors of S1 / S2 or;
- b) H holds more than half of the nominal value of its equity share capital of S1 / S2 or
- c) S2 is a Subsidiary of S1 and S1 is a subsidiary of H.

In Section 4 (2) of this Act, the term "control over the composition of the Board of Directors" has been further elaborated as H may on its own discretion and without the consent of any other person, can appoint or remove all or a majority of the directors in S1/S2.

(III) SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011:

In these Regulations, "Control" is defined in Regulation 2 (1) (e) and it includes:

- 1) The right to appoint majority of the directors or,
- 2) The right to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner:

This definition in SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 is subject to the proviso that a director or officer of a Target Company shall not be considered to be in control over such target company, merely by virtue of holding such position -i.e. the position of the Director.

Therefore, in these Regulations, the emphasis on more on the right to appoint directors and right to control the management / policy decisions of the company.

(IV) Accounting Standard (AS) - 18 Related Party Disclosures:

"Control" is defined in Clause 10 of AS - 18. The emphasis is on:

- a) Ownership of voting power or
- b) Control over composition of Board or
- c) Directing the management / policy decisions through substantial interest in the voting power of a company.

"I would maintain that thanks are the highest form of thought; and that gratitude is happiness doubled by wonder." - G.K. Chesterton

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(V) Consolidated Financial Statements (AS - 21) & Accounting for Investments in Associates in Consolidated Financial Statements (AS - 23):

"Control" is defined in Clause 5 of AS - 21 and in Clause 3 of AS - 23. In both the cases, it includes:

- a) Ownership of more than half of the voting power of an enterprise or;
- b) Control over the composition of the Board of Directors / Governing body with an intention to obtain economic benefits from its activities.

(VI) Financial Reporting of Interests in Joint Ventures (AS - 27):

As AS - 27 relates to Financial Reporting of Interests in Joint Ventures, the Clause 3 of the AS has defined both "Joint Control" and "Control".

"Joint Control" is the contractually agreed sharing of control over an economic activity. "Control" is the power to govern the financial and operating policies of an economic activity so as to obtain benefits from it.

Now, the AS - 27 does not specifically have any provision relating to holding of voting power and control over the composition of the Board of a Company.



(VII) The Companies Bill, 2011:-

It shall include:

- a) Right to appoint majority of the Directors or
- b) Right to control the management or policy decisions exercisable by a person (individually or in concert), directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner.

The definition is as per Clause 2 (27) of the Bill. If, we observe keenly, the definition of "Control" in the Companies Bill, 2011 very similar to the definition of "Control" under SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011.

(VIII) The Income Tax Act, 1961:

In Income Tax Act, 1961 - the term "Control" / "Substantial Interest" / has been defined in various sections and the same is elaborated as under:

- 1) Section 40A relates to "Expenses or payments not deductible in certain circumstances".

The concept of "substantial interest" for the purpose of Section 40A (2b) is given in the Explanation to the Section which states that a person shall be deemed to have a substantial interest (in case of business or profession), if he, at any time during the Previous Year, is the beneficial owner of shares carrying not less than 20% of the voting power.

- 2) Section 92A of the Income Tax Act, 1961 relates to "Meaning of Associated Enterprise". The "Associated Enterprise", in relation to another Enterprise, means an Enterprise:

- (a) Which participates in the management or control or capital of the other enterprise; (here the relation is between two enterprises) or
- (b) In respect of which one or more persons who participate in its management or control or capital, are the same persons who participate in the management or control or capital of the other enterprise (here there is a relation between two enterprises through one or more person).

Such participation can directly or indirectly, or through one or more intermediaries.

There are 13 Tests in the Section (and any one can be applied), to determine, if two enterprises shall be deemed to be Associated Enterprises ("Alpha" and "Beta" mentioned wherever necessary). Some of them are listed as under:

- (a) Holding of not less than 26% of the Voting Power (directly or indirectly);
- (b) Loan advanced by Alpha to Beta constitutes not less than 51% of Book Value of the Total Assets of Beta;
- (c) Alpha guarantees not less than 10% of the Total Borrowings of Beta;
- (d) Beta appoints more than half of the Board of Directors / Members of the Governing Board of Alpha or
- (e) Same person appoints more than half of the directors / Members of Governing Board of each of Alpha and Beta
- (f) Alpha is wholly dependent on the Intellectual Property (IP) of Beta for its manufacturing or processing activity ; or
- (g) Beta supplies 90% or more of the raw materials

"You say grace before meals. All right. But I say grace before the concert and the opera, and grace before the play and pantomime, and grace before I open a book, and grace before sketching, painting, swimming, fencing, boxing, walking, playing, dancing and grace before I dip the pen in the ink." - G.K. Chesterton

and consumables required for the manufacture or processing carried out by Alpha; or

- (h) Alpha manufactures and processed goods / articles and sells to Beta and prices & conditions are influenced by Beta or
- (i) There exists between Alpha and Beta, any relationship of mutual interest, as may be prescribed.

The relationship defined in Section 92A of the Income Tax Act, 1956 is the widest of all (in my view) because it not only considers voting rights and power to appoint Directors; but also covers Control through granting of loan, guarantee of loan, dependency on IP for manufacturing; supply of raw material, control over prices and finalization of terms and conditions.

Really out of Control? :

As seen above, there are many definitions of "Control" in the various legislations and only few are discussed above. So, has the definition of "Control" become out of Control and not manageable? Why can't the all the laws in a country have the one single definition for a legal concept?

The reason, in my view, is that every legislation has its own objective and principles. Broadly speaking, the objective of Company Law is to manage and administer the working of the Companies in India, whereas the objective of Taxation Laws is to ensure the tax is not evaded by the Companies through complicated transactions and the objective of Accounting is to ensure that the Financial Statements give a true and fair view of the state of affairs of the company and also ensure adequate discl requirements. Hence, accordingly

the definition is drafted in a particular legislation to meet its objectives.

Further, the common thread / theme in the above definitions of "Control" is:

- (1) Control over the composition of the Board of Directors / Right to appoint Directors;
- (2) Ownership of Voting Rights;
- (3) Control and Management over the Policies decisions / Management decisions;

Now, the quantum of such theme and the manner of exercising control or influence will depend upon the respective Legislations and its objective.

Here, the "Quantum" means the percentage of the voting rights held and manner of exercising control or influence can be, direct or indirect; individually or in concert; by any agreement, etc.

CONCLUSION:

At the time of decision making, a Professional is required to take comprehensive and complete view of all the applicable laws from the point of view of change in "Control". Having only one and a limited perspective of the law would not assist the management of the Company in taking informed decisions.

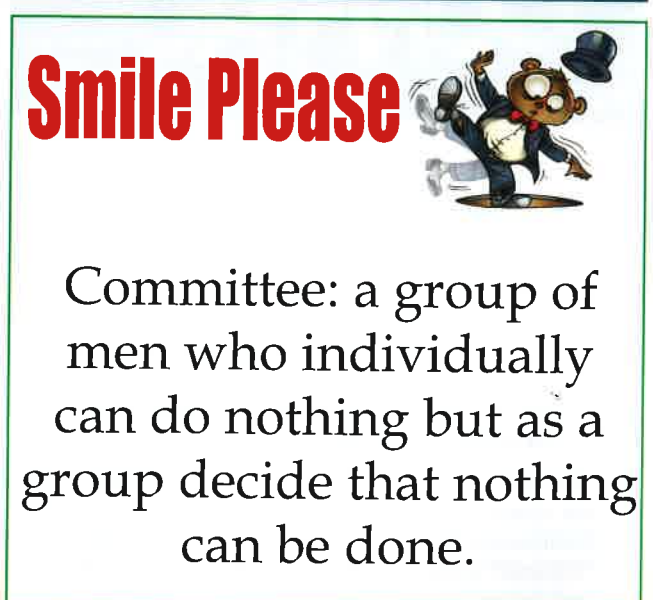
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Source of information: Black's Law Dictionary (8th Edition), The Companies Act, 1956, www.sebi.gov.in, www.icai.org, www.mca.gov.in, www.incometaxindia.gov.in.

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SAY CHEESE !!!



"For each new morning with its light, For rest and shelter of the night, For health and food, for love and friends, For everything Thy goodness sends." - Ralph Waldo Emerson