An Introduction to the Key Concepts and Practical Considerations in Indian M&A Transactions for an International Lawyer

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Introduction

India is a growing and dynamic emerging economy. The year 2017 saw the second highest level of M&A transactions since 2001, with 379 deals announced that had a value $54.7 billion. The M&A market is driven by high volumes of private equity and venture capital investment, foreign investment into key sectors of the economy and, increasingly, distressed M&A involving the businesses of some of the over-leveraged conglomerates in India. However, deal structuring and execution in India often involve a particular set of considerations. A first-time market participant will need quickly to get to grips with myriad regulations, cultural differences in working style and local market practice. This article seeks to provide a guide to navigating these waters effectively.

Overarching concepts

There are certain overarching regulatory concepts that affect different aspects of deal structuring. These are summarised below.

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Types of foreign investment

Investment into India is regulated and the investment conditions that apply are driven by the form that the investment takes. Investment into equity shares or instruments that compulsorily convert into equity shares is known as 'foreign direct investment' (FDI). Investment in certain sectors is subject to investment caps (e.g., insurance, defence etc.) and in certain cases investment conditions also apply (e.g., real estate). The ability of an FDI investor to lend to any Indian company or subscribe for any debt instruments is more limited (as discussed below).

International investors are also able to procure certain investor registrations. These registrations allow them to invest in a broader range of capital instruments, subject to certain conditions. For example, a 'foreign portfolio investor' (FPI) registration, which can be readily obtained within a short time horizon, broadly allows international investors the ability to invest in listed securities (including shares comprising less than ten per cent of the issued share capital of a listed company) and certain types of debt instruments known as 'non-convertible debentures' (NCDs). Another type of investor registration known as a 'foreign venture capital investor' (FVCI) registration provides for greater flexibility in investing in certain debt securities such as optionally convertible debentures, which would otherwise be restricted, in addition to equity investments.

Both these registrations are particularly useful for private equity investors seeking to structure their investments within the confines of what is possible in India. FVCI registration status takes longer to obtain (five to six months) as opposed to just a month or so for FPI registrations. A foreign venture capital investor registration offers certain benefits such as greater flexibility as to pricing and the absence of a three-year regulatory lock-up requirement applicable to 'promoters' (see discussion under 'Promoter concept' below) in initial public offerings (IPOs), but it is limited to investments in certain defined sectors and is subject to certain conditions.[1]

It is possible for an investor to split its investment in any single target company between straightforward FDI and investment through any of the

1 FVCIs may invest in the following sectors: (1) biotechnology; (2) IT related to hardware and software development; (3) nanotechnology; (4) seed research and development; (5) research and development of new chemical entities in the pharmaceutical sector; (6) dairy industry; (7) poultry industry; (8) production of biofuels; (9) hotel-cum-convention centres with seating capacity of more than 3,000; and (10) the infrastructure sector. Recently, 'start-ups' have been added to this list (start-ups are companies that have been incorporated for less than five years and whose revenues have never exceeded INR250m in any financial year and with a focus on technology, innovation or intellectual property). Also, FVCIs are required to invest two-third of their funds in unlisted equity or equity-linked securities.

investment registrations available, although it is preferable that the same investment vehicle does not undertake both types of investment. However, all types of investment will be aggregated in determining the applicability of the caps on foreign investment.

Treatment of debt and guaranteed returns on investments

The Reserve Bank of India (RBI) closely regulates borrowings by Indian companies from international lenders or investors. Only certain types of investors are permitted to lend. These include certain group companies,[2] but apart from this category, the remaining permitted lender categories do not readily apply to most private equity funds. The use of funds by the borrower is regulated, as are the terms of the loan and the cost of debt (in many cases, there is a prescribed spread over LIBOR). There is a limited carve-out from the cap on the cost of debt for commitment fees and prepayment fees/charges, but there is only so far this can go to compensate for any shortfall in returns.[3] This makes the provision of loans difficult or unattractive for many investors.

Related to this is the issue of structuring guaranteed returns in equity investments. The RBI views any investment with contractual exit rights at a guaranteed price as removing the equity risk and thereby making them 'debt-like'. This particularly affects put options on terms that imply that the investor receives a pre-agreed rate of return, which the RBI views as circumventing its debt restrictions. For this reason, put options are only permissible (as between international investors and Indian counterparties) at fair market value at the time of exit.[4]

Clearly, this presents an issue for private equity investors, but various structuring workarounds have evolved as discussed further below. In addition, recent case law has differentiated between guaranteed returns and arrangements implying downside protection (of which there now appears to be greater tolerance). This is discussed further under 'Enforcement of contractual protections' below.

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2 Those that hold a direct 26 per cent interest in the borrower or an indirect 51 per cent interest in the borrower or are part of the same group as the borrower, with a common overseas parent.

3 Paragraph 1.1 of Master Direction – External Commercial Borrowings, Trade Credit, Borrowing and Lending in Foreign Currency by Authorised Dealers and Persons other than Authorised Dealers dated 1 January 2016 issued by the RBI.

4 Regulation 11 of the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations 2017.

Capital v current account transactions

Central to the maze of Indian exchange controls is the question of the nature of transactions. As a starting point, Indian exchange controls prohibit cross-border transactions unless expressly permitted (which is why a cautious approach to Indian exchange controls is prudent). 'Capital account' transactions require the permission of the RBI. These are defined in Indian exchange control regulations by reference to the alteration of assets and liabilities,[5] but certain transactions are carved out and permitted (e.g., the transfer of securities between resident and non-residents or the reverse, subject to fair market valuation rules).[6] For this reason, one of the primary structuring tasks is to fit transaction structures into one of the permitted categories.

One question that has arisen in the past is whether payments pursuant to a warranty, representation or indemnity would constitute 'capital account' transactions requiring RBI approval for payment to be made to parties outside India. The *Balance of Payments Manual* published by the International Monetary Fund treats the 'payment of compensation' as being current account transactions. Although this might constitute the basis to argue that warranty, representation or indemnity payments to compensate investors for a loss should not be capital account transactions, many practitioners have hesitated from endorsing this view in the absence of clear guidance under the Indian foreign exchange regulations.

Indian courts have not directly considered whether such payments are capital accounts transactions, although in a recent line of cases supporting the enforcement of arbitral damages awards, the courts rejected the notion that the RBI's exchange controls should prevent payment.[7] That is a slightly different point, but it should provide some comfort to international investors (see 'Enforcement of contractual protections' for further discussion on the case law).

In any event, because the RBI has (in certain instances) permitted other contractual payments that have required its approval,the commonly held view among practitioners is that the RBI is unlikely to withhold is approval

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5 Section 2(e) of the Foreign Exchange Management Act 1999 (FEMA).

6 The requirements are simply that a chartered accountant or Indian regulated investment bank certify that the transaction has been undertaken at fair market value as determined in accordance with internationally accepted valuation methodologies. There is no further guidance, so parties have the flexibility to interpret this as they will and can pre-agree different techniques, multiples or comparables. Separately, there are also tax valuation rules that will need consideration in most deals.

7 *NTT Docomo Inc v Tata Sons Limited* (2017) 3 Comp LJ 526 (Del) and *Cruz City 1 Mauritius Holdings v Unitech Limited*, 239 (2017) DLT 649.

in respect of the remittance warranty payments out of India, if sought, in a *bona fide* case.[8]

Investment companies

As a general principle, holding companies in the Indian context bring with them regulatory complexity. This is because pure investment or holding companies are regulated by the RBI.

There are two categories of investment companies. The first category, known as 'non-banking finance companies' (NBFCs), comprises companies that satisfy two tests: more than 50 per cent of their total assets (net of intangible assets) are financial assets (i.e., from investments) and more than 50 per cent of their income is derived from financial assets.[9] The second category is known as 'core investment companies' (CICs). These are investment companies that satisfy certain other tests including that at least 90 per cent of their assets are in the form of investments in securities and its investments constitute not less than 60 per cent of their assets (there are other tests too).[10] These tests are determined by reference to the relevant company's most recent set of audited financial statements.[11]

The question of whether NBFCs and CICs comprise separate categories is a matter of debate in the market and the RBI's regulations are not as clear on the point as would be ideal. However, because the RBI defines a CIC to mean 'a non-banking finance company carrying on the business of the acquisition of shares and securities…', there is some support for the view that CICs constitute a sub-set of NBFCs.

NBFCs need to register themselves with the RBI, as do CICs (however CICs with assets of less than INR1bn are not required to register themselves with the RBI, provided they have not subsequently raised 'public funds'). Apart from this registration, there are certain implications of being such an investment company. Both types of such companies are subject to prudential capital requirements, investment concentration limits and

8 The RBI is likely to satisfy itself in this regard by reviewing the claim notice and the court or arbitral tribunal order in favour of payment or correspondence between the parties, where a claim is uncontested.

9 Set out in an RBI Notification dated 19 October 2006.

10 Paragraph 2 of the Master Direction – Core Investment Companies (Reserve Bank) Directions 2016 ('CIC Master Directions').

11 Each of the investment companies above is further classified into 'deposit taking' and 'non-deposit taking' and then into 'systemically important' and 'non-systemically important'.

leverage constraints.[12] In addition, any significant changes of the board of NBFCs require RBI approval.

In addition, downstream investment by such holding companies can only be made using internally generated funds ('internal accruals') or funds that have been transferred from abroad (i.e., domestic debt cannot be used to fund any downstream investments).[13]

Therefore, in the absence of compelling commercial reasons for their use (e.g., to manage liability, or in infrastructure investments in order to isolate risk in individual projects), the use of holding companies with downstream special purpose vehicles should be avoided. Where such structures are needed, international investors should consider implementing structural workarounds (for instance, creating substance and operations in the holding company such that it does not qualify as an investment company).

Promoter concept

International investors will almost certainly come up against the 'promoter' concept. This term is defined in Indian company law[14] and securities laws[15] in slightly different ways and mainly has relevance in the context of listings or public takeovers.

Promoter status is determined by reference to various tests as summarised below.

First, one of the company law tests (but not the securities law test) includes a person 'in accordance with whose advice, directions and instructions, the Board of Directors of the company is accustomed to act'. This is very similar

12 Paragraph 22 of the Non-Banking Finance Company – Systemically Important Non-Deposit Taking Company and Deposit Taking Company (Reserve Bank) Directions 2016 ('NBFC Master Directions') requires investments to be limited to 15 per cent of the NBFC's 'owned funds', and investments in a single group of companies cannot exceed 25 per cent of the NBFC's 'owned funds'. There are exemptions for future investments and existing subsidiaries subject to certain conditions, but that does not apply in the current context.

13 Paragraph 3.8 of the Consolidated FDI Policy dated 28 August 2017 issued by the Department of Industrial Policy and Promotion, Ministry of Commerce and Industry.

14 Companies Act 2013 (the 'Companies Act').

15 The SEBI (Issue of Capital and Disclosure Requirements) Regulations 2009 (the 'SEBI ICDR Regulations').

to the test of shadow directorship in England and Wales and the courts are likely to be guided by those principles in interpreting this provision.[16]

Secondly, both company law and securities law cover being named as a 'promoter' in a prospectus or exercising 'control' over the company (by virtue of shareholding, board nomination rights or other contractual rights). There are different definitions of the term 'control' in various laws in India, but in the context of determination of promoter status, the Indian securities regulator, the Securities and Exchange Board of India (SEBI), is likely to have regard to the definition under the applicable Indian takeover regulations.[17] This is discussed further under the heading 'Mandatory offers' below.

Finally, the securities law test (but not the company law test) also covers person or persons who are instrumental in the formulation of a plan or programme pursuant to which specified securities are offered to public.

Financial investors are capable of being regarded as promoters by SEBI. SEBI's determination will be shaped by the level of shareholding and any special rights given to the financial investor.

In the context of listings, promoter status brings with it additional disclosure requirements as well as certain regulatory lock-up requirements. For example, there is an obligation (to be shared between all promoters) to lock up 20 per cent of the post-IPO share capital for a period of three years and, in addition, any shares held by the promoter in excess of this threshold will be locked up for a period of one year following the listing. In the public takeover context, promoters are deemed to be parties acting in concert, unless this presumption can be rebutted. The rebuttal of this assumption is difficult and SEBI has on numerous occasions refused to provide advance guidance to international investors in this regard.[18] Therefore, to the extent that a future public offering or a takeover is in contemplation in any transaction, this is a factor that will need to be considered.

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16 For example, it must be proved that the directors of the company did not exercise any independent discretion and judgment, but acted solely on the instructions of the alleged shadow director (see *Gramophone and Typewriter Limited v Stanley* (1908) 2 KB 89, CA; *A Company Re (no 005009 of 1987)* [1989] BCLC 13, ChD; *Tasbian Ltd Re (No 3)* [1993] BCLC 297, CA). Also, there will need to be a consistent pattern of compliance with the instructions of an entity and an isolated incident would not normally suffice to conclude the existence of shadow directorship relationship (*Secretary of State for Trade and Industry v Becker* (2003) 1 BCLC 555). Finally, the tests set out in *Re Hydrodam (Corby) Ltd* ((1994) 2 BCLC 180 at 183) are likely to be helpful in this regard.

17 The SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 2011 ('Takeover Regulations').

18 For example, the SEBI 'informal guidance' provided to Reliance Capital Asset Management in July 2004 and to Massachusetts Mutual Life Insurance Company in August 2011 as published on SEBI's website.

It is not necessarily the case that all listed companies are required to have promoters. SEBI has recognised the concept of 'professionally managed companies' that do not have any promoter groups (owing to very low levels of founder shareholding and significant investments by financial institutions). In this regard, SEBI allows former promoters to re-classify themselves as being mere shareholders if the party (together with its concert parties) holds less than ten per cent of the company and does not have any special rights through formal or informal arrangements. However, satisfying these tests is not alwaysa straightforward exercise.

Meaning of 'control'

The term 'control' is used in a number of Indian regulations that affect cross-border investments, including foreign investment regulations, competition laws and the Takeover Regulation (in the context of public M&A transactions). In this regard, the term 'control' has been the subject of considerable judicial and regulatory debate in India, particularly in the context of whether investor protections in the form of affirmative voting rights confer control, even where the shareholding sought to be acquired is less than 50 per cent.

On the issue of affirmative voting rights, following a Supreme Court decision, which held that the matter is still open, positive rights, such as the ability to appoint management and direct operations, are likely to be seen as 'control' by SEBI. On the other hand, negative rights limited to purely defensive investment protection matters (eg, restriction on the disposal of assets or the incurrence of material indebtedness without an investor's consent) are likely to be defensible as not constituting control.[19]

19 In *Subhkam Ventures (I) Private Limited v SEBI* (Appeal no 8 of 2009 in the Securities Appellate Tribunal, Mumbai), the Securities Appellate Tribunal (SAT) examined whether the grant of certain affirmative voting rights to an investor would amount to the acquisition of control by the investor. In this case, the investor had a right to appoint a nominee director on the board and certain veto rights in the company. It was held that 'control' meant *positive control*, that is, the ability to cause a company to perform certain actions, and that it *did not cover rights constituting 'negative control'*, that is, the right to prevent the company from carrying out certain actions. The SAT analysed an extensive set of negative rights in this case, and held that they were only provided for the purposes of protecting the investment and did not amount to providing day-to-day control or management control to the acquirer. However, SEBI had appealed the decision of the SAT before the Supreme Court. The Supreme Court's order ((2011 (5) Comp LJ 386) states that the question of law (i.e., whether negative control would qualify as control) remains open and that the SAT decision would not be treated as precedent. Similarly, in the Jet-Etihad matter, the question arose as to whether the acquisition of 24 per cent of the equity stake in Jet Airways (India) Limited by Etihad Airways would amount to Etihad obtaining 'control' in Jet for the purposes of making a mandatory open offer under the Takeover Regulations. SEBI ruled that Etihad's investment in Jet did not amount to control, relying on the findings of the Foreign Investment Promotion Board regarding the retention of effective control of Jet Airways by Indian promoters.

SEBI undertook a consultation process on whether to more clearly define term in March 2016, However, in a press release on 8 September 2017, SEBI dismissed the proposal of introducing such a 'bright-line test', and has stated that 'control' would continue be determined on a case-by-case basis in line with the current position under the Takeover Regulations.

The ambiguity means that international investors will need to sift through the shades of grey and the regulatory uncertainty to form a view on what is likely to be acceptable. The question that is often asked is in this context is whether SEBI would be willing to provide guidance, but this is very often not a likely outcome. Although SEBI does have an 'informal guidance' process, it is normally guarded as to its responses and, particularly on a policy matter of this nature, is wary of having been seen to have 'blessed' any particular construct. Therefore, commercial principals will need to be guided by their counsel as to what is likely to be acceptable in this context.

Common structuring issues

Routing investments into India and tax optimisation

Time is often spent at the start of any cross-border investment into India in determining the optimal 'route' in relation to the proposed investment into India.

The main consideration in this regard is tax optimisation having regard to the double tax avoidance agreements that India has with other jurisdictions. The choice of jurisdiction will depend on the structuring goal. For optimising capital gains, investors historically routed investments into India through Mauritius (because disposals of shares in a Mauritian company were historically not subject to capital gains tax in either India or Mauritius) or Singapore (where, historically, the treaty conferred similar benefits provided that the 'limitation of benefits' provisions were satisfied. However, recent changes to both treaties have removed the capital gains benefits for both jurisdictions. Instead, currently, jurisdictions such as the Netherlands and Luxembourg (specifically for ships and aircraft operating in international traffic) offer more attractive capital gains tax treatment.

Some investors prefer to optimise for distributions. After 1 April 2018, dividends are taxed at the rate of 20.56 per cent[20] (on a grossed-up basis) in India at the company level and this cannot be generally mitigated using tax treaties, and share buy-backs are not tax efficient either. For some sectors, such as infrastructure, where valuations are undertaken on a 'cash-flow

20 This applies where the beneficiary is a company.

to equity' basis (i.e., discounting dividend streams), this is particularly problematic as any tax leakage with regard to dividends flows through to overall valuation (when determined in this manner).

One approach to mitigate this leakage is to extract cash through interest payments. Of course, the ability to lever up the target company with debt is limited by thin capitalisation rules and the RBI's external commercial borrowing rules (although certain group company members can advance shareholder loans to the borrower company).[21] To the extent that debt is feasible, the most efficient jurisdictions from an interest withholding tax perspective are Mauritius (where the withholding tax rate is 7.5 per cent) or Luxembourg or the Netherlands (where the withholding tax rate is ten per cent). The one factor to consider in all of this is that it is critical to establish genuine commercial substance in the relevant jurisdiction and, as a result of the recent introduction of 'general anti-avoidance rules' in India, which requires that the main object of the structuring is not to minimise tax.[22] Therefore, the use of the jurisdictions indicated above is subject to this overlay and it may not be possible to use some of them owing to a lack of commercial substance. In practice, this means that parties need to find a genuine commercial reason for the use of a jurisdiction, for example a historic business presence or operations of some nature in that jurisdiction.

One other technique that could be considered to mitigate dividend tax leakage is the use of limited liability partnership (LLP) structures. As the tax law currently stands, distributions of profit by LLPs are not subject to dividend distribution tax. In addition, LLPs offer greater flexibility as to governance and management. However, while the use of LLPs is increasing in the joint venture context, it is not always possible to use them. For instance, in the infrastructure sector, government counterparties do not customarily accept the use of LLPs. Also, the current FDI policy only permits foreign investment into LLPs in sectors where foreign investment is not subject to regulatory caps or investment conditions. Finally, there remains a change of tax law risk with regard to the taxation of profit distributions. So, while LLPs present a useful structuring option, it is not a universal solution.

One additional consideration (unrelated to tax) that is relevant to the 'routing' of transactions into Indiais identifying jurisdictions with which India has investment protection treaties. Particularly in extractive industries, or those reliant on government licences or concessions, this can be a useful

21 See footnote 2 for details.

22 GAAR empowers the tax authorities to determine taxability of a transaction or an arrangement to deny tax treaty benefits where they perceive a lack of substance. Also, GAAR has introduced certain thin-capitalisation rules as well, which operate so as to restrict the deductibility of interest from income above certain prescribed thresholds.

defensive tool in the future to militate against expropriation risk (which is the purpose of such treaties). The Indian government is alive to this and has either not renewed various investment protection treaties as they lapse or has sought to renegotiate them. But for jurisdictions where such protection does subsist, this is a factor that is worth considering.

Structuring returns

A critical issue for private equity investors is structuring their investments to achieve certain levels of target returns. Instruments such as preference shares or debentures that do not mandatorily convert into equity are treated as being debt by the RBI, with the consequence that they need to satisfy the RBI's external commercial borrowing rules. This is difficult or impractical in many cases and will not ordinarily be able to generate returns that investors often require (as the interest rate is capped).

Equally, contractual put options to Indian shareholders to achieve a guaranteed return also suffer from similar issues as discussed under the heading 'Treatment of debt and guaranteed returns' under 'Key concepts' above (although there has been some recent easing as far as 'downside' protection is concerned as discussed under the heading 'Enforcement of contractual protection' below).

To address these concerns, various workarounds have evolved. One technique that was, until recently common (particularly in the context of real estate private equity), involved investors registering as FPIs and then subscribing for NCDs in the company. Non-convertible debentures are simply straight bonds without any convertibility features.[23] These instruments are not subject to the RBI's restrictive debt rules and the coupon and the redemption premium upon an exit offer partial downside protection (partial because the protection is over only the debt portion of the investment and cannot also cover the equity piece). However, there are currently NCD capacity issues in the market, which despite recent easing by the RBI, do make it more difficult for NCDs to be used in larger deals. Also, the RBI has recently introduced certain investment and concentration limits in relation to FPIs,[24] which will make the use of this instrument more challenging.

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23 Although the instruments themselves are simple, there are various RBI regulations that apply to them.

24 RBI circulars dated 27 April 2018 and 1 May 2018. Amongst the changes introduced is a cap on the investment by any FPI and its "related parties" of no more than 50 per cent of any corporate bond issue. Also, an FPI cannot invest more than 20% of its total investment in bonds with a residual maturity of less than one year. In addition, there are various investment and concentration limits.

Another technique that is used is for the investors to acquire FVCI registrations as these allow for investment in optionally convertible instruments and also allow for freely negotiated pricing in the sale of securities. The only issue here is that there are investment conditions, including restrictions on the sectors in which investment is permitted, and there is also a longer lead time to obtaining this registration.

Deferred consideration

Historically, all deferred consideration, whether in the form of earn-outs, claims escrows or even an upward adjustment of price pursuant to purchase price adjustment provisions in transaction documentation, needed RBI approval.

There has been some recent easing of this restriction and deferred consideration (such as earn-outs or claims escrows) are permitted to the extent of 25 per cent of the transaction consideration and must be paid out within 18 months of the date of the purchase agreement (not completion).[25] Deferred consideration that is not within these thresholds, will require RBI approval.[26]

Where deferred consideration or escrow arrangements go beyond this, a number of workarounds have evolved. The simplest such technique involves 'holding back' a small proportion of the shares being sold to be transferred later for the deferred consideration (although for deals with large amounts of deferred consideration, this will present re-valuation and accounting challenges). There are other techniques involving the issuance of warrants, compulsorily convertible preference shares or compulsorily convertible debentures to the purchaser, which are repurchased by the seller pursuant to a call option for the deferred consideration later. Where individual sellers are involved, some of the earn-out can be structured as a subsequent management incentive payment, although the payment will be treated as income rather than capital gains in the hands of the seller (which may not be attractive) and the purchaser may not then be able to treat this amount as being part of the acquisition cost that is then amortisable. Finally, there are more elaborate structures involving offshore companies, but those require careful tax and other exchange control analysis.

These requirements and the complexity of some of the workarounds do sometimes take first-time investors in India by surprise, so it is worth factoring in the time to consider and structure around these issues early in any deal timetable.

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25 Regulation 10(9) of the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations 2017.

26 Earn-outs, where payments are tied to the satisfaction of certain target indicators, are not seen as conferring any 'assured return' and do not, of themselves, cause any RBI concerns. The only point of note, as indicated above, is whether the earn-out is within the permissible limit.

Ability to undertake leveraged acquisitions

The ability to undertake leveraged acquisitions in India is extremely limited.

The RBI, in its circular on loans and advances, restricts banks from providing domestic acquisition finance. However, the infrastructure sector benefits from a qualified exception pursuant to which banks can lend up to 50 per cent of financing for the acquisition. One workaround for domestic acquisition finance is to raise this from NBFCs (which are unaffected by the RBI's circular on loans and advances).[27] However, in larger deals, this approach has its limitations because of the NBFC's concentration limits (which would affect their ability to lend above the relevant limits in a single transaction).

Another technique that has evolved is for the leverage to be undertaken outside India. This only works if there is an overseas holding company (which owns the Indian target) and, in such cases, offshore leverage is possible (although the shares of the underlying target Indian company cannot be encumbered as security). Funds raised offshore can be transferred into India, provided that the shares of the Indian target (or its subsidiaries) are not pledged and provided that the Indian target or its subsidiaries have not provided any credit support or security (otherwise, this will be restricted). Non-disposal undertakings over the shares of the Indian target are currently permissible and will not restrict the flow of funds into India.

Entrenchment in articles

Joint venture arrangements and private equity investments are also affected by one additional issue. Indian company law permits entrenchment of provisions from shareholders' agreements in the articles of association of companies.[28] The universal adoption of this practice sometimes comes as a surprise to international counsel, as this makes public negotiated contractual matters that most international investors would ordinarily prefer to remain private. There is a long history of case law this regard in India, as discussed below.

The effect of the Rangaraj judgment

The roots of the practice of entrenchment arise out of the interplay between contractual arrangements involving the company and those involving its shareholders alone. English law is much clearer on this point. In *Russell v*

27 In general, NBFCs are more lightly regulated as far as the acquisition finance is concerned. Of course, there are a number of other general NBFC regulations that would apply to loans by NBFCs (not summarised here for the sake of brevity).

28 Section 5(3) and the proviso to s 58(2) of the Companies Act 2013.

Northern Bank Development Corporation Limited,[29] in the context of provisions dealing with the issuance of shares, the House of Lords distinguished between contractual arrangements seeking to impose fetters on a company's statutory powers (which are unenforceable) from contractual arrangements as between its shareholders alone (which remain enforceable). The Indian courts have, until recently, hesitated from making such a distinction, leading to the practice of entrenchment as a defensive measure.

This approach can be traced back to the judgment of the Supreme Court in 1992 in *V.B. Rangaraj v V.B. Gopalkrishnan*,[30] which held that an agreement in relation to the transfer of shares was unenforceable and did not bind either the company or the shareholders as it was not entrenched in the articles.

In reaching this conclusion, the court observed that: 'The only restriction on the transfer of shares is as laid down in the Articles, if any. A restriction which is not specified in the Articles is, therefore, not binding on the company or its shareholders.'[31]

Had this position been limited to transfer provisions alone, then the impact of this judgment could have been contained. However, in 2004, in *IL and FS Trust Co. Limited v Birla Peruchchini Limited*,[32] it was held that the principles in the *Rangaraj* judgment were not limited to transfer provisions alone and hence the *Ranjaraj* principle assumed even greater significance in the context of joint ventures.

Dilution of this position

Fortunately, there has been some subsequent dilution of this position. In *M S Madhususodhan v Kerala Kaumudi Limited*,[33] the Supreme Court distinguished between matters concerning the company (such as a primary issuance of shares) and matters that are essentially private contractual arrangements, which were capable of enforcement (an approach closer to the *Russell* principle). The court observed '...while it is imperative that a company should be a party to any agreement relating to the allotment of new shares before such an agreement can be enforced, it is not necessary for the company to be party to any agreement relating to the transfers of issued shares for such agreement to be specifically enforced between the parties to the transfer.'[34]

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29 [1992] 1 WLR 588.
30 AIR 1992 SC 543.
31 At paragraph 6 of the judgment.
32 [2004] 121 Comp Cas 335 (Bom) at paragraph 6.
33 (2004) 9 SCC 204.
34 At paragraph 144.

A similar approach has subsequently been adopted by two recent division bench judgments of the Bombay High Court in *Messer Holdings v Shyam Madanmohan Ruia*[35] and in *Western Maharashtra Development Corporation v Bajaj Auto*,[36] where the court held that private contractual matters were enforceable as between shareholders regardless of entrenchment (and in so doing, overruled an earlier contradictory single judge decision of the Bombay High Court in *Western Maharashtra Development Corporation v Bajaj Auto*).[37] In *Messer Holdings*, in considering provisions relating to the transfer of shares, the court observed: '…consensual agreements between particular shareholders relating to their shares can be enforced like any other agreement. It is not required to be embodied in the articles of association.'

Both cases also establish that the provisions of the shareholders' agreement do not need to be reflected in the articles and can be separately enforced on their own. There has also been legislative change and the Companies Act[38] now makes clear that shareholders' agreements are enforceable insofar as transfer provisions are concerned.[39]

Limits to the dilution

However, shareholders' agreements contain provisions other than transfer provisions alone and the broader question remains as to whether the *Messer Holdings* and *Western Maharashtra Development Corporation* cases are authority for the principle that other governance provisions do not need to be entrenched in the articles (notwithstanding the enabling provisions in the Companies Act 2013 that permit entrenchment). On this point, the Delhi High Court in *World Phone India Limited v WPI Group Inc*,[40] which, despite being after the *Messer Auto* judgment (that supported the standalone nature of shareholders' agreements), indicated that affirmative voting rights would need to be entrenched. In so doing, it appears to have taken a different position from the Bombay High Court in *Messer Holdings*.

35 [2010] 159 Comp Cas 29 (Bom).

36 MANU/MH/0820/2015.

37 [2010] 154 Comp Cas 593 (Bom).

38 The proviso to s 58(2), which indicates that shareholders' agreements are enforceable regardless of the principle of free transferability of the shares of public companies.

39 The context for this is that many of the cases relating to the enforcement of shareholder rights concerned the extent to which provisions regulating the transfers of shares of public companies were consistent with company law principles requiring the free transferability of shares of public companies. This proviso addresses that issue by permitting shareholders' agreements to deal with this point.

40 [2013] 178 Comp Cas 173 (Delhi).

Therefore, until there is a Supreme Court ruling on the matter, market participants prefer to entrench provisions in the shareholders' agreement in the articles, even though it would make public the parties' negotiated contractual arrangements.[41]

Indian element of international M&A transactions

The Indian implementation of global M&A transactions does sometimes give rise to certain Indian issues. Many of these issues are deal specific, but two commonly occurring ones are summarised below.

Local integration through business transfers in India

Where local integration of an acquired business with the existing subsidiary of the purchaser is contemplated, there are two issues of note.

First, the Indian nomenclature for going concern transfers sometimes causes confusion. The background to this is that, in the Indian context, asset transfers and business transfers have two different meanings. Indian asset transactions are transactions where the consideration is allocated as between the assets transferred. In contrast, a 'slump sale' is the transfer of an undertaking as a whole[42] on a going concern basis, where the consideration is not allocated as between individual assets. A slump sale can offer certain income-tax and indirect tax benefits; whereas, in the case of sale of assets, both capital gains tax and indirect taxes will apply. In both cases, stamp duty will apply (which varies from state to state).

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41 There is one more subtle issue around whether entrenchment itself causes issues because the provisions might be seen to fetter the company's statutory powers. This is perhaps more relevant in the case of governance rights rather than transfer provisions because case law (*Messer Holdings*) has held that certain transfer provisions do not breach the principle of free transferability of a public company's shares and that, even if they did, the shareholders' agreement would be separately enforceable (a point reinforced by the proviso to Section 58(2) of the Companies Act). In respect of governance provisions such as affirmative voting rights, Section 5(3) of the Companies Act allows for entrenchment, and provides that 'the articles may contain provisions for entrenchment to the effect that the specified provisions of the articles may altered only if the conditions or procedures… are more restrictive than those applicable in the case of a special resolution...' The drafting of this does leave some doubt as to whether a matter that did not need a resolution at all (or only required an ordinary resolution) would be covered, but the spirit of the legislative change seems to be to permit governance related provisions.

42 'Undertaking' is defined in the Income Tax Act 1961 and most cases interpreting this term arise in this context. For instance, in *Rustom Cavasjee Cooper v Union of India* ((1970) Comp Cas 325 (SC)), the Supreme Court held that 'the expression "undertaking" clearly means a going concern with all rights, liabilities and assets as distinct from the various rights and assets which compose it…' Business units or verticals can constitute undertakings and the presence of some shared services would not normally affect that analysis.

Secondly, Indian law does not provide a statutory regime for the automatic transfer of employees in relation to the transfers of business as going concerns. The transfer of employees will involve their consent and is customarily achieved through the resignation of the employees and workmen transferring over and their re-hire with continuity of service (as far as accrued benefits are concerned) by the transferee as a closing action (or a condition precedent). Continuity of service is needed to ensure that the employees are incentivised to transfer over and also to mitigate the costs of retrenchment where the employees are 'workmen'.[43]

Potential Indian public M&A consequences in global M&A transactions

There are Indian public M&A traps for the unwary in that Indian public M&A requirements could apply in the context of transactions that have little connection with India.

This is because, as has been discussed earlier in this article, one of the triggers for a mandatory open offer (which must be for a minimum of 26 per cent of a listed company in India) is the acquisition of 'control', including indirect control. In addition, because of SEBI's approach to the definition of 'control', the acquisition of a minority interest in a global holding company together with veto rights could trigger a mandatory open offer in India. See discussion under the heading 'Meaning of control' above for details on the interpretation of this provision.

Since the term 'acquisition' is defined by reference to executing an agreement to acquire, deal participants would be well advised to seek Indian law advice early in the process, if an Indian company is controlled by the overseas company that is being acquired, or into which the investment is being made.

The other point of note in this context is that it is difficult to achieve a 'take private' transaction in India for various reasons, including the process involved in the de-listing exercise, and the fact that minority squeeze-out requires a separate company law process. Therefore, international deal participants should not assume that this can be readily achieved in the context of the local leg of a broader international transaction.

43 Under the Industrial Disputes Act 1947, the termination of a 'workman' who has been in continuous service of not less than one year, will require the payment of certain retrenchment benefits equivalent to 15 days' pay for each completed year of service, preceded by one month's notice or salary in lieu thereof. This retrenchment payment can be avoided if the workmen are transferred with continuity of service on terms no less favourable than in the past. Other employees, who earn in excess of INR10,000 (approximately USD150) a month and are employed in a managerial or administrative capacity or in a supervisory capacity (but earning in excess of INR10,000 per month as salary), do not benefit from such retrenchment entitlements and any termination payments will be governed by their contracts of employment.

Enforcement of contractual protections

Recent case law

As discussed under the heading 'Treatment of debt and guaranteed returns' under 'Key concepts' above, contractual protections that guarantee investors a return have historically been frowned upon by the RBI. However, the position in relation to investor protections against downside events by way of put options can now be distinguished from this and damages payments for failure to satisfy these obligations have been held to be enforceable in a series of judgments by the Delhi High Court in 2017.

In *Cruz City 1 Mauritius Holdings v Unitech Limited*,[44] Cruz City had invested in a real estate project in India and benefited from a put option allowing it to realise a post-tax internal rate of return of 15 per cent, which could be exercised if the real estate project was delayed beyond a certain period. The counterparty, Unitech, did not honour the put option and an arbitral tribunal awarded damages against Unitech. In upholding the enforcement of the arbitral award, the Delhi High Court held that the Indian exchange controls affecting put options would not preclude the damages claim. The court held that this was not a case of assured returns, but one of downside protection because the option could only be triggered if construction had not commenced according to the agreed timetable.

It is particularly noteworthy that the court was willing to go further and held that 'even if it is accepted that the Keepwell Agreement was signed to induce Cruz City by offering assured returned, Unitech could not escape its liability to Cruz City. Cruz City had invested in Kerrush on the assurances held out by Unitech and notwithstanding that Unitech may be liable to be proceed against violation of [the] provisions of FEMA, the enforcement of the Award cannot be declined'.[45]

In a similar judgment shortly thereafter, in *NTT Docomo Inc v Tata Sons Limited*,[46] the Delhi High Court upheld the enforcement of a damages award made by an arbitration by Docomo against the Tata group for breach of an exit provision in its investment agreement and rejected objections by the RBI that this ought not to be enforced on public policy grounds as it would imply a breach of Indian exchange controls. The investment agreement provided that if the joint venture company, into which Docomo had invested, failed to satisfy certain performance thresholds, then Docomo had the right to require Tata to find a buyer for its shares at the higher

44 239 (2017) DLT 649.

45 Paragraph 122 of the judgment. The reference to FEMA is to the exchange control restrictions in relation to guaranteed returns.

46 (2017) 3 Comp LJ 526 (Del).

of fair market value as at 31 March 2014 or half of the value at which Docomo had made its investment. If Tata failed to do so, it was required itself to acquire or procure the acquisition of the shares at any price and to indemnify Docomo as to any shortfall. In arbitration, Tata's position was that it was unable to make payment without the approval of the RBI due to exchange control restrictions. Nevertheless, the arbitral tribunal ruled that there was sufficient uncertainty such that this did not constitute an assured return construct and hence a damages claim was awarded. The Tata group at first sought to oppose the enforcement of the award, but ultimately agreed to pay in a settlement. However, at that point, the RBI sought to intervene and oppose the enforcement of the damages award on the grounds of public policy. The Supreme Court rejected the RBI's intervention and upheld the damages award.[47]

The Supreme Court, in its judgment, cited internal correspondence from the RBI in relation to this matter, where it appeared that the RBI was inclined to distinguish assured returns from situations of this nature where Docomo was merely putting a floor on the loss on its investment. Indeed, the RBI is quoted as having observed that 'the larger issue here is of fair commitment in contracts in relation to an investment and a downside protection of investment rather than an assured return'.[48] Apart from the judgment itself, this is revealing in itself and helpful to international investors. This appears to suggest that contingent provisions, resulting in an exit at a minimum pre-set value upon the failure to satisfy certain trigger events, will be enforceable (that is, provisions to minimise notional losses suffered appear to be acceptable).

As to the concerns about exchange control, the Supreme Court held that Indian exchange controls contain no absolute prohibition on contractual obligations.[49] It held that the RBI would be bound by the award and that even if the RBI's permission were needed to transfer the funds out of India pursuant to the award, the RBI would be bound by the award.[50]

A similar approach has been adopted in another recent case, *Shakti Nath v Alpha Tiger Cyprus Investment*,[51] so a consistent approach has now evolved.

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47 The RBI acted, seemingly out of a sense of responsibility as guardian of the exchange control regime in India, but the basis for it to do so was always questionable. In this regard, the court also held that the RBI did not have *locus standi* to intervene in these proceedings.

48 Paragraphs 45 and 46 of the judgment.

49 At paragraph 60 of the judgment.

50 At paragraph 43 of the judgment.

51 MANU/DE/1316/2017.

Implications

Apart from the more specific point on the limitations of exchange controls as a defence by the obligor, the judgments have considerable significance in giving investors confidence on the enforceability of contractual protections in India. In addition, the speed at which they were dealt with by the courts was also noteworthy (in the *Docomo* case, the arbitral award dated 22 June 2016 was enforced on 28 April 2017, a period comparable to the enforcement of awards in other jurisdictions).

Also, given the importance placed by the court, particularly in *Cruz City*, on the representations as an inducement to the investment, international investors may want carefully to document the basis on which they have invested and pay particular care to the drafting of the warranties and representations.

Finally, judicial willingness to enforce arbitral awards for damages quickly could open the door for payment by way of other liquidated damages provisions, which Indian law permits pursuant to Section 74 of the Indian Contract Act 1872. International investors seeking protection may wish to consider drafting in provisions of this nature.

Key deal terms

Although the terms used in Indian sale and purchase agreements are similar those in English law governed documents, the effect of these terms in the Indian context will need consideration. A summary of certain key concepts is set out below.

Warranties and representations

The law on warranties and representations is not dissimilar to that in England and Wales. Under Indian law, a warranty is a statement relating to the business that does not confer a right of rescission and gives rise to claims for damages, whereas representations are statements that induce an acquisition and confer a right of rescission.[52]

52 The distinction has been explained by the Madras High Court in *All India General Insurance v S.P. Maheshwari* (AIR 1960 Mad 484) as follows: 'Warranties are representations which are made on the basis of contract, whereas a representation is not strictly speaking a part of the contract or the essence of it, but rather something preliminary and an inducement to it.' Section 19 of the Indian Contract Act 1872 states that misrepresentation confers a right of rescission (i.e. the contract is voidable at the option of the party whose consent was induced by the misrepresentation).

In the context of acquisitions governed by Indian law, warranties are traditionally drafted on a representation basis. This is, of course, likely to be helpful when acting for an investor seeking to acquire a stake in an Indian target, but in relation to exits by international investors, negotiating this down to a mere warranty standard can be difficult, as very few counsel in the Indian market appreciate the distinction between warranties and representations. It is possible to push back on this, although this may require some persistence.

Indemnities

Warranties and representations in Indian M&A transactions are normally provided on an indemnity basis (similar to US market practice). However, before turning to the practicalities of how such indemnities are customarily drafted (in relation to their coverage and their exclusions), it is worth considering the rights that indemnities confer under Indian law.

At first glance, the Contract Act 1872 would appear to treat indemnities in a narrow manner. Firstly, Section 124 of the Indian Contract Act 1872 defines an indemnity as being 'a contract by which one party promises to save the other from loss caused to him…' In addition, Section 125 of the Indian Contract Act 1872, states that the beneficiary of an indemnity can recover from the promisor damages, legal costs and sums paid under the compromise of a law suit.

Given these provisions of Indian contract law, the normal concern is how robust indemnities are in India and, in particular, whether these provisions tie the ability to make an indemnity claim to the beneficiary having to make payment first and then seek reimbursement (rather than claiming on demand) and, also, whether the reference to loss might imply that indemnities are also subject to the customary requirements with regard to consequential loss (Indian contract law codifies the rule in *Hadley v Baxendale*[53]) and the principles with regard to the mitigation of the losses. These points are considered further below.

Reimbursement v payment on demand

As far as the first issue is concerned, despite the provisions of the Indian Contract Act 1872, there is a line of case law establishing that this is not the case and that payment can be made even if the beneficiary has itself not made a payment.

53 (1854) 9 Exch 341. Section 73 of the Indian Contract Act 1872 on the measure of damages for breach of contract includes a test similar to the second limb of this case as far as consequential losses are concerned.

The starting point for this line of cases is the judgment of the Calcutta High Court in *Osman, Jamal and Sons v Purushottam Gopal*,[54] where the court, having reviewed English case law at the time, concluded that equity conferred wider rights than common law in relation to indemnities (in that a beneficiary would not need a loss to be actually suffered before being able to claim under the indemnity). This case was followed by perhaps the cardinal judgment in this thread, *Gajanan Moreshwar Parelkar v Moreshwar Madan Mantri*,[55] where Justice Chagla observed: '…I have already held that ss 124 and 125 are not exhaustive of the law of indemnity and that the Courts here would apply the same equitable principles that the Courts in England do. Therefore, if the indemnified had incurred a liability and that liability is absolute, he is entitled to call upon the indemnifier to save him from that liability and pay it off.'

This approach has been approved in the M&A context more recently in *Jet Airways (India) Limited v Sahara Airlines Limited*.[56] In this case, the court considered the ability on the part of the purchaser to make a claim on demand (in the context of a tax indemnity provision). The court quoted with approval the judgment of Justice Chagla in *Gajanan Moreshwar Parelkar*and held that once a liability is absolute it is payable on demand.

Applicability of the limitations that apply to damages

As to the question of whether the right to seek indemnification would be subject to all the principles that apply to damages (because of the reference to damages in Section 125), the issue has not been explicitly addressed in the cases discussed above. However, the principles set out in those cases do give rise to a powerful argument that indemnity claims ought not to be so limited.

Firstly, the judgment of Justice Chagla in *Gajanan Moreshwar Parelkar* clearly indicates that the rights of an indemnity holder are not limited by Section 125, so the fact that this provision refers to damages alone should not be determinative in and of itself.

Secondly, subsequent cases go further and refer to liabilities rather than losses. For example, in *Kheterpal Amarnath v Madhukar Pictures*,[57] the Bombay High Court specifically considered the remedies available to the beneficiary of an indemnity and observed: '…the object of a contract of indemnity is to protect the indemnity holder against a claim made by a third party against him…That is why it has been held that a contract to indemnify does not mean

54 AIR 1929 Cal 208.
55 AIR 1940 Bom 302.
56 2011 SCC Online Bom 576.
57 1955 SCC Online Bom 299.

a contract to merely reimburse in respect of monies paid, but it also means in a derivative sense the liability of the indemnifier to save the indemnity-holder from a claim by a third party in respect of which the indemnity has been made.'[58]

The use of the word 'liability' rather than 'loss' here is significant. In the *Jet Airways* case, discussed above, the court considered the meaning of the term liability and concluded that once a liability was absolute, it would need to be paid under an indemnity.

However, as a point of practice, regardless of the law on the right to claim for consequential loss under an indemnity, just as in other jurisdictions, this is not a matter that most sellers are prepared to cover. Therefore, it is customary for indemnities to carve out consequential losses and for parties to agree that the claimant should have a duty to mitigate the loss as a contractual matter.

Disclosure

Indian law on disclosure is thin, so it is likely that Indian courts will have regard to the English law principles in this regard. However, as a matter of market practice, disclosure of entire data rooms (subject to an overarching 'fair disclosure' requirement in law) is not common, so international investors should manage their expectations in that regard if they are seeking to exit an investment. One related point of note in this regard is that there has been a recent Delhi High Court judgment[59] that has suggested that failure to disclose matters relevant to the buyer might, in certain instances, be fraud (which would also confer a right of rescission). The applicability of that principle will be fact dependent, but it might be helpful to international investors seeking to acquire interests in Indian targets.

It is usual for seller to seek protection in relation to conduct of claims and most SPAs will provide for language on this point.

Concluding thoughts – guidance on effective execution of Indian M&A deals

From a legal perspective, the M&A landscape is improving, with some easing of regulation, helpful judgments on the enforcement of contractual protections and the growing sophistication of the local market. However, despite this, M&A transactions in India still involve challenges that can make deal execution more complicated than in other jurisdictions. However, there are 'best practices' that can help smooth execution processes as much as possible.

58 At paragraph 4.

59 The judgment of the Delhi High Court on 31 January 2017 in *Daiichi Sankyo Company Limited v Malvinder Mohan Singh and others.*

First, it is important to establish what is feasible before the deal gets too far ahead. M&A features that would be regarded as being 'routine' in other markets (e.g., deferred consideration) are sometimes regulated in India. Apart from the restrictions themselves, often, the regulations are not clearly drafted. Much of Indian M&A involves sifting through ambiguity and the successful execution of transactions sometimes requires structuring creativity and almost always requires a degree of pragmatism. Clear and directional guidance from local counsel is critical in this regard.

Secondly, there is a fine line between structuring creativity and taking aggressive 'views' to get a deal 'across the line' in a manner that risks causing issues later. As a matter of working style, many Indian counsel often form regulatory 'views' more freely than the more measured approach that English lawyers adopt on regulatory matters, discussing issues with bodies such as the Financial Conduct Authority and the Takeover Panel. Some of this is hard to avoid, as the ability to engage with regulators in India is more limited, but it is often difficult to know what the right approach is in any given situation. There is no substitute for judgment in making this assessment, but probing the 'common-sense' risks, conducting scenario analysis in relation to 'worst-case outcomes' and testing for other market precedents is a useful starting point. As a rule of thumb, the more cautious or prudent view is usually the better approach.

Thirdly, shareholder disputes are common and Indian exchange controls have been used in the past by Indian counterparties as a justification for failure to perform their contractual obligations, particularly in relation to exit-related provisions in shareholders' agreements. Against this backdrop, the importance of thorough diligence cannot be overstated. In addition to legal, accounting and financial diligence, the better advised international investors often undertake reputational searches and evaluate their counterparties' past dealings with international investors. Also, in negotiating the transaction documentation (particularly shareholders' agreements), there is often merit in ensuring that the international investor has retained sufficient commercial leverage that can be exerted in addition to legal remedies if issues arise in the future.

Finally, the reality is that undertaking deals in India is often a lengthy process. This sometimes causes issues when the Indian acquisition is part of a larger global M&A process, but international counsel should anticipate and build in the possibility of delays in transaction timetables.

In summary, undertaking an Indian M&A transaction will, in many cases, involve considerable legal analysis. The issues that arise and the structuring involved make these transactions interesting, although sometimes a little too interesting for clients!