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What Foreign Counsels Need To Know About Operating In India
2019

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What Foreign Counsels Need To Know About Operating In India

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M&A In India: Key Statistics

- Foreign direct investment ("FDI") into India has been burgeoning in recent years. In fact, the amount of FDI into India has consistently increased year-on-year since 2013. In line with this trend, India received an amount of US$44 billion between April 2018 and March 2019.
- From a geographic perspective, Maharashtra, Delhi and Karnataka attract the most amount of FDI amongst the states while Tamil Nadu and Gujarat are not far behind.
- Similarly, from a sectoral perspective, foreign investors have largely invested in Services, Computer Software and Hardware, and Telecommunications. At the same time, investors have also ventured into various other sectors, including, Construction Development, Trading and the Automobile Industry.
- From an investor's jurisdiction perspective, Mauritius, Singapore, Japan, United Kingdom, Netherlands and the United States have led the way in investing into India. Mauritius, Singapore and Netherlands are mainly holding company jurisdictions representing parent entities from the United States, United Kingdom and Japan for their investments into India.

Business Management Issues

- In India, individual promoters or promoter families usually control the businesses, which are largely traditional and rarely managed professionally. Given this, most businesses do not comply with all requirements of applicable law especially in respect of maintaining corporate and/or employment records. Therefore, investors must convey their expectations of professional management firmly and prior to engaging in any substantial negotiation.
- In dealing with Indian promoters, investors should bear in mind the cultural nuances which inevitably come into play in such interactions. For instance, Indian promoters may agree to a certain proposal merely to come across as polite. However, it is quite possible for them to open the underlying issue again at a later stage. Similarly, Indian promoters often interpret agreed timelines as indicative and therefore, investors may not be able to meet their goals within the agreed timelines. Therefore, investors should exercise patience when seeking to make an investment in India. Also, it must be ensured that in the negotiation phase all critical decisions must be confirmed and be consented to by the promoters as the promoters sit in supreme position to make decisions.
- Additionally, investors must also appreciate the fact that Indian promoters are often emotionally attached to their business and this attachment strengthens if their families are also involved in the business. Given this, Indian promoters are often unable to separate their personal dealings from their professional ones. Consequently, investors can expect to conduct meetings in informal settings and face severe pushback while negotiating exits, especially in adverse conditions.

Packaging The Deal To The JV Partner

- In the Indian context, a promoter is normally considered such a person who exercises control over the affairs of the company regardless of whether such person exercises such control as a director, a shareholder or otherwise.
- In negotiating a promoter's buy-out, investors should expect to pay a premium. Both, family-owned enterprises and successful start-ups are likely to extract as much value as possible from the transaction. In order to package a good deal to the promoters, investors should explore the possibility of retaining the promoters within the business by offering key employment positions. Usually, Indian promoters will view such an arrangement as a strategic partnership and will be able to look beyond the pure financial aspects of the transaction. On the other hand, investors may also be able to reach an agreement for a lower price if there is an absence of a successor to the business of the successor lacks the necessary skills or interest to manage the business.
- On the flip side, investors are also likely to face pushback when exiting from the company. As such, investors may need to take a hair-cut on the rate of return while attempting to negotiate an exit. Given this and the restrictions under Indian foreign exchange regulatory regime, investors should ideally look to sell their stake in the company to another non-resident. In case of a transfer of shares between two (2) non-residents, Indian regulations do not impose several compliance requirements, such as a mandatory pricing/valuation requirement which applies to a transfer between a resident and a non-resident.

Key Laws For A Foreign-Owned Business

- From a foreign exchange perspective, the Foreign Exchange Management Act, 1999 is the overarching legislation which establishes a framework for the regulatory regime. Within this framework, the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2017 plays a key role in governing the issuance and transfer of shares of an Indian company. Additionally, the consolidated FDI policy also forms a crucial part of the framework as it provides for the sectoral caps and applicable conditions in respect of foreign investments into India.
- Apart from the foreign exchange regulatory regime, investors will need to assess the impact of India's corporate laws. In this regard, the Companies Act, 2013 along with its underlying rules is the key legislation which governs the corporate practices of private companies in India. Further, the Securities Exchange Board of India regulates the functioning of listed companies in India.
- In addition to the foregoing laws, investors must also take into account the provisions of the Income-tax Act and the double tax avoidance agreement given the recent aggressive bent of the Indian tax authorities. Moreover, the Competition Act, 2002 and the Insolvency and Bankruptcy Code, 2016, which provide for the merger control thresholds and restructuring of a corporate debtor respectively, may also have an impact on any investment in India.

- Lastly, investors will also need to review the provisions of the Indian contract law, anti-corruption law, intellectual property rights law, employment law and data privacy laws prior to committing to an investment in India.

Entry Into India

- An investor can explore various structuring options prior to establishing an entity in India such as a liaison office, a branch office, a project office, a private limited company and a limited liability partnership. As each structure has its own pros and cons, investors will need to assess the most suitable entity on the basis of the estimated duration and proposed business activities intended to be conducted in India.
- Investors may establish a liaison or representative office, which is ideal if investors are seeking to establish a place of business to act as a channel of communication for, or represent the interests of, the foreign parent in India. This structure is also ideal if investors are seeking to promote technical and/or financial collaborations in India. However, a liaison/representative office cannot undertake any commercial, trading or industrial activities and can also not generate any income in India.
- A branch office allows investors to carry out specific business activities, including, rendering professional or consultancy services, rendering services in information technology and software development, and carrying out research in India. However, in a presence through a branch office, investors will not be able to carry out any manufacturing activities and will also be restricted from owning any immoveable property in India.
- Unlike the foregoing structures, a project office allows an investor to enter the Indian market for a pre-determined timeframe and for a specific project. Therefore, investors entering the Indian market for a specific duration and/or for undertaking a specific project can choose to establish a project office in India. These are restrictions imposed on the project office's right to own any immoveable property in India.
- A private limited company is one of the most common structures seen in India. It allows investors to conduct the full range of business activities while also limiting investor liability by either, shares or guarantee. Additionally, a private company is a separate legal entity which enjoys perpetual succession and therefore, it allows investors the comfort of business continuity.
- In similar vein, investors may also choose to establish a limited liability partnership in India. Essentially, a limited liability partnership is a hybrid entity which limits the liability of the members akin to a company and is a separate legal entity which enjoys perpetual succession. However, unlike a private company, a limited liability partnership offers greater flexibility and allows the partners to mutually agree upon the terms of the entity's existence and functioning. Also, dividend distribution tax payable in respect of dividends declared to shareholders of companies is inapplicable in case of a limited liability partnership and can result in considerable tax savings.

Foreign Investment - Key Considerations

- While India has considerably liberalized its foreign investment regime in recent years, the regulatory regime now only prohibits foreign investment in a few sectors. The prohibited sectors include the lottery business, the gambling and betting business, trading in transferable development rights, the real estate business, the manufacture of cigars, cigarettes and other tobacco substitutes, atomic energy and the railways.
- In respect of the permitted sectors, investors can purchase up to 100% stake in various sectors under the automatic route, including, single-brand retail trading, greenfield pharmaceuticals, marketplace model e-commerce, business to business model and in all other sectors which are not specifically regulated.
- On the other hand, investors can only acquire a 49% stake in telecommunications, defence, insurance and insurance broking under the automatic route. India's regulatory regime continues to restrict foreign investment in multi-brand retail trading and investors can only acquire up to a 51% stake under the government route. It is interesting to note that although the foreign direct investment policy of India permits foreign investment in multi-brand retail trading, no application has been approved by the government until date for this sector.
- In respect of the e-commerce sector, the owner of the marketplace platform cannot own the goods sold on the platform, whether directly or indirectly. Further, the platform must also ensure that the delivery, warranty, guarantee and after-sales support services are the responsibility of the seller and not that of the marketplace platform.
- In addition to the sectoral caps, investors must also adhere to the pricing guidelines and reporting requirements in respect of their investment in India. Therefore, investors must ensure that the agreed purchase price complies with the fair market value requirements, i.e., the price must be as per the fair market value of the shares computed in accordance with any internationally acceptable pricing methodology.

18/25 Rule on Deferred Consideration and Indemnity

- Since May 20, 2016, the foreign investment regime has imposed caps on deferred consideration and indemnity pay outs in a cross-border share sale transactions. Consequently, parties will need to obtain the approval of the Reserve Bank of India if more than 25% of the consideration amount is deferred or escrowed or if such amount is deferred or escrowed for a period of more than eighteen (18) months.
- Similarly, parties will also need to obtain the approval of the Reserve Bank of India if the seller's indemnity exceeds 25% of the purchase consideration or is for a period exceeding eighteen (18) months from the date of payment of the full consideration.
- Given these restrictions, foreign investors must focus on conducting a thorough due diligence on the target/seller and also explore obtaining representations and warranties insurance.

Restrictions on Assured Returns

- Foreign exchange laws of India permit parties to insert "optionality clauses" in transactions in respect of equity shares, fully, compulsorily and mandatorily convertible debentures and fully, compulsorily and mandatorily convertible preference shares. However, parties may exercise such rights only after the expiry of a lock-in period of one (1) year from the date of allotment and after ensuring that they comply with the pricing guidelines issued by the Reserve Bank of India.

Companies Act, 2013 - Evolving Legislation

- The revamped Companies Act, 2013, and its subsequent amendments in 2015 and 2017, have worked in favour of the diverse players in the Indian market, especially in view of the fast-changing international corporate scenario.
- For instance, Indian company law now provides shareholders the flexibility in choosing the venue for holding extraordinary general meetings while it has also simplified the process of incorporation of companies. However, Indian authorities have also introduced stringent requirements for declaration of significant beneficial interest, which requires the ultimate beneficial owner to disclose his/her interest in the company and other personal details to Indian authorities.

Competition Law

- As per the Indian anti-trust regime, enterprises or persons are prohibited from entering into agreements which cause an appreciable adverse effect on competition within India. This prohibition applies to both, vertical agreements and horizontal agreements, and to activities such as price fixing, production control and collusive bidding.
- Additionally, the Indian anti-trust regime also prohibits entities from abusing their dominant position in the market. Under Indian law, an entity will be considered to be abusing its dominant position by imposing discriminatory conditions in the purchase or sale of goods or services, limiting or restricting production of goods, provision of services or technical/scientific development relating to goods or services to the prejudice of consumers and/or by indulging in practices resulting in denial of market access in any manner.
- Lastly, investors will also need to assess the requirements of the Indian merger control thresholds while pursuing a transaction in India and also assess the target test exemption prescribed under the Indian anti-trust regime.

"Control" - Some Issues

- In respect of companies listed in India, the definition of control remains a key issue as under the SEBI (Substantial Acquisition of Shares and Takeover) Regulations, 2011, a shareholder is required to make an open offer when he/she acquires control over the company.

- Despite several discussions, in September 2017, the Securities Exchange Board of India announced that it will not introduce any bright-line tests to determine meaning of term “control”.
- A key aspect is whether negative control is sufficient to constitute control. In the Shubhkaam Ventures Case, the Securities Appellate Tribunal ruled that negative control will not amount to an acquisition of “control” and therefore, the requirement for a mandatory open offer will not be triggered. While the Securities Exchange Board of India appealed this decision, the parties settled amicably in the interim and the Supreme Court held that the order must not be used as a precedent.
- Thereafter, in Clearwater Capital Partners and Kamat Hotels (India) Limited, Clearwater Capital Partners acquired certain protective rights in the target company (Kamat Hotels) by entering into a shareholders’ agreement. Upon considering the effect of these rights, the Securities Exchange Board of India held that the quorum and affirmative voting rights acquired by Clearwater Capital Partners were merely rights to protect the financial investor. Therefore, it held that such rights did not amount to an acquisition of “control” of Kamat Hotels.
- Various other laws including, the FDI Policy, the Competition Act, 2002 and the Companies Act, 2013 provide for a similar definition of control and such definition gives rise to similar issues. For instance, from an FDI perspective, authorities assess whether control lies in the hands of the non-resident when considering investments made in regulated sectors.
- An example of the controversy surrounding the definition of control was apparent in the Jet-Etihad deal. In this instance, while Etihad initially acquired only 24% of Jet Airways, a number of authorities scrutinized the acquisition from the prism of the subjective definition of control where Etihad had certain preferred rights as a minority shareholder which were not available to Jet Airways as a majority shareholder. Consequently, the authorities instructed the parties to amend the investment agreement.
- From the perspective of conducting due diligence, foreign private equity investors often prefer not to conduct extensive due diligence while making investments into Indian companies. However, investors may commonly come across a variety of issues such as improper maintenance of records, inadequate intellectual property protection and a lack of statutory compliance by the target. Further, in respect of manufacturing concerns, investors are likely to come across various non-compliances in respect of environmental law. Lastly, investors may also find certain practices which are not in compliance with anti-bribery laws.

Assignment of Intellectual Property Rights

- In respect of patents, any patent created by an employee/independent contractor belongs to the employee/independent contractor under Indian law. Therefore, investors must insist that the company enters into a deed of assignment with the employees to ensure adequate protection of patent rights. Moreover, investors must also ensure that the deed specifies the nature of interest in the patent that is being assigned and that the deed is registered with the Patents Registry in a timely manner.

- Also, any copyright created by an employee/independent contractor belong to the employee/independent contractor. Therefore, investors must also insist that the company enters into a deed of assignment with the employees to ensure adequate protection of copyright. Further, the deed of assignment must clearly identify the underlying work and specify the rights assigned. Furthermore, the deed of assignment must also specify the duration and territoriality of assignment, amount of royalty/consideration and terms of revision/renewal. However, unlike a deed of assignment of patents, the assignment of copyright need not be registered with any authority.
- Indian law does not mandate registration of trademarks. India recognizes both, the concept of a well-known trademark and the principle of trans-border reputation. However, akin to a patent, a deed of assignment assigning trademarks is required to be registered with the Trademark Registry.

Data Privacy Issues

- India's data protection laws are not as developed as the laws in the West. Currently, the Information Technology Act, 2000 and the Information Technology (Reasonable security practices and procedures and sensitive personal data or information) Rules, 2011 regulate data security in India which only provides for data security of sensitive personal data exchanged in electronic format and not in physical format. However, the Indian government is proposing to enact a new Personal Data Protection Bill, 2019 to address, among others, this issue.

India's New Insolvency Law

- In 2016, Indian enacted a new Insolvency and Bankruptcy Code. The Insolvency and Bankruptcy Code envisages a two (2) step process and prioritizes the resolution of liabilities. Under this model, a corporate debtor will be liquidated only if the resolution process is not successfully completed. However, the Insolvency and Bankruptcy Code does not permit the promoters persons in control or management of the debtor to bid under the resolution process except in case of micro, small and medium enterprises.
- This process creates an opportunity for investors to acquire stressed Indian companies at bargain prices.
- Despite the fact that the Insolvency and Bankruptcy Code provides for a strict timeline for the resolution of the insolvency process, the timelines were not met in the resolution processes involving the twelve (12) large defaulters who were identified by the Reserve Bank of India.
- The timelines were breached due to a number of reasons such as a lack of judges and trained staff to handle insolvencies, the grant of generous extensions and the declaration of a number of initial bids as invalid.

Enforcement Of Contracts

- Indian contract law does not impose any statutory restrictions in respect of the parties' choice of law. Therefore, if one (1) contracting party is a foreign national or entity, the parties may expressly agree to a foreign governing law.
- In respect of trade secrets and confidential information, there is no law in India which specifically protects trade secrets or confidential information. However, Indian courts have time and again granted injunctions to protect confidential information on the principles of equity and common law.
- In respect of restrictive covenants, investors must remember that any agreement which restricts a person from carrying out a lawful profession, trade or business of any kind, is void to that extent under Indian law, and therefore, the enforceability of non-compete clauses, especially post-termination, is questionable. On the other hand, non-solicitation clauses are usually enforceable both, during the term of the contract and after termination.
- While choosing a dispute resolution mechanism, parties should opt for arbitration as disputes before Indian courts are not usually resolved in a timely manner. Moreover, even in case of agreements where parties have chosen arbitration, courts can grant interim reliefs during the pendency of arbitration proceedings.

Tax Treaties

- A number of investors have routed their investments into India through Mauritius and Singapore. An important factor behind such investments was the capital gains tax exemption granted by respective tax treaties of Mauritius and Singapore. However, these benefits have now come to an end given the amendments made to these treaties.
- Pursuant to the amendment, investments made after April 1, 2017 were subject to capital gains tax at 50% of the tax rate subject to satisfying the limitation of benefits clause. Further, investments made after April 1, 2019 are subject to the normal rate of tax. However, all investments made prior to April 1, 2017 have been grandfathered, subject to fulfillment of commercial substance criteria. The Indian government introduced these changes to prevent round tripping of funds, curb revenue loss, prevent double non-taxation and to streamline the flow of investments into India.
- An option available is to invest in India through the Netherlands, as the India-Netherlands treaty provides for capital gains exemption if the shares are sold to a non-Indian entity at the time of the investor's exit. However, in respect of debt/interest income based investments, investors can continue to invest through Mauritius as the rate of withholding tax on interest payable to a Mauritius-based lender is 7.5% as compared to a tax in excess of 10% under the Indian Income Tax Act, 1961.

Other Tax Considerations

- Investors must take into account transfer pricing provisions under the Income-Tax Act, 1961 prior to engaging in transactions with associated entities. These provisions apply to international transactions involving associated enterprises and the Indian tax law requires such transactions to be conducted at an arm's length price.
- In order to avoid excessive tax liabilities and tax litigation, investors may explore entering into advanced pricing agreements with Indian tax authorities and mutually agree to the tax payable in respect of anticipated transactions.

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