Joint Ventures in India

May 2013

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1. Introduction

The world is looking at India as an attractive investment destination with strategic advantages and lucrative commercial incentives. Over the past year, while numerous economies saw negative GDP growth rates, India posted a growth rate of nearly 6%. The Indian economy, while not significantly affected during the global recession, is preparing itself for another round of aggressive growth. The basis of these lofty expectations is strongly grounded in the vast pool of untapped skilled and unskilled human resources across most economic sectors in India. We have witnessed this through the tremendous growth experienced over the last 10 years in India, in sectors ranging from manufacturing to information technology and services industries. Beyond this, India offers a vast internal market for various products and services. It is therefore apparent that India has a lot to offer to anyone looking to do business here from both the producers' and consumers' perspectives.

In making a decision to enter India, to benefit from the inherent advantages offered by an existing Indian partner in terms of market access, local knowledge or quick ramp-up, foreign investors and companies should seriously consider forming Joint Ventures with Indian businesses (hereinafter referred to as "**JVs**"). While India has progressed in leaps and bounds, it still lacks cutting edge technologies and management processes. Foreign partners possessing such technologies and processes can add significant value to JVs in India and take advantage of local skills and markets. The process of establishing a JV in India and commencing the business can be relatively uncomplicated if it is preceded by proper planning, market research and partner assessment. Pulling off a successful JV requires setting specific and measurable objectives, identifying and critically assessing potential partners and target market, and determining the right mode and format of JV. In this paper, we examine how and why a JV is set up, the legal framework involved in JVs and the nuances of JV documentation.

I. What is a Joint Venture?

A JV may be defined as any arrangement whereby two or more parties co-operate in order to run a business or to achieve a commercial objective. This co-operation may take various forms, such as equity-based or contractual JVs. It may be on a long-term basis involving the running of a business in perpetuity or on a limited basis involving the realization of a particular project. It may involve an

1. *Joint Venture Forms and Precedents,* Butterworths, October 1997.

entirely new business, or an existing business that is expected to significantly benefit from the introduction of the new participant. A JV is, therefore, a highly flexible concept. The nature of any particular JV will depend to a great extent on its own underlying facts and characteristics and on the resources and wishes of the involved parties. Overall, a JV may be summarized as a symbiotic business alliance between two or more companies whereby the complimentary resources of the partners are mutually shared and put to use. It is an effective business strategy for enhancing marketing, positioning and client acquisition which has stood the test of time. The alliance can be a formal contractual agreement or an informal understanding between the parties.

Global proliferation of business and commerce has given an international dimension to JVs. Corporate entities across the globe seek cross-border alliances to share the resources, opportunities and potential to deliver cutting edge performance. Such alliances are designed to suit the commercial requirements of parties and vary from a mere transitory arrangement for one partner to establish its presence in a new market to a calculated step towards a full merger of the technologies and capabilities of the partners.

II. Purposes for Establishing a JV

JVs are envisaged as alliances that yield benefits for the JV partners by offering a platform to attain their business goals which would be difficult or uneconomical to attain independently. Establishing a JV with an ideal partner provides a fast way to leverage complementary resources available with the other partner, share each others' capabilities, access new markets, strengthen position in the current markets, or diversify into new businesses. India Inc. has come of age and is not just an investment destination but also an aggressive investor. Indian companies have exhibited, in the recent past, their ambition to venture into the quest for overseas expansion. The main stumbling blocks for Indian companies in achieving expected levels of global presence are deficiencies in terms of product quality, technology, infrastructure and even management processes. These deficiencies can be negated by way of an alliance with a foreign counterpart who is a strategic fit. Alliances between those possessing varying expertise and capabilities in technology, marketing and distribution, etc. are necessary to meet the growing needs of modern business.

2. *JNew Horizons Limited v. Union of India (UOI) and Ors* (1995) 1 SCC 478.

i. Leveraging Resources

With the globalization, access to labor, capital and technological resources have become driving forces for modern businesses to aim to achieve 'economies of scale.' Today, business commitments are far too large to be executed by a single company. From a wider perspective, the conduct of business mandates a huge pool of resources extending from massive financial backup to plenty of skilled manpower. Cross-border business projects are all the more demanding and the best solution is to either outright acquire or share them by entering into a JV. Co-operation is a great way of reducing research and manufacturing costs while limiting exposure.

ii. Exploiting Capabilities and Expertise

Parties to a JV may have complementary skills or capabilities to contribute to the JV; or parties may have experience in different industries which it is hoped will produce synergistic benefits. The basic tenet of a JV is the sharing of capabilities and expertise of both the partners on mutually agreed terms. Such sharing grants a competitive advantage to the JV partners over other players in the market.

iii. Sharing Liabilities

A JV also offers parties an opportunity to jointly manage the risks associated with new ventures. Through a JV they can limit their individual exposure by sharing the liabilities. When the liabilities and risks are shared the pressure on each individual partner is correspondingly reduced. It reduces the risks in a number of ways as the business activities of the JV can be expanded with smaller investment outlays than if financed independently.

iv. Market Access

JVs are the most efficient mode of gaining better market access. Companies utilize JV agreements to expand their business into other geographies, consumer segments and product markets. In the case of a cross-border JV, the involvement of a locally-based party may be necessary or desirable in countries where it is difficult for a foreign company to penetrate the market or where the local law limits the ownership structure by foreigners. For instance, in India, certain market sectors remain restricted for foreign investment and a local partner with a certain shareholding in the company is a regulatory necessity for commencing business and making investments. These restrictions are discussed in further detail in a later section.

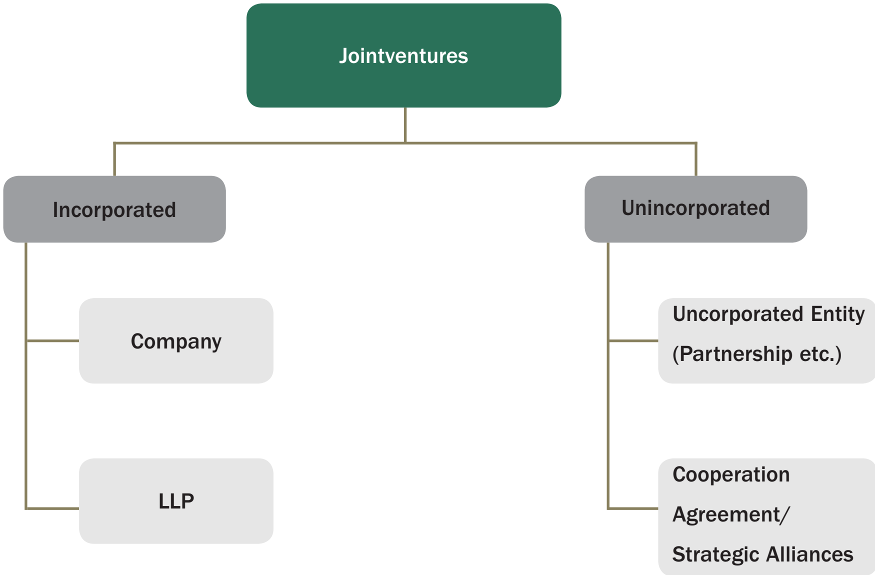
v. Flexible Business Diversification

JVs offer many flexible business diversification opportunities to the partners. A JV may be set up, as a prelude to a full merger or only for part of the business. It offers a creative way for companies to enter into non-core businesses while maintaining an easy exit option. Companies can also resort to JVs as a method to gradually separate a business from the rest of the organization and eventually, sell it off. In certain circumstances, JVs may be set up with strategic investors in the process of entering into a new market so as to initially provide the foreign participant local infrastructure and guidance but with a view to integrate the operations of the JV into the main company in the future. In this situation, the foreign participant may choose to acquire the local participant's interest once the venture is up and running. This can be highly beneficial to both parties as the foreign party is able to establish itself in the local market while the local party gets a liquid exit.

III. Forms of JVs

JVs may be either contractual or structural, or both. They may be broad based or narrowly defined and the main classification of JVs is as equity/corporate JV and contractual JV. An equity JV is an arrangement whereby a separate legal entity is created in accordance with the agreement of two or more parties. The parties undertake to provide money or other resources as their contribution to the assets or other capital of that legal entity. This structure is best suited to long-term, broad based JVs. The contractual JV might be used where the establishment of a separate legal entity is not needed or the creation of such a separate legal entity is not feasible. This agreement can be entered into in situations where the project involves a temporary task or a limited activity or is for a limited term.

The four most common structures employed to constitute a JV are:



i. Company JV

Here the parties to the JV would create a joint venture company ("**JV Co**"), under the Companies Act, 1956 ("**Act**") and would hold the shares of such company in an agreed proportion. This arrangement can also be termed as Equity/Corporate JV.

The advantages of using a corporate vehicle are:

- It is a universally recognized medium which gives an independent legal identity to the JV;
- It puts in place a better management and employee structure;
- participants have the benefit of limited liability and the flexibility to raise finance; and
- The company will survive as the same entity despite a change in its ownership.

The three most common ways of creating of joint venture companies may be described as follows:

1) Parties subscribe to shares on agreed terms

Parties to the JV incorporate a new company and subscribe to the shares of the company in mutually agreed proportion and terms, and commence a new business. The benefit of this route is that it allows structural flexibility in terms of creating an entity which is tailor-made to suit the specifications of both the parties. The documents of incorporation, i.e. the Memorandum of Association (the "**MoA**") and Articles of Association (the "**AoA**") of the JV Co. would be suitably drafted so as to reflect the rights, intentions and obligations of the parties.

2) Transfer of Business or Technology by one Party and Share Subscription by the Other

a variation of the above model, would be where parties to the JV incorporate a new company. One of the parties transfers its business or technology to the newly incorporated company in lieu of shares issued by the company. The other party subscribes to the shares of the company for cash consideration.

3) Collaboration with the Promoters of an Existing Company

A proposed JV partner can acquire shares of the existing company either by subscribing to new shares or acquiring shares of the existing shareholder(s). The MoA and the AoA of the existing company would be amended accordingly to incorporate the JVA into it.

ii. Partnership

A partnership firm created under the Partnership Act, 1932, is in many respects simpler than a company, and may perhaps be regarded as a halfway house between a corporate joint venture and a purely contractual arrangement. A partnership represents a relationship between persons who have agreed to share the profits of business carried on by all or any of them acting for all. A partnership JV or hybrid models are unincorporated forms of JV which represent the business relationship between the parties with a profit motive. This is reflected in the tax regime, whereby partners are separately assessed even though the profits are computed as if the partnership were a separate entity. This JV has inherent disadvantages including unlimited liability, limited capital, no separate identity etc. Whilst tax and commercial factors may sometimes lead to the use of such unincorporated vehicles, the majority of business ventures tend to use a corporate vehicle for establishing a JV, the share capital of which is divided between the parties to the JV. As a result, partnerships are not normally used for major businesses except by professionals such as solicitors and accountants or where there are specific tax advantages.

iii. Limited Liability Partnership

In 2008, the Limited Liability Partnership Act, 2008 (“**LLP Act**”) introduced limited liability partnerships (“**LLPs**”) in India. An LLP is a beneficial business vehicle as it provides the benefits of limited liability to its partners and allows its members the flexibility of organizing their internal structure as a partnership based on an agreement. At the same time a LLP has the basic features of a corporation including separate legal identity. The LLP Act permits the conversion of a partnership firm, a private company and an unlisted public company into an LLP, in accordance with specified rules. As a consequence of the conversion, all assets, interests, rights, privileges, liabilities and obligations of the firm or the company may be transferred to the resulting LLP and would continue to vest in such LLP.

Any contribution to the capital of a proprietary concern, partnership concern or any association of persons in India by a person resident outside India is subject to the approval of the Foreign Investment Promotion Board (“FIPB”) which is granted on a case-by-case basis. This acts as an impediment to such structures, which is why a corporate entity is generally preferred from a structuring perspective. The government has permitted FDI in LLPs, through the Government approval route(as defined below), only for LLPs operating in sectors/activities where 100% FDI is allowed, through the automatic route and there are no FDI-linked performance related conditions (such as ‘Non Banking Finance Companies’ or ‘Development of Townships, Housing, Built-up infrastructure and Construction-development projects’ etc.). LLPs with FDI will not be allowed to operate in agricultural/plantation activity, print media or real estate business. Additionally, aAn Indian company, having FDI, will be permitted to make downstream investment in an LLP only if both-the company, as well as the LLP are operating in sectors where 100% FDI is allowed, through the automatic route and there are no FDI-linked performance related conditions. Whereas, LLPs with FDI will not be eligible to make any downstream investments.

iv. Unincoporated Joint Ventures - Co-operation Agreements/Strategic Alliances

The most basic form of association is to conclude a purely contractual arrangement like a cooperation agreement or a strategic alliance wherein the parties agree to collaborate as independent contractors rather than shareholders in a company or partners in a legal partnership. What qualifies such business relationships as an unincorporated joint venture is when such business relationship between two or more parties is in furtherance of a common purpose or action for a profitable venture, proceeds of which are to be shared in an agreed ratio. This type of agreement is ideal where the parties intend not to be bound by the formality and permanence of a corporate vehicle. Such alliances are highly functional constructs that allow companies to acquire products, technology & working capital to increase production capacity and improve productivity. Strategic alliances provide companies an opportunity to establish a *de facto* geographical presence and aid in accessing new markets, increase market penetration, sales & market share. Co-operation agreements / strategic alliances can be employed for the following types of business activities:

- Technology transfer agreements
- Joint product development
- Purchasing agreements
- Distribution agreements
- Marketing and promotional collaboration
- Intellectual advice

In such a JV the rights, duties and obligations of the parties as between themselves and third parties and the duration of their legal relationship will be mutually agreed by the parties under the contract. The contract will be binding on the parties and breach of it will entitle the other party to seek legal recourse against the defaulter. Even though no corporate vehicle is involved and the parties to the agreement are not partners in a legal sense, it is possible for them to be exposed to claims and liabilities because of the activities of their co-participants on a contractual or quasi-contractual basis. Therefore, an indemnity should be included in the agreement under which one party will indemnify the other for any losses that are caused through the actions of the co-participants.

Additionally, an unincorporated joint ventures may have significant tax issues if not structured properly as the Indian tax authorities may qualify such contractual arrangements as an "association of persons", a term not defined under the Income-tax Act 1961, and only interpreted in case laws. If a contractual arrangement qualifies as an "association of persons", then the Indian tax authorities could tax such association of persons at the maximum marginal rate, which could be as high as 40% if any member of such "association of persons" is a non-resident.

IV. Documentation in a JV

Establishing a JV involves a series of steps and selection of the best partner after proper due diligence is the most significant of all. Once a partner is identified, a memorandum of understanding ("**MoU**") or a letter of intent ("**LoI**") is signed by the parties expressing the intention to enter into definitive agreements. JV transactions demand efficient, clear and foolproof documentation. Depending upon the nature of the JV structure, definitive agreements would be drafted.

Nature of JV Entity	Documentation
Incorporated JV entity	**Company** • JVA / shareholders' agreement ("**JVA**"/"**SHA**"); and • MoA and AoA of the JV entity; and • Other agreements such as trade mark licenses and technology transfers. **LLP** • Limited Liability Partnership Agreement • Other agreements such as trade mark licenses and technology transfers.
Unincorporated JV entity	**Partnership** • Partnership Agreement • Other agreements such as trade mark licenses and technology transfers. **Cooperation/Strategic Alliance/Consortium** • Cooperation Agreement; • Other agreements such as trade mark licenses and technology transfers.

Essentially a JVA/SHA provides for the method of formation of the JV company and sets out the mutual rights and obligations of parties for the purposes of conducting the JV and the manner in which the parties will conduct themselves in operating and managing the JV. A further purpose is to prescribe, as far as possible, for what will happen if difficulties occur.

In the case of non-corporate joint venture structures, the basic objectives of any formal arrangement between the participants will be substantially similar to that of a shareholders' agreement. The arrangement generally reflects, where appropriate, the absence of a separate legal vehicle and the fact that the joint venture may relate to a project of finite duration.

The JVA/SHA or other agreements related to the JV necessarily requires proficient legal drafting and should clearly incorporate all the relevant clauses that specify the mutual understanding arrived at between both parties as to the formation and operations of the JV. The successful implementation and smooth functioning of the JV depends on the definitive agreements and hence it is critical to draft it in the best possible manner without any room for ambiguity. A convoluted and vague documentation can be fatal to the JV and hamper the interest of the parties. The following are the most significant clauses that are to be carefully incorporated into the JVA:

- Object and scope of the joint venture;
- Equity participation by local and foreign investors and agreement to future issue of capital;
- Financial arrangements;
- Composition of the board and management arrangements;
- Specific obligations;
- Provisions for distribution of profits;
- Transferability of shares in different circumstances;
- Remedying a deadlock;
- Termination;
- Restrictive covenants on the company and the participants;
- Casting vote provisions;
- Appointment of CEO/MD;
- Change of control/exit clauses;
- Anti-compete clauses;
- Confidentiality;
- Indemnity clauses;
- Assignment;
- Dispute Resolution;

- Applicable law
- Force Majeure etc.

V. Memorandum & Articles of Association

The Companies Act requires every company to have a Memorandum of Association ("**MoA**") and Articles of Association ("**AoA**"). The MoA and AoA are the charter documents of the company.

The JV agreement is between partners and does not bind the JV company unless its terms are included in the AoA of the JV company.[3] Therefore it is necessary to specifically incorporate the terms of the JVA /SHA into the AoA of the JV company. In India, the AoA and MoA prevail over the JV agreement and the Act prevails over the MoA and AoA. In the light of principles laid down by the courts in number of cases, and the statutory provisions contained in sections 9 and 31 of the Act it could be said that anything contained in any document which is inconsistent with the provisions of the Act or the MoA or AoA of the company, is ineffective and cannot be enforced. In order to avoid conflicts arising between the agreement and the AoA, it is usual to include a provision in the JV agreement to the effect that if the AoA is inconsistent with the provisions of the JV agreement, then the parties will amend the MoA and AoA accordingly.

The main requirement in the MoA will be to make the main object clause sufficiently wide to cover the company's proposed activities. The Memorandum of Association is in a way a flexible document and can be altered by the shareholders in accordance with the provisions of the Act. The objects specified in it, as required by the Act, cannot be overstepped. Any *ultra vires* activity has serious consequences. A contract by a company on a matter not included in the Memorandum of Association is, therefore, ultra vires. Therefore, the parties to the JV should ensure that the current main objects of the company are vide enough to cover the proposed activity of the JV Company.

Articles of Association are regulations for internal management of the company. They are the rules or bye-laws for the conduct of Board & Shareholders meetings, issue and transfer of Shares, Powers & duties of Directors, Managing Director etc. The AoA will contain such of the basic rules of the company as are not set out in the agreement and will set out the different class rights (if any) of shareholders.

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3. *VB Rangaraj v. VB Gopalkrishnan and Ors* 73 Comp Cas 201 (SC) (1992).

2. Initial Considerations – Regulatory and Sectoral Issues

I. Regulatory Issues

With the advent of the new Industrial Policy on July 24, 1991, India opened up its economy and the Government of India permitted foreign investments in India. By virtue of this change many industrial sectors, which were closed, were opened up for investment, both domestic and foreign. Since then, the Government has not looked back, and presently in many areas foreign corporations are allowed to invest, leading to foreign corporations establishing wholly (100%) owned subsidiaries ("**WOS**") and JVs in India.

i. Strategizing Shareholding Patterns

Before examining the regulatory and other restrictions applicable to JV Companies, it is important to understand the effect of shareholding restrictions and thresholds on the control and management of a company under the Act. While the extent of a JV Partner's shareholding may be subject to regulatory restrictions, the strategic imperatives behind the JV will generally determine the shareholding of each JV Partner. For instance, a JV Partner contributing only intellectual property to a JV Company may prefer a smaller shareholding and profit by way of royalties or fees instead of dividends or a beneficial exit. Similarly, a JV Partner with a larger stake may prefer to have full control of the Company's management and operations.

Shareholder rights in relation to any Indian JV Company can be classified into two categories – statutory rights and contractual rights, which are independent of each other. Statutory rights are derived purely on the basis of shareholding (and the extent of shareholding) as per the provisions of the Act, while contractual rights are derived from the terms and conditions of a shareholders' agreement, irrespective of the extent of each shareholder's shareholding in the JV Company. Contractual rights cannot supersede statutory rights.

From a statutory perspective, it is important to understand that any matter to be decided by the shareholders of a JV Company may either be (i) ordinary matters – requiring the consent of at least a simple majority of the shareholders present and voting in any shareholders' meeting; or

(ii) special matters – requiring the consent of at least 75% of the shareholders present and voting in any shareholders' meeting.

Any JV Partner holding more than 25% in the JV Company would be able to exercise a certain amount of control as such a shareholding would endow the JV Partner with the right to block resolutions on special matters. Even as a minority shareholder a JV Partner holding 10% or more of the issued and paid up share capital of the JV Company, can exercise certain statutory rights. Apart from instituting action against the JV Company for oppression and mismanagement, a 10% shareholder is also entitled to:

1) Rights Against Variation

If there is any variation of the rights attached to any class of shares, the holders of at least 10% of the issued shares of that class who do not consent to or vote in favour of the resolution for such variation may apply to the High Court (having jurisdiction over the area where the registered office of the JV Company is situated) to have the variation cancelled. Where any such application is made, the variation shall not have effect unless and until it is confirmed by the said High Court.

2) Derivative Rights

Derivative actions are defined as proceedings on behalf of JV Company by a shareholder or shareholders in instances where the directors fail to live up to their duties. These actions may be taken by any member of the JV Company. The JV Company is joined in such proceedings as a co-defendant. If the action is successful, the JV Company becomes entitled to enforce the judgment. Matters which can be the subject of a derivative action may be raised in petitions against oppression and mismanagement. The court may permit a minority shareholder to join a personal action with a derivative action in a single suit. A derivative action would not lie where what is complained of is nothing but a negligent mismanagement of a company's affairs.

3) Other Rights

In addition to the above, a shareholder holding 10% or more of the issued and paid up share capital of a JV Company is also entitled to:

i. Requisition a general meeting of the shareholders, and if the Board does not call the meeting, the shareholder may call the meeting himself.

ii. Withhold consent and therefore prevent the holding of a meeting of the shareholders at shorter notice [the holding of an annual general meeting at shorter notice requires the consent of all the shareholders and the holding of any other meeting of the shareholders (an 'extraordinary general meeting') requires the consent of 95% of shareholders].

iii. Before or upon the declaration of the result of voting on any resolution by a show of hands, he may demand a poll. A shareholder would be entitled to demand a poll even if he holds shares on which at least Rs. 50,000 has been paid up.

iv. Requisition the JV Company to give notice of any resolution, which he intends to move and circulate to the members a statement with respect to the matter in the proposed resolution or any other business proposed to be dealt with.

v. Apply to the Central Government for appointment of directors to safeguard the interest of the JV Company its shareholders or the public interest.

In the light of the rights attached with the various thresholds of the shareholding of the JV Partner, it is always preferable to hold at least 76% and gain special control over the JV Company. Holding at least 90% of the shares of the JV Company would give a shareholder near absolute control of the JV Company.

The shareholders rights specified above, are available to foreign shareholders as well. The use of some of these rights may be affected contractually through a shareholders' agreement, as discussed in Chapter III below. Furthermore, with the use of instruments such as shares with differential voting rights, the effective shareholding of a party may be increased.

ii. Foreign Direct Investment

The 'liberal' Foreign Exchange Management Act 1999, ("**FEMA**") brought into force on 1 June 2000, replaced the 'draconian' Foreign Exchange Regulation Act, 1973 ("**FERA**").

Presently persons resident outside India[4] are permitted to invest into securities of Indian companies

4. As per Sec 2(w) of FEMA "**person resident outside India**" means a person who is not resident in India.

depending on the sectoral caps and as per the provisions of the FEMA and the delegated legislation thereunder. The FEMA (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000 ("**TISPRO Regulations**"), more specifically Schedule I of TISPRO Regulations provide for investments into Indian companies under the Foreign Direct Investment ("**FDI**") route.

In an attempt to simplify the rules and regulations pertaining to the FDI policy, the Department of Industrial Policy and Promotion ("**DIPP**"), Ministry of Commerce and Industry, Government of India, issued a consolidated FDI policy (the "**Consolidated FDI Policy**") on April 10, 2012. The Circular which became effective from April 10, 2012 consolidates and more importantly, subsumes, all prior press notes/press releases/clarifications issued by the DIPP as on April 10, 2012 and reflects the current policy framework on FDI. The Consolidated FDI Policy clarifies various aspects of the FDI regime, including providing a consolidated chapter on definitions relating to FDI. Certain clarifications on policy include the specific prohibition on the issue of share warrants or partly paid-up shares to foreign investors. Along with the FDI Policy of 2012, the DIPP has also issued a press release ("**Press Release**") whereby DIPP has left a remark that *"it is felt that the need of frequent amendments to the Circular does not exist any longer".* As a result, earlier the consolidated FDI policy which was a part of review process that was undertaken two times annually; now onwards would be revised only annually. However, in the intervening period, DIPP may make changes to the Consolidated FDI Policy by way of press notes.

Investments can be made by person resident outside India in the shares/compulsorily convertible debentures/preference shares of an Indian company, through two routes; the Automatic Route and the Government Route.

Under the 'automatic route' (requiring no prior approval), the foreign investor or the Indian company does not require any prior government approval. The categories of investments that do not qualify to come under the automatic route would be carried out via the non-automatic route, where special approval of the Foreign Investment Promotion Board ("**FIPB**"), and/or other specified government department(s) is required.

Over the past one decade, the scope of automatic route has been expanded and the requirement of Reserve Bank of India ("**RBI**") approval has also been waived in most cases.

Foreign investment into a JV Company can be routed via the FDI scheme as prescribed under the

FEMA. In relation to FDI:

- Some sectors fall under automatic route for 100% investments. The investee company is only required to notify the Regional Office of RBI within 30 days of receipt of inward remittances and file the required documents with that office within 30 days of issue of shares to the foreign investors.;
- For some sectors FDI up to a certain limit has been permitted without approval, however in order to go beyond the sectoral cap the foreign investor has to seek permission from the FIPB or the Secretariat of Industrial Approvals ("**SIA**") depending upon the quantum of investment. For example: In telecommunications, foreign investment up to 49%, in the equity of a joint venture company is permitted without FIPB approval and beyond 49% up to 74% will require FIPB approval.
- There are certain sectors such as atomic energy gambling and betting, where FDI is completely prohibited.

Further, certain sectors and businesses in India have minimum capitalization norms under which a foreign investor intending to invest in these sectors must invest a certain minimum amount. These sectors include:

1) Non-Banking Financial Services
2) Real Estate Construction and Development Projects

While FDI norms apply to direct foreign investments into an Indian company, in 2009, the Government of India via Press Notes 2, 3 and 4 of 2009, attempted to set out a methodology for computing the quantum of indirect foreign investment in downstream entities. Press Note 4, in particular, clarifies such methodology to some extent. The Press Notes brought companies controlled by foreign investors (i.e. companies with more than 50 per cent of their shares held by foreign investors or companies where the foreign investors may have control over the board of directors) within the purview of FDI regulations. However, companies owned and controlled by Indian promoters or entities (as per the same measure) are regarded as domestic companies. In principle, from the language in the aforementioned Press Notes, it appears that holding companies with a minority foreign interest may be able to invest in restricted sectors.

iii. 50:50 JV Entities to be Considered Foreign Entities

In the event a 50:50 joint venture company is categorized as a foreign owned Indian entity, then the downstream investments and sectors in which investments are made by the JV entity, will be subject to foreign investment restrictions. The threshold (to establish foreign ownership) of 50% is inconsistent with Press Notes 2, 3 and 4 of 2009, which placed the relevant threshold at 51%.

As mentioned above, a proposal for joint venture with foreign equity, does not require any approval if it conforms to the industry / product classification and foreign equity limit. In the event the proposed joint venture proposals, does not satisfy these two criteria, it would require the Government of India's, i.e. FIPB's approval.

iv. Foreign Institutional Investment

Schedule II of the TISPRO Regulations provides for purchase/sale of shares or convertible bonds of an Indian company by a registered FII/sub-account under the 'portfolio investment scheme' ("**PIS**") route. It is pertinent to note that a foreign investor cannot acquire listed shares of Indian companies on a recognized Stock Exchange in India through a registered broker, unless such foreign investors are registered as a FII/sub-account and the investments are made under the PIS route as per the provisions of Schedule II of TISPRO Regulations.

FII/sub-accounts are registered with the Securities and Exchange Board of India ("**SEBI**") under its SEBI (Foreign Institutional Investors) Regulations, 1995 ("**SEBI FII Regulations**").

An FII can make investments up to 10% of the total issued share capital of the Indian company either its own behalf or on behalf of each of its sub-accounts. However, a sub-account under 'foreign corporate' or 'foreign individual' category cannot invest more than 5% of the total issued capital of the Indian company. Further, the aggregate holdings of all FIIs/sub-accounts may not exceed 24% of paid-up share capital of the Indian company. However, this limit can be increased, up to the applicable sectoral caps for foreign investment, by the Indian company by passing shareholders special resolution.

It should be highlighted that the aforesaid is applicable to foreign companies and individuals only. Should the investment be made by non-resident Indians (Indian citizens living abroad or persons of Indian origin living abroad and having foreign nationality), the investments laws are more relaxed.

v. Transfer of Securities

Compliance requirement varies depending upon the residency of the transferor and transferee of the shares:

Transferor	Transferee	Compliance, if any
India Resident	India Resident	None, record of transfer on share certificate
India Resident	Non-Resident	Filing of Form FC-TRS with the RBI
Non-Resident	India Resident	Reporting requirements with the authorized dealer, subject to the restriction that the Indian Resident should not have any previous tie-up or venture in the same field
Non-ResidentA	Non-Resident	None, intimation to RBI recommended

In the JVA, any clauses dealing with transfer of shares, should be made subject to applicable laws. Further, the time likely to be taken for obtaining the necessary approvals should also be considered. In the event that shares are being transferred or issued to a non-resident, the pricing of the shares will need to be in accordance with certain pricing guidelines. These guidelines are laid down by the RBI (in the case of companies not listed on a stock exchange) and by SEBI (in the case of listed companies) as the case may be.

vi. Royalties and Lump Sum Fees

Earlier there were monetary caps on remittances (both lumpsum fees and royalties) made for technology collaborations and license or use of trademark / brand name.

Now there are no restrictions and the payments towards the lumpsum fees or royalties for technology collaborations and license or use of trademark / brand name can be made under the automatic route, without any monetary cap.

vii. Competition Law Issues

Section 6 of the Competition Act, 2002 makes void any combination which causes or is likely to cause an appreciable adverse effect on competition within India and requires every acquirer to notify the Competition Commission of India ("**CCI**") of a combination and seek its approval prior to effectuating the same unless such combination has been specifically exempted (see ***Annexure A***).

The Competition Act requires that any acquisition of control, shares or voting rights or assets of an enterprise[5] by a person that crosses the financial thresholds (see ***Annexure B***) prescribed under the said Act needs to be notified to the CCI. In the event of an existing company being converted into a joint venture either through acquisition of shares or through subscription of fresh shares a filing will need to be made with the CCI in the event that the prescribed thresholds are breached. However where a new joint venture entity is being set up, it would need to be seen whether such a new entity would be considered to be an 'enterprise' within the meaning of this provision.

Applicability of the De-Minimis Exemption

The Government of India has notified certain thresholds (Assets of 250 crores and Turnover of 750 crores), whereby all transactions which do not meet such thresholds need not be notified to the CCI. Therefore, if the joint venture partners were to setup a fresh joint venture , which has nil or negligible assets and no value attributable to its turnover at the time that the partners to the joint venture subscribe to the shares of such JV Co, it may be argued that such acquisition may not need to be notified.

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5. enterprise" means a person or a department of the Government, who or which is, or has been, engaged in any activity, relating to the production, storage, supply, distribution, acquisition or control of articles or goods, or

   the provision of services, of any kind, or in investment, or in the business of acquiring, holding, underwriting or dealing with shares, debentures or other securities of any other body corporate, either directly or through one

   or more of its units or divisions or subsidiaries, whether such unit or division or subsidiary is located at the same place where the enterprise is located or at a different place or at different places, but does not include any activity of the Government relatable to the sovereign functions of the Government including all activities carried on by the departments of the Central Government dealing with atomic energy, currency, defence and space.

   Explanation.—For the purposes of this clause,—

   (a) "activity" includes profession or occupation;

   (b) "article" includes a new article and "service" includes a new service;

   (c) "unit" or "division", in relation to an enterprise, includes—

   (i) a plant or factory established for the production, storage, supply, distribution, acquisition or control of any article or goods;

   (ii) any branch or office established for the provision of any service;

viii. Funding

It is important that the joint venture parties discuss the financial requirements of the joint venture and how such requirements will be addressed. Indian banks are only allowed to have limited exposure to capital markets, and to that extent they bank funding for purchase of shares may not always be forthcoming.

From a foreign investor perspective, the JV could be funded in one of the following ways, either by way of equity or debt. If funded by way of equity, or instruments compulsorily convertible into common equity, such investment would qualify as Foreign Direct Investment, or “FDI”. FDI in India is subject to sectoral caps and conditionalities, and also subject to pricing norms inasmuch as no non-resident can subscribe to or purchase Indian securities below the DCF valuation and no non-resident can sell Indian securities above the DCF price. Further, any purchase or subscription to by a non-resident of Indian securities that are not in the nature of equity, or instruments compulsorily convertible into common equity, shall qualify as external commercial borrowings or “ECB”, which are subject to stringent thresholds as set out below. Importantly, non-residents have recently been allowed to subscribe to shares of the Indian company against royalty or fees for technical services due to them, subject to compliance with the aforesaid pricing norms.

Foreign debt, or ECB, in India is subject to stringent conditions. For instance, ECB can only be received by an Indian company which is inter-alia engaged in manufacturing sector, or in hotels, hospitals, or software services. The maximum interest that can be paid on ECB is LIBOR + 500 basis points for a 5 year loan, and ECB can only be used for limited purposes such as capital expansion, and cannot be used for working capital, real estate or discharge of rupee loans.

Most incorporated joint ventures will normally involve the granting of shares in the joint venture entity in consideration of the infusion of capital by the joint venture parties. Such infusion of capital may be take various forms such as:

- Milestone based infusion of capital where the parties clearly define concrete milestones which need to be achieved by the joint venture upon which specific funding would be provided. For instance there may be instances where a foreign joint venture partner would infuse a specific amount of capital upon the joint venture entity obtaining specific regulatory approvals.

- Shares may also be issued to a joint venture partner in consideration of lump sum technical know-how fee or royalty subject to sectoral guidelines and pricing regulations.

For unincorporated joint ventures, it is important that the documentation set out the payment milestones, payment processes and trigger events for breach.

ix. Employees

The socialist economic pattern adopted in India has generally resulted in the formulation of a host of labour laws that are intended to protect the interests of employees (mainly the blue-collar workers). As a result, while interpreting and applying the various labour laws, the Indian courts tend to be liberal and in favour of employees. The applicability of some of the laws will depend on factors such as type of industry, number of employees in the organization, role/designation of the employees etc.

There are no specific laws governing the process of hiring of employees and there is no mandatory requirement to have a written employment contract. However, it is usually advisable to have a detailed employment contract, especially for employees working in the IT or knowledge industry sector and for those likely to generate any form of intellectual property. This type of contract can include provisions on duties and responsibilities, non-disclosure of confidential information, assignment of intellectual property, non-compete, non-solicitation and termination. It is also important to bear in mind that unlike many other jurisdictions in the world, Indian law does not permit an 'at-will' employment relationship. In cases where employees are to be transferred to the joint venture company, the manner of transfer - whether it be structured as resignation and rehire or transfer of the undertaking - becomes important, each having its own set of complications.

II. Industry Issues and Considerations

There are certain sectors in the Indian economy where, due to restrictions on foreign ownership, JVs are a commonly used method of doing business in India. Certain illustrative examples of such sectors are discussed in this section along with issues that may arise specific to the respective sectors.

i. Technology – Media – Telecom

The Technology-Media-Telecom ("**TMT**") sector in India has experienced robust growth over the last decade. The TMT sector provides investment opportunities in areas as diverse as software development, hardware, outsourcing, movies, television, animation, print media, sports, mobile entertainment and advertising. The Government of India has provided the sector its much needed impetus by opening up or relaxing the entry barriers for foreign investments (foreign direct investments/FDI as well as indirect investments) in certain important areas. JVs between Indian and foreign partners, strategic alliances and technology transfer agreements have gained much popularity and significance in this sector.

An India entry strategy in the TMT space must consider the following:

- Potential investment routes and restrictions as per the permitted foreign investment limits in key areas.
- Exchange control regulations under the Foreign Exchange Management Act, 1999 (FEMA) and rules thereunder.
- Guidelines issued by the Ministry of Information and Broadcasting (MIB), Ministry of Communications and Information Technology, Department of Telecom (DOT) and Telecom Regulatory Authority of India (TRAI).
- Regulations governing External Commercial Borrowings (ECB) and Security regulations under the Securities and Exchange Board of India (SEBI).
- Tax considerations under the Income Tax Act, 1961 (IT Act) and tax treaties.

1) IT & ITES

Foreign investment in Information Technology including companies engaged in Business–to–Business (B2B) e-commerce activities is permissible up to 100% under the automatic route, i.e. without obtaining any government approvals.[7] However, foreign investment in Business–to-Consumer (B2C) e-commerce retail activities is prohibited, except for single brand retailing where foreign investment is permissible up to 51%, subject to prior approval of the Foreign Investment Promotion Board (FIPB).[8]

The India Information Technology Act, 2000 has been amended to tackle newer forms of cyber

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7. Press Note 7 (2008 series)

8. Ibid.

crimes such as cheating by impersonation, data theft, cyber terrorism, and offensive e-communications and the Government of India has accepted a long standing demand of the global ITES industry by enacting data protection rules for protection of sensitive personal date or information which is collected / handled / stored by Indian business process outsourcing companies (BPOs).

2) Media

Foreign investment into advertising and content companies is allowed up to 100 percent without any regulatory approvals, while in broadcasting entities, it is subject to the following[9]:

Medium	FDI Permitted
FM Radio	FDI + FII upto 26%
Direct-to-Home	FDI + FII upto 74%, *FDI limit cannot exceed 20%*
Setting up hardware facilities such as up-linking, HUB etc.	FDI + FII upto 74%
Cable Networks (Multi System operators MSOs) undertaking upgradation of networks towards digitalization and addressability)	FDI + FII upto 74%
Cable Networks (Other Multi System operators not undertaking upgradation of networks towards digitalization and addressability and Local Cable Operators (LCOs))	FDI + FII upto 49%
Uplinking a News & Current Affairs TV Channel	FDI + FII upto 26%
Uplinking a Non-News & Current Affairs TV Channel	100%

9. Ibid

Medium	FDI Permitted
Downlinking a News & Current Affairs TV Channel	100% investment subject to FIPB approval
Downlinking a Non-News & Current Affairs TV Channel	100% investment subject to FIPB approval
Publishing of Newspaper and Periodicals dealing with news and current affairs	upto 26%
Publishing of scientific magazines / specialty journals / periodicals	100%
Head-end-in-the-Sky (HITS)	Up to 74%;
Mobile TV	FDI + FII upto 74 %

- Each of the above requires prior approval of FIPB and MIB.
- Broadcasting licenses are granted only to companies incorporated in India.

TRAI has issued recommendations on cross holdings (vertical or horizontal) for media companies. These recommendations are currently being evaluated by the government. Currently, cross-media ownership restrictions are in place in relation to DTH services and private FM radio. Broadcasting companies/cable networks are allowed to own a maximum 20 percent equity in a DTH company and a company providing FM radio services cannot hold more than 15 percent of the total number of radio channels allocated in the country.

3) Telecom

As in case of media, the foreign investment restrictions are as follows:

Medium	FDI Permitted
Telecom services	Up to 74% *Automatic up to 49% and FIPB approval required beyond 49%*
ISP with & without gateways, radio- paging, end-to-end bandwidth.	Up to 74% *Automatic up to 49% and FIPB approval required beyond 49%*
Infrastructure Provider providing dark fiber, right of way, duct space, tower (Category I); electronic mail and voice mail	100% *Automatic up to 49% and FIPB approval required beyond 49%*
Manufacture of telecom equipments	100% *Automatic*

- Each of the above are subject to licensing and security requirements notified by the Department of Telecommunications (DOT).
- Telecom licenses are granted only to companies incorporated in India.

Further, some of the above media and telecom license conditions require:

- majority of the directors to be Indians;
- key positions in the company, if held by foreign nationals, to be security vetted by the Ministry of Home Affairs (MHA);
- promoter's investment to be locked-in for a specified period;
- prior approval for change in shareholding pattern of the licensee entity.

Taking the recent history of this sector coupled with the potential it still holds, along with the rights available to majority and minority shareholder under the Companies Act, 1956, a JV with a foreign investor has to be carefully structured so as to ensure that the interests of the foreign investor is adequately protected.

ii. Pharmaceutical Sector

The India pharmaceutical market is expected to grow at a CAGR of 15% to 20% to reach a value anywhere between US$ 50 billion and US$74 billion by 2020, representing one of the most emerging pharmaceutical markets in the world. Many global pharmaceutical companies have/are in the process of setting up their base in India by increasing stake in their own Indian subsidiaries or collaborating with local pharmaceutical companies.

Drugs and Pharmaceuticals

FDI up to 100% is permitted under the automatic route for greenfield pharmaceutical joint ventures and is permitted up to 100%, subject to governmental approval for brownfield joint ventures.

iii. Power

FDI up to 100% is permitted under the automatic route in respect of projects relating to electricity generation, transmission and distribution, other than atomic reactor power plants. There is no limit on the project cost and quantum of FDI.[11] Tariff regulation is being handled through independent regulator at the Central and State Government level. A ten-year tax holiday is available for companies and industries that generate and distribute power if they have begun operations before March 31, 2010. In addition, a company undertaking substantial renovation and modernization of existing transmission and distribution lines is entitled for deduction of 100% of the profits if the renovation has been undertaken before March 31, 2010. The Electricity Act, 2003 allows the sector to align with market features, and addresses many of the difficulties coming in the way of greater participation of private sector.

iv. Construction Development Projects

As per the FDI Policy, no Indian company that has FDI can engage in "**Real Estate Business**". The

10. *PwC Report-India Pharma Inc.: Capitalising on India's Growth potential, 2010* https://www.pwc.in/assets/pdfs/pharma/PwC-CII_Pharma_Summit_2011_final.pdf

11. *Investment Opportunities in India,* DIPP, Ministry of Commerce and Industry, Pg. 3 accessed from http://siadipp.nic.in/publicat/Investment_opportunities_in_India.pdf

term, 'Real Estate Business', though not defined in the current FDI Policy , was defined in the erstwhile FDI policy under para. 3.3.2 as "dealing in land and immoveable property with a view to earning profit or earning income there from." In spirit, FDI in real estate is permitted only if the FDI is used for developmental purposes and not for speculative purposes.

While the prohibition on FDI in real estate business has long been the case, the process of deregulating foreign investments into real estate was initiated in 2001 and the turning point for foreign investments into the real estate sector came in 2005 with the issue of Press Note 2 of 2005 ("**PN2**") by the DIPP.

PN2 permitted FDI in townships, housing, built-up infrastructure and construction-development projects (which would include, but not be restricted to, housing, commercial premises, hotels, resorts, hospitals, educational institutions, recreational facilities, city and regional level infrastructure) subject to fulfillment of certain entity level and project level requirements. PN2 required that real estate companies seek foreign investments only for construction and development of projects, and not for completed projects.

Per the FDI Policy, FDI in real estate is permitted under the automatic route in (i) housing, built-up infrastructure and construction-development projects (which would include, but not be restricted to, housing, commercial premises, hotels, resorts, hospitals, educational institutions, recreational facilities, city and regional level infra-structure); and (ii) serviced housing plots, subject to fulfillment of the following requirements:

Minimum area: Minimum built-up area to be developed under each project should be at least 50,000 square meters or 10 hectares in case of serviced housing plots;

Minimum capitalization: Company seeking foreign investment for construction development projects must be capitalized to a certain extent (USD 10 million for wholly owned subsidiaries and USD 5 million for joint ventures with Indian partners) by the foreign investor. Also, such capitalization should be brought in within six months of commencement of business of the company.

Lock-in: Original investment is not permitted to be repatriated before a period of three years from the date of completion of minimum capitalization. If the foreign investor sought to make an early exit, he is required to obtain prior approval of the FIPB.

Project Completion: At least 50% of the project must be developed within a period of five years from the date of obtaining all statutory clearances. The investor/investee company is not permitted to sell undeveloped plots and is required to obtain a completion certificate from the concerned local body/service agency before being allowed to dispose of serviced housing plots.

Local Requirements: The project should conform to the norms and standards, including land use require¬ments and provision of community amenities and common facilities, as laid down in the applicable building control regulations, bye-laws, rules, and other regulations of the State Government/Municipal/Local Body concerned. State Government/Municipal/Local Body concerned would monitor the project to ensure com¬pliance with the above conditions.

Companies/projects that meet the above requirements are referred to as "**FDI Compliant**" projects.

The FDI Policy under paragraph 6.2.11.2 Note (i) provides that "The conditions at (1) to (4) above would not apply to Hotels & Tourism, Hospitals, Special Economic Zones (SEZs), Education Sector, Old age Homes and investment by NRIs." Such assets are also for the purpose of this paper referred to as "**FDI Compliant**" proj¬ects. However, investments in these assets, though exempt from the onerous requirements of minimum area, minimum capitalization, lock-in etc., still have to comply with the following requirements:

1) Condition mentioned in point (5) (Local Requirements) above.
2) The investor shall be responsible for obtaining all necessary approvals, including those of the building/layout plans, developing internal and peripheral areas and other infrastructure facilities, payment of development, external development and other charges and complying with all other requirements as prescribed under applicable rules/bye-laws/regulations of the state government/ municipal /local body concerned.
3) The state government/municipal/local body concerned, which approves the building/develop¬ment plans, would monitor compliance of the above conditions by the developer.

SEZ's in addition to the above are also governed by the Special Economic Zones Act, 2005 ("**SEZ Act**") and the rules framed thereunder. Thus an investment in SEZ though exempt from the conditions imposed under the FDI Policy, is subject to the requirements prescribed under the SEZ Act and rules.

Further, the FDI Policy under paragraph 6.2.12 allows 100% FDI under the automatic route in Industrial Parks.

III. Taxation of Joint Ventures

i. Basics of Taxation in India

Taxation of income in India is governed by the provisions of the Indian Income Tax Act, 1961 (hereinafter referred to as the "**ITA**"). The ITA is amended by Finance Acts, from time to time. It lays down elaborate provisions in respect of chargeability to tax, determination of residency, computation of income, *et al.* The ITA provides for different tax rates for different category of persons, *inter alia* individuals, domestic company, i.e. a company incorporated in India, foreign company, association of person (AOP), partnerships, etc.

Section 4 of the ITA referred to as the 'charging section' stipulates the basis of charge of income tax and lays down that 'total income'[12] of any person is subject to income tax. The concept of total income is discussed in Section 5 of the ITA, as per which residents are taxable in India on their worldwide income, whereas non-residents are taxed only on Indian source income, i.e. income that is received or is deemed to be received or income that accrues or arises or is deemed to accrue or arise in India[13]. Section 9 of the ITA is a deeming provision, which discusses when income is deemed to have been received, accrued or arisen in India.

In this context, Section 6 of the ITA provides the basis for determining residency in India. Under Section 6(3) of the ITA, a company is considered to be a tax resident of India, if it is incorporated in India or the control and management is situated *wholly* in India. Accordingly, only if a foreign company is wholly controlled or managed from India, it would be considered to be a tax resident of India from an Indian tax perspective. Further, importantly, as per Section 6(2) of the ITA, a partnership, including a limited liability partnership, is considered to be a tax resident in India, even if a *part* of the control and management is situated in India.

12. *Section 2 (45) defines "Total Income" to mean the total amount of income referred to in Section 5. The scope of "total income" has been listed under section 5 of the ITA.*

13. Section 5 (1) and 5(2) of the ITA.

As mentioned above, as per the provisions of Section 9 of the ITA, a non-resident will be taxed in India to the extent any income is deemed to accrue or arise in India. The provisions stipulated under section 9 of the ITA inter-alia contemplate that that the income accruing directly or indirectly, through or from any business connection in India, shall be deemed to be income accruing or arising in India, and hence where the person is a non-resident, it will be includable in his total income. This section congregates all types of income from all possible sources which a non-resident may have in this country[14]. The fiction created by this section is important in the assessment of income of non-residents owing to the fact that in the case of non-residents, unless the place of accrual of income is within India, such non-resident cannot be subjected to tax. As receipt of income in India by itself attracts tax whether the recipient is a resident or a non-resident, or whether the income arose in India or outside[15], the fiction thus created is general and applies to both a resident and non-resident[16].

The term ‘business connection’ used in section 9 of the Act involves the concept of a control, supervision or a continuous activity in nature. The term has been defined in the ITA inclusively, so as to include businesses which have the authority to enter into a contract on behalf of the non-resident, maintain stock of goods and delivery there-from on behalf of the non-resident and secure orders for the non-resident. However, the definition being inclusive in nature requires further elucidation of the intent of the term. It is noteworthy that the expression has been the subject-matter of interpretation by various courts. The scope of the expression has been explained by the Supreme Court in CIT v. *R.D.Aggarwal & Co.*[17], wherein it was held that in order to constitute ‘business connection’ there must be continuity of activity or operation of the non-resident with the Indian party and a stray of isolated transaction is not enough to establish a business connection[18]. The essence of business connection is thus the existence of a close, real, intimate relationship between the non-resident and the Indian party.

India has an extensive network of tax treaties with various countries. Under the ITA, tax treaties override the provisions of ITA; however the taxpayer has the option to choose the application of the ITA if more favourable. In order to avail benefits of such tax treaties the person needs to be a tax resident of the treaty country. Thus, with respect to a non-resident who is a resident of a country with

14. CIT v. Carborundum Co. (1973) 92 ITR 411 (Mad). Also see Sampath Iyengar’s, Law of Income Tax, 10th Edn. at p 1180.

15. Raghava Reddi (PV) v. CIT (1962) 44 ITR 720 (SC). See also Standard Triumph Motor Co. Ltd. v. CIT (1993) 201 ITR 391 (SC)

16. Sree Meenakshi Mills Ltd. v. CIT (1957) 28 ITR 31 (SC).

17. (1965) 56 ITR 20 (SC).

18. Sampath Iyengar’s, Law of Income Tax, 10th Edn. at p 1189.

which India has signed a Double Tax Avoidance Agreement ("**DTAA**"), the provisions of the ITA apply only to the extent they are relatively more beneficial to the assessee. This view was affirmed by the Supreme Court in the landmark case of Union of India v/s Azadi Bacaho Andolan and others[19] where the issue centered around the challenge to a Circular dated April 13, 2000 by which the Government had clarified that capital gains earned by a resident of Mauritius on alienation of shares of an Indian Company shall be taxable only in Mauritius and not in India.

Thus, taxation of a joint venture in India would depend on the form of entity, and also the residential status of that entity as determined under Section 6 of the ITA. Subsequently, the residential status would determine the scope of the total income to be charged to tax in accordance with Section 5 read alongwith Section 9 of the ITA.

ii. Taxation of the JV Co

1) Company

A corporate tax rate of 30% is presently applicable to domestic Indian companies. A dividend distribution tax ("**DDT**") of 15% is payable upon distribution of dividends to the shareholders. However, such dividend income is then tax exempt in the hands of the shareholders irrespective of their residential status. DDT is payable irrespective of whether the company making the distributions is otherwise chargeable to tax.

In the context of a joint venture with foreign enterprises, it is pertinent to note that as per the Indian transfer-pricing regulations, the Indian joint venture and the foreign shareholders would be considered "associated enterprises" and any transactions between them would be required to be conducted on an arm's length basis.

2) Partnership and LLP

A partnership and an LLP are taxed similarly. The rate of income tax for a partnership and an LLP

19. 2004 (10) SCC; 1

are the same as for corporate entities, that is, 30%. However, the share of profit in a partnership firm (including LLP) is exempt from tax in the hands of the partners. Pertinently, any interest, salary, bonus, commission or remuneration by whatever name called which is received by or is due to a partner from such partnership (including LLP) is chargeable to tax as business income.

3) Branch Office

An offshore may operate in India in the form of a branch. A branch of a foreign company will be taxed in India at the rate of 40%. Currently India does not levy a branch profits tax.

Here again it is pertinent to note that for transfer pricing purposes, the branch and the head office will be considered to be associated enterprises and any transaction between the two entities will be required to be at arm's length.

4) Unincorporated Joint Ventures

An unincorporated joint ventures may have significant tax issues if not structured properly as the Indian tax authorities may qualify such contractual arrangements as an "association of persons", a term not defined under the Income-tax Act 1961, and only interpreted in case laws. If a contractual arrangement qualifies as an "association of persons", then the Indian tax authorities could tax such association of persons at the maximum marginal rate, which could be as high as 40% if any member of such "association of persons" is a non-resident.

iii. Tax Implications of Various Investment Options

1) Investment by way of Equity and Preference Shares

Gains earned on sale of shares of the Indian entity are taxed at the rate of 20% for long term capital gains[20], and 30% and 40% for short term capital gains[21], for residents and non-residents respectively.

Profits may be distributed by an Indian company either by way of dividends or by buy-back of shares or through capital reduction.

20. Gains on sale of shares held for a period exceeding twelve months.

21. Gains on sale of shares held for a period not exceeding twelve months.

- As mentioned above, dividend is taxed in the hands of the company declaring such dividend at the rate of 15% and is exempt in the hands of the recipient of such dividends.

- The second method of distribution, that is, by the way of buy-back/redemption of shares would result in capital gains income in the hands of the shareholders. However, such a buy-back of the equity shares is permitted only once in a period of 365 days, and a fresh issue of the same security is not permitted before a period of six months from the date of the buy-back. Further, the Indian company is permitted to buy-back a maximum of 25% of the outstanding paid up equity share capital in one year. However, the shares which are bought back are exempted from the provisions of deemed dividend.

- The third method of distribution is a scheme of capital reduction (where the foreign investor is selectively bought-back). As an alternative to buy-back, the foreign joint venture partner could approach the courts for reduction of capital under the provisions of section 100 of the Companies Act, 1956; however, the applications for such reduction of capital need to be adequately justified to the court.

However, the Union Budget 2013 proposes to levy a tax of 20% on domestic unlisted companies, when such companies make distributions pursuant to a "buy back" under Section 77A of the Companies Act, 1956. This tax at the rate of 20% has been proposed to be imposed on consideration paid by a company over and above the amount received by the company at the time of issuing of shares. Buybacks hitherto were taxed as capital gains in the hands of the non-resident, and if the non-resident was a resident in a treaty jurisdiction like Mauritius, Cyprus and Singapore then the capital gains tax were exempt.

The following additional challenges could also be faced by a foreign investor in case of payment of dividend/buy – back of shares:

- **Additional 'distribution tax':** Akin to dividend distribution tax, this is an additional tax on distribution of monies by a company on buyback of shares. Though, once taxed at the company level, the proceeds received by a shareholder on account of buy-back will not be subject to further tax, however, introduction of this provision takes away certain benefits which could be availed by the shareholder discussed in detail below.

- **No deduction:** The Budget proposes that tax as imposed under these provisions shall be payable by the company irrespective of whether income tax is payable on its total income as computed under the ITA. The tax paid to the Central Government for the buy-back has been proposed to be treated as the final payment of tax and no further credit can be claimed by the company or any other person in respect of the amount of tax so paid. Further, no deduction is allowed to the company or to the shareholder in respect of the income which has been subject to this tax or the tax thereon. To that extent, the shareholders would now not be able to set-off the capital gains from buy-back of shares against capital losses which they could do earlier.

- **Treaty benefits 'fruitless'/availing foreign tax credit a challenge:** Introduction of this tax seems to be a calculated move by the Government to undo the current practice of resorting to buying back of shares instead of making dividend payments in the international context. The proposed provisions will have a significant adverse impact on offshore realty funds and foreign investors who have made investments from countries such as Mauritius, Singapore, Cyprus etc. where buy-back of shares would not have been taxable in India due to availability of tax treaty benefits. Further, being in the nature of additional income tax payable by the Indian company, foreign investors may not even be entitled to a foreign tax credit of such tax.

More specifically, with respect to buy-back/redemption of shares, the following change introduced in the Union Budget of 2013 is also very important.

- **Secondary purchase and indexation benefit disregarded:** The scope of these provisions are far reaching as they do not just tax gains but tax the difference between the share subscription amount and the distribution. These provisions thereby implicitly tax gains that may have arisen as a result of secondary sales that may have occurred prior to the buy-back. Not only this, these provisions also disregard the cost incurred towards acquisition of shares which earlier did not form part of capital gains. Additionally, in the context of the domestic investor, even the benefit of indexation would effectively be denied to such investor and issues relating to proportional disallowance of expenditure under section 14A *(Expenditure incurred in relation to income not includible in total income)* may also arise. This would therefore result in the buy-back of shares being even less tax efficient than the distribution of dividends.

Up-streaming of cash to the foreign joint venture partners that was hitherto tax efficiently structured in nature of buy-backs by the Indian company of a shares (usually of a separate class) of the foreign joint venture partner, will now be significantly impacted.

This method of distribution is particularly employed in case where offshore enterprises form a JV in India.

2) Investment by way of Debt

AAn investment into JVs may also be structured in the form of debts such as loans or debentures.

Interest paid on the debentures and loans is subjected to withholding tax at the rate of 10% in case of resident JV partners. On the other hand, the withholding tax on debentures held by and loans from non-residents is 40%. However, interest payments on loans availed in foreign currency is subjected to a reduced withholding of 20%.

However, since October 2012 the government has reduced the rate of withholding tax on rupee denominated debit for infrastructure bonds. Infrastructure sector is defined as (i) power, (ii) telecommunication, (iii) railways, (iv) roads including bridges, (v) sea port and airport, (vi) industrial parks, (vii) urban infrastructure (water supply, sanitation and sewage projects), (viii) mining, exploration and refining and (ix) cold storage or cold room facility, including for farm level pre-cooling, for preservation or storage of agricultural and allied produce, marine products and meat.

The interest expense is, however, a tax deductible expense for the Indian company, and hence will go towards reducing the taxable profits of the Indian company.

3) Contribution of Technology and Know-How

Contribution by JV partners could also take the form of technology inputs and know-how. For tax purposes, payments made by the Indian JV entity as consideration for such contributions may be characterized as royalty or fee for technical services ("**FTS**") depending on the terms of the arrangement with the JV partners. For example, due to the application of the India-US tax treaty, payments made by an Indian entity for technical services provided by a US resident would be treated as FTS only if the services result in the imparting of technology or know-how to the Indian entity.

The Union Budget 2013 had led to a marked increase in royalties and fees for technical services. Last year, the definition of royalty was amended to bring within the tax net a number of payments which would not commercially be considered royalty, such as payments towards the purchase of shrink wrap software, subscription to databases and clouds. This year, a further blow has been inflicted by way of an amendment to the rate of tax applicable to payments of royalty and FTS. While previously a rate of 10% was applicable on a gross basis, going forward the rate is proposed to be 25% on a gross basis. The explanation that has been provided is that the 10% rate contained in Indian tax law is lower than the rates applicable to these payments under several of India's tax treaties and that non-residents situated in tax treaty jurisdictions will still be eligible to claim the beneficial rate. There is also a possibility that this move was intended to tap payments of royalty and FTS which have been used by foreign investors to repatriate profits even though the same is presently addressed under the transfer pricing provisions.

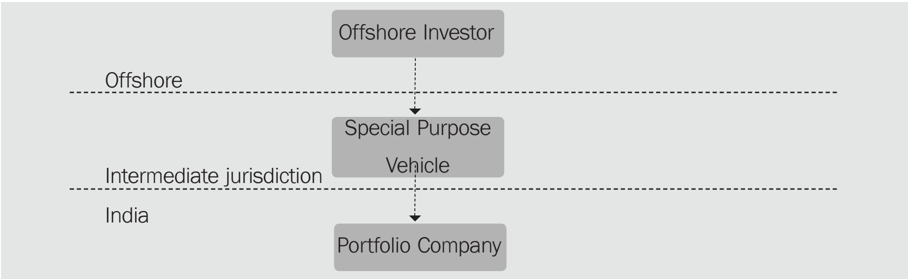
The biggest impact that the above change will have with respect to foreign collaborators will be that the 25% tax would be computed on a gross basis on all payments of royalty and FTS, and not merely on the net income amount. This could translate into the tax being potentially imposed even where there is a situation of loss in the hands of the foreign recipient. This is a retrograde move which is likely to be a significant blow to technology transfer, knowledge sharing and collaboration agreements across sectors, particularly as the foreign investor may never have sufficient tax obligations in its home country against which the substantial Indian taxes could be offset and foreign tax credits claimed.

This can have a significant impact in respect of joint ventures in India, where the Indian party relies on technical know-how and expertise of the foreign joint venture partners.

It may be noted that the characterization of income and the tax rate may vary depending on the beneficial provision of an applicable tax treaty.

iv. Use of Intermediate jurisdiction

Foreign investors may invest in India via an intermediate jurisdiction to mitigate tax leakage. Of the various double taxation avoidance agreements ("**DTAAs**") which India has entered into across the globe, some of them contain beneficial provisions with regard to capital gains tax and tax withholding on interest payments. Favourable legal and regulatory environment, coupled with a lower domestic tax regime in few of these juris-dictions, including Mauritius, Cyprus, Singapore and Netherlands, have made them, over the years, a popular choice for an intermediate jurisdiction. The diagram below illustrates the use of intermediate jurisdiction for investment into India:



Since taxation on business income in most jurisdictions is higher, and repatriation of dividends from India is not tax effective[22], returns to foreign investors from India are generally structured as capital gains or interest income, which can reduce the effective tax liability of foreign investor to 0% or 10% respectively, with the use of appropriate intermediate jurisdiction. Attached in Annexure [•] is a comparison of three key jurisdictions – Mauritius, Singapore and Cyprus from the aspects – (i) corporate and regulatory framework in the intermediate jurisdic¬tion; (ii) protection for investments; (iii) flexibility for restructuring; and (iv) ease of exit.

v. GAAR/Tax Residency

Budget 2013 has proposed a few amendments to the general anti-avoidance rules (“**GAAR**”) introduced into India’s tax statute last year. GAAR which was initially slated for implementation from April 1, 2013 has been widely criticized on account of ambiguities in its scope and application, lack of safeguards, and possibility of misuse by the tax authorities. GAAR empowers the Revenue with considerable discretion in taxing ‘impermissible avoidance arrangements’, disregarding entities, reallocating income and even denying tax treaty benefits to a non-resident investor.

With a view to address the dampening investor sentiment, the Government appointed the Shome Committee to consult with stakeholders and review GAAR as well as the retroactive amendment for taxing offshore share transfers. In its detailed report, the Shome Committee had recommend-

22. There is a dividend distribution tax (“DDT”) of 15% (exclusive of surcharge and cess) payable by the Indian company on the dividend distributed to its shareholders; further, since DDT is a corporate level tax and not a tax in the hands of the shareholder, credit for DDT is usually not available.

ed a substantial narrowing down of the GAAR provisions and other safeguards in the interest of fairness and certainty. Click **here** to read our insights and analysis of the Shome Committee's report.

Some of the key changes proposed to GAAR under Budget 2013 are as follows:

- To defer the implementation of GAAR for 2 years.

- GAAR shall apply only if the main purpose of an arrangement is to obtain a tax benefit. Currently, GAAR may apply even if obtaining the tax benefit is one of the main purposes of an arrangement. Presumably, the new GAAR provisions may not apply if an arrangement is backed by sufficient business purpose.

- Factors such as the holding period of the investment, availability of an exit route and whether taxes have been paid in connection with the arrangement may be relevant but not sufficient for determining commercial substance. Interestingly, these were the key factors considered by the Supreme Court of India when it decided that the USD 11.1 billion Vodafone-Hutch transaction was not a sham and could not be taxed in India.

- GAAR cases shall be scrutinized by an Approving Panel chaired by a retired High Court Judge, a senior member of the tax office (of the rank of Chief Commissioner of Income Tax) and a reputed academician or scholar with expertise in taxation or international trade and business. The existing provisions relating to the Approving Panel only contemplate members from the tax department, which raises issues of independence, lack of objectivity and bias.

Further, this year's Budget also on to state that a tax residency certificate ("**TRC**") shall be *necessary but not a sufficient* condition to claim tax treaty benefits. While no criterion has been prescribed in the Finance Bill 2013-14 to determine what constitutes 'sufficient condition', statements have been made by the Finance Minister that only persons having 'beneficial ownership' of assets would be eligible to claim tax treaty benefits.

3. Nuances of a JV Transaction

I. Due Diligence

The necessity of carrying out a due diligence is dependent on the commercial structure of the joint venture being entered into. A transaction that involves two entities coming together to form a third entity to penetrate a different market or to start a new business line may not require a due diligence unless the diligence to be carried out is on the business partners itself. However, if the joint venture proposed is through the acquisition of an existing company, the conduct of diligence is imperative. No matter what form the transaction takes, each joint venture partner must ensure, whether through a diligence or through representations, warranties and corresponding indemnities, that the other has the ability to perform and carry on the business proposed through the joint venture entity. Additionally, it must be ensured that existing and/or new liabilities of a joint venture partner are not transferred to or suffered by the new joint venture entity.

The scope of a diligence should be established at the outset of a transaction. Akin to a diligence carried out for other corporate transactions, in a joint venture transaction requiring a diligence legal, financial and tax teams are separately appointed to review their corresponding aspects of the company's business. Typically, lawyers tend to peruse corporate documents dating 3 to 5 years prior to the commencement of the diligence and taxation documents dating 7 years prior to the commencement of the diligence, with a thorough diligence on outstanding litigation matters that the party may be involved in, with a view to reasonably eliminate legal risks.

Where a major business asset is proposed to be transferred into the joint venture, the focus of diligence can be more easily defined. In this scenario, one can expect the lawyers to give a full report on major contracts, litigation, regulatory aspects and liabilities affecting the asset, along with a full auditor's report on the accounting treatment for the same. When the focus of the joint venture is an asset that is not familiar to the other partner, it may be advisable to engage an independent business expert to assess the asset. Many parties may be averse to letting an independent expert make an observation report, especially in cases where the asset in question is related to intellectual property, for the fear that trade secrets may be revealed. However, even considering this risk it is advisable to insist on conducting a due diligence on such asset, lest it result in an expensive mistake for the collaborating party.

II. Term Sheet or Memorandum of Understanding

In a joint venture scenario, with the parties still assessing each other's competencies, centering on the heads or terms of the transaction may not be immediately possible. However, a brief description of the terms on which the joint venture is proposed to be undertaken ought to be agreed by the joint venture parties prior to undertaking the transaction. This document is commonly known as a "term sheet" or a "memorandum of understanding". If the transaction necessitates a diligence, then entering into the joint venture can be subject to the favourable outcome of such diligence. The exercise of accurately allocating legal and commercial responsibilities and setting out each party's legal rights in a term sheet is of great importance. Not only are parties clear on the envisaged transaction but this also facilitates drafting and negotiation of legal documentation. More often than not Indian parties tend to treat a term sheet as sacrosanct and deviating from the terms once agreed becomes difficult. Appropriate legal advice ought to be taken prior to entering in a term sheet to ensure more fruitful discussions on legal documentation.

III. Representations and Warranties

Representations and warranties ("**reps and warranties**") are basically presentations of the underlying facts, past, present and future, on the basis of which parties are induced to enter into and consequently arrive at a consensus on the transaction. Depending upon the nature of the arrangement, specific reps and warranties may be made by one JV partner to the other JV partner and/or to the JV entity and vice versa. The extent of the reps and warranties would vary depending upon the purpose, bargaining power of the parties, the extent of shareholding etc.

Some reps and warranties are discussed below:

- It will often be appropriate for joint venture partners to provide for reps and warranties regarding themselves to the other joint venture party. This is mainly to assure the other party of one's financial standing and confirmation that there will be no unpleasant surprises waiting once the joint venture company is underway. Individuals may also be required to give representations regarding past careers, lack of past criminal proceedings, bankruptcy chargers etc.

- When a business or an asset is being transferred to a JV entity by one of the JV Partners, such partner will not only give reps and warranties to the to the JV entity, but also to the other joint venture partner, as often the JV partner participates and receives a stake in the JV on the basis of the assets transferred.

Akin to other commercial transactions, persons making representations would always try to limit both the number of warranties given and the time period for which they are given. These considerations would usually be swayed by the opinion of the party holding more commercial clout between the joint venture partners.

IV. Non-Compete and Non-Solicit

In view of the rights guaranteed to Indian citizens under its Constitution, Indian contract law prohibits non-compete agreements wherein an individual is restrained from freely practicing any trade or profession. However, there are certain exceptions to such a restriction, especially in cases where there is a sale of goodwill, which may typically happens in an acquisition but is uncommon in a joint venture.

Unlike non-compete clauses, the non-solicit clauses should however be generally enforceable as breach of such clauses is regarded as business interference; although in view of the high evidence requirements, there have not been any significant precedents. Practically, however, it may be difficult to prove that the employee was solicited or joined of his own volition; however, in most clauses the provision is worded in such a way that if any employee of the joint venture company joins either party, then such party employing him will be in default.

These provisions, particularly the non-compete clauses can sometimes be critical. For instance a lot of businesses in India are family run and there can be multiple entities carrying on similar business in the same group. Therefore, the non-resident joint venture partner may insist that the non-compete provisions should be extended to the affiliates of the Indian joint venture partner as well. There are no statutory non-compete provision in India that restrict non-residents from setting up competing ventures.

V. Intellectual Property

Intellectual property is one of the primary considerations of a joint venture. This is because of a variety of reasons:

- when two parties get together to form a joint venture is the brand name to be formed and the ownership of the same;

- once a joint venture company is formed, the ownership and protection of intellectual property that the joint venture company creates is usually of prime significance;

- The contribution by a joint venture partners may also in the form of some sort of intellectual property to the joint venture company. For instance an invention or a patent for the invention or a design (in the case of a manufacturing JV), or a trademark or trade name or a business format/know-how/trade secret (e.g. Starbucks – Tata JV Coffee chain) or copyright (in the case of film production JVs).

As a result of the above, intellectual property based license/assignment agreements form the back bone for most joint ventures. We discuss below some of the main issues that arise in such cases.

Transfer of Intellectual Property: While transferring (licensing or assigning) an intellectual property right, issues may arise if the parties do not follow the necessary provisions of the law. For example, in the assignment of any copyright must confirm to certain parameters namely, it must be in writing, signed by both the parties, specifying the rights[23] licensed, the royalty payable if any, the term of the licence and the territory for the rights. Similarly, while transmitting trademarks, the licensor must ensure that the transmission does not create exclusive rights to use the mark in more than one person, with respect to using the trademark for the same types of goods and services or similar description of goods or services and such similarity should not be likely to create any confusion or deception.[24]

Post-term use of trademarks: Disputes involving post-term use of the licensor's mark by the joint venture are potential litigious issues once the licensor has exited the joint venture and the term of the license has expired. Often once the licensor has exited; it may be possible that the joint venture entity continue to use the trademark for reference purposes or as part of a corporate name. Careful drafting of the joint venture agreement and the trademark license agreement could minimize the risks arising from such litigation.

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23. Section 30 and 30A, Copyright Act, 1957.

24. Section 40, Trademarks Act, 1999.

A signatory to the international conventions on intellectual property rights, India offers adequate protection to trademarks or brand names as well as copyright and designs of foreign collaborators. Enforcement mechanisms are becoming more reliable, which has previously been a bone of contention for foreign corporations.

VI. Indemnity

As a legal concept, an indemnity is a contractual obligation to compensate another party for any loss incurred by such other party due to a breach of a contractual obligation undertaken by the indemnifying party. Reps and warranties are often coupled with an indemnity provision. Consequent to the indemnity provision, in the event of a breach of the reps and warranties, the party that suffers losses on account of such breach is entitled to be compensated for such losses. The right to indemnity is one given by original contract and is in addition to the right to damages arising from the breach thereof, which right is granted under law.

VII. Limitation of Liability and Liquidated Damages

Parties may limit their liability whether under an indemnity clause or for a breach of a contractual obligation or for a breach of a rep and warranty by any or all of the following ways:

- By capping the amount of monetary liability under the indemnity clause. For example, the payments to be made under indemnity clause would be limited to the amount of money brought in by the JV partner seeking the indemnity;

- Allocating floor threshold limits in the reps and warranties and any other obligations commercially agreed made so that a breach of the same giving rise to a monetary consequence that is less than that represented is not considered a breach of such rep and warranty

- By including a de-minimum clause, wherein the party claiming indemnity will not be able to claim for every minor breach, but only if the braches individually and/or collectively add up to a certain amount;

- By limiting the time period during which the other party may claim indemnity. In other words, by adding effective clauses to say that no indemnity will be claimed after a certain number of years have passed from the date on which the representations were given. Parties may usually negotiate not to put a time period limitation on the representation on capacity to enter and sign the joint venture agreement, but may agree to limit the representations on contracts for a period of 3-5 years and representations on tax for a period of 7 years.

- Indemnity may also be limited by a disclosure schedule accompanying the representations and warranties, wherein the party giving the reps and warranties discloses specific liabilities and issues, for which it may not be subsequently prosecuted for misrepresentation.

Parties may also choose to include liquidated damages, where upon the occurrence of certain breaches, the party in breach will be required to pay a fixed sum stipulated in the contract. While this may provide the indemnified party with a certain level of comfort, there is no guarantee that such damages will be enforceable, as a court may view them as unreasonable.[25]

VIII. Directors and Control

Representation on the board of directors of a joint venture is dependent on the shareholding agreed to between the joint venture parties. The nuances of the shareholding in an Indian company have been discussed in earlier chapters. It is important to note that not all corporate decisions require the approval of the shareholders. Consequently, many corporate decisions begin and end with the board of directors of a company. Generally, decisions of the board of directors are subject to the approval of the majority of directors present and voting, subject to the requirement of meeting a quorum. A cause for concern is when the joint venture is between 2 parties, both of whom want equal representation on the board of directors of the JV entity with a view to ensure that neither can outvote the other during a board meeting. Such equal representation may lead to deadlock situations hampering the progress of the business of the JV entity.

The position of a director is always a balancing act between what is expected and practical reality. Under law, a director has a fiduciary duty to act in accordance with the best interests of the company. However, practically, a director nominated by one of the parties is expected to be more of a 'look-out'

25. *Fateh Chand v. Balkishan Das AIR 1963 SC 1405; Nait Ram v. Shib Dat* (1882) 5 All 238, 242.

person, who keeps an eye on the working of the company, but at the same time limits his liability in being a director to the maximum extent possible.

Generally, this disparity between the law and practice does not lead to a position of conflict especially since in a joint venture arrangement the directors so nominated represent the interests of the shareholders themselves. Apart from the fiduciary duties of a director, a director is also saddled with many statutory duties and obligations, the breach of which can attract penal provisions under various legislations. For instance, in the event the company commits an economic crime, since the company as a juristic entity cannot serve a prison sentence, the company's directors may be imprisoned instead.

Although more common in a private equity investment, there have been situations in which minority joint venture parties seek certain affirmative voting rights on certain reserved matters in a joint venture transaction. Typically this is seen in situations where one JV party's contribution is financial in nature (being the financially strong JV partner) and the other JV partner contribution is business acumen and experience.

Any matter that is outside the scope of the normal day to day working of the company may be included in this list of reserved matters. Common reserved matters include (without limitation):

a. The appointment and/or removal of senior management or the statutory auditors of the company;

b. Changes in capital structure, mergers and acquisitions, creation of subsidiaries; and

c. Large capital expenses, acquisitions of outside entities, entering into indebtedness.

The exercise of these rights may be either affirmative (requiring the affirmative vote of the right-holder) or negative (granting a veto to the right-holder) in nature. However, in a joint venture scenario, the matters constituting the veto list are usually resolved by way of unanimous vote, which is further resolved by systems to resolve a deadlock situation as discussed later in this chapter.

IX. Directors in Situations of Conflict

The proper action for a director to do would be to declare his interests in front of the board, and exit at the time when such matters concerning his interest are discussed at a level where decisions are taken. Alternately, the said director may also delegate his voting power to another nominee, or to a committee which will have to take decisions in the best interests of the joint venture company.

These solutions will work if there is sufficient number of disinterested directors to continue to vote on matter if the director (s) interested refrains from voting. However, in a joint venture company, almost all directors are nominees of the joint venture partners. Also in a joint venture company, more often than not, the matters discussed and decisions made at the board level, may have differing implications for the joint venture partners and the joint venture company, resulting in a possible conflict of interest for the director representing the joint venture partner. For example, if the joint venture company is undergoing a financial re-structuring that is likely to affect the financial position of all the shareholders, as regards their participation in the joint venture company, this may bring their interest to conflict. In such cases each director will have to balance their interests with the interests of the company. Ideally, directors placing themselves in this situation should have all proceedings of the meeting of the board minutes and in particular the contribution and participation of each director. Further, resolution of dead-lock mechanisms will gain importance in this scenario.

X. Resolving a Deadlock

Confronting and resolving a dead lock is one of the main concerns in a joint venture exercise. A deadlock is usually faced where there are two parties having as equal control of the JV entity, are in dispute and neither party is willing to surrender control to the other.

While there is no definite way of completely avoiding conflicts and deadlocks, one way of possibly minimizing a deadlock situation is to ensure a full document of the joint venture exercise, setting out detailed division of responsibilities for establishment, development and operation of the joint venture company. This, accompanied with a detailed business plan where the commercial parameters are clearly set out, will definitely help in reducing the amount of conflict.

One of the most common ways of resolving a conflict may be to give the chairman of the board a casting vote, so that neither party is deadlocked out of a disagreement. The difficulty in this may be that the both parties may then want to appoint the chairman to the board. If a common chairman cannot be decided, the parties may also opt for an independent person to take on the responsibility of the chairman, thereby having the casting vote, and thereby taking into account the best interests of the joint venture company by not taking into consideration individual party interests.

The English have introduced a so called "gin-and tonic" mechanism for solving possible conflicts that may arise in a joint venture company. This method believes that senior officials from either party, removed from the day to day operational functioning of the party may be in a situation to look at the larger picture and thereby find a sensible solution, something their respective teams cannot. While there is a difference of opinion on how successful this method is, in the least it offers time for the respective executive teams to view the difference objectively and therefore maybe find an amicable solution.

Another approach is to surrender the control of the joint venture to the other party or rather, have the chairman's veto power shift between the two joint venture partners every financial year or two. The advantage of this ethos, which has been seen to work in considerable joint ventures, is that the decision making power shifts from one party to another, thereby giving both parties to the chance lead and accept the other parties' decisions. The disadvantage of this approach could be the change in circumstances, both regulatory and commercial, which could mean that many crucial decisions may have to be taken in one party's term, resulting in resentment by the other party. Another disadvantage may be onset of a "retaliatory" mindset wherein the one party controlling the decisions making power in one year tries to re-do the actions of the other, with an intention to have their way on a particular issue. However joint venture companies who have overcome these hurdles seem to find this balance of power work to the advance of the joint business.

Another approach could be to refer the deadlocked matter to an independent reviewer, who is capable of taking an independent decision in view of the best interests of the company. One of the disadvantages of this approach is that an independent reviewer may not be staffed with the abilities to understand the business of the JV entity. To avoid such a situation, the independent reviewer could be a group comprising independent consultants that have legal, regulatory and commercial experts.

A put or call option (as discussed below) may also be considered as a method for deadlock resolution. Often, the threat of the exercise of such an option will prove a sufficient deterrent to push the parties to resolve the deadlock.

Aggrieved parties from deadlocked situations, deprived of all other solutions may consider routes like mediation and conciliation in order to resolve the deadlock situation. In mediation and conciliation, the parties introduce a third party mediator or conciliator to act as an intermediary between the parties in resolving the deadlocked matter. Although mediation and conciliation are similar dispute resolution techniques, their differences are recognized under the Indian Arbitration and Conciliation Act, 1996. Whilst a mediator is seen to be more of a facilitator helping the parties to arrive at a consensus, a conciliator is seen to be more of an intervener. Apart from assisting the parties to arrive at a consensus, a conciliator is permitted to make proposals for settlements. A settlement agreement arrived at between the parties pursuant to conciliation is binding on the parties. These methods may not be inexpensive and may be time consuming enough for the deadlocked parties to consider resolving the conflict through a more efficient method. Lastly, the parties can adopt dispute resolution mechanism as stated in the agreement such as arbitration or litigation, the outcome of which are binding on the parties. These dispute resolution methods have been discussed in further detail below.

XI. Shareholder's Agreements

While operating a JV involves various intricacies including rights in Shareholders' meetings and Board appointment and voting rights, there are many other important considerations that must be taken into account. Many situations may arise in the course of business that may require changes in the shareholding patterns. Underperformance and similar issues may arise wherein one party may either wish to buy-out another party or sell its stake or the entire JV and exit. In such situations, various Shareholders' rights come into play, including put and call options, drag along rights and various others. Furthermore, various other exit options too may be considered. These and other provisions in the JV Agreement must be looked into in some detail. This chapter discusses these rights and their utility in JVs.

XII. Ancillary Documents

Specifically in joint ventures, the chunk of the documentation in JVs may be in the related documents such as license/technology/services/management agreement(s) which determines the manner and form in which each party contributes towards the JV Co. Thus it is important that each of these documents work cohesively with each other. It is also important to set out the treatment of all these documents at the time of exit along with the ownership of rights created by virtue of these agreements.

XIII. Put and Call Options

As discussed earlier, in any joint venture, the parties are rarely on an even footing. For instance, where one party may possess intellectual property valuable to the JV, another party may have a greater vested interest in the JV (such as being a promoter in an investee JV Co). For these reasons, the rights each party is able to negotiate will vary as well. Put and call options are rights that permit shareholders to force the purchase and sale of shares in the JV Co. These options may also prove useful in avoiding deadlocks wherein one partner may retain one of these rights as a deterrent against deadlocks.

i. Put Option/Redemption

In the context of a JV, a put option is usually negotiated where there is a clearly identified promoter. A put option enables the right-holder to sell their shares to another party such that the other party must compulsorily purchase the shares offered. It is generally exercised as a downside exit or reduction in shareholding.

In certain cases, such as a wholly domestic joint venture, having instruments such as optionally convertible preference shares may permit the redemption of such shares by the JV Co. Further, subject to the restrictions under Section 77A of the Companies Act, 1956, the JV Co may buy back shares up to 25% of its total paid-up equity capital.

Redemption is not an option readily available to foreign residents. Securities issued to foreign residents that are redeemable would be equated with debt and bring the investment under the purview of the external commercial borrowings guidelines, which in turn would result in numerous restrictions.

A put option to the promoter may also be considered wherein a JV partner may be given the option of selling all or part of its shareholding in the JV Co to the promoter. Such a purchase would result in substantially less regulatory issues than the options of redemption or buyback. In the case of a JV, where the shareholding of a JV partner is likely to be greater than 25% and a foreign resident may not have the option of buyback, a put option to the promoter remains the most viable alternative.

A put option to the promoter may also be at the discretion of the promoter and at a price determined by the promoter. A clause of this nature is usually considered onerous and pricing can be tricky. Various methods for determining prices may be used, such as fair market value or determination of a minimum guaranteed return based on the internal rate of return anticipated by the investing JV partner.

ii. Call Option

A call option in JV documentation is usually negotiated by a party which has more than just a financial interest in the JV Co. A call option enables the right-holder to call upon another shareholder to compulsorily sell their shares to the right-holder. Often promoters or promoter groups prefer to retain a call option so that in a downside, they can retain control of the JV Co by buying out other JV partners. In certain situations, where non-promoter partners are confident of carrying out the business of the JV Co, they too may negotiate a call option. This may be due to undervalued assets such as intellectual property contained in the JV Co. A call option is generally triggered by a loss of confidence in the JV partner.

XIV. Transfer and Pre-Emption Rights

When parties enter into a JV, it is often their intention to preserve the ownership of the entity amongst known and friendly entities. For this reason, there are usually numerous restrictions placed on the transfer of shares by such parties. These restrictions, including pre-emptive rights and rights of first offer or refusal, which are put in place to ensure that the ownership and control of the JV is in the hands of the partners or those they approve of. Further, in the event of a sale or an exit, a transfer may be forced or chosen using rights such as drag-along rights and tag-along rights. Many of these rights may be considered onerous on parties not holding them.

i. Pre-Emptive Right

In the event of a fresh issue of shares to a third party by the JV Co, a pre-emptive right-holder will first be given an opportunity to subscribe to these shares. A preemptive right is generally exercisable at the issue price offered to the third party and on the same terms and conditions. In a joint venture, where the partners are more than just investors, very good reasons may exist for preventing the entry of third parties. In such cases, a pre-emptive right offers the right-holder the power to prevent new third party investors from entering the JV Co provided the right-holder is willing to pay the asking price.

ii. Right of First Refusal (ROFR)

A right of first refusal entails that in the event a shareholder in the JV Co intends to sell its shares to a third party, the right-holder must first refuse to purchase the shares in question. The right-holder will, however, have to match the price and terms offered by the third party. In a JV, this would usually be a common right granted mutually. The idea behind granting such a right is that the JV partners are given an opportunity to block the entry of any third party into the JV where they are certain that the selling JV partner is determined to exit.

iii. Right of First Offer (ROFO)

A right of first offer entails that in the event that a shareholder in the JV Co intends to sell their shares, they may only do so after offering the shares to the right-holder. The right-holder may choose a price and terms and respond to the selling shareholder accordingly. The main difference between this right and a ROFR is that with a ROFO, the right-holder has a greater say in the price at which it purchases the relevant shares. While the selling JV partner will usually have the option to reject the right-holder's offer, having the first mover advantage is generally beneficial to the right-holder.

iv. Tag Along Right

A Tag Along Right grants the right-holder a right to 'piggy-back' on the sale of shares of another shareholder and sell their shares to a third party purchaser on the same terms and conditions. A tag along right serves to ensure that no man gets left behind. While the right remains exercisable at the option of the right-holder, a JV Partner who intends to exit will be forced to consider the exercise of a tag along right when negotiating with a third party purchaser. Since the selling JV partner is likely to look out for himself while making the sale, the terms and price negotiated will usually be beneficial to the right-holder. However, situations may arise where the right will need to be exercised in order to avoid being placed together with an undesirable JV partner as a result of the initial JV Partner's sale.

v. Drag-Along Right

A drag-along right is generally viewed as an onerous right. A drag-along right permits a right-holder that is selling its shares the right to force another shareholder to sell their shares alongside the right-holder. This provides the right-holder the ability to offer to sell a greater and perhaps controlling proportion of the JV Co, which may be more attractive to potential third party purchasers. The primary disadvantage to a shareholder against whom this right is exercised is that such shareholder will not have any say in the price and the terms and conditions and will be forced to sell regardless.

However, as with a tag along right, the selling right-holder will usually negotiate terms and a price that are beneficial to it.

XV. Exit Options

Not all JVs are destined to last forever. In fact, some are begun with a specific horizon in mind, at which point the partners will choose to exit the venture. Exits may be effected in various ways, including liquidation, sale and an initial public offering ("**IPO**"). Further, in the event that only certain of the partners want an exit, rights such as drag-along rights can provide them the window necessary to effect the exit.

i. Initial Public Offering

In the event that certain parties wish to exit the venture, an IPO can provide these shareholders an exit at the time of listing. An IPO is usually negotiated with a time threshold in mind and may act as either an exit for certain JV partners or as a liquidity event for all the partners. In the former situation there is usually an identified promoter who wishes to continue with the business while permitting all or some of the other partners to exit. In the latter situation, some of the partners can extract liquid profits from the company without losing control of the JV Co. An IPO can be conducted by way of a fresh issue, where the JV Co will issue and allot fresh securities, or through an offer for sale where the JV Co will offer securities held by the JV Co.'s existing shareholders desiring to exit, or through a combination of both, to inter-alia public for the first time provided that in an IPO conducted by way of an offer for sale the equity shares may be offered for sale to the public only if such equity shares have been held by the sellers for a period of at least one year prior to filing the draft offer document with the Securities and Exchange Board of India. In the event that equity shares received on conversion or exchange of fully paid up convertible securities are being offered for sale, the holding period of such convertible securities as well as that of resultant equity shares together shall be considered for the purpose of calculation of one year period An IPO paves the way for listing and trading of the JV Co's securities on the stock exchanges in India, thus providing the shareholders liquidity for their shares in the JV Co.

The process of conducting an IPO is primarily governed by the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009 ("**SEBI ICDR Regulations**"). Besides the SEBI ICDR Regulations, there are other important legislations that govern IPOs such as are the Companies Act, 1956, the Securities Contracts (Regulation) Rules, 1957 and the listing agreements of the stock exchanges where the securities are proposed to be listed. The ancillary legislations that may get applicable to an IPO are FEMA and the various regulations, press releases and circulars issued thereunder from time to time by the RBI, the foreign direct investment policy of the Government of India and the various industry specific laws and regulations. There are various eligibility criteria that a company must meet prior to undertaking an IPO. Some of the other essential elements such as minimum offer requirements, promoters' contribution and lock-in requirements must also be borne in mind while doing an IPO in India. The price at which the securities are issued/ sold pursuant to the IPO is determined in accordance with the SEBI ICDR Regulations. Broadly, the price may be determined either through a book building issue where the issuer company only stipulates a price band or a fixed price issue where the issuer company stipulates the fixed price.

A promoter is an essential legal component to an IPO and is cast with several obligations in connection with the IPO including but not limited to contributing not less than 20% of the post issue capital which contribution is required to remain 'locked-in' for a period of 3 years. The SEBI ICDR Regulations defined promoter to include the person or persons who are in control of the issuer; (ii) the person or persons who are instrumental in the formulation of a plan or programme pursuant to which specified securities are offered to public; (iii) the person or persons named in the offer document as promoters. An IPO is usually seen as an upside exit for JV partners wishing to exit as they will usually not be effected unless the JV Co is in shape to undergo an IPO both in terms of the health of its finances and the maturity and viability of continuing the business of the JV Co.

ii. Liquidation

Winding-up or liquidating a JV Co permits a full extraction of the principal investment as well as the profit in the JV Co and may often be useful in fixed-horizon projects. However, in India, winding up is a procedure that may face numerous delays including conducting procedures before the courts. In the case of Indian companies investing in other jurisdictions, however, liquidation may prove to be a speedy and convenient exit option. Further, as discussed earlier, structuring a JV Co as an LLP can also provide a speedy exit.

iii. Third Party Sale

A fully functioning JV Co may be sold to a third party purchaser in order to provide an exit for the various partners and to allow them to liquidate their shareholding without going through a lengthy winding up process. Unlike a drag along right, a third party sale is usually negotiated as an upside exit with the extraction of profits occurring through a profitable acquisition.

iv. Drag Along Right

In an exit scenario, a drag along right can prove very useful, especially where the third party purchaser wants a larger chunk of the shareholding of the company than the right-holder can provide. In cases of termination, this may be a default drag along right, as discussed in further detail below.

XVI. Termination and its Consequences

Many JVs tend not to be great business ideas and some simply don't work out in the long run. In these circumstances, it is important to know how the JV Agreement will terminate. While all the aforementioned rights may form a part of the exits, in the event that the parties determine not to continue with the JVA at all, safeguards must be inserted to ensure the equitable distribution of assets.

JVAs often enumerate certain 'events of default' or 'material breaches' upon the occurrence of which non-defaulting parties will have the right to terminate the JVA. In this event, a drag along right may be included as a default provision which may be exercised only upon the occurrence of such an event. Granting a default drag along right generally serves to act as a deterrent against breaches and defaults. Further, a default put option may be considered as well. Termination clauses linked to default or breach provisions generally aim to skew the rights in the agreement to the non-defaulting party.

Parties may terminate the relationship even before the consummation of the transaction and the issue or purchase of shares. Issues that may be faced with respect to the distribution of assets are limited here as the JV Co may not have received any assets at the time of termination.

XVII. Corporate Governance

As corruption emerges as one of the significant threats to India's democratic framework, it is a growing concern for corporations since it not only directly affects their ability to grow and compete but also creates issues for foreign partners. It has been seen if parties to a transaction do not weigh ethical standards in a stringent manner and if there is lack of good internal control systems, such issues may have ramifications (particularly for non-resident investors) in light of the Foreign Corrupt Practices Act, 1977, the UK Bribery Act, 2010 or in many cases, simply because of the internal polices of the non-resident investors. Given the significant tangible and intangible consequences of corruption, it becomes vital for corporations to tackle this phenomenon.

Grave consequences are faced due to corrupt or unethical practices coming into light, which are not only in the form of losing reputation, public and consumer faith but also in the form of heavy civil, criminal and penal sanctions which could even wipe out a business entirely, as seen in majority of cases. Indian corporations are beginning to take issues of corporate governance seriously. We have seen that foreign joint venture parties normally insist on stringent anti-corruption provisions in the documentation to be executed between the parties. FCPA diligences are becoming increasingly common and so are Indian service providers with specialism to conduct such diligence exercises. Here, sometimes Indian entities who may not be as sophisticated may not always understand the gravity or implications of such provisions. It is therefore important at a practical level to ensure that there is adequate training and exposure given to the relevant members of the joint venture in such anti corruption issues and best practices.

From a good governance perspective, we have seen parties adopt a variety of checks and balances such as incorporation of specialized committees (consisting of representatives of the joint venture partners and even independent advisors) to look into particular aspects of the business of the joint venture.

XVIII. Dispute Resolution[25]

JVs may often face disagreements between the partners. While these may not always escalate into full-fledged disputes, it is wise to provide a clear mechanism for dispute resolution. Many forums exist for resolving disputes. If one of the partners is a foreign entity, the courts their jurisdiction may be beneficial. Arbitration, whether ad-hoc or institutional, remains a popular option with many international arbitral institutions opening centers in India. However, in the choice between these, one must consider various factors.

25. Please refer to our Paper titled "Dispute Resolution in India" (available at our website) for further detail on the issues discussed herein.

i. Governing Law and Jurisdiction

In any agreement, it is necessary to identify the governing law, which serves to determine the substantive law that will apply to any legal proceedings which may arise from the agreement. The choice of the governing law of an agreement must be an informed choice. Where multiple jurisdictions are involved, certain legal systems may be better suited to the specifics of the agreement. For instance, in a JV in which IP is licensed from a foreign party to an Indian party, the proprietor of the IP may wish to choose a governing law which affords better IP protection. Similarly, where the parties are likely to seek damages against one another in a dispute, it would be better to choose a jurisdiction that would compute and award damages in a reasonable manner.

Some jurisdictions may be better or faster than others at delivering justice and an informed and coherent choice must be made between the options. Indian courts are generally overburdened and therefore tend to permit various procedural delays to get in the way of a normal hearing process. As a result, cases filed in Indian courts can drag on for decades. However, courts in other jurisdictions tend to be substantially faster in processing matters and delivering justice. Certain parties that may anticipate a default occurring on their part may wish to choose slower courts as opposed to arbitration or foreign courts. Certain jurisdictions may favour their own citizens unreasonably. An informed choice must therefore be made between jurisdictions when determining the governing law and jurisdiction of the contracts.

ii. Arbitration

Arbitration is the prevalent non-judicial dispute resolution mechanism for commercial disputes in many jurisdictions. While it is usually faster than approaching the courts, various factors need to be considered in choosing arbitration. Arbitration generally tends to be more expensive than litigation. In India, arbitration is governed by the Arbitration and Conciliation Act, 1996 (the "**Arbitration Act**"). One of the significant advantages of arbitration is a reduction in or elimination of procedural delays. In India, arbitration is generally preferred for resolving commercial disputes. While awards can be challenged in courts, the courts have begun to frown upon frivolous challenges to reasoned awards.

According to recent judgement of the Indian Supreme Court if the parties opt for international arbitration with venue and seat outside of India, then Indian courts will be barred from getting involved in such arbitration proceedings, which was hitherto the largest concern of the foreign investors as involvement of Indian courts in arbitration process could substantially the litigation process by many years, our analysis of the aforesaid judgment is attached as ***Annexure [•].*** However, as a consequence of the judgment, if the parties have opted for international arbitration, approaching Indian courts for interim reliefs may not be permissible, which could be a sore point sometime as it may be necessary to approach the local Indian courts for urgent interim reliefs.

iii. Enforcement

In India, a significant issue that may arise with both litigation and arbitration is in enforcing the foreign judgment or award. India is a party to the New York Convention (1960). However, though the New York convention has been signed by around 140 countries, under section 45 of the Arbitration Act, India has notified only about 45 of these as reciprocating territories. Therefore, awards delivered only in those 45 countries (i.e. when seat of arbitration is in a reciprocating territory) can be enforced in India on a reciprocal basis. Similarly, India recognizes only about 12 countries for the reciprocal enforcement of judgments. A judgment or award from a jurisdiction that has reciprocity will be enforced in India as though it is a decree of the Indian courts. On the other hand, a judgment or award from a non-reciprocal jurisdiction, while having some credibility, cannot be directly enforced as a decree. A new suit will have to be filed on the basis of such award/judgment and a decree to execute the foreign award/judgment must be obtained in an Indian court . This process could lead to considerable delays. Further, even a judgment or award from a reciprocating territory may be challenged in Indian courts on certain grounds.

4. Conclusion

The Union Finance Minister P Chidambaram presented his 8th Union Budget in times of global gloom. Global economic growth slowed from 3.9 percent in 2011 to 3.2 percent in 2012, similarly for India the rate of growth is estimated to be anywhere between 5 to 5.5 percent failing short of India's potential growth rate of 8 percent. However, the Union Minister in his budget speech drew comfort from the fact that, of the large countries of the world, only China and Indonesia are growing faster than India in 2012-13. And in 2013-14, if India grows at the rate projected by many forecasters, only China will grow faster than India. Between 2004 and 2008, and again in 2009-10 and 2010-11, the growth rate was over 8 percent and, in fact, crossed 9 percent in four of those six years. The average for the 11th Plan period, entirely under the UPA Government, was 8 percent, the highest ever in any Plan period. *Achieving high growth, therefore, is not a novelty or beyond our capacity. We have done it before and we can do it again.*

The Finance Minister while discussing India's current account deficit (CAD) problem held that the only solution was FDI, FII or External Commercial Borrowing (ECB). *"That is why I have been at pains to state over and over again that India, at the present juncture, does not have the choice between welcoming and spurning foreign investment. If I may be frank, foreign investment is an imperative. What we can do is to encourage foreign investment that is consistent with our economic objectives."*

India is presently one of the world's fastest growing economies with one of the largest domestic markets. Before 1991, India's restrictive economic policies resulted in the unavailability of state-of-the-art products and technologies in the country. While the situation has significantly improved since then, the Indian market lagging developed economies in terms of the quality of products and services sold in the domestic market. In this context, joint venture between foreign partners and Indian companies is a great way to bridge this gap. Joint ventures can utilize the best in technology and local market knowledge in order to take advantage of India's massive domestic market and, further, to use India as an attractive export hub. Recent exchange control liberalizations on payments to foreign technology providers will further spur JV activity in the country.

In terms of the security of an investment into India, the Bilateral Investment Agreement now underwrites investments made into India. Furthermore, India has an excellent track record of upholding the various international treaties and trade arrangements it is party to. Since 1994, India has entered into bilateral investment treaties with over 70 countries, further strengthening its commitment to international trade. On a broader level, India has a strong, democratic political structure with a well-rooted legal system based on common law.

India has grown more or less unscathed through the worst of the global recession. It has beaten all expectations and everyone is optimistic of its future as a global economic powerhouse. Taking advantage of India's low-cost operating environment and large domestic market, joint ventures are a great way to participate in India's incredible growth story.

The Finance Minister while concluding his budget speech laid down as follows *"Any economist will tell us what India can become. We are the tenth largest economy in the world. We can become the eighth, or perhaps the seventh, largest by 2017. By 2025, we could become a $ 5 trillion economy, and among the top five in the world. What we will become depends on us and on the choices that we make."*

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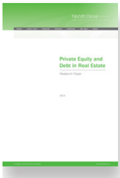

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