Private Equity and Private Debt Investments in India

June 2015
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<td>Compulsorily Convertible Debentures</td>
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<td>Designated Depository Participant</td>
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<td>Dividend Distribution Tax</td>
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<td>DIPP</td>
<td>Department of Industrial Policy and Promotion</td>
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<td>DTC</td>
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<td>EBITDA</td>
<td>Earnings Before Interest Tax Depreciation Ammortization</td>
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<td>External Commercial Borrowing</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>GDR</td>
<td>Global Depository Receipt</td>
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<td>GoI</td>
<td>Government of India</td>
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<td>GP</td>
<td>General Partner</td>
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<td>HNI</td>
<td>High Net worth Individuals</td>
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<td>International Commercial Arbitration</td>
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<td>Initial Public Offering</td>
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<td>Income Tax Act, 1961</td>
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<td>Long Term Capital Gains</td>
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<td>LoB</td>
<td>Limitation on Benefits</td>
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<td>LP</td>
<td>Limited Partner</td>
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<td>MAT</td>
<td>Minimum Alternate Tax</td>
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<td>NBFC</td>
<td>Non-Banking Financial Companies</td>
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<td>NCD</td>
<td>Non-Convertible Debenture</td>
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<tr>
<td>Abbreviation</td>
<td>Description</td>
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<tr>
<td>NRI</td>
<td>Non-Resident Indian</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<td>ODI</td>
<td>Optionally Convertible Debenture</td>
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<td>OHC</td>
<td>Offshore Derivative Instruments</td>
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<td>PAN</td>
<td>Permanent Account Number</td>
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<td>P-Notes</td>
<td>Participatory Notes</td>
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<td>PD</td>
<td>Private Debt</td>
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<td>PE</td>
<td>Private Equity</td>
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<td>PIO</td>
<td>Person of Indian Origin</td>
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<td>PIPE</td>
<td>Private Investment into Public Equity</td>
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<td>Portfolio Investment Scheme</td>
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<td>Qualified Foreign Investor</td>
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<td>Representation and Warranties Insurance</td>
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<td>Reserve Bank of India</td>
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<td>Real Estate Investment Trust</td>
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<td>RoE</td>
<td>Return on Equity</td>
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<td>Rs./INR</td>
<td>Rupees</td>
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<td>Securities and Exchange Board of India</td>
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<td>SGD</td>
<td>Singapore Dollar</td>
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<td>SRA</td>
<td>The Specific Relief Act, 1963</td>
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<td>Short Term Capital Gains</td>
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<td>Securities Transaction Tax</td>
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<td>Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000</td>
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<td>TRC</td>
<td>Tax Residency Certificate</td>
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<td>UN</td>
<td>United Nations</td>
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<td>USD</td>
<td>United States Dollar</td>
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1. Introduction

India witnessed an increase in the number and size of PE investments made in 2014 aggregating to around $11.5 billion, which is 17% higher in terms of the total investment value as compared to the same period last year. E-commerce (led by Flipkart with two major rounds of funding) followed by financial services, power, energy and engineering sectors drove most of the activity with renewed interest in real estate sector as well. Last year we saw as many as 221 exits (including part-exit) amounting to around $3.8 billion. Following are some of transaction trends/issues that gained significance in 2014, and which may be talked about more in 2015:

I. Withholding Taxes

Notwithstanding the fact that the seller was an eligible tax resident of Mauritius or Singapore or other treaty jurisdiction, buyers in almost all secondary transactions insisted on withholding full capital gains taxes, and typically negotiated for a host of alternatives such as NIL withholding certificate, tax escrow, tax insurance, tax opinions and specific tax indemnities. With tax insurance not being available in all cases, deals were seen being done typically on the back of tax opinion and tax indemnity. Please see our article on such safeguards. The Budget 2015 has not given any clarity and to that extent such challenges will continue.

II. General Anti-Avoidance Rules ("GAAR")

The 2015 budget has further deferred GAAR by another 2 years i.e. GAAR will now be applicable from April 1, 2017. Further, it has also been proposed to grandfather investments made upto March 31, 2017 and make GAAR applicable prospectively, i.e. to investments made only after April 1, 2017. The Memorandum to the Finance Bill, 2015 states that keeping in mind the Base Erosion and Profit Shifting ("BEPS") project under Organization of Economic Cooperation and Development is continuing and India is an active participant in the project, it would be proper that GAAR provisions are implemented as part of a comprehensive regime to deal with BEPS and aggressive tax avoidance. The deferral of the GAAR provisions is definitely a huge positive for the investment community. We have analyzed the effect of GAAR in detail.

III. Companies Act, 2013

2014 also saw the implications of the new Companies Act, 2013 ("CA Act 2013") replacing the Companies Act 1956 ("CA Act 1956") as majority of provisions of the 2013 Act were notified only in 2014. As of this date, 1956 Act has not been completely repealed and some of the major portions continue to be in force along with the provisions of the CA Act 2013. We have analysed the changes brought in by the CA Act 2013 in detail. Some of the important provisions of the CA Act 2013 which gained significance last year are:

A. Directors’ liability

For the first time ever, the duties of the directors have been codified and a monetary punishment has been prescribed in case the directors act in contravention of their prescribed duties. Further, under the CA Act 2013, any director who becomes ‘aware’ of any contravention of the provisions of the CA Act 2013 by way of his participation in the board meeting or receipt of information under any proceedings etc. but does not object to such contravention is termed as an officer in default and the concerned director is subject to the punishment prescribed under the CA Act 2013. Such liability also extends to the non-executive directors in addition to the executive directors. Notification of these provisions last year made the investors re-think about the board position, and many investors in practice appointed an observer even when they had a right to appoint a director. Directors and Officers Liability Insurance (D&O Insurance) was seen as a necessity, even though in some cases such insurance has been found to be inadequate.

B. Insider Trading

Insider trading provisions do exist for listed companies and very recently the Securities Exchange Board of India (“SEBI”) has notified the new regulations. However, the CA Act 2013 has also introduced an insider trading provision, which in addition to public listed companies, also applies to unlisted companies (whether public or private). We have analysed the new insider trading regulations.6

C. Voting Arrangements

Under CA Act 1956, concept of different classes of shares i.e. equity shares and preference shares was not applicable to private companies, and hence such companies were allowed to issue shares (whether equity or preference) with differential rights. For instance, preference shares with voting rights on as if converted basis, etc. However under the CA Act 2013, (i) the provision relating to different classes of shares has been made applicable to both private and public companies; (ii) no separate exemption has been provided to private companies for the issuance of shares (whether equity or preference) with differential rights; and (iii) it has been specifically provided that preference shares cannot have voting rights; therefore, private companies now cannot issue preference shares with voting rights. Since, preference shares continue to be the preferred instrument of investment because of certain other benefits such as better enforcement of anti-dilution and liquidation preference, we have seen more voting rights arrangements being entered into between the shareholders, to give effect to the commercials.

IV. Representation and Warranties Insurance (“R&W Insurance”)

R&W insurance gained popularity in 2014, especially in secondaries between PE players. Since in such deals, (i) the original promoter or the company may not directly benefit, (ii) the selling investor is typically not involved in the day to day management of the company, and (iii) the selling investor is not in a position to give business related warranties, R&W Insurance was seen as an important risk and liability mitigation tool at a rather reasonable premium. This also is the case, where the fund life of the selling investor is going to end soon. The costs for such R&W Insurance could be borne completely by the seller, or shared between the buyer and the seller. In cases where the promoter may not have the financial wherewithal to honor his / its representations and warranties, R&W Insurance offered an ideal prospect in deal making.

V. Structured Debt Transactions

Structured debt, mostly listed non-convertible debentures with payable-when-able structures or variable-linked-coupon structures gained credence in 2014 as well. Such structures were also seen in promoter funding structures where the promoter entity (i) issues structured debt to acquire shares in their listed company with the return on these debt instruments linked to performance of the listed stock with some downside protection. As these are debt instruments, PE investors derived comfort from: (i) guaranteed returns plus equity upside depending upon the company’s EBITDA, stock prices, cash flows, etc.; and (ii) security creation in the form of mortgage, pledge, guarantee etc. For the promoters, such instruments offered tax optimization without equity dilution.

VI. RBI’s Timeline for Regulatory Approval

In July last year, RBI came out with certain timelines for different kinds of regulatory approvals. Under these timelines, RBI has made its departments answerable in case they exceed the prescribed timeline. The investor community and other stakeholders have always been apprehensive about approaching any regulatory body for any approval and therefore the transactions were typically structured in a way to avoid the requirement of any approvals, at times, by even letting go of certain rights. This was because, in most cases, the regulatory bodies instead of opining on the application would just hold on, leading to unnecessary delays in the project. But now with the RBI’s ‘Timelines for Regulatory Approvals’, the stakeholders would have more certainty from a timeline perspective, and hence they will be more forthcoming in approaching them for the approvals.

VII. Shareholder Activism

Shareholder activism has slowly gathered pace in India. Several big conglomerates last year faced the ire of minority shareholders who rejected their various resolutions like setting up of a subsidiary company, related party transactions, increase in the remuneration of the top executives and disposal of an undertaking of a company. Some reports suggest that the instances of shareholder activism in India are highest in Asia. Advent of shareholder activism in India is a welcome change and is being appreciated by global investors as it brings transparency in the system and also helps the minority shareholders to raise their concerns directly with the top management of the company. It also ensures that the interest of the various investors, be it small retail investors or an institutional investor is safeguarded at all times and the companies provide detailed rationale for each resolution proposed and also to address the perceptual issues as well. While shareholder activism may bring in more transparency into the system, if misused it can also lead to hampering of the decision making process in the company.

X. Externalisation

Externalization, or setting up of offshore holding companies for Indian assets, continued to attract both private equity players and their portfolio companies, especially in the tech space. Some of the major reasons for doing so include tax benefits at the time of exit, avoiding Indian exchange control issues, mitigating currency fluctuation risk, better enforceability of rights, etc. For a more detailed analysis on ‘externalisation’, please refer to our hotline.11

XI. Depository Receipts (“DRs”)

Ministry of Finance allowed issuance of ADRs / GDRs both sponsored and unsponsored by unlisted companies in India. This allowed for Indian companies to tap global capital markets without first going public in India considering that only a handful of Indian companies went public in 2014. DRs also allow a tax optimized entry and exit route for private equity to invest in Indian companies. Please refer to our article on DRs for a detailed analysis.12

VIII. Diligence

2014 witnessed investors conducting more stringent background checks on the promoters and key managerial personnel. Forensic audits and anti-corruption / anti-bribery compliances gained increased importance.9

IX. Entry and Exit Facilitation

RBI relaxed the discounted cash flows based pricing for entry and exits to a more liberal internationally accepted pricing methodology. Put options (common mode of exit in certain asset classes like real estate) were legitimised.10 Capital account controls were also relaxed to allow for partly paid shares and warrants, which were quite helpful in structuring foreign investments within the convoluted and stringent Indian regulatory framework.

7. http://www.ft.com/cms/s/0/3f0aa396-7ba7-11e4-b6ab-00144feabdc0.html#axzz3OaSRBnji
8. ibid
2. Private Equity Investments

Foreign investments into India are primarily monitored by the Reserve Bank of India ("RBI"), the Foreign Investment Promotion Board ("FIPB") and the Department of Industrial Policy and Promotion ("DIPP"), an instrumentality of the Ministry of Commerce & Industry. In addition to these, the Securities and Exchange Board of India ("SEBI") regulates the dealings in securities that are listed or offered to the public.

The Foreign Exchange Management Act, 1999 ("FEMA") and the rules framed therein, in particular, the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 ("TISPRO Regulations") regulate foreign investment into India.

Foreign investment into India can be broadly made through either of the following regimes:

i. Foreign Direct Investment ("FDI");
ii. Foreign Venture Capital Investment regime, for investments made by SEBI registered Foreign Venture Capital Investors ("FVCI"); and
iii. Foreign Portfolio Investor regime, for investments made by registered Foreign Portfolio investor ("FPI").

I. FDI Regime

FDI in India is mainly governed by the TISPRO Regulations. The DIPP and the RBI used to make policy pronouncements on foreign investment through Press Notes / Press Releases / Circulars. These Press Notes / Press Releases / Circulars were notified by the RBI as amendments to the TISPRO Regulations. Unless otherwise specified, the Press Notes / Press Releases / Circulars were effective from the date of their issue.

In order to bring clarity and certainty in the policy framework, the DIPP for the first time issued a consolidated policy relating to FDI in India on April 1, 2010, which subsumed and superseded all the previous Press Notes / Press Releases / Clarifications / Circulars issued by DIPP. The DIPP now revises the FDI Policy annually and the latest policy is dated May 12, 2015 ("FDI Policy").

However, the Finance Bill 2015 ("Bill") now seeks to shift the power to regulate non debt capital account transactions from the fold of RBI to the Central Government, limiting the powers of RBI to only capital account transactions involving debt instruments.

It appears that this change has been introduced as capital account controls is a policy issue and not a regulatory matter. Practically too, since, the DIPP used to make policy pronouncements on FDI through Press Notes/Press Releases which were then notified by the RBI as amendments to the TISPRO Regulations, this change is a positive move as it removes multiple regulators for the same matter, and obviates the need for an amendment to TISPRO Regulations by RBI for a foreign investment related policy decision.

A. FDI into Indian Companies is regulated as below

i. Prohibited Sectors - There are some sectors where FDI is prohibited, including

   i. Atomic Energy
   ii. Lottery business
   iii. Gambling and betting
   iv. Manufacturing of cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes

ii. Sectors under Automatic Route

Under the automatic route, for investments into an Indian company (carrying on business in the specified sectors that are identified as under ‘automatic route’) prior approval of India’s central bank, RBI or the approval of the Central Government (through FIPB) is not required.

a. Sectors under automatic route with 100% FDI

FDI, up to 100%, is permitted in most sectors in India under the ‘automatic route’.

b. Sectors under automatic route with thresholds

In few sectors, which are under the automatic route, foreign investment cannot exceed specified limits. Sectors with such limits are:

   a. Commodity Exchanges (49%)
iii. Sectors under Government Approval Route

There are some sectors where FDI is allowed only with the approval of the Central Government. Some of them are:

i. Defence — Approval of the Central Government is required for investment up to 26%. For investment above 26% approval of Cabinet Committee on Security will be required.

ii. Tea sector including tea plantations (investment can be made up to 100% with approval of the Central Government)

iii. Air transport services (approval required for foreign investment which is limited to 49%)

iv. Multi brand retail trading (approval required for foreign investment which is limited to 51%)

v. Other Conditions

Further, certain sectors and businesses in India have minimum capitalization norms for a foreign investor intending to invest in these sectors and the foreign investor must invest at least a minimum prescribed amount. These sectors include:

i. Non-Banking Financial Services

ii. Development of townships, housing, built up infrastructure and construction development projects.

In addition to the prescription on investment amount, for few sectors, the FDI norms also contain additional terms and conditions that are required to be complied with by the foreign investor. For example, with respect to single brand retail the following conditions should also be satisfied:

i. Products to be sold should be of a ‘single brand’ and the products should be sold under the same brand internationally;

ii. If the FDI is proposed to be beyond 51% then sourcing of 30% of the value of the goods purchased should be done from India.

Recent changes in the FDI regime include permitting foreign equity participation in multi brand retail, up to 51% with government permission. Such permission will be subject to certain conditions, such as:

i. Minimum amount of USD 100 million to be invested by the foreign investor

ii. 50% of the total FDI in the first tranche to be invested in the backend infrastructure within 3 years

iii. Retail sales outlets may be set up in those States which have agreed or agree in future to allow FDI in multi brand retail trade

iv. 30% mandatory local sourcing requirement from Indian micro, small, medium industries which have a total investment in plant and machinery not exceeding USD 2 million.

However, foreign investment in e-commerce (single brand retail and multi brand retail) is not permitted under the current FDI regime.

B. Downstream Investment

FDI into Indian companies may be direct or indirect and FDI norms apply to both direct and indirect foreign investments into an Indian company. In case of direct investment, the non-resident investor invests directly into an Indian company.

Indirect FDI is referred to as the downstream
Further, downstream investment made by a 100% foreign owned and/or controlled banking company as a result of any loan structuring scheme, in trading books or acquisition of shares as a result of default in loan, will also not be considered as indirect foreign investment.

C. Instruments for FDI

Under the FDI regime, investment can only be made into equity shares, fully and compulsorily convertible preference shares ("CCPS") and fully and compulsorily convertible debentures ("CCD"). Instruments which are not fully and mandatorily convertible into equity are considered to be external commercial borrowing ("ECB") and therefore, are governed by ECB regime. Also, any such instrument having a ‘put option’ in favour of a non-resident shall not be FDI compliant unless in consonance with the conditions laid down by RBI.

Please refer to Annexure I for a detailed analysis on put options.

Herein below is a table setting out a brief comparative analysis for equity, CCPS and CCD:

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Equity</th>
<th>CCPS</th>
<th>CCD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic Character</td>
<td>Participation in governance and risk based returns</td>
<td>Fixed dividend – convertible into equity</td>
<td>Assured coupon – convertible into equity</td>
</tr>
<tr>
<td>Returns</td>
<td>Dividend may be declared out of profits of the company</td>
<td>Fixed or variable interest coupon - not dependent on profits</td>
<td></td>
</tr>
<tr>
<td>Limits to Payment</td>
<td>No cap on dividend</td>
<td>Dividend on CCPS cannot exceed 300 basis points over and above the prevailing State Bank of India prime lending rate at the time of issuance. CCPS is issued. No legal restriction on interest on CCD, however in practice it is benchmarked to CCD limits.</td>
<td></td>
</tr>
<tr>
<td>Tax Implication</td>
<td>No tax deduction in the hand of investee company; Dividend payable from post-tax income and an additional Dividend Distribution Tax of 15% levied on the company making distributions</td>
<td>Interest expense deductible – Withholding tax as high as 40% but it can be reduced to 10% if investment done from favourable jurisdiction</td>
<td></td>
</tr>
<tr>
<td>Statutory Liquidation Preference</td>
<td>CCD ranks higher than CCPS in terms of liquidation preference. Equity gets the last preference. However, liquidation preference may be fixed contractually</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Others</td>
<td>Buy-back or capital reduction permissible. For tax implications refer to Chapter 4</td>
<td></td>
<td>CCDs need to be converted to equity before they can be bought back or extinguished by the Indian company</td>
</tr>
</tbody>
</table>

---

D. Pricing Requirements

FEMA also regulates the entry and exit price of investments made under the FDI regime. The pricing requirements are different for companies having their shares listed and unlisted.

For unlisted companies, the price at which foreign direct investor subscribes / purchases the equity shares from a person resident in India shall not be lower than the price computed by any internationally accepted pricing methodology ("Fair Value") as calculated by a chartered accountant or a merchant banker registered with SEBI. However, this Fair Value does not apply in case the foreign investor is subscribing to the memorandum of the company or purchasing the shares of Indian company from another non-resident. Similar Fair Value pricing applies in case the non-resident exits through exercise of put option in favour of a resident.

In case of the transfer of equity shares from a non-resident to a resident, such transfer shall not be effected at a price higher than the Fair Value.

For listed companies, the price at which the foreign investor subscribes / purchases the shares from a person resident in India shall not be lower than the price at which the preferential allotment of shares can be made under the SEBI guidelines ("Preferential Allotment Price"), which is currently higher of the following:

i. The average of the weekly high and low of the closing prices of the related equity shares quoted on the recognised stock exchange during the six months preceding the relevant date (which shall be the date of purchase or sale of shares); or

ii. The average of the weekly high and low of the closing prices of the related equity shares quoted on a recognised stock exchange during the two weeks preceding the relevant date.

Similarly, when the non-resident transfers the shares of listed company to a resident, the Preferential Allotment Price becomes the ceiling price.

Please note the consideration for the subscription / purchase has to be brought into India prior to or at the time of allotment / purchase of shares to / by the foreign investor. Any deferred consideration shall require regulatory approval.

II. FVCI Regime

SEBI introduced the SEBI (Foreign Venture Capital Investors) Regulations, 2000 ("FVCI Regulations") to encourage foreign investment into venture capital undertakings. The FVCI Regulations make it mandatory for an offshore fund to register itself with SEBI if such fund intends to avail of benefits under the FVCI regime.

A. FVCIs have the Following Benefits

i. Free Pricing

The entry and exit pricing applicable to FDI regime do not apply to FVCIs. To that extent, FVCIs can subscribe, purchase or sell securities at any price.

ii. Instruments

Unlike FDI regime where investors can only subscribe to only equity shares, CCDs and CCPS, FVCIs can also invest into Optionally Convertible Redeemable Preference Shares ("OCRPS"), Optionally Convertible Debentures ("OCDs"), even Non-Convertible Debenture ("NCDs") and Non-Convertible Preference Shares ("NCPS").

iii. Lock-in

Under the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 ("ICDR Regulations") the entire pre-issue share capital (other than certain promoter contributions which are locked in for a longer period) of a company conducting an initial public offering ("IPO") is locked for a period of 1 year from the date of allotment in the public issue. However, an

16. RBI clarified in its A.P. (DIR Series) Circular No. 36 dated September 26, 2012, that shares can be issued to subscribers (both non-residents and NRIs) to the memorandum of association at face value of shares subject to their eligibility to invest under the FDI scheme. The DIPP inserted this provision in the FDI Policy, providing that where non-residents (including NRIs) are making investments in an Indian company in compliance with the provisions of the Companies Act, 1956, by way of subscription to its Memorandum of Association, such investments may be made at face value subject to their eligibility to invest under the FDI scheme. This addition in the FDI Policy is a great relief to non-resident investors (including NRIs) in allowing them to set up new entities at face value of the shares and in turn reduce the cost and time involved in obtaining a DCF valuation certificate for such newly set up companies.

17. Venture capital undertaking means a domestic company: t¬ (i) whose shares are not listed in a recognised stock exchange in India; (ii) which is engaged in the business of providing services, production or manufacture of articles or things, but does not include such activities or sectors which are specified in the negative list by the Board, with approval of Central Government, by notification in the Official Gazette in this behalf.
exemption from this requirement has been granted to registered FVCIs, provided, the shares have been held by them for a period of at least 1 year as on the date of filing the draft prospectus with the SEBI. This exemption permits FVCIs to exit from investments immediately post-listing.

iv. Exemption under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 Takeover Code (“Takeover Code”)

SEBI has also exempted promoters of a listed company from the public offer provisions in connection with any transfer of shares of a listed company, from FVCIs to the promoters, under the Takeover Code.

v. QIB Status

FVCIs registered with SEBI have been accorded qualified institutional buyer (“QIB”) status and are eligible to subscribe to securities at an IPO through the book building route.

vi. FII sector restrictions are not applicable to FVCIs

However, the RBI while granting the permission/certificate mandates that an FVCI can only invest in the following sectors, viz. infrastructure sector, biotechnology, IT related to hardware and software development, nanotechnology, seed research and development, research and development of new chemical entities in pharma sector, dairy industry, poultry industry, production of bio-fuels and hotel-cum-convention centers with seating capacity of more than three thousand.

III. FPI Regime

On January 7, 2014, SEBI introduced the SEBI (Foreign Portfolio Investment) Regulation 2014 (“FPI Regulations”). FPI is the portfolio investment regime. The Foreign Institutional Investor (“FII”) and Qualified Foreign Investor (“QFI”) route have been subsumed into the FPI regime. Exiting FIs, or sub-account, can continue, till the expiry of the block of three years for which fees have been paid as per the SEBI (Foreign Institutional Investors) Regulations, 1995, to buy, sell or otherwise deal in securities subject to the provisions of these regulations. However, FII or sub-account shall be required to pay conversion fee of USD 1,000\(^{18}\) on or before the expiry of its registration for conversion in order to buy, sell or otherwise deal in securities under the FPI Regulations. In case of QFIs, they may continue to buy, sell or otherwise deal in securities subject to the provisions of these regulations, for a period of one year from the date of commencement of FPI Regulations, or until he obtains a certificate of registration as FPI, whichever is earlier. Under the new regime SEBI has delegated the power to designated depository participants (“DDP”) who will grant the certificate of registration to FPIs on behalf of SEBI.

A. Categories

Each investor shall register directly as an FPI, wherein the FPIs have been classified into the following three categories on the basis of risk-based approach towards know your customer.

i. Category I FPI

Category I includes Government and government-related investors such as central banks, Governmental agencies, sovereign wealth funds or international and multilateral organizations or agencies.

ii. Category II FPI

Category II includes the following:

i. Appropriately regulated broad based funds;

ii. Appropriately regulated persons;

iii. Broad-based funds that are not appropriately regulated but their managers are regulated;

iv. University funds and pension funds; and

v. University related endowments already registered with SEBI as FIs or sub-accounts.

The FPI Regulations provide for the broad-based criteria. To satisfy the broad-based criteria two conditions should be satisfied. Firstly, fund should have 20 investors even if there is an institutional investor. Secondly, both direct and underlying investors i.e. investors of entities that are set up for the sole purpose of pooling funds and making investments shall be counted for computing the number of investors in a fund.

\(^{18}\) Specified in Part A of the Second Schedule of the FPI Regulations
iii. Category III FPI

Category III includes all FPIs who are not eligible under Category I and II, such as endowments, charitable societies, charitable trusts, foundations, corporate bodies, trusts, individuals and family offices.

B. Investment Limits

The FPI Regulations state that a single FPI or an investor group shall purchase below ten percent of the total issued capital of a company.

Under the FPI Regulations, ultimate beneficial owners investing through the multiple FPI entities shall be treated as part of the same investor group subject to the investment limit applicable to a single FPI, with no investor holding more than forty-nine per cent of the shares or units of the fund.

C. ODIs / P Note

An offshore derivative instrument ("ODIs") means any instrument, by whatever name called, which is issued overseas by a foreign portfolio investor against securities held by it that are listed or proposed to be listed on any recognised stock exchange in India, as its underlying units Participatory Notes ("P-Notes") are a form of ODIs.\(^{19}\)

P-notes are, by definition a form of ODI including but not limited to swaps\(^{20}\), contracts for difference\(^{21}\), options\(^{22}\), forwards\(^{23}\), participatory notes\(^{24}\), equity linked notes\(^{25}\), warrants\(^{26}\), or any other such instruments by whatever name they are called.

Below is a diagram that illustrates the structure of an ODI.

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**Fig 1: Investment through ODIs.**

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19. Section 2(3)(j) of the FPI Regulations

20. A swap consists of the exchange of two securities, interest rates, or currencies for the mutual benefit of the exchangers. In the most common swap arrangement one party agrees to pay fixed interest payments on designated dates to a counterparty who, in turn, agrees to make return interest payments that float with some reference rate.

21. An arrangement made in a futures contract whereby differences in settlement are made through cash payments, rather than the delivery of physical goods or securities. At the end of the contract, the parties exchange the difference between the opening and closing prices of a specified financial instrument.

22. An option is a financial derivative that represents a contract sold by one party to another party. It offers the buyer the right, but not the obligation, to call or put a security or other financial asset at a certain price during a certain period of time or on a specific date.

23. A forward contract is a binding agreement under which a commodity or financial instrument is bought or sold at the market price on the date of making the contract, but is delivered on a decided future date. It is a completed contract – as opposed to an options contract where the owner has the choice of completing or not completing.

24. Participatory notes (P-notes) are a type of offshore derivative instruments more commonly issued in the Indian market context which are in the form of swaps and derive their value from the underlying Indian securities.

25. An Equity-linked Note is a debt instrument whose return is determined by the performance of a single equity security, a basket of equity securities, or an equity index providing investors fixed income like principal protection together with equity market upside exposure.

26. A Warrant is a derivative security that gives a holder the right to purchase securities from an issuer at a specific price within a certain time frame.
The position of the holder of an ODI is usually that of an unsecured counterparty to the FPI. Under the ODI (the contractual arrangement with the issuing FPI), the holder of a P-note is entitled only to the returns on the underlying security with no other rights in relation to the securities in respect of which the ODI has been issued. ODIs have certain features that prevent the holder of such instruments from being perceived as the beneficial owner of the securities. These features include the following aspects: (i) whether it is mandatory for the FPI to actually hedge its underlying position (i.e. actually “hold” the position in Indian securities), (ii) whether the ODI holder could direct the voting on the shares held by the FPI as its hedge, (iii) whether the ODI holder could be in a position to instruct the FPI to sell the underlying securities and (iv) whether the ODI holder could, at the time of seeking redemption of that instrument, seek the FPI to settle that instrument by actual delivery of the underlying securities. From an Indian market perspective, such options are absent considering that the ownership of the underlying securities and other attributes of ownership vest with the FPI. Internationally, however, there has been a precedence of such structures, leading to a perception of the ODI holder as a beneficial owner – albeit only from a reporting perspective under securities laws.30

The FPI Regulations provide that Category I FPIs and Category II FPIs (which are directly regulated by an appropriate foreign regulatory authority) are permitted to issue, subscribe and otherwise deal in ODIs.28 However, those Category II FPIs which are not directly regulated (which are classified as Category-II FPI by virtue of their investment manager being appropriately regulated) and all Category III FPIs are not permitted to issue, subscribe or deal in ODIs.

On November 24, 2014, SEBI issued a circular1 (“Circular”) aligning the conditions for subscription of offshore derivative instruments (“ODIs”) to those applicable to FPIs. The Circular makes the ODI subscription more restrictive. As per the Circular, read with the FPI Regulations, to be eligible to subscribe to ODI positions, the subscriber should be regulated by a BIS member regulator.

Further, the Circular states that an FPI can issue ODIs only to those subscribers who meet certain eligibility criteria mentioned under regulation 4 of the FPI Regulations (which deals with eligibility criteria for an applicant to obtain registration as an FPI) in addition to meeting the eligibility criteria mentioned under regulation 22 of the FPI Regulations. Accordingly, ODIs can now only be issued to those persons who (a) are regulated by an ‘appropriate foreign regulatory authority’; (b) are not resident of a jurisdiction that has been identified by Financial Action Task force (“FATF”) as having strategic Anti-Money Laundering deficiencies; (c) do not have ‘opaque’ structures (i.e. protected cell companies (“PCCs”) / segregated portfolio companies (“SPCs”) or equivalent structural alternatives); and (d) comply with ‘know your client’ norms.

The Circular further requires that multiple FPI and ODI subscriptions belonging to the same investor group would be clubbed together for calculating the below 10% investment limit.

The existing ODI positions will not be affected by the Circular until the expiry of their ODI contracts. However, the Circular specifies that there will not be a rollover of existing ODI positions and for any new ODI positions, new contracts will have to be entered into, in consonance with the rules specified in the Circular.29

FPIs shall have to fully disclose to SEBI any information concerning the terms of and parties to ODIs entered into by it relating to any securities listed or proposed to be listed in any stock exchange in India (Fig 1).

Please refer to our research paper ‘Offshore Derivate Instruments: An Investigation into Tax Related Aspects’30, for further details on ODIs and their tax treatment.

27. CSX Corporation v. Children’s Investment Fund Management (UK) LLP. The case examined the total return swap structure from a securities law perspective, which requires a disclosure of a beneficial owner from a reporting perspective.

28. Reference may be made to Explanation 1 to Regulation 5 of the FPI Regulations where it is provided that an applicant (seeking FPI registration) shall be considered to be “appropriately regulated” if it is regulated by the securities market regulator or the banking regulator of the concerned jurisdiction in the same capacity in which it proposes to make investments in India.

29. http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/sebi-rewrites-rules-on-offshore-derivative-instruments-odi.html?no_cache=1&cHash=60c81c4a0fcc1c1ffbbe8d1a8e5e2e5b

3. Private Debt Investments

Private debt investments are becoming increasingly popular in India. Private debt is usually in the form of structured debt instruments customized to suit the needs of the borrower. These instruments may either take the form of listed NCDs (subscribed to under the FPI route) or redeemable debentures or shares (subscribed to under the FVCI route, subject to the sector limitation for the FVCIs). Private debt can be structured in the manner that is commercially best suited – with a coupon that is payable annually, or a coupon that is paid only upon cash flows in the company, or any other trigger event. The amount of coupon payable can also be a function of underlying equity price, EBITDA or any other commercially agreed variable. Since the coupon paid is a deductible for the investee company, and in many ways the instrument works more as a form structured equity than structured debt, private debt is quickly gaining ground in the Indian context.

To summarize, private debt offers the following benefits:

A. Tailored Financing

Unlike Indian banks, which may be unable to tinker with their financial terms and are generally averse to advance loans to few sectors such as software, biotechnology, real estate etc. Private debt would not only offer highly tailored solutions (such as longer coupon moratoriums, profit linked coupons etc.) but would also cater to niche industry segments where banks may be apprehensive to lend, or may have significantly higher exposure limits.

B. Tax Optimization

Private debt offers tax optimization to the investee company since any coupon paid on the debt is a deductible for the Indian company. Not only does this result in a saving of 30% corporate income tax for the investee company, it also saves the 15% dividend distribution tax (“DDT”) as set out in the table later. Unlike DDT, which may not be creditable against the domestic taxes in the home jurisdiction of the investor, foreign tax credit is usually available against the withholding tax paid on the coupon in India.

C. Structured Transaction

Return of capital is a huge challenge in case of equity or instruments mandatorily convertible into equity. However, with private debt investors can structure their investment as quasi-debt or quasi-equity or both and wherein they have an option to protect their downside and to link their upside to the profits, share price, EBITDA of the investee company.

D. Security Creation

Private debt allows the investee company to create security interest on the assets of the company or the shares of the founders. Security is created in favour of a local security trustee that would act on the instructions of the debenture holders. Security creation would not be permissible if the instrument for FDI investments or investments where the instrument is either equity or mandatorily convertible into equity.

Some of the benefits of private debt vis-a-vis through PE in the Indian context are set out in the table below:

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Particulars</th>
<th>Private debt</th>
<th>Private equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Assured returns</td>
<td>Investors are eligible for assured returns on their investment through interest and redemption premium, both of which can be legally assured.</td>
<td>Returns on PE investments cannot be assured. Put Options are not looked at favorably and will be subject to the conditionalities as set out in this paper.</td>
</tr>
<tr>
<td>2.</td>
<td>Capital repatriation</td>
<td>Capital can be fully repatriated.</td>
<td>Repatriation of capital limited to buy-back or reduction of capital and subject to the conditionalities as set out later in this paper.</td>
</tr>
<tr>
<td>3.</td>
<td>Tax benefits</td>
<td>Interest payments are a deductible expense of the borrower.</td>
<td>Dividend payment and buyback are taxed at the hands of the investee company at 15% or 20% respectively in addition to corporate tax of 30%. Hence, foreign tax credit against such tax paid in India may not be available.</td>
</tr>
</tbody>
</table>
In India, private debt investment can be currently made through either FPI regime or FVCI regime.

I. FVCI Regime

Under Schedule VI of the TISPRO Regulations and the FVCI Regulations, FVCIs can invest, *inter alia*, in NCDs and OCDs of an Indian venture capital undertaking or a venture capital fund.

As discussed in the Chapter 2, investments by FVCIs are subject to certain restrictions. In addition, the FVCI Regulations specify that:

1. at least 66.67 percent of the investible funds of a FVCI shall be invested in unlisted equity shares or equity-linked instruments of venture capital undertaking; and
2. not more than 33.33 percent of the investible funds of a FVCI may be invested by way of, *inter alia*, debt or debt instrument of a venture capital undertaking in which the FVCI has already made an investment by way of equity.

II. FPI Regime

Under Schedule V of the TISPRO Regulations, read with the provisions of the FPI Regulations, FPIs are permitted to invest, *inter alia*, listed or to be listed NCDs issued by an Indian company. FPIs are permitted to hold securities only in the dematerialized form.

Currently, there is an overall limit of USD Fifty-One Billion on investment by FPIs in corporate debt, of which 90% is available on tap basis. Further, FPIs can also invest up to USD Thirty Billion in government securities.

Listing of NCDs on the wholesale debt market of the Bombay Stock Exchange is a fairly simple and straightforward process which involves the following intermediaries:

1. Debenture trustee, for protecting the interests of the debenture holders and enforcing the security, if any;
2. Rating agency for rating the non-convertible debentures (There is no minimum rating required for listing of debentures); and
3. Registrar and transfer agent ("R&T Agent"), and the depositories for dematerialization of the non-convertible debentures.

The entire process of listing can be completed in about three weeks. The typical cost of intermediaries and listing for an issue size of INR Ten Million is approximately INR One Million to INR One Million and Two Hundred Thousand.

Using the NCD structure bears certain distinct advantages over other structures:

1. Recently, RBI issued certain conditions that FPIs will be allowed to invest only in those NCDs which have a minimum residual maturity of three years and FPIs are prohibited from investing in NCDs with optionality clauses exercisable prior to 3 years. However, FPIs will not be subject to the lock-in period and shall be free to sell the NCDs even those with a maturity of less than 3 years to domestic investors;
2. Assured returns to the investor by way of interest / redemption premium, irrespective of profits of the issuer company;
3. No specified limit on interest / redemption premium;
4. Interest expense is deductible from the taxable income of the issuer company. In some cases,

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4. Sources of payment | Interest may be paid out of any source of the borrower. | Dividends can be paid out of profits only. Reduction of capital may be done without profits, but is a court driven process and subject to lender approvals

5. Security | Debt may be secured by creation of security over the assets of the borrower. | No security creation is possible to secure the investment amount or returns thereon.

6. Equity upside | Returns may be structured as interest or redemption premium and linked to cash flow, share price etc. hence achieving equity like structure with tax optimization. | Returns may be structured by way of dividends or capital reduction, both of which may be tax inefficient structures.

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31. Regulation 11 of the FVCI Regulations. These investment conditions may achieved by the FVCI at the end of its life cycle
redemption premium may also be allowed to be deducted from the taxable income of the company;
v. Security of investment by way of creation of charge on the assets of the borrower; and

vi. Cost-effective implementation.

A comparison between the key features of FPIs and FVCIs is provided below:

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Particulars</th>
<th>FPI</th>
<th>FVCI</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Registration</td>
<td>Registration with DDP is mandatory.</td>
<td>Registration with SEBI is mandatory under the FVCI Regulations.</td>
</tr>
<tr>
<td>2.</td>
<td>Investment instruments allowed</td>
<td>Listed or to-be-listed NCD of Indian companies.</td>
<td>NCD, OCD or OCRPS of Indian venture capital undertaking and/ or venture capital funds.</td>
</tr>
<tr>
<td>3.</td>
<td>Listing of securities</td>
<td>Listing is mandatory. A FPI may subscribe to to-be-listed non-convertible debentures of an Indian company. However, such non-convertible debentures are required to be listed on a recognized stock exchange within 15 days from the date of allotment.</td>
<td>Listing is not required.</td>
</tr>
<tr>
<td>4.</td>
<td>Maximum interest payable</td>
<td>No limits specified on interest payable.</td>
<td>No limits specified on interest payable.</td>
</tr>
<tr>
<td>5.</td>
<td>Sectoral restrictions</td>
<td>No sectoral restrictions – FPIs may invest in debt securities of Indian companies engaged in any sector.</td>
<td>Sectoral restrictions are present – FVCIs may invest in the infrastructure sector or in Indian venture capital undertakings as discussed in Chapter 2.</td>
</tr>
</tbody>
</table>

### III. CCD vs. NCD

Following table gives a brief comparative analysis of investment through FDI (CCDs) and FPI (NCDs) route:

<table>
<thead>
<tr>
<th>Particulars</th>
<th>CCD – FDI</th>
<th>NCD – FPI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Ownership</td>
<td>Initially debt, but equity on conversion</td>
<td>Mere lending rights; however, veto rights can ensure certain degree of control.</td>
</tr>
<tr>
<td>ECB Qualification</td>
<td>Assured returns on FDI compliant instruments may be construed as ECB.</td>
<td>Purchase of NCDs by the FPI from the Indian company on the floor of the stock exchange is expressly permitted and shall not qualify as ECB.</td>
</tr>
<tr>
<td>Coupon Payment</td>
<td>Interest pay out may be limited to SBI PLR + 300 basis points. Interest can be required to accrue and paid only out of free cash flows.</td>
<td>Arm's length interest pay out should be permissible resulting in better tax efficiency. Higher interest on NCDs may be disallowed. Interest can be required to accrue only out of free cash flows. Redemption premium may also be treated as business expense.</td>
</tr>
<tr>
<td>Pricing</td>
<td>Fair Value applicable</td>
<td>Fair Value not applicable</td>
</tr>
<tr>
<td>Security Interest</td>
<td>Creation of security interest is not permissible either on immovable or movable property</td>
<td>Listed NCDs can be secured (by way of pledge, mortgage of property, hypothecation of receivables etc.) in favor of the debenture trustee who acts for and in the interest of the NCD holders</td>
</tr>
<tr>
<td>Sectoral conditionalities</td>
<td>Only permissible for FDI compliant activities</td>
<td>Sectoral restrictions not applicable.</td>
</tr>
<tr>
<td>Equity Upside</td>
<td>Investor entitled to equity upside upon conversion.</td>
<td>NCDs are favorable for the borrower to reduce book profits or tax burden. Additionally, redemption premium can be structured to provide equity upside which can be favourable for lender since such premium may be regarded as capital gains which may not be taxed if the investment comes from Singapore.</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>No intermediaries required</td>
<td>NCD listing may cost around INR 10-15 lakh including intermediaries cost.</td>
</tr>
</tbody>
</table>
4. Tax Considerations and Evolving Structures

I. Overview of Indian Taxation System

Income tax law in India is governed by the Income Tax Act, 1961 (“ITA”). Under the ITA, individuals and entities, whether incorporated or unincorporated, if resident for tax purposes in India, shall be taxed on their worldwide income in India. Companies are held to be resident in India for tax purposes a) if they are incorporated in India; or b) if they are controlled and managed entirely in India. Therefore, it is possible for companies incorporated outside India to be considered to be resident in India if they are wholly controlled in India. Non-residents are taxed only on income arising from sources in India.

India has entered into more than 80 Double Taxation Avoidance Agreements (“DTAAs” or “tax treaties”). A taxpayer may be taxed either under domestic law provisions or the DTAA to the extent that it is more beneficial. In order to avail benefits under the DTAA, a non-resident is required to furnish a tax residency certificate (“TRC”) from the government of which it is a resident in addition to satisfying the conditions prescribed under the DTAA for applicability of the DTAA. Further, the non-resident should also file tax returns in India and furnish certain prescribed particulars to the extent they are not contained in the TRC. For the purpose of filing tax returns in India, the non-resident should obtain a tax ID in India (called the permanent account number “PAN”). PAN is also required to be obtained to claim the benefit of lower withholding tax rates, whether under domestic law or under the DTAA. If the non-resident fails to obtain a PAN, payments made to the non-resident may be subject to withholding tax at the rates prescribed under the ITA or 20%, whichever is higher.

A. Corporate tax

Resident companies are taxed at 30%. However, the Finance Minister has announced in the budget speech that the corporate tax rate would be reduced from 30% to 25% (excluding surcharge and cess) over the next four years, coupled with rationalization and removal of various exemptions and rebates.

Further, till date, a company is said to be resident in India if it is incorporated in India or is wholly controlled and managed in India. The Bill proposes moving to a more subjective test of place of effective management (“POEM”), and considers a foreign company resident in India if its POEM is in India at any time in the relevant financial year. POEM has been defined to mean “a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance made”.

Therefore, for example, in the situation described above, where an offshore company has 100% Indian resident shareholders, majority of Indian directors and one director offshore, the company could now be considered Indian resident under the POEM test. In that case, the worldwide profits of the offshore company would be taxable in India. Even if the shareholding is less than 100%, with some portion held by non-Indian investors, Indian promoters may still want ownership and management control, which could create exposure. This could impact a range of structures, including outbound investment structures by Indian business families and personal wealth/carried structures such as personal holding companies.

Non-resident companies are taxed at the rate of 40% on income derived from India, including in situations where profits of the non-resident entity are attributable to a permanent establishment in India.

B. Tax on dividends and share buy-back

Dividends distributed by Indian companies are subject to a distribution tax (DDT) at the rate of 15%, payable by the company. However, the domestic law requires the tax payable to be computed on a grossed up basis; therefore, the shareholders are not subject to any further tax on the dividends distributed to them under the ITA. An Indian company would also be taxed at the rate of 20% on gains arising to shareholders from distributions made in the course of buy-back or redemption of shares.

C. Capital gains

Tax on capital gains depends upon the holding period of a capital asset. Short term capital gains (“STCG”) may arise if the asset has been held for less than three years (or in the case of listed securities, less than one year) before being transferred; and gains arising from the transfer of assets having a longer holding period than the above are characterized as long term capital gains (“LTCG”).
LTCG earned by a non-resident on sale of unlisted securities may be taxed at the rate of 10% or 20% depending on certain considerations. LTCG on sale of listed securities on a stock exchange are exempt and only subject to a securities transaction tax (“STT”). STCG earned by a non-resident on sale of listed securities (subject to STT) are taxable at the rate of 15%, or at ordinary corporate tax rate with respect to other securities. Foreign institutional investors or foreign portfolio investors are also subject to tax at 15% on STCG and are exempt from LTCG (on the sale of listed securities). All income earned by Foreign Institutional Investors or Foreign Portfolio Investors are also treated as capital gains income. In the case of earn-outs or deferred consideration, Courts have held that capital gains tax is required to be withheld from the total sale consideration (including earn out) on the date of transfer of the securities / assets.

India has also introduced a rule to tax non-residents on the transfer of foreign securities the value of which may be substantially (directly or indirectly) derived from assets situated in India. Therefore, the shares of a foreign incorporated company can be considered to be “situated in India” and capable of yielding capital gains taxable in India, if the company’s share derives their value “substantially from assets located in India”. Please refer below for a detailed explanation on taxation of indirect transfers. However, income derived from the transfer of P-notes and ODI derive their value from the underlying Indian securities and is not considered to be income derived from the indirect transfer of shares in India because it does not constitute an ‘interest’ in the Indian securities.

Tax is levied on private companies and firms that buy/ receive shares of a private company for less than their fair market value. Therefore, where the consideration paid by a private company or firm is less than the fair market value of the shares, the purchaser would be taxed on the difference under these provisions.

D. Interest

Interest earned by a non-resident may be taxed at a rate between 5% to around 40% depending on the nature of the debt instrument. While there is a concessional withholding tax rate of 5% for interest on long term foreign currency denominated bonds availed prior to July 1, 2017, in case of rupee-denominated non-convertible debentures, there is a concessional withholding tax rate of 5% for interest paid until May, 2015, which has been extended to June, 2017 under the Bill.

E. Minimum Alternate Tax

Minimum alternate tax ("MAT") is a tax levied based on the book profits of the company, where the overall tax paid by the company is less than 18.5% of the book profits. In case of non-residents, where there is no permanent establishment in India, Courts have traditionally held that no MAT is applicable since they do not maintain their books under the Indian Companies Act. However, there have been certain decisions by the Authority for Advance Rulings2 levying MAT on FPIs even where their long term capital gains tax are not taxable in India.

The Bill has proposed to specifically exempt long term capital gains arising to FPIs from the ambit of the MAT provisions. However, ambiguity still surrounds applicability in case of other residents availing treaty benefit, particularly, on capital gains earned on exit by strategic investors in Indian companies. In fact, by specifically only referring to FPIs, the budget announcements seemed to indicate that non-residents other than those specifically exempted may be covered.

F. Tax pass through for AIFs

The Finance Minister has sought to extend pass through status to AIFs that are registered with the Securities and Exchange Board of India (SEBI) as Category I AIFs or Category II AIFs under the SEBI (Alternative Investment Funds) Regulations, 2012 (AIF Regulations).

Prior to the Finance Minister’s announcement, pass-through status was only available to Category I AIFs under the venture capital fund sub-category and venture capital funds that were registered under the erstwhile SEBI (Venture Capital Funds) Regulations, 1996 (VCF Regulations). The Bill includes a proviso to section 10(23FB) of the ITA pursuant to which Category I and Category II AIFs that are registered under the AIF Regulations will be taxed according to the new rules set forth in the newly introduced Chapter XII-FB of the ITA. Consequently, venture capital funds registered under the erstwhile VCF Regulations will continue to be eligible to claim the exemption under section 10(23FB) of the ITA in respect of income from investments in venture capital undertakings.

The Bill defines an “investment fund” to mean a fund that has been granted a certificate of registration as a Category I or a Category II AIF and provides that any income accruing or arising to, or received by, a unit-holder of an investment fund out of investments made in the investment fund shall be chargeable
to income-tax in the same manner as if it were the income accruing or arising to, or received by such person had the investments made by the investment fund been made directly by the unit-holder. In other words, the income of a unit-holder in an investment fund will take the character of the income that accrues or arises to, or is received by the investment fund.

However, the Bill contemplates that income chargeable under the head ‘Profits and gains of business and profession’ will be taxed at the investment fund level and the tax obligation will not pass through to the unit-holders. In order to achieve this, the Bill proposes to introduce two provisions:

i Section 10(23FBA) which exempts income of an investment fund other than income chargeable under the head ‘Profits and gains of business or profession’; and

ii Section 10(23FBB) which exempts the proportion of income accruing or arising to, or received by, a unit-holder of an investment fund which is of the same nature as income chargeable under the head ‘Profits and gains of business or profession’.

Where the total income of an investment fund in a given previous year (before making adjustments under section 10(23FBA) of the ITA) is a loss under any head of income and such loss cannot be, or is not wholly, set-off against income under any other head of income, the Bill allows such loss to be carried forward and set-off in accordance with the provisions of Chapter VI (Aggregation of Income and Set Off or Carry Forward of Loss). Further, the Bill provides that the loss will not pass through to the unit holders of an investment fund and accordingly, the unit holders will be precluded from off-setting their proportionate loss from the investment fund against other profits and gains that they may have accrued. This is unlike under the current rules for taxation, where a trust is regarded as being a determinate trust or where an investor’s contribution to the trust is regarded as a revocable transfer, in which case the investor retains the ability to off-set its proportionate losses against its other profits and gains.

If the income of an investment fund in a given previous year is not paid or credited to the account of its unit-holders at the end of the previous year, such income will be deemed to have been credited to the account of its unit-holders on the last day of the previous year in the same proportion in which the unit-holders would have been entitled to receive the income had it been paid in the previous year.

An important feature of the pass-through framework is the requirement to deduct tax at 10% on the income that is payable to the payee as outlined in the newly proposed section 194LBB of the ITA. In view of the rule mandating the deemed credit of income to the accounts of unit-holders, the Bill extends the requirement to deduct tax to scenarios where income is not actually paid or credited but only deemed to be credited.

A welcome move provided for in the Memorandum to the Bill is that income received by investment funds would be exempted from TDS by portfolio companies. While a separate notification would be issued in this respect, when implemented, this should be helpful in case of interest / coupon payouts by portfolio companies to such funds. Previously, it was administratively difficult for investors to take credit of the TDS withheld by portfolio companies.

While the proposed pass-through regime is a welcome development, it is not without its set of difficulties. For example, the withholding provision in its current form would apply to exempt income such as dividends and long-term capital gains on listed equity shares. Further, no clarity has been provided on whether the withholding obligation would also apply in respect of non-resident investors who are eligible to treaty benefits. While section 195(1) of the ITA casts a withholding obligation only on sums that are chargeable to tax under the provisions of the ITA, it would have been preferable if the Bill clarified that section 194LBB would not be applicable in connection with the credit of income to an investor that is eligible for treaty benefits.

II. Specific Tax Considerations for PE Investments

A. Availability of Treaty Relief

Benefits under a DTAA are available to residents of one or both of the contracting states that are liable to tax in the relevant jurisdiction. However, some fiscally transparent entities such as limited liabilities companies, partnerships, limited partnerships, etc. may find it difficult to claim treaty benefits. For instance, Swiss partnerships have been denied treaty benefits under the India-Switzerland DTAA. However, treaty benefits have been allowed to fiscally transparent entities such as partnerships, LLCs and trusts under the US and UK DTAs, insofar as the entire income of the entity is liable to be taxed in the contracting state; or if all the beneficiaries are
present in the contracting state being the jurisdiction of the entity. On the other hand, Swiss partnerships have been denied treaty benefits under the India-Switzerland.

Benefits under the DTAA may also be denied on the ground of substance requirements. For instance, the India-Singapore DTAA denies benefits under the DTAA to resident companies which do not meet the prescribed threshold of total annual expenditure on operations. The limitation on benefits ("LoB") clause under the India-Luxembourg DTAA permits the benefits under the DTAA to be overridden by domestic anti-avoidance rules. India and Mauritius are currently in the process of re-negotiating their DTAA to introduce similar substance based requirements.

B. Permanent Establishment and Business Connection

Profits of a non-resident entity are typically not subject to tax in India. However, where a permanent establishment is said to have been constituted in India, the profits of the non-resident entity are taxable in India only to the extent that the profits of such enterprise are attributable to the activities carried out through its permanent establishment in India and are not remunerated on an arm’s length basis. A permanent establishment may be constituted where a fixed base such as a place of management, branch, office, factory, etc. is available to a non-resident entity; or where a dependent agent habitually exercises the authority to conclude contracts on behalf of the offshore entity.

Under some DTAAAs, employees or personnel of the non-resident entity furnishing services for the non-resident entity in India may also constitute a permanent establishment. The recent Delhi High Court ruling in e-Funds IT Solutions/ e-Funds Corp vs. DIT laid down the following principles for determining the existence of a fixed base or a dependent agent permanent establishment:

i. The mere existence of an Indian subsidiary or mere access to an Indian location (including a place of management, branch, office, factory, etc.) does not automatically trigger a permanent establishment risk. A fixed base permanent establishment risk is triggered only when the offshore entity has the right to use a location in India (such as an Indian subsidiary’s facilities); and carries out activities at that location on a regular basis.

ii. Unless the agent is authorized to and has habitually exercised the authority to conclude contracts, a dependent agent permanent establishment risk may not be triggered. Merely assigning or sub-contracting services to the Indian subsidiary does not create a permanent establishment in India.

iii. An otherwise independent agent may, however, become a permanent establishment if the agent’s activities are both wholly or mostly wholly on behalf of foreign enterprise and that the transactions between the two are not made under arm’s length conditions.

Where treaty benefits are not available, the concept of ‘business connection’, which is the Indian domestic tax law equivalent of the concept of permanent establishment, but which is much wider and has been defined inclusively under the ITA, would apply to non-resident companies deriving profits from India.

The Bill has proposed amendments to encourage fund management activities in India – by providing that having an eligible manager in India should not create a tax presence (business connection) for the fund in India or result in the fund being considered a resident in India under the domestic ‘place of effective management’ rule.

However, while this change may be well intentioned, it employs a number of rigid criteria that would be impossible for PE funds and difficult for FPIs to satisfy:

i. No ability to “control and manage”

To qualify, the fund shall not carry on or control and manage, directly and indirectly, any business in India. It is unclear whether shareholders rights such as affirmative rights can be considered "control and management". Further, particularly in a PE/VC fund context, it is expected that the fund brings in management expertise that enables the company to grow.

ii. Broad basing requirement

The fund is required to have a minimum of 25 members who are directly/ indirectly unconnected persons. This seems similar to the broad-basing criteria applied to Category 2 FPIs and isn’t quite appropriate for PE/VC funds which may often have fewer investors. Further, there is no clarity on

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32. TS 63-HC-2014 (DEl); MANU/DE/0373/2014
whether the test will be applied on a look through basis (which could impact master-feeder structures).

iii. Restriction on investor commitment

It is required that any member of the fund, along with connected persons should not have a participation interest exceeding 10%. It has also been stated that the aggregate participation of ten or less people should be less than 50%. This would restrict the ability of the fund sponsor/anchor investor to have a greater participation. It would also have an impact on master feeder structures or structures where separate sub-funds are set up for ring fencing purposes.

iv. Fund manager cannot be an employee

The exemption does not extend to fund managers who are employees or connected persons of the fund. Further, it is not customary in industry to engage managers on a consultancy/independent basis, for reasons of risk and confidentiality, particularly in a PE/VC fund context. Therefore, this requirement is likely to be very rarely met.

C. Indirect Transfer of Shares in India

The indirect transfer tax provisions were introduced in the Finance Act, 2012 by way of Explanation 5 to Section 9(1)(i) of the ITA, “clarifying” that an offshore capital asset would be considered to have a situs in India if it substantially derived its value (directly or indirectly) from assets situated in India.

On the basis of the recommendations provided by the Shome Committee appointed by the then Prime Minister, the Bill proposes to make various amendments to these provisions which are summarized below:

i. Threshold test on substantiality and valuation

The Bill provides that the share or interest of a foreign company or entity shall be deemed to derive its value substantially from the assets (whether tangible or intangible) located in India, if on the specified date, the value of Indian assets (i) exceeds the amount of INR 10 Crores (INR 100 million); and (ii) represents at least fifty per cent of the value of all the assets owned by the company or entity. The value of the assets shall be the Fair Market Value ("FMV") of such asset, without reduction of liabilities, if any, in respect of the asset. The manner of determination of the FMV of the assets has not been prescribed in the Bill and is to be provided for in the rules.

ii. Date for determining valuation

Typically, the end of the accounting period preceding the date of transfer shall be the specified date of valuation. However, in a situation when the book value of the assets on the date of transfer exceeds by at least 15%, the book value of the assets as on the last balance sheet date preceding the date of transfer, then the specified date shall be the date of transfer. This results in ambiguity especially in cases where intangibles are being transferred.

iii. Taxation of Gains

The gains arising on transfer of a share or interest deriving, directly or indirectly, its value substantially from assets located in India will be taxed on a proportional basis based on the assets located in India vis-à-vis global assets. While the Bill does not provide for determination of proportionality, it is proposed to be provided in the rules. It would be necessary to ensure that only the value of the Indian assets is taxed in India. It is important to address the cost adjustment, if at a later point in time, the Indian assets are transferred. For example, if an offshore company derives substantial value from Indian company shares held by it, and tax is paid on transfer of the offshore company on account of the value derived from India, will there be a step up in cost basis if the shares of the Indian company are subsequently transferred?

Exemptions

The Bill also provides for situations when this provision shall not be applicable. These are:

i. Where the transferor of a shares or interest in a foreign entity, along with its related parties does not hold (i) the right of control or management; and (ii) the voting power or share capital or interest exceeding 5% of the total voting power or total share capital in the foreign company or entity directly holding the Indian assets (Holding Co).

ii. In case the transfer is of shares or interest in a foreign entity which does not hold the Indian assets directly, then the exemption shall be available to the transferor if it along with related parties does not hold (i) the right of management or control in relation to such company or the entity; and (ii) any rights in such company which
would entitle it to either exercise control or management of the Holding Co or entitle it to voting power exceeding 5% in the Holding Co.

Therefore, no clear exemption has been provided to portfolio investors as even the holding of more than 5% interest could trigger these provisions. This is a far cry from the 26% holding limit which was recommended by the Committee. Further, no exemption has been provided for listed companies, as was envisaged by the Committee.

iii. In case of business reorganization in the form of demergers and amalgamation, exemptions have been provided. The conditions for availing these exemptions are similar to the exemptions that are provided under the ITA to domestic transactions of a similar nature.

D. General Anti-Avoidance Rule

India has introduced general anti-avoidance rules (“GAAR”) which provide broad powers to tax authorities to deny a tax benefit in the context of ‘impermissible avoidance agreements’, i.e., structures (set up subsequent to August 30, 2010) which are not considered to be bona fide or lack commercial substance. GAAR was supposed to be made applicable and implemented from April 1, 2015.

The 2015 budget has further deferred GAAR by another 2 years i.e GAAR will now be applicable from April 1, 2017. Further, it has also been proposed to grandfather investments made up to March 31, 2017 and make GAAR applicable prospectively, i.e. to investments made only after April 1, 2017. The Memorandum to the Finance Bill, 2015 states that keeping in mind the Base Erosion and Profit Shifting (“BEPS”) project under Organization of Economic Cooperation and Development is continuing and India is an active participant in the project, it would be proper that GAAR provisions are implemented as part of a comprehensive regime to deal with BEPS and aggressive tax avoidance.

The deferral of the GAAR provisions is definitely a huge positive for the investment community. It is further hoped that as and when the revised provisions are introduced, they would be in line with the global practices.

E. Transfer Pricing Regulations

Under the Indian transfer pricing regulations, any income arising from an “international transaction” is required to be computed having regard to the arm’s length price. There has been litigation in relation to the mark-up charged by the Indian advisory company in relation to services provided to the offshore fund / manager. In recent years, income tax authorities have also initiated transfer pricing proceedings to tax foreign direct investment in India. In some cases, the subscription of shares of a subsidiary company by a parent company was made subject to transfer pricing regulations, and taxed in the hands of the Indian company to the extent of the difference in subscription price and fair market value.

F. Withholding Obligations

Tax would have to be withheld at the applicable rate on all payments made to a non-resident, which are taxable in India. The obligation to withhold tax applies to both residents and non-residents. Withholding tax obligations also arise with respect to specific payments made to residents. Failure to withhold tax could result in tax, interest and penal consequences. Therefore, often in a cross-border the purchasers structure their exits cautiously and rely on different kinds of safeguards such as contractual representations, tax indemnities, tax escrow, nil withholding certificates, advance rulings, tax insurance and legal opinions. Such safeguards have been described in further detail under Annexure IV.

G. Structuring through Intermediate Jurisdictions

Investments into India are often structured through holding companies in various jurisdictions for number of strategic and tax reasons. For instance, US investors directly investing into India may face difficulties in claiming credit of Indian capital gains tax on securities against US taxes, due to the conflict in source rules between the US and India. In such a case, the risk of double taxation may be avoided by investing through an intermediary holding company.

While choosing a holding company jurisdiction it is necessary to consider a range of factors including political and economic stability, investment protection, corporate and legal system, availability of high quality administrative and legal support, banking facilities, tax treaty network, reputation and costs.

India has entered into several BITs and other investment agreements with various jurisdictions, most notably, Mauritius. It is important to take advantage of structuring investment into India,
may be the best way to protect a foreign investor’s interest. Indian BITs are very widely worded and are severally seen as investor friendly treaties. Indian BITs have a broad definition of the terms ‘investment’ and ‘investor’. This makes it possible to seek treaty protection easily through corporate structuring. BITs can also be used by the investors to justify the choice of jurisdiction when questioned for GAAR.

Please refer to Annexure V for detailed note on BITs.

Over the years, a major bulk of investments into India has come from countries such as Mauritius, Singapore and Netherlands, which are developed and established financial centers that have favorable tax treaties with India. Cyprus was also a popular investment holding jurisdiction, but due to a recent ‘blacklisting’ by India due to issues relating to exchange of information, investments from Cyprus could result in additional taxes and disclosure till this position changes. The following table summarizes some of the key advantages of investing from Mauritius, Singapore and Netherlands:

<table>
<thead>
<tr>
<th>Head of Taxation</th>
<th>Mauritius</th>
<th>Singapore</th>
<th>Netherlands</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital gains tax on sale of Indian securities</td>
<td>Mauritius residents not taxed. No local tax in Mauritius on capital gains.</td>
<td>Singapore residents not taxed. Exemption subject to satisfaction of certain 'substance' criteria and expenditure test by the resident in Singapore. No local tax in Singapore on capital gains (unless characterized as business income).</td>
<td>Dutch residents not taxed if sale made to non-resident. Exemption for sale made to resident only if Dutch shareholder holds lesser than 10% shareholding in Indian company. Local Dutch participation exemption available in certain circumstances.</td>
</tr>
<tr>
<td>Tax on dividends</td>
<td>Indian company subject to DDT at the rate of 15%.</td>
<td>Indian company subject to DDT at the rate of 15%.</td>
<td>Indian company subject to DDT at the rate of 15%.</td>
</tr>
<tr>
<td>Withholding tax on outbound interest</td>
<td>No relief. Taxed as per Indian domestic law.</td>
<td>15%</td>
<td>10%</td>
</tr>
<tr>
<td>Withholding tax on outbound royalties and fees for technical services</td>
<td>15% (for royalties). FTS(^{33}) may be potentially exempt in India.</td>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td>Other comments</td>
<td>Mauritius treaty in the process of being renegotiated. Possible addition of ‘substance rules’.</td>
<td>There are specific limitations under Singapore corporate law (e.g. with respect to buyback of securities).</td>
<td>To consider anti-abuse rules introduced in connection with certain passive holding structures.</td>
</tr>
</tbody>
</table>

\(^{33}\) Fees for Technical Services
5. Effect of Key Investor Rights and Impact of Companies Act, 2013

I. Enforceability of Key Investor Rights

A. Liquidation Preference

PE investment documentation would typically provide for a ‘liquidation preference’ upon the happening of certain liquidity events for instance merger, change in control etc. However, since the investment under the FDI regime can only be made through equity, CCPS or CCD, there is always a practical difficulty in giving effect to the liquidation preference, as these instruments cannot be easily bought back / redeemed, and various conditions have to be met. On the other hand, since under the FVCI regime, investment can also be made through OCRPS, OCDs etc., giving effect to liquidation preference is much simpler.

B. Anti-Dilution

Anti-dilution effectively means compensating investor by issuance of further shares for the loss in his share value due to a downround issue (issuance of shares at lower price than the price at which the investor subscribed) by the investee company.

Anti-dilution could be in the form of weighted ratchet or full ratchet. In either of these cases, anti-dilution is achieved either by increasing the conversion ratio of the convertibles subscribed to by the investors or the investor contractually requiring the company to issue further equity shares at lower value. Since, investment under the FDI regime is subject to pricing norms (Fair Value, as mentioned earlier), if the triggering of anti-dilution requires shares to be issued to the investor below the Fair Value, prior regulatory approval would be required. On the other hand, as no such pricing requirements are applicable in case of investment under the FVCI regime, anti-dilution works much better for FVCI investors.

C. Share Transfer Restrictions

Companies Act, 1956, provided for the free transfer of the shares of a public limited company. Inter-shareholders agreements and private agreements between two shareholders restricting the transfer of shares had been a point of debate and confusion with the courts adding to the confusion by giving conflicting judgments. The latest position laid down in the judgment of Bombay High Court in the case of Messers Holding, provided that the provision of free transferability does not take away the right of shareholders to enter into consensual agreements / arrangements like right of first offer / right of first refusal etc. However, the position has now been clarified in the Companies Act, 2013, wherein the inter-shareholder agreements and private agreements have been given legal sanctity, even though obligation of the company to honour such agreements remains ambiguous.

D. Representation and Warranties Insurance

Insurance is not only available for tax liabilities, but also for liabilities arising out of breach of representation and warranties (“R&W Insurance”). R&W Insurance as a product is helpful in PE transactions as it (i) limits the cash pay-out from the promoter if there is a breach of representation and warranties; and (ii) gives comfort to the PE investor that irrespective of the financial wherewithal of the promoters post the transaction, they will be covered for any loss they suffer due to breach of representations and warranties. Representations and warranties are being increasingly used these days to mitigate risks, and are becoming popular, especially in case of secondary transfer from one PE investor to another where the company and / or the promoter may not have an incentive to provide representation and warranties which are required by the transferee investor.

E. Non-Compete

Non-compete typically applies in two situations – one, vis-à-vis employment, and the second, vis-à-vis, business. As regards employment, though non-compete during the course of employment is recognized, but Indian law does not recognize / enforce non-compete clauses in employment.
contracts post the termination of employment. As regards business, typically a non-compete is deemed to be ‘restraint of trade’ and hence void under section 27 of the Indian Contracts Act, 1872. However, there is a carve-out in case where the goodwill of a business is sold. In such cases, non-compete may be enforceable provided the restriction is only within specified local geographical limits and is reasonable in court’s view.

F. Put Option

Put options in favour of a non-resident requiring an Indian resident to purchase the shares held by the non-resident under the FDI regime were hitherto considered non-compliant with the FDI Policy by the RBI. The RBI has now legitimized option arrangements through its recent amendment to the TISPRO Regulations. TISPRO Regulations now recognizes that equity shares, CCPS and CCD containing an optionality clause can be issued as eligible instruments to foreign investors. However, the amendment specifies that such an instrument cannot contain an option / right to exit at an assured price.

The amendment, for the first time, provides for a written policy on put options, and in doing that sets out the following conditions for exercise of options by a non-resident:

i. Shares/debentures with an optionality clause can be issued to foreign investors, provided that they do not contain an option/right to exit at an assured price;

ii. Such instruments shall be subject to a minimum lock-in period of one year;

iii. The exit price should be as follows:
   - In case of listed company, at the market price determined on the floor of the recognized stock exchanges;
   - In case of unlisted equity shares, at a price not exceeding the Fair Value. The guiding principle here is that the non-resident investor is not guaranteed any assured exit price at the time of making such investment/agreements and shall exit at the Fair Value computed as above at the time of exit, subject to lock-in period requirement, as applicable.

Please refer to Annexure I for detailed analysis on put options.

II. Impact of Companies Act

India adopted new company law in the 2013, CA 2013. CA 2013 replaced Companies Act, 1956 (“CA 1956”). CA 2013 introduces several new concepts and modifies several existing ones. Some of the relevant new provisions introduced by CA 2013 are as follows:

i. Shares with Differential Rights

ii. Listed Company

iii. Inter-Corporate loans

iv. Deposits

v. Insider trading

vi. Squeeze out provisions

vii. Directors

viii. Director’s Duties and Liabilities

ix. Subsidiary and Associate Company

x. Merger of an Indian company with offshore company.

A. Shares with Differential Rights

Under CA 1956, private companies were allowed to issue shares with differential rights for their contractual agreements because of an exemption available to them. However, with the replacement of CA 1956 with CA 2013, this flexibility is no longer available to private companies. Now, the private Companies, like public companies, can issue only equity and preference shares and shares with differential rights subject to certain conditions prescribed by CA 2013 and The Companies (Share Capital and Debentures) Rules, 2014 for issuance of equity share capital, such as:

i. Share with differential rights shall not exceed 26% (twenty six per cent) of the total post issue paid up equity share capital, including equity shares with differential rights issued at any point of time;
ii. The company shall have a consistent track record of distributable profits for the last 3 (three) years;

iii. The company should not have defaulted in filing financial statements and annual returns for the preceding 3 (three) financial years.

Accordingly, preference shares with voting rights on an as-if-converted basis may not be permitted now. With this change, structuring different economic rights for different classes of equity shareholders may become difficult given the conditions that companies have to comply with under the Companies (Share Capital and Debentures) Rules, 2014.

B. Listed Company

The CA 2013 defines listed company as a company which has any of its securities listed on any recognized stock exchange.40 Even private companies with their NCDs listed on any recognized stock exchange will be considered as a listed company. The CA 2013 places a whole gamut of obligations on listed companies, such as:

- Returns to be filed with the registrar of companies if the promoter stake changes;
- Onerous requirements relating to appointment of auditors;
- Formation of audit committee, nomination and remuneration committee and stakeholders relationship committee;
- Secretarial audit.

C. Inter-Corporate Loans and Guarantee

Under CA 1956, loans made to or security provided or guarantee given in connection with loan given to the director of the lending company and certain specified parties required previous approval of the Central Government. However, section 185 of the CA 2013 which has by far been the most debated section of CA 2013, imposes a total prohibition on companies providing loans, guarantee or security to the director or any other person in whom the director is interested. Whilst the restriction contained in the CA 1956 applied only to public companies, CA 2013, has extended this restriction to even private companies. Such restriction would create significant difficulties for companies which provide loans, or guarantee/security to their subsidiaries or associate companies for operational purposes.

D. Deposits

Under CA 2013, acceptance of deposits by an Indian company is governed by stricter rules. Securities application money that is retained for more than 60 days without issuance of securities shall be deemed as a deposit. CA 2013 lays down stringent conditions for issuance of bonds and debentures – unsecured optionally convertible debentures are treated as deposits. CA 2013 also specifies additional compliances for deposits accepted prior to the commencement of CA 2013.

E. Insider trading

CA 2013 now has an express provision for insider trading wherein insider trading of securities of a company by its directors or key managerial personnel is prohibited.41 SEBI had notified the SEBI (Prohibition of Insider Trading) Regulations, 1992 to govern public companies. The provision governs both public and private companies. Hence, nominee director appointed by a private equity investor may also be subjected to insider trading provisions. However, the practical application of section 195 of the 2013 Act, with respect to a private company remains to be ambiguous.

F. Squeeze Out Provisions

Under CA 2013 an acquirer or person acting in concert, holding 90% of the issued equity share capital has a right to offer to buy the shares held by the minority shareholders in the Company at a price determined on the basis of valuation by a registered valuer in accordance with prescribed rules.42 The corresponding provision under the 1956 Act was permissive and not mandatory in nature.43 In this regard, private equity investors may want to exercise some caution while the majority shareholders approach the 90% shareholding threshold in a company. Interestingly, there is no provision that minority shareholders will be bound to transfer their shares to an acquirer or person acting in concert and the section lacks the teeth required to enforce a classic squeeze up.

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40. Section 2(52), Companies Act, 2013
41. Section 195, Companies Act, 2013
42. Section 236, Companies Act, 2013
43. Section 395, Companies Act, 1956
G. Directors

CA 2013 introduces new categories of directors\(^4\) such as:

i. **Independent Director**

Independent directors have been formally introduced by CA 2013, earlier the listing agreements\(^5\) provided for appointment of independent directors. CA 2013 provides that ‘Every public listed company’ shall have at least one third director of the total number of director as independent director. The term ‘every public listed company’ is ambiguous as it is the only instance in CA 2013 which applies to the ‘public listed company’ and not ‘listed company’. This is relevant because under CA 2013, a ‘listed company’ also includes a private company which has its securities listed on the stock exchange.

ii. **Resident Director**

Every company to have a director who was resident in India for a total period of not less than 182 days in the previous calendar year.

iii. **Women Director**

Prescribed class of companies shall have at least one woman director.

H. Director's Duties and Liabilities

Duties of directors have been gaining increasing importance in India. CA 2013, has for the first time laid down specific duties of directors. It sets out that the director shall:

i. act in accordance with the articles of the company.

ii. act in good faith in order to promote the objects of the company for the benefit of its members as a whole and in the best interests of the company, its employees, the shareholders, and the community and for the protection of environment.

iii. exercise his duties with due and reasonable care, skill and diligence and shall exercise independent judgment.

iv. not involve in a situation in which he may have a direct or indirect interest that conflicts or possibly may conflict, with the interest of the company.

v. not achieve or attempt to achieve any undue gain or advantage either to himself or his relatives, partners, or associates and if such director is found guilty of such, he shall be liable to pay an amount equal to that gain to the company.

vi. not assign his office and any such assignment shall be void.

Having said the above, the CA 2013 also recognizes to some extent, the limited role of independent / nominee / non-executive directors in the day to day functioning of the company. To that extent, the liability of an independent director and non-executive director has been restricted to such acts of omission or commission which had occurred with his knowledge, attributable through board processes, and with his consent or connivance or where he had not acted diligently.\(^6\)

I. Control and Subsidiary and Associate Company

CA 2013 defines the term 'control' and the definition of subsidiary and associate company has changed:

i. According to CA 2013, control\(^7\) “shall include the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner”. It is for the first time that the control has been defined in the company law.

ii. Subsidiary Company: An entity will be subsidiary of the holding company, if holding company controls the composition of the board of directors of the company or controls (directly or indirectly) more than one half of the total share capital.\(^8\)

iii. Associate Company: An entity will be an associate of the company, if the company has a significant influence over the entity, but it is not the subsidiary company of the company.\(^9\)

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44. Section 149, Companies Act, 2013
45. Listing agreements set out the conditions that a company or issuer of share has to abide. Clause 49
46. Section 149(12) of the Companies Act, 2013
47. Section 2(27), Companies Act, 2013
48. Section 2(87), Companies Act, 2013
49. Section 2(6), Companies Act, 2013

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The concept of control as provided in the definition of subsidiary company is narrower than what is provided in the definition of the control.

J. Merger of an Indian company with Offshore Company.

Section 234 of CA 2013 permits mergers and amalgamations of Indian companies with foreign companies. However, the provisions of Section 234 go on to say that such mergers and amalgamations are permitted only with companies incorporated in the jurisdictions of such countries notified from time to time by the Central Government. Hitherto, only inbound mergers were permitted, whereby a company incorporated outside India could merge with an Indian company. The section is yet not notified.
6. Exits For Private Equity and Private Debt Investments

I. IPO

Globally one of the most popular forms of exit for the PE investors is through the IPO. However, the Indian IPO market was sluggish in 2013, with only 3 mainboard listings on the stock exchange. Few of the reasons for such performance are, lack of institutional participation in the market and bank policies of not lending money for the purchase of the shares etc. An IPO is a tax-optimized exit since there is no capital gain tax on the shares sold on the floor of the stock exchange if the shares are held for more than 12 months.

It is pertinent to note that under ICDR Regulations, the entire pre-issue capital held by persons other than promoters shall be locked-in for a period of one year. However, an exemption is provided to the equity shares held by a venture capital fund or a FVCI for a period of at least one year prior to the date of filing the draft prospectus with the SEBI.  

II. Trade sale

The investor could also exit either by way of a sale of shares of Indian company or by the selling the offshore holding company (“OHC”), holding the shares of Indian company to another party. If the transfer of shares of the Indian company is between a non-resident and resident then the pricing requirements of the TISPRO Regulations will apply as mentioned earlier. Pricing guideline shall not apply in case of the sale of the OHC.

There would be withholding tax implication on the sale of shares of Indian company or an OHC. Please refer to Annexure III for a detailed analysis on tax implication on direct or indirect transfer.

III. Buy-back

In this exit option, shares held by the foreign investor, are bought back by the investee company. Buy-back of securities is subject to certain conditionalities as stipulated under Section 68 of the Companies Act, 2013, such as:

- Buy-back normally requires a special resolution\(^{51}\) passed by the shareholders of the company unless the buy-back is or less than 10% of the total paid-up equity capital and free reserves of the company;
- buy-back cannot exceed 25% of the total paid up capital and free reserves of the company in one financial year; and
- post buy-back, the debt equity ratio of the company should not be more than 2:1.

A company can only utilize the following funds for undertaking the buy-back (a) free reserves (b) securities premium account, or (c) proceeds of any shares or other specified securities.

From a tax perspective, traditionally, the income from buyback of shares has been considered as capital gains in the hands of the recipient and accordingly if the investor is from a favourable treaty jurisdiction, he could avail the treaty benefits. However, in a calculated move by the government to undo this current practice of companies resorting to buying back of shares instead of making dividend payments the Budget 2013-2014 levied an additional distribution tax of 20% on domestic companies, when such companies make distributions pursuant to a share repurchase or buy back.

The said tax at the rate of 20% is imposed on a domestic company on consideration paid by it which is above the amount received by the company at the time of issuing of shares. Accordingly, gains that may have arisen as a result of secondary sales that may have occurred prior to the buy-back will also be subject to tax now.

This provision has had a significant adverse impact on offshore funds and foreign investors who have made investments from countries such as Mauritius, Singapore and Netherlands etc., where buy-back of

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50. Regulation 37, SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009
51. Under Companies Act 2013, a Special Resolution is one where the votes cast in favor of the resolution (by members who, being entitled to do so, vote in person or by proxy, or by postal ballot) is not less than three times the number of the votes cast against the resolution by members so entitled and voting. (The position was the same under the Companies Act, 1956)
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.

IV. Depository Receipts (“DRs”)

Last year, Ministry of Finance notified the Depository Receipts Scheme, 2014 (“New Scheme”). The New Scheme rationalises the old framework and proposes significant deregulation and rationalisation of the manner in which Indian companies could tap global capital markets. It provides the Indian firms, domestic investors and foreign investors freedom to access financial markets within the prevalent foreign investment regime in India. Therefore, aims at bringing the DR route at par with any other foreign investment.

Broadly, the New Scheme has been introduced with the intention to provide the Indian firms, domestic investors and foreign investors freedom to access financial markets within the prevalent foreign investment regime in India. As per the New Scheme:

i. Any Indian company, listed or unlisted, private or public or any other issuer or person holding permissible securities is eligible to issue or transfer permissible securities to a foreign depository for the purpose of issuance of DRs. Except for persons barred from accessing international capital markets, no restrictions as such have been set out under the New Scheme as regards Indian issuer of securities.

ii. DRs can be issued on the back of any permissible securities (“Permissible Securities”). Permissible Securities has been defined to include securities as defined in the Securities Contracts (Regulation) Act, 1956 whether issued by a company, mutual fund, government or any other issuer and similar instruments issued by private companies.

iii. A regulated entity having the legal capacity to issue DRs (i.e. a person which is not prohibited from acquiring Permissible Securities), that is regulated in a permissible jurisdiction and that has the legal capacity to issue depository receipts in the permissible jurisdiction, may issue DRs.

iv. A domestic custodian has been defined to include a custodian of securities, an Indian depository, a depository participant, or a bank and having permission from SEBI to provide services as custodian.

v. Both sponsored and unsponsored DRs can be issued on the back of Permissible Securities. Unsponsored DRs can be issued on the back of listed Permissible only if two conditions are fulfilled viz., (i) DRs give the holder the right to issue voting instructions and (ii) the DRs are listed on an international exchange.

vi. A company, whether listed or unlisted, can issue shares for issue of DRs only in permissible jurisdictions (“Permissible Jurisdictions”). As per the New Scheme, a Permissible Jurisdiction would be a foreign jurisdiction that satisfies twin requirements i.e. the foreign jurisdiction is a member of the FATF and the securities regulator of that jurisdiction is a member of IOSCO.

vii. The New Scheme does not prescribe any specific pricing norms for issuance of DRs. The only restriction imposed under the New Scheme is that Permissible Securities shall not be issued to a foreign depository at a price less than the price applicable to a corresponding mode of issue of such securities to domestic investors under applicable laws. Pricing of ADR / GDR issues shall be done in accordance with the pricing guidelines issued under FEMA. For the purpose of issue of depository receipts for listed companies, the minimum pricing norms as applicable under the SEBI Guidelines shall be complied with.

viii. There are no end-use restrictions on the deployment of proceeds from issuance of DRs.

ix. Voting rights should be exercised by the foreign depository in respect of underlying securities; the depository may take instructions from DR holders. If the DR holders have the right to instruct the depository to vote on their behalf, they would have the same obligations as if it is the holder of the underlying equity shares under the Takeover Code. Also, shares of a company underlying the DRs shall form part of “public shareholding” (i) if the holder of the securities has the right to issue voting instructions and (ii) such DRs are listed on an international stock exchange.

Please refer to Annexure VI for our article in Economic Times analysing DRs as fund raising mode. Also, please refer to Annexure VII for our detailed analysis on New Scheme and its tax implications.


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V. Externalisation

One of the means of exit for shareholders of a company and also a way of accessing global public capital is by setting up of an OHC. In this structure, the promoter flips his interest in the Indian company to an OHC set up in a tax optimized jurisdiction which can be used to raise global capital offshore or to give an exit to offshore investors. In externalization, while exiting one should take into account potential tax liability due to indirect transfer. Please refer to Chapter 4 for a detailed analysis on taxation of indirect transfers.

Please refer to Annexure VIII for our article in Economic Times analysing benefits of externalisation.

While deciding the country for setting up of an OHC, the investor should broadly consider the following points:

i. whether the country is a sophisticated and reputed jurisdiction with an established banking framework and a well-developed corporate law system;

ii. whether the country has an independent, efficient and mature judicial system;

iii. if the country has a treaty with India for the avoidance of double taxation or not and what are terms of the treaty; and

iv. if the country have treaties for avoidance of double taxation with other major jurisdictions; and

v. what is the corporate tax rate in that country.

Private Equity and Private Debt Investments in India

7. Dispute Resolution

It is important for every decision maker in an investment fund (“Fund”) to understand legal nuances involved in interpreting and enforcing the contracts and rights and remedies available for non-performance. This not only aids decision making but enables the decision makers to assess legal feasibility of the objectives in mind, thus eliminating the expectation mismatch between business and law.

This chapter aims to summarize the legal nuances under Indian law involved in interpreting and enforcing investment agreement and rights and remedies available for non-performance with a focus on (i) contractual misrepresentations and fraud (ii) non-performance of material obligations (iii) failure to maintain transparent governance (iv) dispute resolution.

I. Contractual Misrepresentations and Fraud

For an agreement to be valid contract under Indian Law, it is essential that it is made by the free consent of parties. Consent is said to be free when it is not caused by inter alia misrepresentation and fraud. Thus in cases of misrepresentation and fraud, the law recognizes the right of investors to cancel the investment agreement as these cases affects the consent of the investor to enter into the transaction in the first place.

A. Meaning

An action or omission is a “fraud” when a party to the contract, or any other person with his connivance, or his agent makes a false assertion, active concealment or promise to do something without the intention of performing it, with the intent to deceive the other party thereto or his agent, or to induce him to enter into the contract. Thus, under Indian Law, unlike English Law, besides false assertions and active concealment even making a promise (a covenant) without the intention of performing it amount to fraud.

Misrepresentation on the other hand can be classified into three broad categories (i) a statement of fact, which if false, and the maker believes it to be true though it is not justified by the information he possesses; (ii) any breach of duty which gains an advantage to the person committing it by misleading another to his prejudice, even though there is no intention to deceive; and (iii) causing a party to an agreement to make a mistake as to the substance of the thing which is the subject of the agreement, even though done innocently.

Thus, the principle difference between fraud and misrepresentation, under India Law is that in the first case the person making the suggestion does not believe it to be true and in the other he believes it to be true, though in both the cases, it is a misstatement of fact which misleads the other party entering into the contract.

B. Effect & Remedies

When consent to an agreement is so caused by either fraud or misrepresentation, the agreement is a contract voidable at the option of the party whose consent was so caused. Thus, a party who enters into an agreement based on certain misrepresentation or is defrauded into entering into an agreement has a right to rescind the agreement and upon such recession each party who has received any benefit under the impugned contract, is required to restore such benefit to the person from whom it was received or make compensation for it to that extent or both.

But not every misstatement or concealment of fact renders a contract liable to be avoided. Remedies available can only be exercised if the misrepresentation and/or fraud pertains to a material fact. A representation is material when a reasonable

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58. Laxmibai v. Keshav Anaj Pokharkar, AIR 1916 Bom 239
62. Section 64 r/w Section 65 of the Contract Act; Section 30 of the Contract Act.
man would have been influenced by it in deciding whether or not to enter into the contract. Only facts which materially influences the making of a contract or determining, whether to accept or not to accept a proposal is a material fact which if incorrectly stated may amount to misrepresentation or fraud. It is thus important to cover all material representation in a transaction in an investment agreement. Also, recitals to an agreement which cover the background of the deal can be used to capture certain representations which cannot be expressly negotiated though essential in making the decision to invest as recital elicit the intentions of the parties while entering into the agreement.

A party to the contract, whose consent was caused by fraud or misrepresentation, may, if he thinks fit, in addition and/or in alternate to recession, insist that the contract shall be performed, and that he shall be put in a position in which he would have been if the representations made had been true in the form of damages or restitution. The measure of damage recoverable, in such a case, is essentially that is applicable to the tort of deceit, i.e. all the actual loss directly flowing from the transaction induced by the fraud, including the heads of consequential loss, and not merely the loss which was reasonably foreseeable. Thus, in cases of misrepresentation and fraud, besides the rights available under an investment agreement, the law recognizes the rights to cancel the investment agreement and seek return of the principle investment along with reasonable interest.

C. Limitation

The law require that when a part exercises his option to rescind the contract, he must be in a state to rescind; that is, he must be in such a situation to be able to put the parties into their original state before the contract, implying that recession is possible only when the parties can be restored to substantially the same position as they were before the contract was made, and where restitution is not possible there can be recession.

Thus in cases where certain part of the investment is sold to the third party or where the investor derives other benefits besides the investment instrument, in such situation recession may not be an available remedy. In such situations appropriate remedy would be to seek damages and in some situations where plausible, specific performance of the representation. These are discussed in detail in the section below.

II. Non-Performance of Material Obligations

A. Repudiatory Breach

When a party to fails to perform or refuses to perform or disables himself from performing any obligation under a contract, in each case in such a manner as to shown an intention not to fulfill his part of the contract and if the result is likely to deprive the innocent party of substantially the whole benefit of the contract such a breach or non-performance is regarded as material/repudiatory breach of a contract.

B. Remedies

In such a situation the innocent party has a right to accept the repudiation, put the agreement to an end and bring an action to seek damages/compensation for the losses suffered by him for the breach. Alternately, the innocent party can seek specific performance of the contract and compel the breaching party to perform his part of the contract. Alternately, the innocent party may only chose to sue for damages caused to it by the breach of contract and continue the remaining contract.

C. Specific Performance

Specific performance is equitable relief granted by the courts cases of breach of a contract in form of a judgment directing a defendant to perform his obligation under the investment agreements according to its terms and stipulations. In many cases, like in cases of breach of exit clause, a Fund is not interested in the compensation for breach of the investment agreement rather the objective is

63. Bhagwani Bai v. Life Insurance Corp of India, AIR 1984 MP 126 at 129.
64. Geroge P Varghese v. G Daniel, AIR 1988 Ker 120.
66. Prithuram Kalita v. Mayaram Sarma, AIR 1925 Cal 555
68. Clarke v. Dickson, (1858) EB & E 148 per Crompton J at 154
69. Solle v. Butcher, 1950 1 KB 671

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to achieve a timely exit. In such, no compensation can be considered enough. In such cases, obtaining specific performance of the contract, compelling the promoters and/or the company to honor their obligations to provide an exit under the investment agreement may be an appropriate remedy to seek.

One thing which should be carefully captured in the investment agreement to achieve this is that non-performance of the exit obligation is a repudiatory/material breach. As, explained above, the option of recession can be available for a breach of an obligation only, if the obligation is material in nature i.e. the breach is repudiatory in nature. Thus, making it clear in the investment agreement would reduce scope of debate at the time of a dispute.

Also, it is important to be mindful that, specific performance is granted only in cases where compensation is not an adequate remedy. Hence seeking compensation/damages in alternate to specific performance may proof fatal.

It is also important to bear in mind that specific performance is granted only for executory contracts and not concluded/executed contracts. Concluded/executed contracts are those in which both parties have discharged all their obligations. Thus under a share purchase or shareholders agreement after closing the contract would generally be a concluded contract. Hence, it is important to cover exit options/obligations under a shareholder’s agreement and a positive covenant from the target company and/or promoters.

Additionally, specific performance is an equitable relief and thus it is important be mindful that any clause under the investment agreement, restricting equitable reliefs should be absolutely avoided.

D. Recession

While strategizing the exit one has to keep in mind that “Specific Performance” as a remedy is available only in limited situation and is not a matter of right and is granted:

i. in cases of those contracts for the non-performance of which compensation will not be an adequate remedy

ii. where enforcement of the terms of the contract is not difficult, expensive or ineffective

iii. where the plaintiff’ conduct does not disentitle from seeking the equitable relief

iv. where the court considers fit to grant specific performance in the discretion of the court, to be exercised on the basis of sound principles

Thus it is appropriate in such cases to seek certain alternate remedies. The Specific Relief Act, 1963 (“SRA”), which is a specialized legislation dealing with specific performance of a contract under law, specifically provides the claimant a right to seeking recession of a contract in alternate to specific performance of a contract. As, explained in the section above, while seeking recession, parties as expected to return the benefit obtained under a contract, hence the effect of the alternate reliefs of recession would in terms be returning the investment instrument and receiving the investment amount.

Thus an exit can not only be achieved through seeking specific performance of the contract but also to seeking to rescind the investment agreement. The price though would only be the principle investment amount, but Indian law recognizes a right of a party to receive reasonable interest. This is because, as discussed above, at the time of recession parties are put to a position as if the investment agreement did not exist, which situation would require the target company and/or the promoters to compensate the investor for the lost interest over the investment period. The rate of interest awarded is left to court/arbitral tribunal discretion and subjected to a test of reasonability. In the past depending on facts and circumstances of cases the Indian Supreme Court has held that an interest rate between 12 to 21% is a reasonable rate of interest. Thus, one can factor interest between these ranges as additional return over the principle investment.

70. Section 10 of the Specific Relief Act, 1963 (“SRA”)
73. ibid
74. Section 14 of SRA
75. Section 16 of SRA
76. Section 20 of SRA
77. Section 29 of the SRA
79. Section 64 r/w Section 65 of the Contract Act, Section 30 of SRA
In situations where due to regulatory changes and uncertainty the exit mechanism has become difficult to enforce, recession on standalone can prove an appropriate remedy to achieve exit.

E. Damages

Unlike in cases of specific performance damages/compensation can be sought in alternate to recession of contracts or at a standalone for every breach of a contract, whether material or not.\(^1\) Also, if specific performance does not compensate for the loss already suffered, a relief of damage is available to seek restitution for losses caused de hors the relief of specific performance.\(^2\)

Damages under Indian Law are governed by common law principles and Section 73 and 74 of the Contract Act. Under Section 73 of the Contract Act, when a contract has been broken, the investor is entitled to receive compensation for any loss caused which they considered a likely result from the breach of the investment agreement at the time of entering the transaction. Thus, in deciding whether damage claimed is too remote, the test is whether the damage is such as must have been in the contemplation of parties as being a possible result of the breach. If it is, then it cannot be regarded as remote.\(^3\) Foreseeability is seen as at the time of making the contract.\(^4\) Thus, in case an investor anticipates any special circumstances which may be affected by breach of the investor agreements, it important to communicate the same to the target company at the time of investment.\(^5\) It may also be useful to document an internal risk report at the time of investment, which can be shared by the target and used as evidence of knowledge of potential losses.

In addition the investor can also claim damages for the losses arising after the breach like liability from third parties like co-investors, LPs.\(^6\) In cases where non-performance of an exit obligation causes the investor to sell the investment to a third party at a lower price, the difference in price obtained can also be regarded as damage.

This Section is to be read with Section 74 of the Contract Act, which deals with penalty stipulated in the contract, inter alia provides that when a contract has been broken, if a sum is named in the contract as the amount to be paid in case of such breach, the party complaining of breach is entitled, whether or not actual loss is proved to have been caused, thereby to receive from the party who has broken the contract reasonable compensation not exceeding the amount so named. Section 74 emphasizes that in case of breach of contract, the party complaining of the breach is entitled to receive reasonable compensation whether or not actual loss is proved to have been caused by such breach. Therefore, the emphasis is on reasonable compensation. If the compensation named in the contract is by way of penalty, consideration would be different and the party is only entitled to reasonable compensation for the loss suffered. But if the compensation named in the contract for such breach is genuine pre-estimate of loss which the parties knew when they made the contract to be likely to result from the breach of it, there is no question of proving such loss or such party is not required to lead evidence to prove actual loss suffered by him.\(^7\) This, in negotiable, it may be useful to include genuine pre-estimate of losses in the investment agreement for certain breaches.

F. Indemnity

An agreement of indemnity, as a concept developed under common law, is an agreement wherein the promisor, promises to save the promisee harmless from loss caused by events or accidents which do not or may not depend on the conduct of any person or from liability for something done by the promisee at the request of the promisor. Section 124 of the Contract Act defines a “Contract of Indemnity” as a contract, by which one party promises to save the other from loss caused to him by the conduct of the promisor himself, or by the conduct of any other person. Thus, obligations of the promoters and/or the company can be backed by negotiating an indemnity into the agreement for non-performance.

As such the scope of “Indemnity”, as a concept developed under the common law, is much wider in its scope and application than the scope of “Indemnity” as defined under Section 124 of the Contract Act. “Indemnity”, as developed in common law, includes losses caused by events or

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\(^1\) Section 73 of the Contract
\(^2\) Section 21(3) of SRA
\(^3\) Hadley v. Baxendale, (1854) 9 Exch 341
\(^5\) Chitty on Contracts, 28th edn., para 27-051 at 1296.
\(^6\) Borries v. Hutchison, (1865) 18 CBNS 445.
\(^7\) ONGC v. Saw Pipes, AIR 2003 SC 2639
accidents which may not depend on the conduct of any person and therefore includes losses due to accident or events which have not been caused by the indemnifier or any other person. Thus, even non-promoter subsidiaries and individuals can be made parties to an investment agreement as an indemnifying party.

But it should be kept in mind that a right to indemnity is distinguished from the right to damages arising from a breach of a contract. While the right of indemnity is given by the original contract, the right to damages arises in consequence of breach of that contract. Where a contract contains an indemnity clause and does not exclude the right to damages, the investors have to choose between the remedies as both cannot be simultaneously adopted. But in an investor agreement there are multi-parties which are jointly and severally liable for every breach. In such a situation, it may be advisable to limit the claim of damage to one or two such entities and lodge a separate claim of indemnity against the other entities. This will help the investor to expedite the claim for recovery under two simultaneous actions.

The question which remains unanswered under Indian Law and has received divergent legal opinions from different courts of law it that with regards to commencement and extent of liability. One view is that when a person contracts to indemnify another, the latter may compel the indemnifier to place him in a position to meet the liability that may be cast upon him, without waiting until the indemnity holder has actually discharged it. The other view to the contrary is that the indemnity holder does not become liable until the indemnified has incurred actual loss. Thus making it important to negotiate the mechanism commencement of indemnity and the extent of liability and capture the same into the investment agreement.

III. Inability to Maintain Transparent Governance

Investors put their money into a company on certain conditions. The first of them is that the business in which he invests shall be limited to certain definite objects. The second is that it shall be carried on by certain persons elected in a specified way. And the third is that the business shall be conducted in accordance with certain principles of commercial administration defined in the statute, which provide some guarantee of commercial probity and efficiency. If the investors find that these conditions or some of them are deliberately and consistently violated and set aside by the action of the promoter and/or other officials of the company who wields an overwhelming voting power or excise control on the day to day affairs of the company, and if the result of that is that, for the extrication of their rights as shareholders, they are deprived of the ordinary facilities which compliance with the companies acts would provide them with, then the investor should relieve for oppression and mismanagement available under Section 397 to 408 of the erstwhile companies act and now under Section 241 to 244 & 246 of the Companies Act, 2013, de hors the investment agreement.

A. Action for Oppression and Mismanagement

‘Oppressive’ means “burdensome, harsh and wrongful. It will ordinarily be an act of oppression on an investor if he is deprived of his privilege and rights. Such an act will undoubtedly be harsh, burdensome and wrongful and will necessarily be an act of oppression to the member concerned. Element of lack of probity of fair dealing to a member in matters of his proprietary rights as a shareholder, is also oppression. Even if the oppression was of a short duration and of a singular conduct if its effects persisted indefinitely it is an act of oppression. Thus actions in disregard of the shareholder rights like appointment of directors, prior consent, sufficient disclosure and information, including reserved item rights, could be classified as acts of oppression.

Whereas when the affairs of the company are being conducted in a manner prejudicial to the interests of the company, it amounts to mismanagement. Over the years the following acts have been held as amounting to mismanagement:

- Where there is serious in-fighting between directors.
- Where Board of Directors is not legal and the illegality is being continued.
- Where bank account(s) was/were operated by unauthorised person(s).
- Where directors take no serious action to recover amounts embezzled.
- Continuation in office after expiry of term of directors.

88. Krishnaswami Iyer v. Thakia Raghaviah Chetty, AIR 1928 Mad 1135
Sale of assets at low price and without compliance with the companies act.

Violation of Memorandum.

Violation of statutory provisions and those of Articles.

Company doomed to trade unprofitably

In such cases, though there may exist certain obligations under the investment agreements which may be breached they may not amount to repudiatory or specifically performable breaches. Hence, resort to remedies for oppression and mismanagement under the companies act may be more suitable course of action because under the erstwhile companies law the powers of the Company Law Board ("CLB") in cases of oppression and mismanagement were very wide. These include:

i. the regulation of the conduct of the company's affairs in future;

ii. the purchase of the shares or interests of any members of the company by other members thereof or by the company;

iii. in the case of a purchase of its shares by the company as aforesaid, the consequent reduction of its share capital;

iv. the termination, setting aside or modification of any agreement, howsoever arrived at, between the company on the one hand, and any of the following persons, on the other namely:
   a. the managing director;
   b. any other director;
   c. the manager;

Further the powers extended to the bankruptcy court (winding up court) under sections 539 to 544 of the erstwhile act have been extended to the CB for proceedings under sections 397 or 398 of the erstwhile act by virtue of section 406 of the erstwhile act. Similar power, though not yet in force, are available under Section 336 to 341 of the Companies Act, 2013. There are as follows:

i. Sections 539 and 540 of the erstwhile act are essentially penal provisions relating to falsification and fraud respectively. Whilst section 539 of the erstwhile act can be applied to companies in respect of which an application under section 539 and 540 of the erstwhile act have been made, section 540 of the erstwhile act deals with companies in respect of which the CLB subsequently makes an order under sections 397 or 398.

90. Section 402 of the Companies Act, 1956
B. Actions for Siphoning of Assets

In cases involving siphoning of assets through unauthorized bank accounts, related party supplier and customer contracts, related party loans and deposits, etc. in addition to the remedies available for mismanagement remedies such as full disclosure and access to companies accounts, forensic investigation of accounts, return of siphoned assets, personal liability of malefactor directors and members are provided for both under the erstwhile companies act and the Companies Act, 2013.

Under S. 235(2) of the erstwhile companies act, an application can be made to the CLB seeking a declaration that ‘the affairs of a company ought to be investigated by an inspector or inspectors’. Investigation into the affairs of a company means investigation of all its business affairs – profits and losses, assets including goodwill, contracts and transactions, investments and other property interests and control of subsidiary companies as well. Similar relief, though not yet in yet are available under Section 210 of the Companies Act, 2013.

Such a declaration can be made by the CLB upon receiving an application made by ‘not less than two hundred members or from members holding not less than one-tenth of the total voting power’ in case of a company with a share capital. The CLB though not obliged to direct appointment of investigators has the discretion to direct investigation in cases which it deems fit. The CLB is required to afford the parties an opportunity of being heard upon receiving such an application. Thereafter, if the CLB makes a declaration that the affairs of the company ought to be investigated by an inspector or inspectors, the Central Government is mandatorily required to appoint one or more competent persons as investigators.

It has been held that in cases where there are allegations of siphoning off of funds, fabrication of resolutions, non-compliance with CLB orders directing disclosure of information about affairs of the company to shareholders and violation of provisions of the Act and articles of association, the CLB may legitimately declare that the affairs of the company ought to be investigated. An investigation may also ordered when directors of a company were removed and assets of the company sold off. It is pertinent to note, however, that an investigation under S. 235 may only be ordered when public interest or shareholders’ interests are involved; it must not be ordered merely on the basis of shareholders’ dissatisfaction.

Further under Section 237 of the erstwhile companies act the CLB also has power to order an investigation where there are circumstances suggesting—

i. that the business of the company is being conducted with intent to defraud its creditors, members or any other persons, or otherwise for a fraudulent or unlawful purpose, or in a manner oppressive of any of its members, or that the company was formed for any fraudulent or unlawful purpose;

ii. that persons concerned in the formation of the company or the management of its affairs have in connection therewith been guilty of fraud, misfeasance or other misconduct towards the company or towards any of its members; or

iii. that the members of the company have not been given all the information with respect to its affairs which they might reasonably expect.

Similar power, though not yet in force, are available under Section 213 of the Companies Act, 2013.

C. Nominee Directors Actions

In cases where the target fails to maintain transparent governance, it becomes critical for the nominee directors of the Fund to take steps with prudence. This is essential to avoid defenses of acquiescence by the target and also to avoid liability under statutory provisions. In such cases it is also essential for the directors to balance between their duties towards the fund and fiduciary duties towards the target company. The do’s and don’ts can be listed as follows:

91. R. v. Board of Trade, Ex parte, St. Martin Preserving Co. Ltd., (1964) 2 All. E.R. 561; Ramaiya, 3240.
92. S. 235 (2) (a) of the Act.
94. S. 235 (2) of the Act; RAMAIYA, 3239.
i. Board Meetings

It’s common for such information to be brought to the knowledge of the investor, through an on ground advisory team which would include the nominee director. In such situations, it’s reactionary for the nominee director to use his board seats to voice the concerns of the Fund during a board meeting. Instead it is advisable for the investor to directly address concerns to board, which the nominee director may then press for deliberation, rather than the nominee director raising these issues himself.

Further, while making recommendations and tabling resolution, the nominee director should bear in mind his fiduciary obligations towards the target company and should refrain from making suggestions, which though in the favor of the investor are against the interest of the target company.

ii. Investigation & Forensic Audit

In situations where improprieties are brought to the knowledge of the nominee director it becomes extremely important for him to act prudently and insist on having investigations and forensic audits to receive expert advice on the alleged improprieties. This helps the nominee director establish good faith on this part and help him discharge his fiduciary duties towards the target company.

Also, at such times the nominee director should refrain from approving any radical operating budgets and balance sheets. This ensures elimination of personal liability of the nominee director for wrong doings by the promoters and promoter group.

iii. Independent Advisors

It is essential for the nominee director to insist on separate legal advisors for the board and the target company from that of the investor and promoters. This ensure a balance of fiduciary obligations and dispels believe of investor control over actions taken by nominee director.

iv. Resignation

Only after attempting to take sufficient steps, as above, should a nominee director resign from the target companies. This helps the nominee director to ensure discharge of his fiduciary obligations towards the target company, to the extent possible and under his control.

D. Interplay Between CLB Action and Arbitration

In cases of lack of transparent governance, it also becomes important to understand the interplay between the CLB action and rights available under the arbitration agreement contained in the investment agreements. Both actions can be used harmoniously to expedite investor actions to tackle these improprieties.

As discussed above, the CLB has wider powers than an arbitral tribunal and hence it’s important to seek only those reliefs before CLB which an arbitrator cannot grant. If this is not ensured, the promoters may use the arbitration clause to stall the CLB action on jurisdictional objections. Additionally, the evidence obtained through CLB orders of investigations and disclosure can provide sufficient arsenal to achieve exit through the arbitration route.

Thus, an inclusive strategy to issues of lack of transparent governance would include taking appropriate board actions, while balancing between the rights available before CLB and those provided for under the investment agreement, in the form of an arbitration agreement.

IV. Disputes with Managers and Advisors

The disputes discussed above are not limited between investors and the target. Many times, investors face similar disputes with their own fund managers and advisors. Though the law applicable to agreements between the investor and manager and between investor and advisor is likely to be a foreign law, strategies in handling the disputes remain the same.

Similarly, GPs, who also act as managers and advisors through various entities, should be mindful that lack of prudent action or inaction, misrepresentation, incomplete disclosure, if not brought to the attention of the LPs in time could lead to similar liabilities that a target would face in such situations.

V. Dispute Resolution

Owing certain controversial decisions by the Indian judiciary in the recent past, especially in cases involving a foreign party, the international community has kept a close watch on the
development of arbitration laws in India and has often criticized the Indian judiciary for its interference in international arbitration and extra territorial application of domestic laws to awards obtained outside India.

Attitude of the Indian judiciary towards arbitration is now rapidly changing since the past couple of years. Never before has one seen so many pro-arbitration rulings by Indian Courts. From 2012 to 2013 the Supreme Court of India declared the Indian arbitration law to be seat centric, removed Indian judiciary’s power to interfere with arbitrations seated outside India, referred non-parties to an arbitration agreement to settle disputes through arbitration, defined the scope of public policy in foreign seated arbitration and has thus shown the much needed pro-arbitration approach.

Section 2(1)(f) of the Arbitration and Conciliation Act, 1996 ("A&C Act") defines an international commercial arbitration ("ICA") to mean one arising from a legal relationship which must be considered commercial where either of the parties is a foreign national or resident or is a foreign body corporate or is a company, association or body of individuals whose central management or control is in foreign hands. Thus under Indian Law an arbitration with a seat in India, but involving a foreign party will also be regarded as an ICA, and hence subject to Part I of the A&C Act. Where an ICA is held outside India, Part I of the Act would have no applicability to the parties but the parties would be subject to Part II of the A&C Act.

Following are the top 10 significant pro-arbitration developments in 2012-13:

A. Bharat Aluminum Co. v. Kaiser Aluminum Technical Service, Inc ("BALCO")

The constitutional bench of the Supreme Court after laudable consideration of the jurisprudence laid down by various Indian & foreign judgments and writings of renowned authors, ruled that its findings in Bhatia International and Venture Global were incorrect. It concluded that Part I of the A&C Act has no application to arbitrations seated outside India, irrespective of the fact that whether parties chose to apply the A&C Act or not. Hence getting Indian law in line, with the well settled principle recognized internationally that “the seat of arbitration is intended to be its center of gravity”. Although the Court has overruled many of its previous decisions it provides no relief to parties who have executed their arbitration agreements prior to the date of the present judgment as the Court directed that the overruling was merely prospective and the laws laid down therein applied only to arbitration agreements made after September 6, 2012.

B. Chloro Controls (I) P. Ltd. v. Severn Trent Water Purification Inc. & Ors.

In yet another landmark, ruling the Supreme Court has held that the expression ‘person claiming through or under’ as provided under Section 45 of the A&C Act would mean and take within its ambit multiple and multi-party agreements and hence even non-signatory parties to some of the agreements can pray for and be referred to arbitration. This ruling has widespread implications for foreign investors and parties as in certain exceptional cases involving composite transactions and interlinked agreements, even non-parties such as the parent company, subsidiary, group companies or directors can be referred to and made parties to ICA.

C. Shri Lal Mahal Ltd. v. Progetto Grano Spa

The ever-growing judicial support to ICA and the seminal shift in judicial mindset is now more than established from a landmark ruling of the Supreme Court, wherein the Court has in fact overruled its own decision passed in Phulchand. The Supreme Court while dealing with objections to enforceability of certain foreign awards on the grounds that such awards are opposed to the public policy of India, has significantly curtailed the scope of the expression ‘public policy’ as found under Section 48(2)(b) of the A&C Act and thereby limiting the scope of challenge to enforcement of awards passed in foreign seated arbitrations. Therefore, enforcement of foreign awards would not be refused so easily. Thus, a practical takeaway from the above would be to give preference to a foreign seated arbitration as a mechanism for dispute resolution as this would afford a speedy remedy without significant Court interference.

98. (2012) 9 SCC 552
99. (2013) 1 SCC 641
100. 2013 (8) SCALE 489
D. World Sport Group (Mauritius) Ltd v. MSM Satellite (Singapore) Pte. Ltd

The Supreme Court held that only bar to refer parties to foreign seated arbitrations are those which are specified in Section 45 of the A&C Act i.e. in cases where the arbitration agreement is either (i) null and void or (ii) inoperative or (iii) incapable of being performed and expressly removed allegations of fraud as a bar to refer parties to foreign seated arbitrations.

E. Mulheim Pipe Coatings GmbH v. Welspun Fintrade Ltd and Anr

The Bombay High Court formulated the principles of the doctrine of severability and held that an arbitration clause in a share purchase agreement could survive annulment of the share purchase agreement by the parties. The Court held that for the arbitration agreement to be null and void, inoperative or incapable of performance the doctrine of separability requires a direct impeachment of the arbitration agreement and not a simple parasitical impeachment based on a challenge to the validity or enforceability of the main agreement. By applying this principle, it upheld the validity of arbitration agreement within a share purchase agreement which was declared null and void by a settlement agreement entered into by the parties.

F. Konkola Copper Mines (PLC) v. Stewarts and Lloyds of India Ltd

The Bombay High Court provided assistance to a certain degree and indicated that the interpretation to various provisions of the statute as provided in BALCO would not be limited to a prospective application. As per the judgment, the question regarding whether Part I would apply to an arbitration where the arbitration agreement was entered into prior to September 6, 2012 would be decided in accordance with the principle laid down in the Bhatia International case. However having once decided that Part I applies, the question as to which Court would have jurisdiction to entertain applications under Section 9 or Section 34 of the A&C Act etc. would be decided in accordance with the principles provided in the BALCO judgment. The Court explained that while the ratio of the BALCO judgment i.e. Part I of the Act would apply only to arbitrations seated in India, would operate with a prospective effect, the interpretation of Section 2(1) (e) of the A&C Act as provided by the Supreme Court would not be limited to a prospective application.

G. Tata Capital Financial Services Limited v. M/s Deccan Chronicle Holdings Limited

The recent judgment of the Bombay High Court in Tata Capital Financial Services Limited v. M/s Deccan Chronicle Holdings Limited gains significant importance in light of the recent spur in lending disputes. The Bombay High Court while dealing with a petition seeking interim reliefs in aid of arbitration under Section 9 of the A&C Act has held that even though certain debts may be secured by a mortgage, the lender may choose to bring only a claim for recovery of the amounts due and not sue for enforcement of mortgage. Accordingly, as money claims arising under contracts are arbitrable disputes, Courts are empowered to grant interim reliefs under Section 9 of the A&C Act.

H. Antrix Corp. Ltd. v. Devas Multimedia P. Ltd

This case is yet another example of the pro-arbitration approach adopted by the Supreme Court, where the Courts, to the extent possible, deter from interfering in the arbitration process or with the Arbitrators’ judgment. The Supreme Court has relied upon a fairly simple proposition that once an arbitration agreement has been invoked on a particular dispute and an Arbitrator has been appointed, the other party to the dispute cannot again independently invoke the provisions of the arbitration agreement. The issue revolved around a petition filed under Section 11 of the A&C Act, wherein the Supreme Court relying on the above proposition held that once the power to appoint an Arbitrator has been exercised, no powers are left to refer the same dispute again to arbitration under Section 11 of the A&C Act.
I. Bharat Oman Refineries Limited v. M/s. Mantech Consultants

The Division Bench of the Bombay High Court held that the award passed by the Arbitrator after an efflux of period prescribed in the agreement is bad in law and upheld the principle laid down in NBCC Limited v. J.G. Engineering Private Limited that the contract of arbitration is an independent contract and parties to such contract (including the Arbitrator) are bound by the terms of such contract. The present case, proceeds on the principle that if the arbitration agreement prescribes a period within which the award is to be passed, any award passed beyond such period would be bad in law unless the parties have mutually agreed to extend this period.

J. Denel (Proprietary Limited) v. Govt. of India, Ministry of Defence

This case lays down two clear principles with regard to appointment of Arbitrator under Section 11(6) of the A&C Act. First, failure to appoint an Arbitrator within 30 days as prescribed under Sections 11(4) and (5) of the A&C Act do not amount to forfeiture of rights unless the opposite party has filed their petition under Section 11 (6) prior to the said appointment. Secondly, though it is a well-established principle that appointment is required to be done as per the terms and conditions of the contract, however if circumstances exists an independent Arbitrator may be appointed as an exception to the general rule, if there is reasonable apprehension of bias and impartiality.

VI. Conclusion

Thus, while strategizing an tackling disputes investors have to examine the rights available to them in light of obstacles which are bound to arise while litigating against and India Party with overarching aim to safeguard the “interests” which they investors seeks to secure through the dispute resolution process. A silo approach adopting “rights” based strategy disregarding the inherent obstacles or the “interest” of the clients would lead to the litigation becoming burdensome and eventually a futile process costing thousands of dollars in legal fees for the years of litigation without achieving the desired exit at the desired time.

The correct approach towards a tackling disputes during the life cycle of the fund is to examine the entire cycle of the exit, including the dispute notice stage, the dispute resolution stage and the execution stage at the time of formulating a “pre-dispute strategy”, like one would examine the cycle of the investment at the time of entry and aim to achieve the most commercially viable exit in the least possible time bringing a harmony between the expectations in the “board room” and challenges of the “court room”.

106. 2012 (2) ArbLR 482 (Bom)
107. (2012) 2 SCC 759
2014 also saw renewed interest in the real estate sector. Under the FDI Policy, Indian companies with FDI are prohibited from engaging in ‘Real Estate Business’. Term ‘Real Estate Business’ is defined as “dealing in land and immovable property with a view to earning profit or earning income there from and does not include development of townships, construction of residential/ commercial premises, roads or bridges, educational institutions, recreational facilities, city and regional level infrastructure, townships.”

Over the period of years, Government has liberalized foreign investment in real estate sector. First notable step in this direction was taken in 2005 when DIPP issued the press note 2 of 2005 (“PN2”). 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. In order to provide impetus to the real estate sector, Government further liberalized investment conditions by issuing press note 10 of 2014 (“Press Note 10”).

Following are few of the key changes introduced by Press Note 10:

A. Minimum area requirement for development of projects has been revised

i. Development of serviced plots

Minimum land area requirement of 10 hectares that was prescribed earlier has been done away with;

ii. Construction-development projects

Minimum area requirement for construction development projects has been reduced from 50,000 sq. meters of built-up area to 20,000 sq. meters of floor area.

B. Minimum capitalization

The minimum capitalization has been reduced to US $5 million. Further, different minimum capitalization prescribed for wholly owned subsidiaries and joint ventures with the Indian partners has been done away with.

C. Affordable housing

An exemption is provided to the real estate projects which allocate 30% of the total project cost towards the affordable housing projects from complying with the minimum land area and minimum capitalization requirements.

Press Note defines ‘affordable housing projects’ as projects where at least 40% of the FAR / FSI is for dwelling unit of floor area of not more than 140 sq. meters, and out of the total FAR / FSI reserved for affordable housing, at least 1/4th (one-fourth) should be for houses of floor area of not more than 60 sq. meters.

D. Lock-in restriction

The Press Note has done away with the requirement that a foreign investor can exit from its investment on expiry of 3 (three) years from the date of final investment, and hence, an investor can now exit from the project once it is completed or after the development of the trunk infrastructure.

i. No minimum lock-in period

As per the earlier FDI Policy, each tranche of investment was locked in for a period of 3 years. Though this was intended to provide some long term commitment to the project by a foreign investor, even if the project was completed, some later tranches of foreign investment, especially the last mile funding could still be locked in. By removing the 3 year (three) lock-in now, the government has encouraged foreign investments in shorter projects (also applicable as the minimum area requirements have now been relaxed), and removed deterrence for a foreign investor to provide subsequent funding in case of longer projects.

ii. Ambiguity in exit from multi-phase projects

Previously if a project was developing in phases, a foreign investor could exit from the project upon
completion of the initial phase, provided the 3 (three) year lock-in period had expired. However now, since the exit is linked to either project completion or development of trunk infrastructure, it is unclear whether a foreign investor can exit (whether partly or completely) upon completion of any phase of the project, when the trunk infrastructure for later phases is not developed.

E. Completed assets

Press Note 10 has clarified that 100 percent FDI under the automatic route is permitted in completed projects for operation and management of townships, malls/shopping complexes and business centres.

It has been long debated whether FDI should be permitted in commercial completed real estate. By their very nature, commercial real estate assets are stable yield generating assets as against residential real estate assets, which are also seen as an investment product on the back of the robust capital appreciation that Indian real estate offers. To that extent, if a company engages in operating and managing completed real estate assets like a shopping mall, the intent of the investment should be seen to generate revenues from the successful operation and management of the asset (just like a hotel or a warehouse) as against holding it as a mere investment product (as is the case in residential real estate). The apprehension of creation of a real estate bubble on the back of speculative land trading is to that naturally accentuated in context of residential real estate. To that extent, operation and management of a completed yield generating asset is investing in the risk of the business and should be in the same light as investment in hotels, hospitals or any asset heavy asset class which is seen as investment in the business and not in the underlying real estate. Even for REITs, the government was favorable to carve out an exception for units of a REIT from the definition of real estate business on the back of such understanding, since REITs would invest in completed yield general real estate assets. The Press Note 10 probably aims to follow the direction and open the door for foreign investment in completed real assets, however the language is not entirely the way it should have been and does seem to indicate that foreign investment is allowed only in entities that are operating and managing completed assets as mere service providers and not necessarily real estate. While it may seem that FDI has now been permitted into completed commercial real estate sector, the Press Note 10 leaves the question unanswered whether these companies operating and managing the assets may own the assets as well.
Another mode of extending loans or investing in Indian companies is through NBFCs. An NBFC is defined in terms of Section 45I(c) of the RBI Act, 1934 ("RBI Act") as a company engaged in granting loans/advances or in the acquisition of shares/securities, etc. or hire purchase finance or insurance business or chit fund activities or lending in any manner provided the principal business of such a company does not constitute any non-financial activities such as (a) agricultural operations, (b) industrial activity, (c) trading in goods (other than securities), (d) providing services, (e) purchase, construction or sale of immovable property. Every NBFC is required to be registered with the RBI, unless specifically exempted.

The RBI Act does not define ‘principal business’ and thereby responsibility is conferred on the regulator to determine what is the principal business of a company. Accordingly, the test applied by RBI to determine what is the principal business of a company was articulated in the Press Release 99/1269 dated April 8, 1999 issued by RBI. As per the said press release, a company is treated as an NBFC if its financial assets are more than 50 per cent of its total assets (netted off by intangible assets) and income from these financial assets is more than 50 per cent of its gross income. Both these tests ("50% Tests") are required to be satisfied in order for the principal business of a company to be determined as being financial for the purpose of RBI regulation.

RBI had constituted a Working Group on the Issues and Concerns in the NBFC Sector chaired by Usha Thorat ("Usha Thorat Committee"). Usha Thorat Committee recommended that the twin criteria of assets and income for determining the principal business of a company does need not be changed. Usha Thorat Committee recommended the minimum percentage threshold of assets and income should be increased to 75 per cent. Accordingly, the financial assets of an NBFC should be 75 per cent or more (as against more than 50 per cent) of total assets and income from these financial assets should be 75 per cent or more (as against more than 50 percent) of total income. However, RBI has not given effect to this recommendation.

The NBFC could be structured as follows.

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**Annexure II**

**Onshore Debt Funding – The NBFC Route**

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The Offshore Fund sets up an NBFC as a loan company, which then lends to Indian companies. The NBFC may either lend by way of loan or through structured instruments such as NCDs which have a protected downside, and pegged to the equity upside of the company by way of redemption premium or coupons.

I. Advantages of the NBFC Route

A. Assured Returns

The funding provided through NBFCs is in the form of domestic loans or NCDs, without being subjected to interest rate caps as in the case of CCDs. These NCDs can be structured to provide the requisite distribution waterfall or assured investors' rate of return ("IRR") to the offshore fund.

B. Regulatory Certainty

The greatest apprehension for funds has been the fluid regulatory approach towards foreign investment, for instance put options. The NBFC being a domestic lending entity is relatively immune from such regulatory uncertainty.

C. Security Creation

Creation of security interest in favour of non-residents on shares and immoveable property is not permitted without prior regulatory approval. However, since the NBFC is a domestic entity, security interest could be created in favour of the NBFC. Enforceability of security interests, however, remains a challenge in the Indian context. Enforcement of security interests over immovable property, in the Indian context, is usually a time consuming and court driven process. Recognizing this issue, Finance Minister in his Budget Speech 2015 mentioned that the NBFCs that (a) are registered with the RBI and (b) have an asset size of INR 500,00,00,000 (Rupees Five Hundred Crores) (INR 5 billion) shall be considered as ‘financial institution’ for the purposes of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act. However, the necessary changes have not been notified yet.

D. Repatriation Comfort

Even though repatriation of returns by the NBFC to its offshore shareholders will still be subject to the restrictions imposed by the FDI Policy (such as the pricing restrictions, limits on interest payments etc.), but since the NBFC will be owned by the foreign investor itself, the foreign investor is no longer dependent on the Indian company as would have been the case if the investment was made directly into the Indian entity.

E. Tax Benefits to the Investee Company

As against dividend payment in case of shares, any interest paid to the NBFC will reduce the taxable income of the investee company. However, an NBFC may itself be subjected to tax to the extent of interest income so received, subject of course to deductions that the NBFC may be eligible for in respect of interest pay-outs made by the NBFC to its offshore parent.

II. Challenges involved in the NBFC Route

A. Setting up

The first challenge in opting for the NBFC route is the setting up of the NBFC. Obtaining a certificate of registration from the RBI for an NBFC is a time consuming process. This process used to take anywhere in the region of 12 – 14 months earlier, which was reduced to around 6 months. Recently, RBI came up with the Timelines for Regulatory Approvals’ to ensure the timely delivery of the services. Under the timeline, RBI has prescribed 45 days as the period for the issuance of certificate of registration. However, this 45 days period start from the day all the documents for the registration have been submitted to RBI.

Due to the elaborate time period involved in setting up the NBFC, one of the common alternatives adopted, especially in case of non-deposit taking NBFCs was to purchase an existing NBFC. This was because earlier there was only a requirement of giving 30 thirty days' written notice prior to

108. SARFAESI Act facilitates enforcement of security interest without intervention of the courts.
109. The public notice had be published in one English and one vernacular language newspaper, copies of which were required to be submitted to the RBI.
effecting a change of ‘control’ of non-deposit NBFC (the term ‘control’ has the same meaning as defined in the SEBI Takeover Code), and a separate approval was not required; and unless the RBI restricted the transfer of shares or the change of control, the change of control became effective from the expiry of thirty days from the date of publication of the public notice.

However, RBI vide its circular dated May 26, 2014\(^\text{(10)}\), has prescribed that in order to ensure that the ‘fit and proper’\(^\text{(11)}\) character of the management of NBFCs is continuously maintained for both, ‘deposit accepting’ and ‘non-deposit accepting’ NBFCs, its prior written permission has to be obtained for any takeover or acquisition of control of an NBFC, whether by acquisition of shares or otherwise. This RBI circular requires prior approval in the following situations also:

i. any merger/amalgamation of an NBFC with another entity or any merger/amalgamation of an entity with an NBFC that would give the acquirer / another entity control of the NBFC;

ii. any merger/amalgamation of an NBFC with another entity or any merger/amalgamation of an entity with an NBFC which would result in acquisition/transfer of shareholding in excess of 10 percent of the paid up capital of the NBFC;

iii. for approaching a court or tribunal under Section 391-394 of the Companies Act, 1956 or Section 230-233 of Companies Act, 2013 seeking order for mergers or amalgamations with other companies or NBFCs.

The above mentioned RBI approval is sought from the DNBS (Department of Non-Banking Supervision) division of the RBI.

Separately, earlier, any transfer of shares of a financial services company from a resident to a non-resident required prior approval of the Foreign Exchange Department of the Reserve Bank of India (“FED”), which took anywhere in the region of 2 – 4 months. In a welcome move, as per a recent RBI circular dated November 11, 2013, the requirement to procure such an approval was removed if:

i. any ‘fit and proper/ due diligence’ requirement as regards the non-resident investor as stipulated by the respective financial sector regulator shall have to be complied with; and

ii. The FDI policy and FEMA regulations in terms of sectoral caps, conditionalities (such as minimum capitalization, etc.), reporting requirements, documentation etc., are complied with.

Since, the requirement of obtaining RBI approval in case of change in control even for non-deposit taking NBFC is relatively very new, only time will tell how forthcoming RBI is in granting such approvals and to that extent, how favourable is this option of purchasing NBFC.

**B. Capitalization**

The NBFC would be subject to minimum capitalization requirement which is pegged to the extent of foreign shareholding in the NBFC as set out in the FDI Policy.

<table>
<thead>
<tr>
<th>PERCENTAGE OF HOLDING IN THE NBFC</th>
<th>MINIMUM CAPITALISATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 51% FDI</td>
<td>USD 0.5 million, with entire amount to be brought upfront</td>
</tr>
<tr>
<td>More than 51% FDI</td>
<td>USD 5 million with entire amount to be brought upfront.</td>
</tr>
<tr>
<td>More than 75% FDI</td>
<td>USD 50 million, with USD 7.5 million to be brought upfront and the balance in 24 months.</td>
</tr>
</tbody>
</table>

\(^\text{(10)}\) DNBS (PD) CC.No.376/03.10.001/2013-14

\(^\text{(11)}\) Under the Master Circular on Corporate Governance dated July 1, 2014, RBI had emphasized the importance of persons in management who fulfill the ‘fit and proper’ criteria. The Master Circular provides as follows:

“…..it is necessary to ensure that the general character of the management or the proposed management of the non-banking financial company shall not be prejudicial to the interest of its present and future depositors. In view of the interest evinced by various entities in this segment, it would be desirable that NBFC-D with deposit size of Rs 20 crore and above and NBFC-ND-SI may form a Nomination Committee to ensure ‘fit and proper’ status of proposed/existing Directors.”
Considering the need for capitalization, it is not uncommon to see non-residents holding less than 75% stake in the NBFC even though a significant portion of the contribution comes from non-residents. Premium on securities is considered for calculating the minimum capitalization.

In addition to the above, every NBFC is required to have net owned funds of INR 20 million (INR 2.5 million provided application for NBFC registration is filed on or before April 20, 1999). RBI has revised the net owned funds requirement for the NBFCs registered before April 20, 1999. Those NBFCs will have to increase their net owned funds to INR 20 million in a systematic manner by March 2017.

C. The Instrument

All non-deposit accepting NBFCs are subjected to NBFC (Non-Deposit Accepting or Holding) Companies Prudential norms (Reserve Bank) Directions (the Prudential Norms), once such NBFC has ‘total assets’ in excess of INR 5 billion, the NBFC is referred to as a ‘systemically important NBFC’. Unlike other NBFCs, a systemically important NBFC is required to comply with Regulation 15 (Auditor’s Certificate), Regulation 16 (Capital Adequacy Ratio) and Regulation 18 (Concentration of Credit/Investment) of the Prudential Norms. The choice of instrument is largely dependent on the capital adequacy ratio required to be maintained by the NBFC for the following reason.

Regulation 16 of the Prudential Norms restricts a systemically important NBFC from having a Tier II Capital larger than its Tier I Capital.

“Tier I Capital” = Owned funds + Perpetual debt instruments (upto15% of Tier I Capital of previous accounting year) + Investment in shares of NBFC and share/debenture/bond/loans/deposits with subsidiary and Group company (in excess of 10% of Owned Fund)

“Tier II Capital” = Non-convertible Preference shares / OCPS + Subordinated debt + General Provision and loss reserves (subject to conditions) + Perpetual debt instruments (which is in excess of what qualifies for Tier I above) + Hybrid debt capital instruments + revaluation reserves at discounted rate of fifty five percent;

D. No ability to make investments

Under the FDI Policy, an NBFC with foreign investment can only engage in certain permitted activities under the automatic route, and engaging in any financial services activity other than such activities will require prior approval of the Foreign Investment Promotion Board (“FIPB”), an instrumentality of the Ministry of Finance of the Government of India.

While lending qualifies as one of the permitted categories (‘leasing and finance’), ‘investment’ is not covered in the list above. Therefore, any FDI in an NBFC that engages in ‘investments’ will require prior approval of the FIPB. Such an approval though discretionary is usually granted within 3 months’ time on a case to case basis. Therefore, an NBFC with FDI can only engage in lending but not in making investments.

We are given to understand that in a few cases where the redemption premium of the NCDs was linked to the equity upside, RBI qualified such instruments to be in the nature of investments rather than just loan instruments. Once the nature of the instrument changed, then nature of the NBFC automatically changed from lending to investment, and FIPB approval was immediately required in respect of foreign investment in an NBFC engaged in investment activity.

112. Net Owned Funds has been defined in the RBI Act 1934 as (a) the aggregate of paid up equity capital and free reserves as disclosed in the latest balance sheet of the company, after deducting there from (i) accumulated balance of loss, (ii) deferred revenue expenditure and (iii) other intangible asset; and (b) further reduced by the amounts representing (i) investment of such company in shares of (i) its subsidiaries; (ii) companies in the same group; (iii) all other NBFCs and (c) the book value of debentures, bonds, outstanding loans and advances (including hire purchase and lease finance) made to and deposits with (i) subsidiaries of such company and (ii) companies in the same group, to the extent such amounts exceed ten percent of (a) above.

113. Note that an NBFC becomes a systemically important NBFC from the moment its total assets exceed INR 500 crores and above as shown in the last audited balance sheet.

114. “Owned Fund” means Equity Capital + CCPS + Free Reserves +Share Premium + Capital Reserves – (Accumulated losses + BV of intangible assets + Deferred Revenue Expenditure)


116. The FDI Policy however under paragraph 6.2.17.8.2 (i) provides that: “(iv) NBFCs (i) having foreign investment more than 75% and up to 100%, and (ii) with a minimum capitalisation of USD 50 million, can set up step down subsidiaries for specific NBFC activities, without any restriction on the number of operating subsidiaries and without bringing in additional capital. (v) Joint Venture operating NBFCs that have 75% or less than 75% foreign investment can also set up subsidiaries for undertaking other NBFC activities, subject to the subsidiaries also complying with the applicable minimum capitalisation norms.”
CORE INVESTMENT COMPANIES

A core investment company ("CIC") is a company which satisfies the following conditions as on the date of the last audited balance sheet (i) it holds not less than 90% of its net assets in the form of investment in equity shares, preference shares, bonds, debentures, debt or loans in group companies; (ii) its investments in the equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in group companies constitutes not less than 60% of its net assets; (iii) it does not trade in its investments in shares, bonds, debentures, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment; and (iv) it does not carry on any other financial activity referred to in Section 45 I (c) and 45 I (f) of the Reserve Bank of India Act, 1934 except for granting of loans to group companies, issuing of guarantees on behalf of group companies and investments in bank deposits, money market instruments etc.

A CIC is not required to register with the RBI, unless the CIC accepts 'public funds' AND has total financial assets in excess of INR 1 billion.

'Public funds' for the purpose of CIC include funds raised either directly or indirectly through public deposits, Commercial Papers, debentures, inter-corporate deposits and bank finance but excludes funds raised by issue of instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue.

E. Deployment of Funds

NBFCs can issue debentures only for deployment of the funds on its own balance sheet and not to facilitate requests of group entities/parent company/associates. Core Investment Companies have been carved out from the applicability of this restriction.

F. Credit concentration norms

A systemically important NBFC is not permitted to lend or invest in any single company exceeding 15% of its owned fund117, or single group118 of companies exceeding 25% of its owned fund. If however the systemically important NBFC is investing and lending, then these thresholds stand revised to 25% and 40% respectively.

Exemption from such concentration norms may be sought and has been given in the past where the NBFC qualified the following two conditions – firstly, the NBFC did not access public funds119 and secondly, the NBFC did not engage in the business of giving guarantees. Interestingly, 'public funds' include debentures, and to that extent, if the NBFC has issued any kind of debentures (including CCDs), then such relaxation may not be available to it. In the absence of such exemption, it may be challenging for loan or investment NBFCs to use the leverage available to them for the purpose of making loans or investments.

G. Only Secure Debentures can be Issued

NBFCs can only issue fully secured debentures whether by way of private placement or public issue. The security has to be created within a month from the date of issuance. If the security cover is inadequate, the proceeds have to be placed in an escrow account, till the time such security is created.

H. Enforcing Security Interests

Currently NBFCs, are not entitled to protection under the SARFAESI Act. However as mentioned earlier, Government is proposing to extend SARFAESI benefits to the NBFCs that (a) are registered with the RBI and (b) have an asset size of INR 500,00,00,000 (Rupees Five Hundred Crores) (INR 5 billion) as shall be considered as 'financial institution' for the purposes of the SARFAESI Act.

This is a welcome move for the NBFC industry in India for the following key reasons. Firstly, eligible NBFCs would now be able to enforce security interest without court intervention thereby considerably expediting the security enforcement mechanism. Secondly, assets of eligible NBFCs can now be sold to asset reconstruction or securitization companies. Additionally, eligible NBFC would now also be considered a qualified institutional buyer and would

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117. Supra Note 44
118. The term 'group' has not been defined in the Prudential Norms
119. “Public funds” includes funds raised either directly or indirectly through public deposits, Commercial Papers, debentures, inter-corporate deposits and bank finance.
be able to acquire security receipts issued by an asset reconstruction company or a securitization company.

I. Exit

Exit for the foreign investor in an NBFC is the most crucial aspect of any structuring and needs to be planned upfront. The exits could either be by way of liquidation of the NBFC, or buy-back of the shares of the foreign investor by the NBFC, or a scheme of capital reduction (where the foreign investor is selectively bought-back), or the sale of its shares in the NBFC to another resident or non-resident, or lastly, by way of listing of the NBFC.  

Unlike most countries, liquidation in the Indian context is a time consuming and is an elaborate process in India which sometimes takes in excess of 10 years.

Buyback of securities is another alternative, however, CCDs cannot be bought back. CCDs must be converted into the underlying equity shares to be bought back. Buy-back of securities is subject to certain conditionalities as stipulated under Section 68 of the Companies Act, 2013. A buyback of equity shares can happen only out of free reserves, or proceeds of an earlier issue or out of share premium. In addition to the limited sources that can be used for buy-back, there are certain other restrictions as well that restrict the ability to draw out the capital from the company. For instance, only up to a maximum of 25% of the total paid up capital and free reserves of the company can be bought in one financial year, the debt equity ratio post buy-back should not be more than 2:1 etc. Buy-back being a transfer of securities from a non-resident to a resident cannot be effected at a price higher than the price of the shares as determined by the discounted cash flows method.

From a tax perspective, tax at the rate of 20% is imposed on a domestic company on consideration paid by it which is above the amount received by the company at the time of issuing of shares. Accordingly, gains that may have arisen as a result of secondary sales that may have occurred prior to the buy-back will also be subject to tax. This will have a significant adverse impact on offshore realty funds and foreign investors who have made investments from countries such as Mauritius, Singapore, United States of America and Netherlands 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.

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 of the ITA (Expenditure incurred in relation to income not includible in total income) may also arise. This may therefore result in the buy-back of shares being even less tax efficient than the distribution of dividends.

As an alternative to buy-back, the investor could approach the courts for reduction of capital under the provisions of section 68 of the Companies Act, 2013; however, the applications for such reduction of capital need to be adequately justified to the court. From a tax perspective, the distributions by the company to its shareholders, for reduction of capital, would be regarded as a dividend to the extent to which the company possesses accumulated profits and will be taxable in the hands of the company at the rate of 15%. Any, distribution over and above the accumulated profits (after reducing the cost of shares) would be taxable as capital gains.

Sale of shares of an NBFC or listing of the NBFC could be another way of allowing an exit to the foreign investor; however, sale of shares cannot be effected at a price higher than the price of the shares determined by the discounted cash flow method. Listing of NBFCs will be subject to the fulfillment of the listing criterion and hinges on the market conditions at that point in time.

120. The forms of exit discussed here are in addition to the ability of the foreign investor to draw out interest / dividends from the NBFC up to 300 basis points over and above the State Bank of India prime lending rate.

121. As a structuring consideration, the CCDs are converted into a nominal number of equity shares at a very heavy premium so that the share premium can then be used for buy-back of the shares.

122. Exclusive of surcharge and cess
Annexure III
Foreign Investors Permitted to put: Some Cheer, Some Confusion

- Amendment recognizes shares/debentures with a built-in option/right as eligible instruments which may be issued to foreign investors;
- Such securities cannot have an assured exit price, although the Amendment specifies methodologies to determine the exit price;
- The prescribed price determination measures may make it more beneficial to invest in compulsorily convertible securities rather than equity shares;
- A minimum lock-in period of one year has been prescribed before the option can be exercised.

I. Background

The validity and enforceability of put options has always been a bone of contention from an Indian securities law and exchange control perspective.

In the past, Securities and Exchange Board of India ("SEBI") had taken a stand, in context of public companies, that option arrangements are akin to forward contracts, hence restricted. SEBI relaxed its position through a notification in October, 2013. The SEBI notification granted validity to contracts containing clauses related to preemptive rights, right of first offer, tag along right, drag along right, and call and put options.

From an RBI perspective, the issue was more from an external commercial borrowings ("ECB") perspective. RBI had issued a notification on June 8, 2007 vide Circular 73, setting out that non-residents could only subscribe to FDI Instruments, and any instrument that may be redeemable or optionally redeemable will qualify as ECB. Interpreting that Circular, the RBI regarded put options in favour of non-residents as redeemable instruments, not permitted under the FDI regime. That interpretation was even extended to situations where the put option was not on the company, but the promoters of the company.

On a separate count, taking a cue from SEBI, the RBI also took a view that a put option provision in an investment agreement would qualify as a 'option' or an over the counter derivative, which is not permitted under the FDI route. That view was taken despite the fact that no separate price was paid for the optionality, and the optionality could not be traded independent of the FDI Instrument.

Having said that, there was no clear written policy that restricted put options, and RBI's approach was seen to be on a case-to-case basis, typically in cases where the promoters (not willing to honor the put) approached the RBI themselves. However, the aggressiveness with which the RBI implements such an unwritten policy was remarkable. The risk of having a put was not just limited to it being not enforceable, RBI in fact regarded the mere existence of put in a contract as a violation of the FDI Policy and initiated proceedings against the parties for having provided for such options in their investment contracts.

In fact, the Department of Industrial Policy and

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Private Equity and Private Debt Investments in India

Promotion (DIPP) had brought in a written prohibition on options in the Consolidated FDI Policy dated October 01, 2011, but deleted that provision within 30 days of it in light of industry wide criticism. However, notwithstanding the deletion of prohibition of options, RBI continued with its approach that put options in favour of non-residents were violative of the FDI policy. Please refer to our hotline discussing the change in regulatory policy here http://tmp.nishithdesai.com/old/New_Hotline/CorpSec/CORPSEC%20HOTLINE_Oct0311.htm and here http://tmp.nishithdesai.com/old/New_Hotline/CorpSec/CORPSEC%20HOTLINE_Nov0111.htm.

II. Amendment

The Amendment, for the first time, provides for a written policy on put options, and in doing that sets out the following conditions for exercise of options by a non-resident:

i. Shares/debentures with an optionality clause can be issued to foreign investors, provided that they do not contain an option/right to exit at an assured price;

ii. Such instruments shall be subject to a minimum lock-in period of one year;

iii. The exit price should be as follows:
   - In case of listed company, at the market price determined on the floor of the recognized stock exchanges;
   - In case of unlisted equity shares, at a price not exceeding that arrived on the basis of Return on Equity ("RoE") as per latest audited balance sheet. RoE is defined as the Profit after Tax divided by the net worth (defined to include all free reserves and paid up capital);
   - In case of preference shares or debentures, at a price determined by a Chartered Accountant or a SEBI registered Merchant Banker per any internationally accepted methodology.

III. Analysis

In a market where IPOs are almost non-existent, put options give tremendous comfort to offshore private equity funds, should a trade sale not materialize within their exit horizons. Put options become even more important for certain asset classes like real estate or other stabilized yield generating assets where secondary sales and IPOs are not very common in the Indian context. The Amendment is a positive development for such players as commercial justifications behind inclusion of options into investment agreements have been recognized, and Indian companies and their founders can no longer treat such rights/options as mere paper rights.

A detailed analysis of the Amendment, its ambiguities and practical challenges are set out herein below.

A. Lock in

- While a minimum lock in period of one year has been specified, it is unclear as to which date it should apply from. For example, if the date of optionality agreement and issuance of securities are different, which would be the relevant date? On a conservative basis, it may be appropriate to reckon the lock-in conditions from the later of the two dates.

- There are also issues about whether the lock-in restricts only the exercise of securities or also the secondary transfer of securities, as well as whether a secondary transfer would reset the clock in the hands of the new investor. It appears that the one year lock would be required only if the option is being exercised (and not in case of all secondary transfers), and would apply afresh in the hands of each subsequent transferee.

B. Will DCF Pricing Cap Still Apply, if the Exit Price for Options is Higher than DCF

- Under the current regulations, non-residents are not entitled to sell the FDI Instruments to an Indian resident at a price exceeding the price computed per the discounted free cash flows ("DCF") methodology.

- However, the DCF cap applicable to FDI Instruments will not be applicable to sale of FDI Instruments with a put option. This is because the exit pricing applicable in case of exercise of the option by the non-resident has been introduced by amendment to Regulation 9 of the TISPRO regulations, whereas the DCF price cap is applicable to securities transferred under Regulation 10 B(2) (by virtue of the RBI circular dated May 4, 2010). Regulation 10B only applies to transfers by non-residents, which are not covered under Regulation 9. Therefore, the DCF cap will not be applicable when determining the exit price pursuant to exercise of put option.

- The question remains on whether the option
pricing norms set out in the Amendment will only apply if the option is exercised, or even if shares with options are transferred to the grantor of the option without the exercise of an option.

C. Exit Price for Equity Shares

- The Amendment provides that the exit price in respect of equity shares of unlisted company should not exceed the price arrived at on the basis of Return on Equity (“RoE”) as per the last audited balance sheet.
- The formula is divorced from the traditional form of calculating RoE (where the denominator is average shareholder equity and not networth) and brings in several impractical situations set out below.
- Plain reading of the provision suggests that the exit price would be capped at the RoE. Whilst it is not clear, it appears that the RoE formula should be interpreted to mean principal plus the RoE. That is to say, if the invested amount was INR 100, and the company generated profits of INR 20 each year for five years, leading to a hypothetical net worth of 200, the RoE would be equal to the profit of the sixth year divided by 200. If the profit after tax in the sixth year were INR 20, the RoE would be 20/200 or 10%. Accordingly, the exit price for the foreign investor would be capped at INR 110, which clearly may not be reflective of the FMV of the instrument.
- The formula for determining the exit price seems to be at complete odds with the pricing suggested for convertibles (any internationally accepted valuation methodology), listed equity shares (ruling market price), or even shares and convertibles without optionality attached (discounted cash flow valuation), which are likely to be much closer to FMV than the RoE methodology.
- For instance, if the formula is applied, accumulated profits only decrease the RoE. The formula also leaves the exit price contingent on the last audited balance sheet, which may have unintended and distorting consequences. For example, if the put option is to be triggered after a fixed period of time (being five years, in the above example), and the company incurs a loss in the sixth year, on a conservative basis, the exit price may be capped at a price lower than the investment amount.
- If the put option is tied to an event of default, the valuation mechanism may have unintended consequences as the default may have an impact on the profitability of the company in the year of exit.
- Requiring an exit at RoE is clearly ambiguous. Ideally the RoE can only be the basis to compute the exit price. To that extent, it remains to be seen if the RBI will permit the exit price on equity shares with optionality attached to be a variable of the RoE that brings the exit price closer to FMV, just as in case of convertibles and listed shares.

D. Determination of Price of Convertibles Securities

- The Amendment provides the exit price for convertibles upon exercise of put option should be a price determined based on international accepted pricing methodology, as determined by a SEBI registered merchant banker or chartered accountant.
- This valuation mechanism is likely to provide more flexibility to investors at the point of exit, and hence going forward we may see investors preferring more of convertible securities as compared to equity shares for their investments in Indian companies. Having said this, it is unclear why different valuation mechanisms were believed to be required for equity shares and compulsorily convertible securities, which are in any case treated on the same footing and subject to DCF cap on an as if converted basis under the current regulatory regime.

E. Status of Existing Option Arrangements

- The Circular clearly sets out that all existing contracts must comply with the conditions set out in the Amendment to qualify as being FDI compliant.
- In light of this, a position could be taken that all existing contracts that are not compliant with the conditions set out in the Amendment become FDI non-compliant, especially if they provide for options with assured returns.
- The terms of such put options contained in existing contracts may need to be revisited to bring them in compliance with the Amendment. However, if the existing terms of issuance already provide that the exit price should be subject to applicable law, then the terms of the security may be considered to have been amended by the law and should thus be considered valid notwithstanding the Amendment.
F. Impact on Joint Ventures and M&A Deals

- Options are not just contained in private equity transactions. Even joint venture transactions and sometimes M&A transactions contain put options in favour of non-residents. These options are usually pegged to fair market value (determined per commercial negotiations) or at discount or premium to the fair market value.
- There may be a need to look at such joint venture agreements, as the commercially negotiated price will now be subjected to the pricing for options as set out in the Amendment.

IV. Conclusion

The Amendment is a welcome development as it gives predictability and commercial flexibility to foreign investors, in relation to contractual provisions, which are fairly standard in the international investment context. However, pegging the exit price for equity to RoE (and not a multiple of RoE that brings the exit price closer to FMV) is likely to be a cause of major concern for investors. While preference shares may be preferred from an exit pricing perspective, Companies Act 2013, which denies the flexibility of voting on as-if-converted basis may galvanize the investors to invest in common equity. The need to amend existing contracts to bring them in line with the Amendment may be a challenging task, especially for most offshore private equity players that would be hesitant to revisit investment agreements if they are close to their exit horizons. What will also be interesting is to see how the term ‘exercise’ is interpreted and whether RBI will require exit pricing as set out for options to be applicable even when the shares are transferred to the Indian resident granting the option voluntarily, and not in exercise of the option/right.

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Annexure IV

Specific Tax Risk Mitigation Safeguards for Private Equity Investments

In order to mitigate tax risks associated with provisions such as those taxing an indirect transfer of securities in India, buy-back of shares, etc., parties to M&A transactions may consider or more of the following safeguards.

I. Nil withholding Certificate

Parties could approach the income tax authorities for a nil withholding certificate. There is no statutory time period prescribed with respect to disposal of applications thereof, which could remain pending for long without any clarity on the time period for disposal. In the last few years, there have not been many instances of such applications that have been responded to by the tax authorities. However, recently, in January 2014, an internal departmental instruction was issued requiring such applications to be decided upon within one month. The extent to which the instruction is adhered to remains yet to be seen.

II. Advance Ruling

Advance rulings obtained from the Authority for Advance Rulings ("AAR") are binding on the taxpayer and the Government. An advance ruling may be obtained even in GAAR cases. The AAR is statutorily mandated to issue a ruling within six months of the filing of the application, however due to backlog of matters; it is taking about 8-10 months to obtain the same. However, it must be noted that an advance ruling may be potentially challenged in the High Court and finally at the Supreme Court.

III. Contractual Representations

Parties may include clear representations with respect to various facts which may be relevant to any potential claim raised by the tax authorities in the share purchase agreement or such other agreement as may be entered into between the parties.

IV. Escrow

Parties may withhold the disputed amount of tax and potential interest and penalties and credit such amount to an escrow instead of depositing the same with the tax authorities. However, while considering this approach, parties should be mindful of the opportunity costs that may arise because of the funds getting blocked in the escrow account.

V. Tax insurance

A number of insurers offer coverage against tax liabilities arising from private equity investments. The premium charged by such investors may vary depending on the insurer’s comfort regarding the degree of risk of potential tax liability. The tax insurance obtained can also address solvency issues. It is a superior alternative to the use of an escrow account.

VI. Legal opinion

Parties may be required to obtain a clear and comprehensive opinion from their counsel confirming the tax liability of the parties to the transaction. Relying on a legal opinion may be useful to the extent that it helps in establishing the bona fides of the parties to the transaction and may even be a useful protection against penalties associated with the potential tax claim if they do arise.

VII. Tax indemnity

Tax indemnity is a standard safeguard used in most M&A transactions. The purchasers typically seek a comprehensive indemnity from the sellers for any tax claim or notice that may be raised against the purchaser whether in relation to recovery of withholding tax or as a representative assessee. The following key issues may be considered by parties while structuring tax indemnities:
A. Scope

The indemnity clause typically covers potential capital gains tax on the transaction, interest and penalty costs as well as costs of legal advice and representation for addressing any future tax claim.

B. Period

Indemnity clauses may be applicable for very long periods. Although a limitation period of seven years has been prescribed for reopening earlier tax cases, the ITA does not expressly impose any limitation period on proceedings relating to withholding tax liability. An indemnity may also be linked to an advance ruling.

C. Ability to Indemnify

The continued ability and existence of the party providing the indemnity cover is a consideration to be mindful of while structuring any indemnity. As a matter of precaution, provision may be made to ensure that the indemnifying party or its representatives maintain sufficient financial solvency to defray all obligations under the indemnity. In this regard, the shareholder/s of the indemnifying party may be required to infuse necessary capital into the indemnifying party to maintain solvency. Sometimes back-to-back obligations with the parent entities of the indemnifying parties may also be entered into in order to secure the interest of the indemnified party.

D. Conduct of Proceedings

The indemnity clauses often contain detailed provisions on the manner in which the tax proceedings associated with any claim arising under the indemnity clause may be conducted.

E. Dispute Resolution Clause

Given that several issues may arise with respect to the interpretation of an indemnity clause, it is important that the dispute resolution clause governing such indemnity clause has been structured appropriately and covers all important aspects including the choice of law, courts of jurisdiction and/or seat of arbitration. The dispute resolution mechanism should take into consideration urgent reliefs and enforcement mechanisms, keeping in mind the objective of the parties negotiating the master agreement and the indemnity.
India has entered into several BITs and other investment agreements. Relying on the BITs in structuring investment into India, may be the best way to protect a foreign investor’s interest. Indian BITs are very widely worded and are severally seen as investor friendly treaties. Indian BITs have a broad definition of the terms ‘investment’ and ‘investor’. This makes it possible to seek treaty protection easily through corporate structuring. BITs can also be used by the investors to justify the choice of jurisdiction when questioned for GAAR.

The model clauses for Indian BITs include individuals and companies under the definition of an “investor”. Further, companies are defined to include corporations, firms and associations. More importantly, Indian BITs adopt the incorporation test to determine the nationality of a corporation. This is a very beneficial provision as a holding company, which even though is merely a shell company, would not be excluded from treaty benefits.

Further, the word “investment” is defined to include every kind of asset established or acquired including changes in the form of such investment, in accordance with the national laws of the contracting party in whose territory the investment. It specifically includes the following within the ambit of investment:

i. movable and immovable property as well as other rights such as mortgages, liens or pledges;
ii. shares in and stock and debentures of a company and any other similar forms of participation in a company;
iii. rights to money or to any performance under contract having a financial value;
iv. intellectual property rights, in accordance with the relevant laws of the respective contracting party; and
v. business concessions conferred by law or under contract, including concessions to search for and extract oil and other minerals.

The benefit of this is that even if the foreign parent or subsidiary is merely a shareholder in a locally incorporated Indian company, they would be able to espouse claims under the treaty by the virtue of their investment in the nature of shares in India. This again aids corporate structuring and enables an investor to achieve maximum treaty benefits. Thus, if the parent company incorporated within a non-treaty jurisdiction (P), carries out operation in India through an Indian subsidiary (S) which is held through an intermediary incorporated within a treaty jurisdiction (I), the parent company can seek protection of their investment in the subsidiary through the treaty benefits accrued to the intermediary (See fig 1).

Fig 1: Operations through an India subsidiary which is held through an intermediary in a treaty jurisdiction.
Further, it is an established principle under international law that minority shareholder rights too are protected under BITs. This gives a right to the non-controlling shareholders to espouse claims for losses to their investments. This also enables an investor to diversify its investments through different treaty jurisdictions which will enable the investor to bring multiple claims under different proceedings to ensure full protection of one’s investment (See fig. 2). The exact right guaranteed to a particular structure will vary on case to case basis and can be achieved to the satisfaction of the investors by pre-analyzing treaty benefits at the time of making the investments.

An important point further in favour of the foreign investor investing in India is that India has lucrative BITs with almost all tax efficient jurisdictions including Mauritius, Netherlands, Switzerland, Cyprus, Singapore etc. This enables an investor to achieve maximum benefit from one’s investment.

Fig 2: Investment in Indian Investee Company through multiple Subsidiaries in different treaty jurisdiction.
Government’s recent initiative to allow unlisted companies to list on offshore markets through the depository receipt (DR) mechanism without the requirement of simultaneous listing in India is likely to be a major shot in the arm for many sectors, and also offer exits to private equity players looking to monetize their investments. Though offshore listing was permitted later last year by Ministry of Finance, such listings could not happen as SEBI had not prescribed the disclosures for such listings.

Government has only recently prescribed that SEBI shall not mandate any disclosures, unless the company lists in India. Once the air around disclosures to SEBI has been cleared, we can expect offshore listing of DRs to grow on the back of the reasons set out below.

First, offshore listing will offer the opportunity to a slew of young Indian companies to tap the overseas markets, which unlike domestic markets remain quite vibrant. 2012 saw only 3 mainboard listings as against 256 in the US.

Second, offshore listing would allow Indian entrepreneurs the platform to tap investors that have a much better understanding of the value proposition of the business. For instance, innovative tech, biotech, internet services are likely to receive a better valuation on NYSE / NASDAQ as against domestic markets.

Today, markets have become associated with sectors - NYSE / NASDAQ is known for tech, SGX for real estate and infra, LSE/AIM for infra and manufacturing. DR’s would allow the opportunity to list on exchanges that are most conducive to the sector.

Third, foreign investors will find it more amenable to invest in DR’s denominated in foreign currency as against INR, which has depreciated by more than 50% since 2007. Hedging cost is likely to be an important driver for the growth of DRs. Many private equity players suffered the wrath of their LPs due to the steep rupee depreciation, despite the company outperforming the expectations.

Fourth, while the offshore listing regime is meant for fund-raising (it requires that funds must be brought back into India within 15 days unless utilized offshore for operations abroad), with a little bit of structuring, the proceeds can also be used to provide tax free exits to offshore private equity players.

Since there is no end use prohibition, proceeds of the DR can be structured to retire existing debt or private equity. With a growing number of secondary direct funds looking at India, DRs can be the preferred way to invest in India, retire existing investors and monetize the investment later on the floor of the exchange.

Fifth, from a tax perspective, investors can finally breathe easy. There will be no tax on the sale of DRs on the stock exchange. Hence, investors need not worry about GAAR and substance in the treaty jurisdiction or risk of indirect transfer taxation.

Sixth, listing of DRs is likely to be much cheaper than listing of shares on foreign exchanges and sometimes the compliance costs of ADR / GDR may be lower than the compliance costs of domestic listing.

Seventh, offshore listing would give depth to Indian capital markets as well, and brighten the chances of the company going public in India after having a successful show on the offshore markets.

Eighth, listing on offshore exchanges like NYSE / NASDAQ / SGX has its own snob value and is likely to benefit many of the younger companies in gaining reputation and recognition overseas.

Ninth, an increasing number of acquisitions, especially in the tech space are happening by way of swaps, or in other words, the shareholders of the target company receiving consideration in form of shares of the acquirer company.

This is a common strategy to keep the interests of both the parties aligned post acquisition. With most targets for tech companies being offshore, such swap deals are hard to achieve, as there may be few takers for Indian unlisted shares. To that extent, DRs being dollar denominated can be used as currency for acquisitions.

However, notwithstanding the enormous benefits that the offshore listing regime brings, its success...
remains circumspect as the scheme has only been allowed for 2 years on a pilot basis. The specter of what will happen after 2 years (6 months of which have already elapsed) and the fear of the government requiring simultaneous listing in India (as was done in 2004) is likely to keep many issuers away. Having said that, offshore listing regime unveils a huge opportunity for fund raising, particularly for young IT / ITES, biotech companies etc. which do not feature on the list of either private equity or banks. What remains to be seen is the if the Government allows for DRs with underlying debt instrument as against equity.

Nishchal Joshipura,
Ruchir Sinha

You can direct your queries or comments to the authors
Annexure VII
Access to Global Capital Markets Made Easier!

II. Framework of the New Scheme

Broadly, the Scheme has been introduced with the intention to provide the Indian firms, domestic investors and foreign investors freedom to access financial markets within the prevalent foreign investment regime in India. Therefore, the provisions of the New Scheme are aimed at bringing the DR route at par with any other foreign investment. Following are the key provisions introduced under the New Scheme:

A. Requirement for approval for issuance of DR

As per the 1993 Scheme, for issuance of DRs, prior approval of the Ministry of Finance (MoF) was required. The New Scheme has done away with this requirement. However, the issue and transfer of permissible securities to a person resident outside India to form the underlying for DRs would still require approvals, if any, under the Foreign Exchange Management Act, 1999 (“FEMA”).

B. Eligibility Criteria

i. For Issuer of Underlying Securities

Under the New Scheme, any Indian company, listed or unlisted, private or public or any other issuer or person holding permissible securities is eligible to issue or transfer permissible securities to a foreign depository for the purpose of issuance of DRs. Except for persons barred from accessing international capital markets, no restrictions as such have been set out under the New Scheme as regards Indian issuer of securities.

ii. For Issuer of DRs

As per the New Scheme, a regulated entity having the legal capacity to issue DRs i.e. a person which is not prohibited from acquiring permissible securities; is regulated in a permissible jurisdiction; and has the legal capacity to issue depository receipts in the permissible jurisdiction, may issue DRs. As per the

I. Introduction

Depository Receipts (DRs) in India were governed by the Foreign Currency Convertible Bonds and Ordinary Shares (Through Depositary Receipt Mechanism) Scheme, 1993 (“1993 Scheme”) as amended from time to time. On October 21, 2014, the Ministry of Finance (“MoF”) notified (“Notification”), the Depository Receipts Scheme, 2014 (“New Scheme”) by virtue of which issuance of DRs has been taken out of the 1993 Scheme and is now regulated by the New Scheme. The New Scheme has come into effect from December 15, 2014.

The New Scheme is based on the recommendations of the Sahoo Committee, which under the chairmanship of Mr. M.S. Sahoo undertook a comprehensive review of the 1993 Scheme and proposed significant deregulation and rationalisation of the manner in which Indian companies could tap global capital markets.
1993 Scheme, only a bank authorized by the issuer of underlying securities could issue DRs.

iii. For Custodian of DRs
As per the New Scheme, any regulated entity having legal capacity for underlying securities can act as the custodian. A domestic custodian has been defined to include a custodian of securities, an Indian depository, a depository participant, or a bank and having permission from SEBI to provide services as custodian. Under the 1993 Scheme, only a banking institution could be a domestic custodian of DRs.

C. Kinds of issue of DRs
Under the New Scheme, both the category i.e. sponsored and unsponsored DRs can be issued on the back of permissible securities. Unsponsored DRs can be issued on the back of listed permissible securities only if two conditions are fulfilled viz., (i) DRs give the holder the right to issue voting instructions and (ii) the DRs are listed on an international exchange. International exchange as per the New Scheme has been defined to mean a platform for trading of depository receipts in a permissible jurisdiction is accessible to the public for trading and provides pre-trade and post-trade transparency to the public.

D. Permissible Securities
As per the 1993 Scheme, DRs could be issued only on the back of equity shares of Indian companies and were not required to be in dematerialized form. Further, the 1993 Scheme suggested that DRs could be issued on the back of foreign currency convertible bonds (“FCCBs”) as well. As per the New Scheme, DRs can be issued on the back of any permissible securities (“Permissible Securities”). Permissible Securities has been defined to include securities as defined in the Securities Contracts (Regulation) Act, 1956 (“SCRA”) whether issued by a company, mutual fund, government or any other issuer and similar instruments issued by private companies. All permissible securities are required to be in dematerialized form before they can be used as underlying for a DR issue.

E. Jurisdictions for Issue of DRs
As per the 1993 Scheme, a listed company could issue DRs in any jurisdiction across the world for listed companies and unlisted companies could issue DRs in either FATF or IOSCO compliant jurisdictions. As per the New Scheme, a company, whether listed or unlisted, can issue shares for issue of DRs only in permissible jurisdictions (“Permissible Jurisdictions”). As per the New Scheme, a Permissible Jurisdiction would be a foreign jurisdiction that satisfies twin requirements i.e. the foreign jurisdiction is a member of the FATF and the securities regulator of that jurisdiction is a member of IOSCO. The New Scheme provides a list of 34 permissible jurisdictions as on date of the Notification.

F. Pricing
The New Scheme does not prescribe any specific pricing norms for issuance of DRs. The only restriction imposed under the New Scheme is that Permissible Securities shall not be issued to a foreign depository at a price less than the price applicable to a corresponding mode of issue of such securities to domestic investors under applicable laws. In accordance with FEMA, pricing of ADR/GDR issues shall be done as per guidelines issued by the Reserve Bank of India (“RBI”). For the purpose of issue of depository receipts for listed companies, the minimum pricing norms as applicable under the SEBI Guidelines shall be complied with.

G. End Use Restrictions
Partial end – use restrictions were specifically imposed on utilization of funds raised from issuance of DRs, these funds being prohibited from being deployed or invested in real estate and stock market. The New Scheme does not provide for any end-use restrictions on the deployment of proceeds from issuance of DRs. Although, there are no restrictions on deployment of proceeds from issue of DR, restrictions as applicable under FEMA shall still be applicable.

H. Public Shareholding and Voting Rights
As per the New Scheme, the voting rights should be exercised by the foreign depository in respect of underlying securities; the depository may take instructions from DR holders. If the DR holders have the right to instruct the depository to vote on their behalf, they would have the same obligations as if it is the holder of the underlying equity shares under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (“Takeover Code”). Also, shares of a company underlying the DRs shall form part of ‘public shareholding’ (i) if the holder of the securities has the right to issue voting instructions
and (ii) such DRs are listed on an international stock exchange. The New Scheme has attempted to bring this provision in line with the Takeover Code which includes all depository receipts carrying an entitlement to exercise voting rights in the target company within the definition of 'shares' for the purpose of the Takeover Code. Therefore, this would enable the DRs with voting rights to count for public shareholding as well as have obligations under the Takeover Code.

I. Market Abuse

Sahoo Committee was conscious of the risk that DR Route may expose the Indian securities market to potential market abuse and money laundering. No explicit provision as the authority which is to be approached in case of market abuse was provided under the 1993 Scheme. To put an oversight mechanism, New Scheme categorically provides that use of DRs or market of DRs which has potential to cause or has caused abuse of securities market in India shall be dealt with by SEBI.

III. Lack of Tax Clarity

As regards, tax treatment, presently under the Income Tax Act, 1961 (“IT Act”), a non-resident to non-resident transfer of DRs is exempt from capital gains tax, whilst a non-resident to resident transfer of DRs is subject to capital gains tax at a 10% rate (exclusive of surcharge and education cess).

However, DRs, as envisaged under the IT Act at present, do not include DRs issued on the back of securities other than ordinary shares. The provisions of the IT Act would need to be amended to also include DRs issued on the back of other Permissible Securities for the above benefits to be carried forward.

Further, at present, there is no specific exemption from capital gains tax contained in the IT Act for conversion of a DR. The Sahoo Committee had recommended conversion of DRs into Permissible Securities and vice versa should not be considered as taxable events in India since DRs since the underlying securities should be treated as the same asset. We await amendments in the next budget adding an exemption similar to the exemption provided to conversion of compulsorily convertible debentures.

Also, clarity would also be needed as regards the computation of holding period for capital gains tax as to whether the period for which the foreign investor holds the DRs should also be taken into account for calculating the capital gains tax arising out of sale of the underlying securities by the foreign investor in the domestic market.

One of the other recommendations of the Sahoo Committee was that tax treatment for tendering shares by shareholders of a listed company for issue of DRs should be aligned with that of sale of shares on a stock exchange. As of now, this recommendation has not been incorporated in the IT Act either.

We await amendments in relation to taxation of transactions in relation to DRs in the next budget.

IV. Analysis

A green flag for unsponsored DRs would mean that present investors in Indian companies can initiate DR programmes without the co-operation of the company. Existent investors will now have a viable exit option along with access to an alternate foreign capital markets. For instance, this will allow private equity and venture capital funds to cash out in case the Indian company delays or resists going public.

The New Scheme has also attempted to plug loopholes in the 1993 Scheme thereby providing filip to the foreign investment regime in India, although some concerns continue to remain unaddressed.

Treating DR Route like any other foreign investment route, Sahoo Committee had recommended that DRs be allowed to be issued on the back of all kinds of securities such as bonds, debentures, government securities, units of mutual fund, ETFs, derivative products and on a range of securities. However, for DRs to be issued on the back of debt, such as non-convertible bonds issues by an Indian company, the depository will need to be qualified as a Foreign Portfolio Investor, for instance besides other challenges. The exchange control regime needs to be amended to allow DRs to go beyond the FDI regime.

However, as detailed above, until there is clarity on the tax treatment of issuance and conversion/transfer of DRs and the Indian tax policy is made compatible with global standards, the New Scheme may not be able to achieve much.

Tanya Pahwa,
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You can direct your queries or comments to the authors
Annexure VIII

Regulatory Regime Forcing Cos’ ‘Externalisation’

DOING BUSINESS AWAY FROM INDIAN TAX OVERSIGHT AND EASE OF FUND-RAISING AMONG REASONS FOR INDIA INC’S TRYST WITH FOREIGN SHORES

With Indian companies rapidly expanding their presence internationally, there has been an increased keenness in companies operating in high growth sectors to migrate their holding company structures from India to reputed offshore jurisdictions. For lack of a better word, let’s refer this process of structuring/ restructuring as ‘externalisation’ as that term may fit the reference better than ‘globalisation’ or ‘internationalisation’, both of which have much wider imports.

There are several drivers for externalisation. First, it moves the businesses away from Indian tax and regulatory challenges into jurisdictions that may be more conducive from an operational standpoint and also substantially mitigates tax leakage and regulatory uncertainty. Unwritten prohibition on ‘put options’, retroactive taxation of indirect transfers, introduction of general anti-avoidance rules fraught with ambiguities, etc, are a few examples why Indian companies may want to avoid direct India exposure.

Second, from a fund raising perspective, it offers Indian companies to connect with an investor base that understands their business potential and thus values them higher than what they would have otherwise been valued at in domestic markets. Infosys, Wipro, Rediff, Satyam are classic examples of companies which preferred to tap the global capital markets (NYSE and Nasdaq) without going public in India.

Third, with the Indian currency oscillating to extremes, one of the biggest concerns for foreign investors is currency risk. By investing in dollars in the offshore holding company (OHC), foreign investors can be immune from the currency risk and benefit from the value appreciation of the Indian companies. Many foreign investors that invested in 2007 when the rupee was at around 42 to a dollar have suffered substantially with the rupee now being at 62 to a dollar.

Fourth, and this is more of a recent issue, with the coming of the new Companies Act, 2013, which provides for class-action suits, enhanced director liability, statutory minimum pricing norms (beyond exchange control restrictions), there will be keenness to flip the structure to an OHC and ring-fence potential liabilities under the Companies Act, 2013.

Lastly, such offshore jurisdictions also provide for great infrastructure and governmental policies that are discussed with businesses and are more closely aligned to growth of the businesses as against meeting revenue targets. With most clients offshore, there may be certain amount of snob value that may be associated with establishment in such offshore jurisdictions.

Indian tax and regulatory considerations play a very important role in externalisation. From a tax standpoint, flipping the ownership offshore may entail substantial tax leakage, and to that extent it is advisable if the flip is undertaken at early stages before the value is built up in the Indian asset. Another challenge from a tax perspective is the choice of jurisdiction for the holding company in light of the impending general anti-avoidance rules that may disregard the holding company structure if it is found lacking commercial substance. To protect the tax base from eroding, some of the developed countries like the US have anti-inversion tax rules which deter US companies from externalising outside the US.

From a regulatory standpoint, one of the challenges is to replicate the Indian ownership in the OHC, especially since swap of shares or transfer of shares for consideration other than cash requires regulatory approval, which may not be forthcoming if the regulator believes that the primary purpose of the OHC is to hold shares in the Indian company. Indian companies may be restricted from acquiring shares of the OHC on account of the OHC likely qualifying as a financial services company and Indian individuals may be restricted to acquire shares of the OHC under the new exchange control norms since OHC will not be an operating company. The extent of operations to be evidenced remains ambiguous. OHCs acquisition of Indian shares will also need to be carefully structured as the OHC will not be permitted to acquire Indian shares at below fair market value from an Indian tax and exchange control perspective.

India has recently allowed Indian companies to directly list on offshore markets, but the conditions that such listing can only be for 51% shares of the Indian company and that the proceeds of such
issuance must be used overseas within 15 days may not allow the true potential of offshore listings to be unleashed. The utilisation of the direct listing regime remains to be seen as the Sebi is yet to come out with a circular setting out disclosures required for such listing.

However, considering the challenges faced by India Inc, the need to move away from India for growth seems inevitable in current times.

This article was published in The Economic Times dated January 15, 2014. The same can be accessed from the link
Private Equity and Private Debt Investments in India

Annexure IX

49% FDI in insurance: A long successful battle

The amendments to the insurance laws in India to increase foreign investment limits to 49% from the existing 26% in the insurance sector has been subject to many a political debate. The new government was keen to push through this economic reform which had been languishing since 2008 but received strong opposition in the various houses of parliament. Despite the opposition, ordinances and rules were passed by the Government of India proving temporary legal backing to the amendment. However the logjam has been put to rest with the upper house of parliament assenting to the amendments proposed by the Government on March 12, 2015. In this hotline we have analysed the various events which finally led to the increase of foreign investment in India.

I. Background

Under the Insurance Act, 1938 (“Insurance Act”), an ‘Indian Insurance Company’ was permitted to have foreign investment of up to 26% of the equity share capital of the company. Out of 23 private life insurers, more than 20 had foreign investment of above 22%. Additionally, out of 17 non-life insurers in the private sector, 14 had more than 22% foreign investment. The Indian insurance sector has seen low penetration in the country essentially because of dearth of funds to permit growth and accordingly, it was felt that there was need for permitting additional foreign investment into the insurance sector.

Realizing this requirement, the amendment to the Insurance Act to increase the maximum permitted foreign shareholding to 49% was introduced in 2008, and has been pending since, when the Insurance Laws (Amendment) Bill (“2008 Insurance Bill”) was tabled in the Rajya Sabha on December 22, 2008. An amendment of the Insurance Act is required, since unlike other sectors, the Insurance Act lays the maximum foreign shareholding permitted in an Indian insurance company. Accordingly, a notification by the Central Government or a notification under the exchange control regulation would not be sufficient. This 2008 Insurance Bill was referred to the Standing Committee on Finance, which submitted its report on December 13, 2011. Subsequently, some amendments to the 2008 Insurance Bill were introduced in July 2014. These amendments were then referred to the Select Committee in the Rajya Sabha who submitted a report on December 11, 2014 which included a revised Insurance Laws (Amendment) Bill.

The Insurance Laws (Amendment) Bill could not be passed in the winter session of the Parliament in 2014. To clarify its intent to bring in the changes, the Central Government notified the Insurance Laws (Amendment) Ordinance, 2014 on December 26, 2014 (“Ordinance”) to amend the Insurance Act giving interim legal standing to the new amendments. Under the Ordinance, the foreign investment permitted in an Indian Insurance Company was increased from 26% to 49% of the company. However, the insurance company would necessarily be required to be Indian owned and controlled.

The Ordinance required the approval of both the houses of the Parliament in the ongoing session. If the Ordinance was not cleared by both the houses of the Parliament, the Ordinance would have lapsed on April 5, 2015. Notwithstanding that the Ordinance still required the approval of the Parliament, the Government and its departments in the interim brought about the following:


ii. The Department of Industrial Policy and Promotion, Ministry of Commerce (“DIPP”) on [•] issued Press Note No. 3 of 2015 (“Press Note”) affecting changes in the exchange control laws to give effect to the increased foreign investment limits.

125. Under Section 2C of the Insurance Act, 1938, no insurer other than an ‘Indian Insurance Company’ is permitted to commence or carry on any class of insurance business after the commencement of the Insurance Regulatory and Development Authority Act, 1999

126. IRDA Annual Report for the year ended March 31, 2014, available online www.irda.gov.in

127. Under the Indian Constitution, an Ordinance may be promulgated by the President of India, when the Parliament is not in session to transact any urgent business. The ordinance lapses on the expiry of 6 weeks from the date of the beginning of the next session of the Parliament or if both houses disapprove of the bill to replace the ordinance.
The Insurance Law (Amendment) Bill 2015 ("2015 Insurance Bill") was finally tabled on March 3, 2015 in the Lok Sabha.

The 2015 Insurance Bill has been passed by the Lok Sabha on March 3, 2015 and by the Rajya Sabha on March 12, 2015. The Ordinance shall now be replaced by the 2015 Insurance Bill once it receives the assent of the President.

II. Changes brought about by the amended legislation and analysis

A. Foreign investment: 26% to 49%

i. The 2015 Insurance Bill the Rules and the Press Note clarify that the maximum foreign investment permitted in the equity shares of an Indian Insurance Company shall be 49% (forty nine percent) compared to 26% (twenty six percent) earlier.

ii. Foreign investment would be under the automatic route up to 26% and under the government or approval route for any investment above 26% till 49%.

iii. The cap of 49% shall include direct and indirect foreign direct investment as well as foreign portfolio investment. Foreign portfolio investment has been defined to include investments by foreign institutional investors, qualified financial investors, foreign portfolio investors and non-resident investors.

iv. The mechanism for calculation of indirect foreign investment continues to remain the same.

B. Control and ownership

The Indian Insurance Company shall at all times ensure that its ownership and control is with Indian residents. Indian ownership is defined to mean more than 50% (fifty percent) of the equity share capital being held by Indian residents. Control is defined to include the right to appoint majority directors on the board of the company or to control the management or policy decisions, including by virtue of shareholders or management rights or shareholder agreements or voting agreements. The definitions of 'ownership' and 'control' are in line with the definitions of 'control' and 'ownership' under the foreign direct investment ("FDI") policy 2014 ("FDI Policy").

III. Analysis

- The changes introduced are in line with the budget speech of 2015 and the Ordinance, increasing the foreign investment limits from 26% to 49%, with any investment above 26% being under the approval or government route.

- The calculation of foreign investment into insurance companies has been explained to include foreign direct investment and portfolio investment (which includes non-resident Indian investment). This is similar to the mechanism for calculation of foreign investment into insurance company till now, which was capped at 26%.

Additionally, foreign investment also includes any investment in the promoter entities of such insurance companies, by the foreign companies (or its subsidiaries), non-resident investors or other foreign investors who hold shares in the insurance companies.

- Under the Insurance Act, insurance companies were permitted to have issue only one class of equity shares, and no other form of share capital was permitted. This made structuring of investments in the form of preference shares or other instruments difficult. The Ordinance, however, permitted the Insurance Regulatory Development Authority of India ("IRDAI") to prescribe such other classes of shares which may be issued by the insurance companies. However, IRDAI has not made any change to the existing regulations, and the share capital of an Indian insurance company can only contain equity shares currently.

IV. Analysis

- The Insurance Act earlier did not provide for control and ownership of an Indian insurance company to be with resident individuals. As a consequence, it was possible for offshore strategic partners in the insurance sector to have substantial control rights, including reserved matters or veto rights on operational and financial policy decisions of the joint venture.

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128. Investing through preference shares, is preferred, especially for foreign shareholders, since preference shares gives priority with respect to payment of dividend and payments at the time of liquidation.
This may be a concern for offshore partners in joint ventures. The definition of ‘control’ under the Rules is similar to that under the FDI Policy and SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011. The Foreign Investment Promotion Board (“FIPB”) had raised concerns with Etihad Airways enjoying veto and quorum rights under its investment agreement with Jet Airways, and these rights were made to be watered down. Similar instances of reducing extent of rights in Indian insurance companies by offshore partners may be seen in future.

There is no precedent as to how IRDAI interprets the requirements of control and ownership being in the hands of Indian residents. Having said that, extensive veto rights, which offshore joint venture partners in the insurance sector have traditionally enjoyed, going forward it may not pass the FIPB test of ‘control’, and may have to be curtailed.

C. Other changes

i. Applicability of the 49% foreign investment

The increase in foreign investment in the insurance sector would be applicable to insurance brokers, third party administrators (“TPA”), surveyors, loss assessors and other insurance intermediaries appointed under applicable IRDAI regulations.

The FDI Policy included the limit of 26% (twenty six percent) for insurance companies, insurance brokers, third party administrators, surveyors and loss assessors. The appropriate regulations for certain intermediaries clarified that the limit of foreign investment in the relevant intermediary would not be more than 26% (twenty six percent) - such as for TPAs under the IRDA (Third Party Administrators-Health Services) Regulations, 2001, for insurance brokers under the IRDA (Insurance Broker) Regulations, 2002 and for insurance surveyors under the Insurance Surveyors and Loss Assessors (Licensing, Professional Requirement and Code of Conduct) Regulations, 2000.

There was certain ambiguity as to whether 100% FDI was permitted in other intermediaries which did not fall under the categories specifically mentioned under the FDI Policy, such as corporate agents. For instance, Berkshire India Private Limited, a wholly owned subsidiary of Berkshire Hathaway Inc. acted as a corporate agent in India. It was argued that since there is no specific restriction on foreign investment on corporate agents under the IRDA (Licensing of Corporate Agents) Regulations, 2002 or under the FDI Policy, 100% FDI was permitted in these intermediaries.

The Rules now clarify that the restriction on foreign investment shall also be applicable to ‘other insurance intermediaries appointed under applicable IRDAI regulations’, thereby plugging the necessary gaps.

However, there is some ambiguity about the status of those intermediaries which already have more than 49% foreign shareholding. Since they were not required to restrict their foreign shareholding, it is unclear whether they would be asked to bring down their foreign shareholding, or would a status quo be granted.

ii. Exception

An exception from the 49% restriction on foreign investment has been for a bank which is functioning as an insurance intermediary. In case the revenue of such bank from non-insurance related business is in excess of 50% (fifty percent) of the total revenue in any financial year, the foreign equity limit as applicable in the banking sector would apply to such banks.

The Press Release has further clarified that Clause 6.2.17.2.2 (i) (c) shall be applicable for banks having a joint venture/ subsidiary in the insurance sector. Accordingly, all applications for foreign investment by private banks shall be addressed to the Reserve Bank of India, which shall consider the same in consultation with the IRDA.

V. Conclusion

With the recent changes, the Indian insurance industry is finally ready to take off. The change was the demand of the industry for long. Additional investment of an estimated USD 3.2 billion is expected in the insurance sector129, which shall provide Indian insurance companies much required funds, and discussions between the joint venture partners have already commenced.130 These changes coupled with the changes introduced in the budget, i.e. to give certain identified employees the option of choosing private insurance players under the

Employees' State Insurance Scheme, and increase in permitted deductions for insurance premium paid, is indicative of a positive shift to encourage the growth of the insurance industry.

The future of the insurance industry seems to be secured, for now at least.
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Over the years, we have produced some outstanding research papers, reports and articles. Almost on a daily basis, we analyze and offer our perspective on latest legal developments through our “Hotlines”. These Hotlines provide immediate awareness and quick reference, and have been eagerly received. We also provide expanded commentary on issues through detailed articles for publication in newspapers and periodicals for dissemination to wider audience. Our NDA Insights dissect and analyze a published, distinctive legal transaction using multiple lenses and offer various perspectives, including some even overlooked by the executors of the transaction. We regularly write extensive research papers and disseminate them through our website. Although we invest heavily in terms of associates’ time and expenses in our research activities, we are happy to provide unlimited access to our research to our clients and the community for greater good.

Our research has also contributed to public policy discourse, helped state and central governments in drafting statutes, and provided regulators with a much needed comparative base for rule making. Our ThinkTank discourses on Taxation of eCommerce, Arbitration, and Direct Tax Code have been widely acknowledged.

As we continue to grow through our research-based approach, we are now in the second phase of establishing a four-acre, state-of-the-art research center, just a 45 minute ferry ride from Mumbai but in the middle of verdant hills of reclusive Alibaug Raigadh district. The center will become the hub for research activities involving our own associates as well as legal and tax researchers from world over. It will also provide the platform to internationally renowned professionals to share their expertise and experience with our associates and select clients.

We would love to hear from you about any suggestions you may have on our research reports. Please feel free to contact us at research@nishithdesai.com