

IP Centric Deals

Key legal, tax and structuring considerations from Indian law perspective

August 2018

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Executive Summary

Several M&A's, joint venture or commercial transactions are driven by the intellectual property (“IP”).

IP based transactions can take several forms ranging from acquisition of an IP portfolio (with or without aligned assets including human resources), in-licensing deals, joint development deals, M&A or joint venture. In some cases, the real value may be in the human resource of the target, in which case

local labor laws may play a major role in structuring the deals.

Each transaction has its own set of complexities and nuances. However, there are certain underlying concepts and issues which are common to most of IP transactions. In this paper we have discussed some of these pertinent issues in the Indian context and shared our experience on dealing with such matters.

1. Due Diligence Considerations

The first step in any transaction is due diligence (“DD”). For a DD to be most effective in terms of issue spotting, the process should be a well-coordinated effort by the business, legal, technical and tax teams of the acquirer.

From target’s perspective, target should ideally conduct IP audit first, to determine potential issues and iron them out before going in the market. This makes the process smoother and faster for the investor and investee alike.

In this chapter we have discussed key due diligence issues and some industry specific considerations.

Some common issues that we noticed whilst conducting an IP due diligence are:

- i. Lack of IP mindset among founders or key personnel. In one potential transaction, a foreign investor backed off from the deal as the Indian entity had not applied for registration of its trademarks / brand logo’s. The investor was not happy with lack of IP awareness;
- ii. Application/ registration of IP in the name of a group entity, which is not the selling entity;
- iii. Failure to renew or maintain IP registrations;
- iv. Lack of / incomplete record of IP owned by selling entity;
- v. Failure to record names of subsequent owners with the registries;
- vi. Imperfect title / ownership of IP due to the failure to obtain proper IP assignments from employees / consultants for the IP created during their employment / period of consultancy, specifically with regard to any patentable inventions;
- vii. Deficiencies / issues in the licenses obtained by the selling Indian entity with regard to the ownership of improvements / derivative works created from licensed IP;

- viii. Use of open source software in violation of the relevant terms of use.

I. Identification of IP

When the IP is registered or applied for, it is easy to conduct a further due diligence to ascertain ownership, validity, strength of IP and other related aspects. However, in case of unregistered IP, ascertaining all these aspects becomes an issue. For instance, in India, it is not common to register copyrighted work (which may exist in source codes, programmes, notes, algorithms, drawings etc.). In such a case, the IP in copyrighted work is generally identified based on the documentation available with the seller entity and /or on the basis of representations given by the seller entity.

Trade secrets and know-how are protected under contracts in India as confidential information, there is no specific statute in India relating to them. Hence, it is important to review the strengths of the agreements and processes used to protect the know-how and trade secrets. It needs to be ascertained whether trade secrets and know-how are indeed providing competitive advantage.

Further, often the IP may be protected in some countries but not in the other. The fact that IP rights are territorial in nature may not be fully appreciated. For example, a buyer may perceive value from a patented product in the US in the Indian market. But if the patent protection is not available in India, this may be a non-starter for the deal. Even if this situation is to be examined from a licensing agreement perspective, then firstly it will not be proper to give a license to an IP in a jurisdiction where you don’t even own it. Secondly, technically, no value could be assigned to licensing in jurisdictions where IP is in the public domain, because it is open to use by all.

II. IP in Public domain

One needs to identify whether certain IP including trade secrets have fallen in the public domain. For instance, if an entity develops a novel product or process, but discloses it to public, it may lose the opportunity to patent or to protect it as a trade secret. This may become a deal breaker from a commercial perspective if the value of the company was based on the novel product or process itself. Further, at times, in technology transfer agreements know how or trade secrets shared are not clearly identified, hence, fact finding exercise is required to ensure that none of them fall within public domain.

Indian courts typically will protect trade secret from disclosure, when the same is not in public domain, the persons to whom it was disclosed had knowledge of its confidential nature and there is threat of disclosure.

III. Ownership of IP

Having a clear chain of title to the asset is the back bone of any transaction. Some common issues connected with ownership of IP that we have come across are:

A. Ownership of Rights

- i. *Home grown IP*: In case of home grown IP i.e. created by the employees or consultants of an entity, it is important to have clear documentation to show that IP rights vest in favor of the entity. Unlike in other countries, in India “work for hire” as a concept is recognized largely in relation to copyrighted works in an employer-employee relationship. Hence, clear assignment clauses in consultant and third party contractor agreements are an absolute must from a chain of title perspective. In case of any other form of IP (such as trademarks, patents, know-how etc.) the IP rights need to be specifically assigned.

From a documentation perspective, we have noticed that agreements executed

amongst Indian companies usually lack appropriate IP clauses. In such a case, it is imperative for such Indian entities to execute necessary amendments / addendums to ensure that there are no shortcomings in the IP title. Another interesting aspect in relation to home grown IP is the taxation on its transfer. We have dealt with this aspect in detail in the chapter pertaining to the key structuring issues and post-closing compliances, contained below.

- ii. *Acquired IP*: In case of acquired IP, the entire chain of title documents needs to be examined to ascertain whether the entity from which IP is to be acquired actually has valid title to the IP and the ability to transfer the IP. There are specific provisions under Indian IP laws which need to be complied with / borne in mind whilst transferring IP. For instance, in case of copyright, it needs to be ensured that the term and territory of the assignment is specified in the assignment and license documents, in the absence of which the term is deemed to be 5 years¹ and territory to be India.² Further, unless the parties contract to the contrary, the assigned or licensed rights revert to the assignor/ licensor if the assignee/ licensee does not utilize these rights within a period of 1 year from the grant.³ We have noticed that these points are often missed out in documentation, resulting in title imperfections and ownership issues. If the acquisition of IP by the selling entity has a defect, then the seller cannot pass on a better title to the buyer. These aspects needs to be factored whilst evaluating the ownership of acquired IP.
- iii. *Joint Ownership*: Some of the IP laws in India have specific provisions dealing with the concept of joint ownership of IP, i.e. where the rights in any particular IP are held by more than one proprietor.

1. Section 19(5) of the Copyright Act, 1957

2. Section 19(6) of the Copyright Act, 1957

3. Section 19(4) of the Copyright Act, 1957

For example, under the Trade Marks Act, 1999 (“**Trademarks Act**”) a trademark can be registered jointly by more than one person provided that it is used collectively for the same business.⁴ Thus, in such a case, assignment of the trademark by only one proprietor of the mark will violate the rights of the other proprietor, and create a question mark on the validity of acquisition itself. Concepts of co-ownership are imbibed in the Copyright Act, 1957 (“**Copyright Act**”) and the Patents Act, 1970 (“**Patents Act**”) as well.

To take an example, in the technology industry, we have often noticed that several developers work on the same product, resulting in joint ownership of IP rights. In the pharmaceutical industry, co-development by researchers is common. In the media industry, the financier and producer tend to own IP jointly, thereby creating co-ownership of IP rights. These rights may need to be consolidated in one ownership entity from which the purchase is made; or the rights need to be acquired from each co-owner (to the extent of their share) of IP. In addition, such co-ownership arrangements gain more prominence in global M&A transactions, as joint ownership of IP is dealt with differently in different countries / jurisdictions. Joint ownership of IP may become a hurdle in IP acquisitions, if all the owners do not consent to the transfer of IP.

- iv. *Government or University funded IP:* Often startups get government grants or funding for their research and development. In such cases, it is important to review letter of grant issued by the grantor to determine if any IP rights are to vest in the government department giving the grant. For example, “*Start up India*”, a campaign launched by the Indian Government in 2015 to foster the growth of start-ups in India has announced the “*Scheme for Facilitating Startups Intellectual*

Property Protection”, to nurture and foster innovation and protection of IP amongst start-ups in India. The Indian Government, as part of the scheme, obtains a percentage stake / ownership in the IP that is developed by the start-ups that sign up for the campaign.

In addition, we have also come across situations where joint ownership has been created with the government. However, the document lacks clarity on the manner in which the share of IP can be purchased back from the government, or the terms on which government owned IP can be used, terms on which waiver can be obtained from the government in relation to use or exploitation. For instance, even if the government owns a share in the IP, can the owners exploit the full IP without taking consent from the government each time they commercialize the concerned IP? If such issues are not resolved satisfactorily, they may become deal hurdles.

- v. *Use of third party IP:* Seller may be using certain third party IP, which can be categorized as follows:
 - a. *Licensed third party IP:* At times, license agreements have clauses which restricts the ability of the licensee to assign the agreement/ licensed IP further. These terms must be carefully examined by the seller. Further, the ownership terms in relation to any derivative work created from the licensed materials / IP must be examined, including joint ownership and exploitation clauses to determine who owns such work. Sometimes, while the licensee may have the ability to create derivative work, the work may be dependent on the third party IP. Sellers must see what kind of permissions/ licenses are required from the licensor to use such derivative work
 - b. *Unlicensed third party IP and Use of open source:* In the Indian context, it is not uncommon for employees / consultants to incorporate third party

4. Section 24 of the Trademarks Act, 1999

unlicensed IP or open source IP in their products without the consent of the company. This is due to lack of awareness and process on how and when to use third party IP. Hence, technical review followed by legal review of the IP is very important.

vi. *Use of an affiliate's IP:* In case of group companies, IP is sometimes registered / owned by one entity but the selling party is another group entity. Thus, the acquirer should ascertain that the selling party is the one which actually owns the IP. This issue becomes significant when the IP may be held in different jurisdictions. Due to exchange control restrictions in India, the flow of payments to Indian and foreign group entities should be carefully structured as there are mandatory time limits within which payments need to be completed with regard to export / import of goods / services by Indian entities under exchange control laws in India. Failure to adhere to such time limits may result in both the buyer and the seller being penalized by the Reserve Bank of India ("RBI"). There are also tax implications on such transactions which could have an impact on the commercials. For instance, payments to related parties for IP transfers and licensing should also be on arm's length basis from an Indian taxation perspective. Such commercials, may also change deal dynamics.

vii. *Charge/ Lien on IP:* While conducting limited IP due diligence, the issue of charge / lien created in favour of the banks or other lenders may be missed out. In India, all companies are required to register the charges created on their physical property with the Registrar of Companies ("ROC"). While there is a specific provision to register charge in the Register of Patents under the Patents Act and a provision to register a mortgage on design under the Design Act, 2000 ("Design Act"), other IP legislations does not have such specific provisions. Further, filing of charge details is not mandatory for other legal entities,

such as a limited liability partnership.

Hence, it is important to examine all the loan documents of the target carefully to check for any lien or encumbrance on IP.

IV. Validity of IP

An IP acquisition is based on the premise that the IP being purchased is valid and subsisting in the jurisdiction in which it is used or registered. Thus, the status of registration of the IP and the duration for which the proprietary rights in the IP will remain in subsistence, are key negotiation points.

By way of an example, an IP (i) which is not registered (e.g. an unregistered trademark); or (ii) which is due to expire soon (e.g. a patent whose term is nearing expiration); or (iii) which is freely available in public domain (a copyright work which is inadequately protected and versions of which are easily accessible in public domain), may not be of a great economic significance to the acquirer.

Further, from a transaction perspective, one must also be aware of the peculiarities under the local laws, which may affect the validity of the IP.

For example, Patents Act requires that an invention which has been created by an Indian resident should be first applied in India, failing which the patent shall be deemed to be abandoned.⁵ Failure to comply with this condition can be fatal to the validity of Indian patent.

- In addition, the Patents Act, also requires that patents filed in India are worked / used by the patentee on a commercial scale in India on a yearly basis. This is evidenced by the mandatory requirement for patentee's to file "Form 27", which specifies the details pertaining to the working of the patent, with the controller of patents, before March 31st, every year.⁶ Failure to file the aforementioned form shall result in the patentee being liable to penalty which may extend to INR 1,000,000 (i.e. INR One Million

5. Section 39 and 40 of the Patent Act, 1970

6. Section 146 of the Patents Act, 1970

or approx. USD Twenty Thousand Dollars).⁷ In addition, if it is discovered that the information provided by the patentee in the “Form 27” that is filed is false, the patentee may become liable for imprisonment for a term which may extend to six months, or with fine, or with both.⁸

- Under the Patents Act, the mere discovery of a new substance which does not result in enhancement of efficacy of the known substance is not patentable.⁹ This becomes especially important in pharmaceutical industries where the claims are related to derivatives, salts, ether, esters or isomers of known compounds.
- Additionally, the mere discovery of any new property or new use for a known substance or of the mere use of a known process, machine or apparatus unless such known process results in a new product or employs at least one new reactant is not patentable; (The above two points pertain to the famous “Section 3(d)” or “Ever-greening” exception under Indian patent law);

Hence, when patent applications are pending the strength of the patent needs to be tested.

- Under the Trade Marks Act, associated trademarks can only be transferred together as a whole. Assignment of an associated trademark, in any other manner shall be deemed to be void.¹⁰ We have dealt with issues pertinent to / to be kept in mind with regard to associated trademarks in the chapter dealing with documentation requirements for transfer of IP.
- The nuances under copyright law for assignment/ licensing deals has been discussed under section 3 (a)(i) above.

V. Infringement

Infringement claims are not only a huge monetary liability for a seller but also affect their goodwill and reputation in the market. Thus, the acquirer should be wary of any potential infringement claims that may arise in case of acquisition of the IP. Though, the database of Indian courts is being digitized, not all data is still searchable. Further, in India, it takes several years to have final determination of disputes. Hence, it is often advisable to have the IP related claims settled prior to the transaction. However, the acquirer / buyer, in the interest of consummating the concerned transaction may also decide to take the necessary representations and warranties, backed by indemnify from the seller to ensure that no liabilities in this regard are acquired by the acquirer / buyer. In some cases, a public notice may be given through lawyers, inviting claims, if any, against the relevant IP. This is common in the media industry.

VI. Internal processes to protect trade secrets and confidential information

Confidential information and trade secrets (“CI”) are protected under common law in India as there are no statutes that specifically govern the protection of the same. In order to protect trade secrets and confidential information, watertight agreements should be agreed upon, and they should be supported by sound policies and procedures.

7. Section 122 (1) (b) of the Patents Act, 1970

8. Section 122 (2) of the Patents Act, 1970

9. Section 3(d) of the Patents Act, 1970.

10. Section 44 of the Trademarks Act, 1999.

The DD team should evaluate:

- Confidential agreements with employees, consultants and vendors to ensure that CI is appropriately described and covered and all standard clauses such as delivery post termination are covered;
- Internal process of marking documents as confidential;
- Process followed for storage of CI;
- Whether there are internal trainings of employees, consultants and vendors to sensitize them on the importance of CI.

If the seller has not executed such agreements with employee, consultants or vendors, this could be a condition precedent for the deal.

VII. Acquisition of Portals

Often the transaction involves transfer of web portals.. It needs to be checked whether the domain names are registered in the name of correct entity. Often domain names are registered in the name of individuals or group companies. When the ownership / registration details of the domain names are masked, the acquirer can request for the log details to the private domain registrar of the seller and confirm the domain name registration details therein A web portal or website has a host of IP, especially in the nature of copyright. Diligence must be conducted to ensure the material on the website is lawful and non-infringing. If the website is built using some APIs or uses third party source coded, then restrictions, if any, to transfer ownership of website to third party should be checked in API terms/ source code usage terms. Further, in the Indian context, one also needs to review the terms and conditions and privacy policy to ensure that issues such as the requirement to comply with the Information Technology (Reasonable Security Practices and Procedures and Sensitive Personal Data or Information) Rules 2011 .are properly covered.

2. Key Structuring Issues, Deal Terms And Post Closing Compliances

I. Nature of transactions

A. Acquisition of target v/s IP

If the acquisition of target is for its intangibles (such as a brand, or patentable invention or a copyrightable work, like a film) and employees, then the transaction may be structured as asset transfer or business transfer (slump sale). In case of asset transfer, the acquirer cherry picks the assets and does not inherit most of the entity level liabilities arising out of company level / statutory non-compliances. In a slump sale, the business as a whole is acquired with all assets and liabilities, as a going concern. Whether the transaction should be structured as an asset purchase or slump sale depends on various factors, including tax considerations which play a key role in deal structuring. *Joint ventures*

A joint venture (JV) enables its partners to utilize each other's resources, such as IP, which may be in the nature of technology or patents (in the case of a manufacturing JV), trademarks or trade name or a business format / know-how / trade secret (e.g. Starbucks – Tata JV Coffee chain) or copyrights (in the case of film production JVs), along with market expertise. The relationship may be a long term relationship or a short term relationship for a particular project. It may involve an entirely new business, or an existing business that is expected to significantly benefit from the introduction of the new participant. The parties can either assign the IP in favor of the JV or use it jointly or they may license the IP to the JV entity.

Typical IP issues in relation to joint ventures:

- In case of contractual JVs, when IP is jointly created or held by the parties, the contract / agreement needs to spell out exact arrangement with respect to ownership of jointly developed

IP as well as the inter se rights. For instance, who owns the IP, can one party use the IP without the consent of other or is there an implied consent etc. In some IP legislations, if the contract is not clear then certain default provisions on joint ownership apply.

- In case derivative works are created on the IP owned by the JV (for instance, further upgrades on a software), then the agreement should clarify which party can carry on such works of creating derivative work, who will own the IP in such derivative work, etc. It should also specify if there is any right to use or other economic right being granted by JV/ one party to the other party.
- The ownership of IP post termination of JV should also be specified. This becomes important in cases where IP is owned by the JV entity. For instance, the JV entity registered a unique trademark. If the JV entity dissolves, and neither party intends to use the trademark, then the matter is resolved. But at times, the trademark may be a combination of the two JV party names. In such cases, can one party acquire the right to use the trademark which is a combination of JV partners' mark? If yes, what are the commercial terms for such use?
- Where parties license their respective IP to the joint venture entity, the manner in which the IP will revert back to the respective parties (by way of return or destruction of copies) or the terms on which the IP will continue to be used by the remaining party (in case the licensor party agrees to allow the other party to use its IP for consideration post expiry or termination) should also be set out clearly in the JV agreements.

II. Transfer conditions and Documentation requirements

A. Transfer of trademark

i. Documentation

The assignment of trademark must be in writing. For recordal of the assignment with the Trademarks Registry, the deed of assignment is required to be filed along with applicable form. In complex transactions, trademark may be just one the assets getting transferred. The parties may not want to file asset purchase documentation with the Trademarks Registry. In such a case, a separate trademark assignment deed / agreement may be filed with the Trademarks Registry. However, articulation of consideration in such a document may sometime become complex, especially in the context of stamping of the documents. On a case to case basis, these issues need to be carefully considered and accordingly dealt with.

ii. Transfer with or without goodwill

As per Section 38 and Section 39 of the Trademarks Act, a registered or unregistered trademark can be assigned or transmitted with or without the goodwill of the business concerned. In case of with goodwill assignment, the procedure for recordal is straight forward. However, in case of without goodwill assignment, the assignment does not get recorded directly.

The assignee is required to file the appropriate forms with the Trade Marks Registry to obtain directions for the advertisement of the assignment within 6 (six) months of such assignment taking place.¹¹ Post the advertisement of the assignment as per the directions of the Trade Marks Registry, the applicant can apply for the recordal of the assignment of the trademarks without goodwill. This is a longish process than the assignment of trademark with goodwill of the business.

iii. Transfer of trademarks in relation to some goods and services

As per Section 38 of the Trademarks Act, a registered proprietor of a trademark in India may assign or transfer its trademarks in relation to some of the goods or services for which the trademark has been applied. However, while doing so, it needs to be ensured that assignments or transmissions does not create concurrent exclusive rights in more than one person, so as to confuse the public. If assignment or transmission creates multiple rights, it may be invalidated. Further, assignments or transmissions should not be on a territorial basis, so as to create exclusive rights in the mark in favor of different entities in different parts of India. Such splitting of trademarks is not permitted, unless the trade mark officer consents to it.

B. Transfer of associated trademarks

As per Section 44 of the Trademarks Act, associated trademarks can only be transferred together as a whole. Assignment of an associated trademark, in any other manner is deemed to be void.¹² In several transactions, we note that only a few trademarks out of the group of associated trademarks are actually used, hence parties consider those for valuation. However, for the purpose of transfer all the trademarks need to be transferred, which gives rise to some complications at the time of negotiating representations, warranties and indemnities.

III. Trademark license

In case of trademark licensing deals, registration of license with Trademark office is not mandatory. However, registration offers following benefits:

- A registered user of a trademark can file an infringement suit as if he were the proprietor of the trademark.

11. Section 42 of the Trademarks Act, 1999.

12. Section 44 of the Trademarks Act, 1999.

- A registered user is also entitled to call upon the proprietor of the trademark to initiate infringement proceedings in relation to the concerned trademark.¹³

The Trademarks Act recognizes non-registered licensed use as “permitted use” only if such use is with the consent of the proprietor as embodied in a written agreement and if such user satisfies the prescribed conditions of license and as set out under the Trademark Act.

The benefit of use by the registered / license user that satisfies abovementioned conditions accrues to the benefit of the trademark’s proprietor.

In case of multi-level licensing of trademarks, the documentation has to be appropriately drafted so as to satisfy the “permitted use” criteria under the Trademarks Act.

IV. Domain name transfers

Typically, at the time of registration of a domain name, the registrant is given certain registration details such as a log in / password, and has the ability to access and amend the registrant’s registration details such as the name, email address etc. provided to the registrar. In case a domain name is assigned, the transfer of a domain name usually takes place by notifying the domain name registrar (with whom the domain name is registered) of the change in ownership and updating the registration details to reflect the assignee’s name and contact details.

However, in the event a domain name is locked, or masked, certain additional verification steps may need to be undertaken, by the seller, in order to effect the assignment.

In terms of the legal rights and obligations, a domain name is considered at par with trademarks, and therefore should be specifically assigned in writing, by the seller. Such assignment can be made as part of a trademark assignment or other transaction document, or by way of a specific agreement / letter showing

assignment of the domain name(s). Given that assistance of the seller may be required for the purpose of verification of the domain name ownership / assignment as discussed above, as a best practice, the seller should be required to provide any assistance required by the buyer, in order to ensure that the domain name is transferred in the name of the buyer.

V. Transfer of copyright

Assignment of a copyright is not valid unless such assignment is in writing and signed by the assignor. Such assignment ought to identify:

- the work and the rights assigned,
- the territorial extent (otherwise it is deemed to be India), and
- the duration of the assignment (otherwise it is deemed to be 5 year)

In addition, if the assigned rights are not exercised by the assignee within a period of one year from the date of assignment, the assigned rights revert to the assignor unless the parties contract out of such a provision. Under Section 18 of the Copyright Act, even the copyright in a future work can be assigned in accordance with Section 19, however, such assignment shall come into effect only upon date of creation of the work.

As per the Indian copyright law, assignment is valid only with respect to those mediums or modes of exploitation of the work which did exist or were in commercial use at the time when the assignment was made. With the constant evolution of technology, it becomes difficult to foresee the future modes and mediums. For instance, assuming Blu-Ray was not in existence at the date of assignment of a work, the rights for use in Blu-Ray medium will not accrue in favor of the assignee even if it was intended to assign all rights to assignee. The buyer should take a specific note of this provision under the Indian law and ensure that the seller is obligated to assign rights in a work in future mediums and modes as well.

¹³. Section 52 of the Trademarks Act, 1999.

Similar principles apply for licensing of copyright as well. However, a copyright license agreement, though needs to be in writing, need not be specifically signed by the licensee. Any mode of acceptance to contract is fine. This help in e-contracts –such as click wrap agreements.

A. Waiver of moral rights

Section 57 of the Copyright Act grants an author “special rights,” which exist independently of the author’s copyright, and subsists even after the assignment (whole or partial) of the said copyright. The author has the right to (a) claim authorship of the work; and (b) restrain or claim damages with respect to any distortion, mutilation, modification, or other act in relation to the said work if such distortion, mutilation, modification, or other act would be prejudicial to his honor or repute. These special rights can be exercised by the legal representatives of the author.

Prior to the enactment of the Amendment, the right to claim authorship could not be exercised by legal representatives of the author. However, post the enactment of the Amendment, the legal representatives of the author are also entitled to exercise the aforementioned rights on behalf of the author, post the death of the author. Whether moral rights can be waiver or not is not a settled position under Indian law. However, from a documentation perspective, especially in media matters, buyer may want to take a representation and indemnity from the seller towards any claim under Section 57 prior to the assignment date.

VI. Transfer of Patents

Patents are key assets from a transactional perspective. A patentee may assign the whole or any part of his patent rights by executing appropriate documentation. There are three kinds of transfers: assignment, transfer of interest in a share in a patent and mortgages.

A valid assignment under the Patents Act requires the assignment to be in writing, to be contained in a document that embodies all terms and conditions. It is recommended to bring the assignment on record of the patent office, to ensure that the acquirer’s name is shown as the proprietor of the patent in public documents as well.

Often, clauses which require the assignor/ seller to assist the assignee/ acquirer in registration of IP are added in the documentation as the process of registration of IP can be time consuming, and authorities may require clarifications from time to time.

VII. Transfer of designs

Like the other IP legislations, the Design Act also requires that the transfer of any interest in design should be reduced in writing between the parties. Further, an application for registration of title to the design needs to be filed with the authorities within 6 months.

VIII. Transfer of trade secrets

In the absence of a specific legislation to protect trade secrets, agreements are the best way to document the assignment of the rights existing in them. From a practical perspective, we have seen that transfer of trade secrets usually happen at the top executive level, where the trade secret is recorded in a document / or a medium and passed in sealed envelope to maintain confidentiality. There are strict confidentiality agreements to protect against disclosure.

IX. Exchange Control Regulations

A. Acquisition of shares of Indian target entity holding IP

If an Indian target's shares are getting acquired by an offshore acquirer from a resident seller, the acquirer is required to pay to the seller, the minimum price per share (or anything above that) to be arrived at by internationally accepted pricing methodology. When IP is being acquired in a distress transaction, purchasing of IP / assets (subject to appropriate valuation) may work out as a better option than acquiring the company.

B. Foreign acquirer of Indian IP

There is no express restriction on Indian entity to transfer IP to a foreign acquirer, though some authorized dealers (Banks) take a conservative view that such transaction should be undertaken only with the permission of Reserve Bank of India. However, it may be interpreted that when the IP is capitalized / recognized as an asset in the books of the Indian entity, then RBI permission as may be required for such cross border transfer.

The realization of sale proceeds are subject to the relevant time periods as prescribed under the FEMA (Export) Regulations, 2000. In some cases, escrow is agreed upon between the parties for the purpose of covering representations, warranties and post-closing covenants. The creation of escrow in India will require the approval of the Reserve Bank of India, but creating an escrow outside India, does not need any approval but the monies have to be brought into India within the prescribed time limit. In case of delay of receipt of funds, the permission of the RBI will be required.

X. Human resources

A. Transfer of Employees

Since all IP is the creation of human intellect, human resources play a valuable role as far as development and exploitation of IP is concerned. Often the real value in the business is in highly skilled workforce. From a transaction perspective, if the future value of a product depends heavily on retaining certain key personnel, then the acquirer typically wishes to get the key employees on board as well. This is specifically true in asset acquisition or slump sale transactions. Depending on the nature of transaction, the employee may either be transferred from the seller to the buyer entity or may be required to resign from his employment with seller and then take up employment with the buyer. There are certain nuances to be followed for this process as well. For instance, the terms of the new employment should however not be less favorable than the earlier employment terms.

B. Consent requirements for transfer of employees

Nuances under India labor laws need to be borne in mind which employees are transferred in case of a business transfer or an asset sale. Indian laws do not recognize automatic transfers of employees. Hence, such arrangements of transfer have to be appropriately structured. Further, depending on the mode of transfer the parties would also need to factor the treatment of statutory benefits such as, gratuity, leave encashment, bonus etc.

C. Post termination covenants

In India, post termination restrictive covenants are not enforceable except in case of confidentiality provisions. In this context to retain the key talent, some specific packages may be worked out.

If the principals or key employees are not likely to continue with the acquirer post the acquisition, then consulting agreements, non-disclosure agreements or covenants not to compete (where enforceable) may lessen the severity of their departure. Exit interviews also play a key role where employee can be explained about his confidentiality obligations and the importance of keeping the information confidential.

XI. Stamp Duty

Under Indian laws, every instrument is required to be stamped as per the applicable stamp laws, which are state specific. The instrument, which is not stamped cannot be admitted as evidence in a court, except in certain cases.¹⁴ In some states, a person signing an unstamped document may also become liable for criminal prosecution. Further, unstamped documents could be confiscated by the authorities.

Under the stamp laws, IP is treated as movable property and the rate of duty varies from state to state. In some states it is as high as 6 % of the deal value. Hence, it is important to ascertain the amount of applicable stamp duty and the party/ties, who will bear that cost. In deals where IP is coupled with other assets, it is important to identify separate consideration, so that higher duty is not made applicable to the entire consideration. In slump sale deals, though the consideration cannot be split from taxation perspective, parties may still allocate separate value for calculation of stamp duty.

In case of multi-jurisdictional transactions, at times India specific documents may have to be created and stamped for recordal with IP authorities. In this case, the value for Indian IP may have to be specially assigned for duty calculation purposes.

XII. Representations, warranties and indemnities

In IP focused transactions, representations and warranties are fundamentally centered on the sole and exclusive ownership of all right, title and interest in and to all the IP that forms part of the transaction along with any improvements or alterations to such IP. The seller is required to provide a specific representation that it has obtained all the requisite assignments, consents and waivers from any consultants and / or contractors that it may have engaged in relation to the development of the IP that is the subject matter of the assignment. These representations are considered fundamental in nature. Breach of these representations are not curable, and could trigger indemnity obligations, in addition to immediate termination.

In addition, there are several other representations and warranties as well. For instance, representation in such transactions is with respect ensuring that the IP has been rightly registered, the registration is valid and there is no pending payment including royalty payments that are due. Confirmation that IP is not subject to any lien, encumbrance or third party rights is also sought.

Further, the seller is also usually required to confirm that the IP hasn't been infringed, diluted, misappropriated etc. along with the fact that the IP does not infringe, misappropriate or otherwise conflict with, any third party IP.

The sellers usually try to time bound such warranties, or negotiate for a monetary cap, so as to have a limitation of liability in case such a breach does occur.

Since there is no separate legislation with respect to confidential information / trade secrets, the acquirers also usually insist on representations with respect to the fact that all the proprietary, non – public information of the company has been protected through adequate confidentiality agreements.

14. Even though a document is not stamped, it continues to be a valid and legal document. Further, the document may be admitted in evidence on payment of the stamp duty along with the prescribed penalty.

Lastly, in most control based acquisitions a negative representation is usually sought certifying that apart from that IP has been disclosed or being acquired, there is no other IP that is being used in relation to the business.

XIII. Post Acquisition

In addition to the above, some key points that the acquirer may insist are:

A. Post – Term use of transferred IP

In a transaction involving complete acquisition of the IP i.e assignment of IP, the acquirer may require the seller to destroy any residual IP that may remain in the seller’s possession and provide a written confirmation that the IP has been destroyed. Further, the acquirer may also insist on taking representations from the seller that the seller will not use the same or similar IP nor shall challenge the rights of the acquirer to the IP in future.

B. Reasonable Assistance

The acquirer may require the seller to assist in recording the name of the acquirer as the proprietor of the IP in the relevant IP records. The acquire may also consider taking a power of authorization from the seller in the acquirer’s favor, for executing documents on behalf of seller, if the seller is unavailable or unable to do so.

XIV. Competition law

The Competition Commission of India (“CCI”) has been established pursuant to the Competition Act, 2002 (“**Competition Act**”) to control anti-competitive agreements, abuse of dominant position by an enterprise and for regulating certain combinations.

With respect to anti – competitive agreements, the Competition Act essentially contemplates two kinds of agree-ments – horizontal agreements or agreements between entities engaged in similar trade of goods or provisions of services, and vertical agreements or

agreements between entities in different stages / levels of the chain of production, in respect of production, supply, distribution, storage, sale or price of goods or services. Anti-competitive agreements that cause or are likely to cause an appreciable adverse effect on competition within India (“**AAEC**”) are void under the provisions of the Competition Act.

A horizontal agreement that (i) determines purchase / sale prices, or (ii) limits or controls production supply, markets, technical development, investment or provision of services, or (iii) shares the market or source of production or provision of services, by allocation of geographical areas / type of goods or services or number of customers in the market, or (iv) results in bid rigging / collusive bidding, are presumed to have an AAEC.

On the other hand, vertical agreements, such as tie-in arrangements,¹⁵ exclusive supply or distribution agreements, etc., are anti-competitive only if they cause or are likely to cause AAEC.

In the case of a vertical agreement, there is no presumption that such agreement would have an AAEC, and the CCI would have to prove such effect. However, in the case of a horizontal agreement, the burden of proof would lie with the entities who are party to the agreement, to prove that there is no appreciable adverse effect on competition in India.

The transacting parties should evaluate whether the transaction could be questioned under Section 3 or 4 of the Competition Act and risk mitigation should be taken into account.

A “Combination”, for the purposes of the Competition Act means:

- a. an acquisition of control, shares or voting rights or assets by a person;

15. A tie-in arrangement would include any agreement requiring a purchaser of goods, as condition of such purchase to purchase some other goods. A classic example of this on a global scale may be Microsoft’s bundling of its web browser Internet Explorer along with the Windows operating system, limiting Netscape’s web browser, Navigator, from having a significant presence in the market.

- b. an acquisition of control of an enterprise where the acquirer already has direct or indirect control of another engaged in identical business; or
- c. a merger or amalgamation between or among enterprises;

that exceed the ‘financial thresholds’ prescribed under the Competition Act.¹⁶ Unless specifically exempted,¹⁷ the Competition Act requires every ‘Combination’ to be notified to the CCI in the manner set out in the Competition Act read along with the CCI (Procedure in regard to the transaction of business relating to combinations) Regulation, 2011 (“**Combination Regulations**”) and seek CCI’s approval prior to effectuating the same. The parties to the Combination can provide the said notice (“**Notice**”) to the CCI any time after the following: (a) approval of the proposal relating to merger or amalgamation by the board of directors of the enterprises of the Combination in case of a merger/amalgamation; or (b) execution of any agreement or other document for acquisition referred to in clause (a) of section 5 of the Competition Act or acquiring of control referred to in clause (b) of that section. However, if the parties to the Combination fail to give a Notice to the CCI before the consummation or closing of the Combination, Section 43 A of the Act empowers the CCI to impose a penalty on such parties extending up to one percent of the total turnover or the assets, whichever is higher. After the Notice is made to the CCI, the CCI in turn is required to make a determination as to whether such a combination is likely to result in causing an ‘appreciable adverse effect on competition’ for Section 6 of the Competition Act makes void any combination which causes or is likely to cause an appreciable adverse effect on competition within India.

XV. Tax

In the Indian context, examination and characterization of every transaction from taxation perspective is critical due to aggressive approach of the tax authorities at the lower administrative and judicial levels. In the case of IP driven transactions, two main streams of income that are relevant are: (i) royalty; and (ii) fees for technical services (FTS). Capital gains also becomes relevant, particularly in case of an outright sale of IP.

Explanation 2 to section 9(1)(vi) and Explanation 2 to section 9(1)(vii) of Income Tax Act, 1961 (“**ITA**”) define the terms “royalty” and “FTS” respectively. “Fees for technical services” means any consideration (including any lump sum consideration) for the rendering of any managerial, technical or consultancy services (including the provision of services of technical or other personnel) but does not include consideration for any construction, assembly, mining or like project undertaken by the recipient or consideration which would be income of the recipient chargeable under the head “Salaries”. Royalty has a detailed definition under the ITA and in summary is understood as meaning being consideration, including lump sum consideration for transfer of rights, including the grant of license in respect of a wide variety of intellectual property (patents, invention, copyrights etc.).

These definitions are wider in scope than the definition of royalty and FTS in most tax treaties that India has entered into. For e.g. the FTS provision under the ITA potentially includes within its ambit payments made by a non-resident to another non-resident in relation to services utilized in India. Whereas in several treaties (such as with the US and UK), the definition of FTS is limited to circumstances where the services are “made available” to the recipient.

¹⁶ Please refer to Section 5 of the Competition Act.

¹⁷ Please refer to Schedule I of Combination Regulations and De-minimis Exemption.

With respect to the definition of royalty under the ITA, it is important to note that for the purposes of determination of whether a payment for a right, property or information is in the nature of royalty, it is irrelevant whether the payer is in possession or control of such right, property or information or whether such right, property or information is used directly by the payer. Further, the location of such right, property or information is also not of essence.

Recently, in *Google India Private Limited*, the Bangalore Bench of the Income Tax Appellate Tribunal has taken a view that payments made for incidental use of intellectual property under a services agreement may also be re-characterized as “royalty”, even if the main purpose of the payment was not for the use, right to use, or transfer of any intellectual property. In doing so, the Tribunal distinguished a long line of cases which had accepted that mere incidental use of or access to intellectual property while providing services under an agreement would not result in the payments being made under such agreement being considered as royalty. This was on the basis that any consideration paid for use or for the right to use confidential information would amount to royalty income. Thus, from a cross-border perspective, it is crucial to delineate the purpose for which payments involving the use of IP are made.

Taxation of ‘software’: Earlier, India did not have specific rules governing the taxation of licensed software. There have been quite a few disputes centered on the difference between characterization of payment for software as ‘a copyrighted article’ (payment for which should be taxable as business income) or as ‘a copyright’ (payment for which should be taxable as royalty). This is a key area of concern considering the withholding obligations on the Indian resident payer in cross-border transactions. These disputes have arisen in different contexts, including shrink-wrapped software, embedded software and online databases. Finance Act, 2012 introduced retrospective ‘clarificatory’ explanations to section 9(1)(vi) of the ITA to target payments towards shrink-wrapped and embedded software, online databases and data clouds, so as to include such payments within the

ambit of ‘royalty’. However, depending on the relevant tax treaty, it may still be possible to distinguish a copyrighted article from a copyright taking the view that payments for right to use a copyrighted article should be considered as business income not chargeable to tax in India in the absence of a PE.

A. Domestic transaction

i. Withholding tax considerations

Consideration paid under a domestic transaction for royalty or fees for technical services by one resident to another should be subject to a withholding tax of 10%. Withholding tax is on a gross basis. Even in the context of a domestic transaction, the definition of ‘royalty’ (as well as FTS) is the same as provided under section 9 of the ITA.

ii. Direct tax considerations

Once the consideration is received by the recipient, the recipient is taxable on the consideration as ordinary income or business income depending upon the nature and frequency of the transaction. Further, depending upon the laws of the recipient’s jurisdiction and quantum of taxes paid, a credit for withholding taxes may also be available

An outright transfer of IP should result in capital gains tax for the seller of the IP. On such a transfer, gains which are taxed are computed by deducting the cost of acquisition of the capital asset (i.e. the IP in question) from the sale proceeds. The identification of an asset as a capital asset and the determination of cost of acquisition are easily done in case of tangible property. These issues however, pose a problem in the case of IP, i.e., intangible property, especially self-developed IP and must be addressed carefully while structuring the transaction. Further, for domestic transactions, there is no requirement to withhold taxes in case of characterization as capital gains. In this context, it may be noted that in *CUB Pty Limited*

v. Union of India,¹⁸ the Delhi High Court, in the context of trademarks has held that the *situs* of IP would be the location of the owner of the IP, regardless of where the IP is used or develops value. Thus, basis this judgment, sale of IP used in India should not be taxable in India unless the owner of the IP was located in India.

Nonetheless, a question may also arise as to whether there is a need to apportion the income taxes on transfer of IP, particularly in case the Indian entity, which may be a subsidiary of the parent entity (IP owner), was instrumental in development of the IP or brand. A connected factor is of course, how such IP / brand development services were recorded between the parties, and whether transfer pricing becomes applicable in this respect. Transfer pricing issues may come up where expenditure has been incurred by the Indian entity for the development of the brand or IP.

Tax incentives available include incentives for a company engaged in the business of biotechnology or in any business of manufacture or production (except certain specified businesses), whereby such companies can claim a deduction equivalent up to 150% of the expenditure incurred for in-house R&D facilities (not being expense in the nature of cost of land and building) that have been approved by Department of Scientific and Industrial Research, Ministry of Science and Technology, Govt. of India. In other cases, a deduction shall be allowed for any expenditure laid out on scientific research related to the business carried out by the company is allowed.

Depreciation is allowed on intangible assets in the nature of know-how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of a similar at the rate of 25% as per written down value method. Computer software is entitled to depreciation at a higher rate i.e. 40%.

iii. Indirect tax considerations

Goods and Services Tax (GST), which has recently replaced the indirect tax regime in India, is imposed on all taxable supplies of goods and services at rates varying from 0 – 28% depending on the nature of the good or service concerned.

An Integrated GST (IGST) is levied on every interstate supply of goods or services by the Central Government under the IGST Act, 2017, while every intrastate supply is concurrently subject to a Central GST (CGST) by the Central Government under the CGST Act, 2017 and a State GST (SGST) by the relevant State Government under the relevant SGST Act.

Schedule II of the CGST Act treats the following to be a “supply of services” for the purposes of GST:

- temporary transfer or permitting the use or enjoyment of any intellectual property right;
- development, design, programming, customization, adaptation, upgradation, enhancement, implementation of information technology software; and
- transfer of a right to use goods for any purpose for a consideration.

However, permanent transfer of title in goods is treated as a “supply of goods” for the purposes of GST.

Currently, GST is charged at 12% on “*temporary or permanent transfer or permitting the use or enjoyment of Intellectual Property (IP) right in respect of goods other than Information Technology software*”, and at 18% on “*temporary or permanent transfer or permitting the use or enjoyment of Intellectual Property (IP) right in respect of Information Technology software*”.

18. [2016] 388 ITR 617.

While there is a distinction between the two entries regarding IT software, the incongruous presence of the language “in respect of goods” in the first entry and its corresponding absence in the second entry is unclear. This could lead to ambiguity in classification and resulting litigation. Moreover, the reference to a “permanent transfer” of IP is rather surprising given that IP assignments should typically be considered to be supplies of goods under the CGST Act because they involve a transfer title in goods.

B. Import transaction

In a case where a resident receives IP licenses or technical services there is also a withholding tax applicable under Indian domestic laws at the rate of 10% on a gross basis. The withholding obligation under Section 194J extend to a non-resident payor as well.

Disallowance of business expenditure: Under section 40(a)(i), Indian tax authorities have the ability to disallow deduction of expenses incurred by the taxpayer towards payments to the non-resident recipient of royalty/ FTS payments on the basis that adequate withholding was not made by the payor in respect of payments made to the recipient towards royalty. Similar provisions for disallowance are also present for royalty and FTS payments made to a resident.

C. Export transaction

i. Direct tax considerations

Royalties and FTS, which are chargeable to tax in India and are payable to non-residents who do not have a permanent establishment (PE) in India, are subject to withholding tax at the rate 10% on a gross basis.¹⁹ The withholding tax rate may be reduced if there is a favorable provision in the tax treaty between India and the country of residence of the non-resident.

Consequences of non-withholding include payment of simple interest at 1% per month from non-compliance to the point at which taxes are paid. A penalty of up to 100% of the tax amount can also be levied under the ITA for non-withholding. No deductions are allowed from the gross royalties or FTS. . If the non-resident company having a PE in India receives royalties/FTS, which is chargeable to tax in India and the payment of such royalties/FTS is effectively connected to the PE in India, then such royalties/FTS would be liable to tax in India as business income at the rate of 40% on a net basis.²⁰ In such cases, expenditure incurred in this respect by the non-resident in earning the royalties/FTS would be allowable as a deduction.

Payments of royalties/FTS made by one non-resident to another non-resident are brought within the Indian tax net, if such royalties/ FTS are payable with respect to any business or profession carried on by such non-resident in India or for earning any income from any source in India. Thus, for example if any royalties/FTS are payable by a non-resident sub-licensor to a non-resident licensor, the same could be subject to tax in India if they are payable by the sub-licensor in respect of any business or profession carried on by him in India or for earning any income from any source in India. However, under certain tax treaties, which India has entered into, such second tier royalty/FTS can be taxed in India only if the sub-licensor has a PE in India and the royalties/FTS are borne by the PE.

Income tax benefits are also available under the domestic law, to a domestic company engaged in the manufacture and export of goods and services if the export is undertaken via a facility set up in a Special Economic Zone. In such a case, a tax exemption equivalent to 100% of the profits derived by such unit from export of goods and services is available for the first 5 years of its operations and a 50% tax exemption on such profits is available for subsequent five years. Subject to fulfillment of specific conditions

19. Section 115AA and 115BB respectively of the ITA.

20. Section 44 DA of the ITA

regarding creation of a reserve and utilization of profits, a 50% tax exemption for an additional 5 years may also be claimed. However, a sunset clause has been introduced so that the benefits are no longer available for companies starting these operations on or after April 1, 2021. The phasing out of these benefits was in line with the Government's move on lowering the corporate tax rates for domestic companies.

Specifically, in relation to computer software, Circular No. 1 of 2013²¹ issued by the Central Board of Direct Taxes (CBDT) seeks to provide clarity on various issues relation to export of computer software. Some key aspects include:

- Software developed at a client's place i.e. on-site development would be eligible for benefit under the relevant provisions of the ITA and would qualify as an export activity.
- Tax benefits under sections 10A, 10AA and 10B of the ITA would not be denied merely on the ground that a separate and specific Master Services Agreement does not exist for each Statement Of Work (SOW)
- The sole ground of change in ownership of an undertaking cannot be grounds for denying the claim of exemptions for the remaining period.

ii. Indirect tax considerations

Export of services is "zero rated" under the GST regime i.e. the rate of GST on exports is 0%. However, there are certain compliances that need to fulfill for this purpose. In addition, exporters are allowed to obtain a refund of GST paid on input goods and services received by them in the course or furtherance of the export.

21. F.No. 178/84/2012-ITA.I

3. Conclusion

Like any transaction, there is no one single way of structuring and IP centric transaction. Several factors, such as nature of IP, flow of rights, exchange control requirements, tax and compliance issues etc need to be looked into. Local law nuances relating to IP creation,

registration and transfers add further complexity, as these are often overlooked. Hence, to avoid last minute surprises or improper title transfer, it is always advisable to review the documentation from a local law perspective.

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At Nishith Desai Associates, we have earned the reputation of being Asia's most Innovative Law Firm – and the go-to specialists for companies around the world, looking to conduct businesses in India and for Indian companies considering business expansion abroad. In fact, we have conceptualized and created a state-of-the-art Blue Sky Thinking and Research Campus, Imaginarium *Aligunjan*, an international institution dedicated to designing a premeditated future with an embedded strategic foresight capability.

We are a research and strategy driven international firm with offices in Mumbai, Palo Alto (Silicon Valley), Bangalore, Singapore, New Delhi, Munich, and New York. Our team comprises of specialists who provide strategic advice on legal, regulatory, and tax related matters in an integrated manner basis key insights carefully culled from the allied industries.

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Research is the DNA of NDA. In early 1980s, our firm emerged from an extensive, and then pioneering, research by Nishith M. Desai on the taxation of cross-border transactions. The research book written by him provided the foundation for our international tax practice. Since then, we have relied upon research to be the cornerstone of our practice development. Today, research is fully ingrained in the firm's culture.

Our dedication to research has been instrumental in creating thought leadership in various areas of law and public policy. Through research, we develop intellectual capital and leverage it actively for both our clients and the development of our associates. We use research to discover new thinking, approaches, skills and reflections on jurisprudence, and ultimately deliver superior value to our clients. Over time, we have embedded a culture and built processes of learning through research that give us a robust edge in providing best quality advices and services to our clients, to our fraternity and to the community at large.

Every member of the firm is required to participate in research activities. The seeds of research are typically sown in hour-long continuing education sessions conducted every day as the first thing in the morning. Free interactions in these sessions help associates identify new legal, regulatory, technological and business trends that require intellectual investigation from the legal and tax perspectives. Then, one or few associates take up an emerging trend or issue under the guidance of seniors and put it through our "Anticipate-Prepare-Deliver" research model.

As the first step, they would conduct a capsule research, which involves a quick analysis of readily available secondary data. Often such basic research provides valuable insights and creates broader understanding of the issue for the involved associates, who in turn would disseminate it to other associates through tacit and explicit knowledge exchange processes. For us, knowledge sharing is as important an attribute as knowledge acquisition.

When the issue requires further investigation, we develop an extensive research paper. Often we collect our own primary data when we feel the issue demands going deep to the root or when we find gaps in secondary data. In some cases, we have even taken up multi-year research projects to investigate every aspect of the topic and build unparalleled mastery. Our TMT practice, IP practice, Pharma & Healthcare/Med-Tech and Medical Device, practice and energy sector practice have emerged from such projects. Research in essence graduates to Knowledge, and finally to *Intellectual Property*.

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