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RBI mulls ECB rules for escrow accounts

MUMBAI: THE banking regulator has questioned deals that foreign investors often strike with Indian companies to protect their money.

Foreign strategic investors regularly enter into an arrangement where local firms and promoters keep aside some assets that can be sold from a special account to buy out the overseas party. Better known as the escrow account mechanism, it gives the foreign investor a chance to salvage the investment and exit if the local firm fails to perform or meet certain conditions.

Here, the foreign investor, which can be a private equity player, may enjoy the right to sell its stake to the local promoter. Once the foreign investor exercises such a right (or, put option in investment parlance), the Indian promoter can arrange the funds by selling assets in the escrow account.

But such an agreement, feels RBI, creates an interest on domestic assets in favour of non-residents, which is similar to an offshore bank lending against shares or land in India -- transactions that violate foreign exchange regulations.

"A senior lawyer and a trustee company who were appointed as escrow agents have been recently asked by RBI as to how such agreements were signed," a person familiar with the development told ET.

An agent is appointed by the local party and is entrusted with the job of liquidating the assets at the company's direction.

According to legal minds and consultants who help in structuring such in-bound deals, there are two distinct issues involved. First, whether foreign investors can have put options; second, is an escrow mechanism against the law?

"Such structures are common. It's not a capital account transaction," says H Jayesh, founder partner JurisCorp, a Mumbai-based law firm.

According to him, the escrow mechanism is like a negative pledge -- an arrangement where the assets held as collateral can't be pledged to another party. Siddharth Shah, who heads the Corporate & Securities Practice group at Nishith Desai Associates agrees with Jayesh. "The escrow agent acts on behalf of a Indian resident to discharge the latter's obligation," says Shah.

Many foreign investors insist on the escrow mechanism because of the bitter experience they had when a few local parties refused to honour the option and buy back the shares. "While the escrow is not a water tight arrangement, it gives comfort to the investor," said an official with an MNC bank. It is not known whether RBI has raised the issue with banks where such escrow accounts have been opened.

"Whether put options can be considered akin to debt as per the relevant RBI guidelines is a highly debatable issue and would depend on the terms and conditions attached to put option," feels Punit Shah who heads the financial services tax and regulatory practice at KPMG.

The central bank is categorical that foreign direct investment can be in the form of either plain equity or compulsorily convertible debentures or compulsorily convertible preference shares. And, if there is a put option attached to any of these instruments, then the investment takes the nature of 'debt' and not 'equity'. Such investments, said an RBI official, should be governed by the more restrictive rules on external commercial borrowings (or, foreign loans), and not FDI.

However, legal professionals differ. Indeed, they think options can be freely given by privately held companies. "Currently, there is no provision that invalidates put or call options between resident and non-resident parties," says Siddharth Shah.

But it's debatable whether foreign investors have adequate legal rights if a local promoter disregards the put option and refuses to pay up. Recent judicial precedents, says Punit Shah, seem to suggest that the put option may not be enforceable in certain circumstances, even though there is no finality achieved on the subject.

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