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Selected Essays in Private Equity

A Cyril Amarchand Mangaldas Thought Leadership Initiative

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Foreword

The events of the last year have demonstrated that the democratic process and private business are very deeply and organically intertwined.

If beginning of the previous financial year was glorious dawn, tinged with hope and potential, the present period can be described as high noon. The vague aspirational shadows of exponential growth and instant change, have been replaced by more realistic and sharply defined contours of what is possible, and perhaps more importantly, what is palatable to the nation as a whole rather than the narrow, relatively homogenous business and investment community.

The emergent picture, though different, is reasonably hopeful. As you will read in the following pages, this has been a year of record growth in PE investments, surpassing the glory days of 2007. A year of change, with disruption and young businesses leading the charge, as they well should.

This has accompanied regulatory changes, with new investment structures, instruments, vehicles, avenues and sectors being opened up with a general trend towards de-regulation, at least in most sectors.

Perhaps more importantly, it has been a year characterized by increased clarity and responsiveness. Long standing pain points such as the ambiguity on control, restrictions on holding companies and ambiguous taxation are in the process of being put to rest. More fundamental changes and relaxations are on the horizon particularly with respect to Company Law. Regulatory responses to ambiguous positions have become more precise and explicit.

Increasing investment into India, and the attendant need for consistency in governance, have been recognized across both the legislative and executive branches of government as normative ideals.

“Make in India”, the Start-up initiative, the UID and financial inclusion regimes, and perhaps more importantly “Stand Up India”, with all their attendant vagueness, have the potential to be powerful transformative forces which will fundamentally change the landscape of tomorrow's India and with it, tomorrows businesses.

One may say that this high noon is not however, entirely without its shadows. Eagerly anticipated labour, land and taxation reforms have proved difficult to implement. Legislative paralysis, a malaise which is usually cured by a decisive majority, has been all too evident.

The executive, while more decisive and responsive, has not been infallible. Attempts at regulating emerging businesses, and particularly the online space, has proved to be difficult and drawn the ire of vibrant and vocal public opinion, which has been amplified by the all too effective megaphone of the internet.

More concerning than this all too familiar Realpolitik, are the raging debates surrounding fundamental freedoms and public expression. They currently serve as a distraction for political capital which is sorely needed elsewhere, and which requires urgent correction in our democratic set up.

Macroeconomics aside, the public sphere has also influenced private businesses at a much more granular level. Businesses, particularly those dealing directly with customers no longer enjoy a comfortable lag in which they can respond to issues.

The virality with which errors are made public and debated and the speed of the attendant regulatory, judicial or even legislative response means that business have to rely on proactively managing public expectation, rather than reacting to failures after the fact.

The linkage between the public and private spheres is not unilateral. Businesses, even relatively young and small ones, have demonstrated the ability to disproportionately influence and impact public opinion. Online media is often the first and most accessible source for emerging developments, and online forums serve to catalyze debate. Traditional crucibles for the emergence of dissent and change are moving online, and on to resources run by private businesses.

Technology and decreasing cost of bandwidth and cloud storage gives private business the ability to circumvent and even disrupt conventional means of regulation and governance. Young entrepreneurs enjoy the unenviable choice of whether or not to put key aspects of a business including information, infrastructure and even revenues and treasury out of the reach of regulators. However, one cannot fully ignore the fact that some take the low road, prioritizing expedience over compliance. An inevitable side effect of this is broad strokes regulation, which affects the innocent and the guilty alike as one can see.

The following essays attempt to help private equity investors in India introspect and analyse for themselves as also evaluate and advise their investees on some emerging trends and developments, and navigate the tightrope between public and private law.

I hope that you will find these essays, the latest chapter in our Thought Leadership initiative, informative and useful and look forward to hearing from you on them.

CYRIL SHROFF
Managing Partner
Cyril Amarchand Mangaldas
cyril.shroff@cyrilshroff.com
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LIST OF CONTRIBUTORS

Aarti Joshi

Akshay Jeet Bhat

Anchal Dhir

Arjun Lall

Arun Prabhu

Dhananjay Kumar

Ganesh Rao

Gyanendra Kumar

Harminder Chawla (Harry)

Himanshu Dodeja

Manita Doshi

Nikhil Naredi

Niloufer Lam

Nisha Uberoi

Nivedita Tiwari

Ravi Kumar

Reeba Chacko

S. R. Patnaik

Shaneen Parikh

Smruti Shah

Srinivas Kilambi

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*Disclaimer: These articles are not intended to serve as legal advice and the position of law expressed in these articles are only valid as on the date of publication of such article.

Private Equity Investments – Recent Regulatory Developments and Trends

Amidst the global economic slowdown, the Indian economy has held its own, and may now be said to have justified its 'world's only bright spot' adjective, at least in terms of private equity (PE) investments into the country.

The year 2015 witnessed the highest levels of PE investments in India (USD 22.4 Billion) surpassing the previous chart-topping year, 2007 (USD 17 Billion) with a 38% rise in numeric terms.[1] Start-up investments dominated, with 600 out of the 1,049 PE deals being made in the start-up space.[2]

This PE growth story has many facets to it ranging from the obvious ones, like the liberalization initiatives of the government, the start-up push, some rationalization in valuation expectations, to changes in investment patterns (such as emergence of control deals, multi-investor driven deals, etc.), each of which affect the structuring of PE deals. The following paragraphs trace some of the recent regulatory developments and PE deal trends in the country, including key changes and issues faced by PE investors.

Regulatory Regime

The previous year saw the government liberalize several sectors and investment avenues under the foreign direct investment (FDI) regime in line with the 'Make in India' pitch. With more sectors being opened to foreign investment through the automatic route,[3] PE funds now have a wider array of investment opportunities to choose from. A snapshot of some of these changes are as follows:

- Restrictions of minimum project area and minimum capitalization for investment into the construction sector have been done away with. Additionally, exit conditions under the automatic route have been relaxed from project or trunk infrastructure completion, to a period of 3 years from investment (if it is earlier). Foreign investment is also permitted in certain types of completed projects like shopping malls and business centres, which is also subject to the 3 year lock-in.
- The marketplace e-commerce model, followed by several players, has been specifically validated, albeit with stringent conditions (such as the marketplace not directly or indirectly influencing the price of goods or

1 Http://www.livemint.com/Industry/DZYKCErQomg1vBKjrCfBDO/Private-equity-investments-in-India-highest-in-2015-report.html last visited on March 3, 2016

2 Fourth edition of Grant Thornton report, The Fourth Wheel 2016, referenced in a Mint report available at http://www.livemint.com/Industry/PLc3XdUS15LbKCuxPI2SWK/Startups-drive-private-equity-investments-in-2015-report.html last visited on March 8, 2016

3 Under the FDI regime, investments can be made via approval route i.e. investment with approval of the Foreign Investment Promotion Board (FIPB) and the automatic route, where investment does not require any approval. The FDI policy states the sectors which are prohibited, sectors which are in the automatic route and conditionalities thereto, and the approval route sectors.

services, and not permitting a single vendor and its group companies to effect more than 25% of sales on the marketplace). Further, single brand retailers operating brick-and-mortar stores are now permitted to sell through e-commerce.

- Foreign investment is permitted upto 100% under the automatic route in coffee, rubber, cardamom, palm tree and olive-oil tree plantations, giving a boost to the agri-products sector.
- Permitted FDI limit in the defence sector has gradually been increased from 26% to 49% under the automatic route and for investment above 49%, FDI under the government route, where it is likely to result in access to 'modern and state-of-the-art technology' has been permitted.
- FDI limit has been increased in the insurance and pension sector from 26% to 49% under the automatic route, subject to prescribed conditions.
- Certain new avenues and instruments have been introduced in the FDI regime, which give more flexibility to PE players in structuring their transactions:
- Formation of limited liability partnerships (LLP) was permitted under a legislation of 2008 and has slowly gained prominence in the corporate world. However investment into only certain LLPs was permitted under the government approval route. The policy has been revised to permit foreign investment in LLPs undertaking certain specific activities (where no pre-approval is required and no FDI conditions are attached). Such LLPs can also make downstream investments in compliance with the extant foreign exchange regulations.
- The FDI regime did not encourage investment into shell companies (with no operations or investments), and any such investment required FIPB approval. The requirement to obtain FIPB approval has been relaxed for such companies, where the investment is for the purposes of undertaking activities in the automatic route without performance conditions.
- FIPB approval requirement for share swaps has been relaxed for companies undertaking activities in the automatic sector, subject to fair valuation of the shares. This, for instance, can facilitate consolidation moves in the start-up space, which are often funded as all stock deals or part-stock deals.
- Foreign investment is permitted into 'Investment Vehicles', which includes real estate investment trusts (REITs), infrastructure investment trusts (InViTs), and alternative investment funds governed by regulations issued by the Securities and Exchange Board of India (SEBI). The notification in this regard also clarified that only if the manager or sponsor is foreign owned or controlled, would the downstream conditions apply to investments, dispelling doubts on foreign ownership dictating downstream investments in these investment vehicles.
- In the last set of reforms in respect of permitted instruments for foreign investment, warrants and partly paid equity shares were permitted, subject to conditions. These instruments enable PE funds to acquire rights / securities in investee companies, by deferring the consideration over a period of time,

making part payment upfront and perhaps exploring variety of valuation principles linked to future performance parameters.

Besides significant changes aimed at de-regulation in the FDI regime, there have also been other noteworthy regulatory developments which are key drivers in the PE story. In March 2016, the government liberalised the thresholds which trigger competition filings. There has been a fair amount of start-up boost both from the government and regulators, including the Start-up India Action Plan, which will provide both incentives and a simpler compliance framework for start-ups. SEBI eased listing norms for specified start-up companies, and facilitated the listing of such companies on the institutional trading platform (ITP)[4], making it easier for such companies to raise capital and also generate exit opportunities for investors.

The Reserve Bank of India also has, in its efforts to further boost the start-up ecosystem,[5] indicated the creation of a framework for deferment of considerations for transfer of ownership and facilities for escrow arrangements. On the taxation front, the government has introduced safe harbour provisions for offshore funds which clarifies when there will not be a business connection in India, provided a tax pass through status to investors in category I and category II alternative investment funds (in respect of income other than business income) and also clarified the withholding tax norms for investors in these funds.

Recent trends and structuring concerns and takeaways

Besides the regulatory challenges, some of the recent trends witnessed in PE investments, change the way investments are negotiated and structured.

Control investments

Indian promoters are generally averse to control transactions, and the norm has been for PE players to take a minority stake with affirmative voting rights. A recent emerging trend is for PE funds to acquire a controlling stake in target companies. Over the last year, about 20 private equity funds have completed control transactions, worth about USD 2 billion.[6] PE funds see benefit in such transactions as they eventually facilitate smoother exits. While this may be true for private secondary sales, in an exit scenario by way of a public offering on the equity platform of stock exchanges in India, the controlling investor has limited avenues to avoid being classified a promoter.

Recent SEBI regulations[7] have for the first time, formulated provisions for re-classification and de-classification of promoters, which may subsequently come to the aid of exiting investors in such situations.

Structuring discussions in control deals circle around finding a balance between the investor's role as the majority stakeholder versus operational freedom to the promoters in minority for day-to-day activities, and an incentive structure which encourages the promoters in management to contribute to the growth of the target,

4 Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) (Fourth Amendment) Regulations, 2015 dated August 15, 2015; http://www.sebi.gov.in/cms/sebi_data/pdffiles/31307_t.pdf last visited on March 7, 2016

5 Sixth Bi-Monthly Monetary Policy Statement, 2015-16, dated February 2, 2016

6 Http://www.livemint.com/Companies/wSJesUJsRO9XnwwHcLFYdL/PE-funds-increasingly-looking-for-buyout-deals.html last visited on March 8, 2016

7 SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (in force since December, 2015

and other retention structures to offset limited ownership interests.

Yet another issue for PE investors to watch out for is the liability of their nominee directors, who are now no more merely "non-executive directors" representing a minority interest. Key items of concern are classification as 'officer-in-default', 'employer' or 'person-in-charge' under various laws leading to significant liabilities. Fiduciary duty versus conflict issues are often addressed contractually through matters being referred to shareholders. While these concerns are to some extent applicable to all transactions, the issue is more pronounced in a control transaction.

Consolidation

Market consolidation as a phenomenon is not a new trend. However, the burgeoning e-commerce sector and service aggregation models (for example for taxi-cab aggregators or such other specialized technology services), have paved the way for PE funds investing in companies in the same sector, anticipating an eventual sectoral consolidation. Many private equity backed investee companies, predominantly start-ups, have consolidated with other companies in the same or similar fields, in the recent past. With share swaps now being permitted for companies in the automatic route, structuring a consolidation deal is less complex; however, the contractual framework in such deals are more complex.

Investment documents in this regard need to consider several nuances, including re-negotiations of the rights of investors in both the companies, as well as detailed iteration of the role and responsibility of the promoter of the business that is being acquired. The issues become even more complex where both businesses in consolidation are of a comparable size. Separately, as a precaution, the fiduciary duties of directors need to be carefully understood, in order to avoid any conflict with participation on boards of other investee companies and in discussions on the consolidation.

Insurance

Reports indicate that 2015 was one of the best years for exits by private equity investors.[8] Exits happened in the public market space, in secondary sales and also strategic sales,[9] with secondary transfers and strategic sales being the predominant route. Due to limited fund life and other constitutional concerns, PE funds are reluctant to give standard representations at the time of exit. Similar is also the case with promoters in professionally managed companies. To bridge the gap, insurers are offering representation and warranty insurance, for a one-time premium payment. Although the number of transactions which include such insurance is small in number, this will be an important risk mitigation device, going forward. High premium costs (in our experience approximately 2.5 to 3% of the insured value) and wide exclusions (including all information known to the investor), are some irritants in the success of the warranty insurance story. With the volume and size of deals which opt for insurance increasing, the premium amounts may reduce, as has been the experience in developed countries.

8 Http://www.indiainfoline.com/article/news-top-story/2015-turns-bumper-year-for-private-equity-exits-115082000159_1.html last visited on March 9, 2016

9 Http://www.livemint.com/Companies/vEVPbz7y4a7Tr0jejDNmbJ/PE-fund-exits-in-2015-so-far-highest-in-five-years.html last visited on March 9, 2016

PE funds with limited life-cycles are also relying on parent guarantees, albeit with much reluctance.

Promote

In a majority of PE transactions involving promoter centric companies, considerable time and energy today is expended on structuring of promote. A significant limitation today is that promoters, even in private companies, cannot be granted stock options or other similar incentive instruments due to restrictions under the new company law. Selective bonus, cash incentive schemes, phantom stocks, and so on are some of alternatives being observed in recent PE deals.

Regulatory overlap

Yet another challenge in structuring is linked to the lack of regulatory consistency on how common concepts are treated. For example, while SEBI is attempting to bring certainty to the 'control' regime and exclude minority protection rights commonly retained by financial investors from the purview,[10] multiple 'control' regimes still exist under company law, competition law and foreign exchange regulations. While transactions may be bound to take into account all variations, lack of clarity keeps options open for consideration of divergent views and this invariably necessitates drafting complex provisions.

Conclusion

Over the past few years, the government has consistently tried to liberalise the FDI regime, which has opened up new avenues for investment to PE players. As part of the announcements in this year's budget, 100% FDI in asset reconstruction companies was permitted in the automatic route; additional activities under non-banking financial services sector were added and hybrid instruments were proposed. The regulators have also been sensitive to the requirements of PE funds to exit their investments, and have permitted put/call options; introduced the ITP platform for start-up listing, amongst others.

Most of these changes are fairly recent and would take time to make an impact. What lies ahead would predominantly depend on whether PE funds consider the new sectors and avenues viable, if not attractive. For example, (a) whether investments in warrants and partly paid up shares can transform the structuring exercise, is yet to be seen; (b) similarly, until the ITP platform for start-up listing shows some successful precedents, structuring for offshore listing for at least some kinds of businesses will continue to dominate. Importantly, a stable central government which has the political will to carry through and implement these changes will be critical.

Changes in the regulatory climate, coupled with the increasing maturity of both promoters and PE funds (specifically those with learnings post 2008), we believe, could pave way for the evolution of newer trends and investment strategies.

10 SEBI Discussion Paper on "Brightline Tests for Acquisition of 'Control' under SEBI Takeover Regulations."

GAAR – Hot Potato for Private Equity Transactions

With increased availability of funds, heightened expectations of the promoters and lack of exit options, private equity funds (**PE Funds**) investing in India have found the Indian landscape to be relatively tougher in recent times. While India remains the sole bright spot among emerging markets, the signs of global slowdown are making investors nervous at the time of allocating money to emerging markets. Global investors are leaving no stone unturned to ensure that all uncertainties have been taken into account in the investment calculations.

As tax reduces the returns on investments, tax efficient exits also constitute a very important part of the exit strategy. For example, non-resident PE Funds often make investments in India from tax friendly jurisdictions like Singapore, Mauritius, etc. In order to maximise returns for investors, they also sometimes invest in a mix of debt and equity.

Structuring transactions to minimise incidence of tax, while practised almost universally, both by large multinational enterprises as well as PE Funds, has however, become the subject matter of considerable debate. Most governments have been trying to galvanise public opinion against aggressive tax planning, especially after the global economic slowdown of 2008. Often, the line between tax planning and tax avoidance also gets blurred. In a bid to counter large scale tax planning, governments across the globe have either introduced or tightened several anti avoidance regulations and tools. Many jurisdictions introduced General Anti-Avoidance Rules **(GAAR)** to plug tax leakages. Not to be left behind, India also introduced GAAR in 2012, by amending the (Indian) Income Tax Act, 1961 **(IT Act)**.

Genesis of GAAR in India

Structuring of transactions in a tax effective manner has been de rigueur since taxes were introduced into modern society. In India, the Hon'ble Supreme Court **(SC)** had in Raman and Co.[1] held that avoidance of tax by arranging commercial affairs is not prohibited. However, in McDowell & Co. Ltd. the SC held that it was wrong to encourage or entertain the belief that it was honourable to avoid the payment of taxes by resorting to dubious methods. Subsequently, in Azadi Bachao Andolan the SC held that while planning, adopted as a device to avoid tax has to be deprecated, the principle cannot mean that a person should arrange his affairs to attract maximum tax liability and every act, which results in tax reduction, should not be construed as a device of tax avoidance.

1 [(1968) 67 ITR 11]

GAAR was originally mooted as part of the now shelved Direct Taxes Code. GAAR was first introduced into the IT Act, in 2012. However, since it contained onerous provisions with significant powers granted to the Indian Revenue Authorities (**IRA**) and was introduced with little consultation, it led to widespread condemnation of the Government's moves leading to deferral of the implementation of GAAR. A committee headed by Dr. Parthasarathi Shome (Shome Committee) was also constituted to provide guidance on the implementation of GAAR, which has since submitted a report to the Government.

Arrangements enabling invocation of GAAR

The GAAR provisions, empowered to override other provisions of the IT Act, could be invoked in cases where the taxpayer enters into an "impermissible avoidance arrangement" whose main purpose or at least one of the main purposes, is to obtain a tax benefit.

The IT Act describes an impermissible avoidance arrangement that (i) creates rights and obligations in a manner not ordinarily created between persons acting on arm's length basis; (ii) intends to abuse or misuse the IT Act; (iii) lacks commercial substance; or (iv) is undertaken in a manner not ordinarily employed for bonafide purposes.

Similarly, for this purpose, tax benefit refers to (i) reduction, deferral or avoidance of tax under the IT Act or under the any treaty; (ii) increased refund under the IT Act or under any treaty; (iii) reduction in total income; or (iv) increase in loss, etc.

Considering the wide ambit of GAAR, a number of legitimate business transactions could come within its purview, unless the taxpayer is able to establish the contrary to the satisfaction of the IRA.

The threshold limit for invocation of GAAR has been set at INR 30 million. As per the assurance given by the Hon'ble Finance Minister to the Indian Parliament in 2015, transactions or arrangements put in place prior to April 1, 2017 shall be grandfathered and only such transactions or arrangements undertaken after such date could come under the purview of GAAR. GAAR provisions also would not be invoked in respect of non-resident investors who have invested through offshore derivative instruments directly or indirectly under the Foreign Portfolio Investor regime.

What happens when it starts

We would do well to understand the significant powers that IRA is vested with in dealing with anti avoidance arrangements. This will also give us a sense of what to expect and what to account for while dealing with the issue. The IRA is empowered to:

- deny tax benefits by disregarding or recharacterising any arrangements,
- treat the arrangement as if it had not been entered into,
- disregard any accommodation party deeming persons who are connected to each other to be one and the same,
- reallocate amongst the parties to the arrangement any accrual/ receipt of capital or revenue nature or any expenditure, deduction relief or rebate,

- treat any place of residence of a party or situs of an asset or transaction, at a place other than the place of residence, location of the asset or location of the transaction as provided under the agreement,
- look through any arrangement by disregarding the corporate structure,
- treat equity to be debt and vice-versa,
- recharacterise a receipt of capital nature as revenue nature and vice versa, etc.

Given the wide powers granted to the IRA and taking into account their past record of very aggressive approach towards taxpayers, there is palpable concern amongst taxpayers. As can be seen from the above, GAAR empowers the IRA to re-characterise an income, ignore a part or whole of a transaction, deny treaty benefits, etc. Such unbridled powers granted to the IRA could result in completely different characterisation of income and thus, could significantly alter the tax calculations/liabilities determined by the taxpayer. Since tax planning is a significant aspect of transaction structuring for PE Funds, such planning may, going forward, have to factor in GAAR implications, at the time of making the investment, during the life of the investment, and during an exit.

Impact of invocation of GAAR on PE transactions

As per Government sources, GAAR provisions would not be invoked retrospectively and would only be invoked on or after the GAAR provisions become effective, that is, with effect from April 1, 2017. In case GAAR is invoked, the following consequences could arise in respect of transactions undertaken or arrangements put in place on or after April 1, 2017:

- interest received / receivable on fully convertible debentures could be re-characterized as dividends;
- treaty benefits could be denied to investors routing their investments through tax friendly jurisdictions like Mauritius and Singapore;
- in case any transaction or arrangement undertaken by the taxpayer is held to be lacking in commercial substance, it can be ignored either completely or partially;
- any transfer of shares or other assets from one taxpayer to another without any consideration in an internal restructuring can be ignored on the ground that it lacks commercial substance;
- any payment of interest in respect of a loan granted by a shareholder may be re-characterised as dividend, etc.

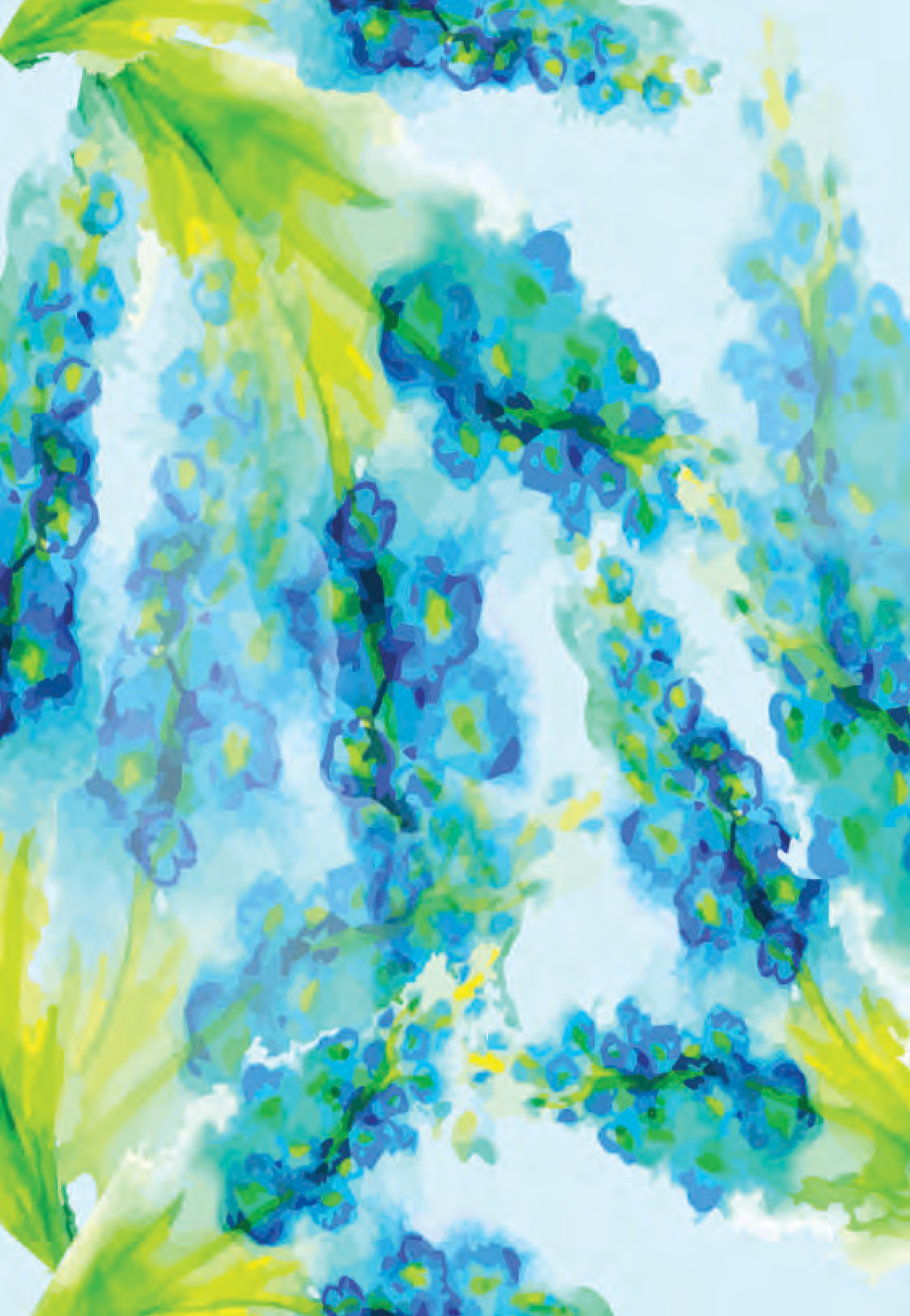
However, so long as the taxpayers including PE Funds are able to demonstrate that the transactions have been undertaken in accordance with prevailing market norms and to give effect to business exigencies, the transactions should be acceptable. For example, if the investor has invested in convertible debentures or granted a loan wherein the interest is payable on arm's length basis and no significant management control is granted to the investor, the business rationale of the transaction should be accepted by the IRA. As far as denial of treaty benefits is concerned, it is a very debatable issue and even the Shome Committee had recommended that instead of denying treaty benefits to the taxpayer by invoking GAAR, the government should renegotiate the concerned treaties to build in appropriate safeguards.

Conclusion

GAAR could result in a paradigm shift in what could have been currently construed as acceptable tax planning. PE firms should be mindful of not allowing tax to be the primary driver of the business decision; rather, business exigencies and benefits should. Ensuring that transactions are undertaken for genuine commercial reasons, with embedded substance should mitigate risks of invocation of GAAR. PE firms should, therefore, rethink their strategy of aggressive tax planning to achieve maximum returns.

However, the problem in India is sometimes not so much with the regulation itself, but with how such regulation is proposed to be implemented. As we have experienced in the past, the IRA has used discretionary powers granted to it under the IT Act indiscriminately and hence, the fear is there might be a significant increase in tax litigations because of introduction of GAAR unlike other countries where GAAR has been invoked sparingly.

It is hoped that the IRA would be cautious enough to invoke GAAR in the rarest of circumstances and as a matter of last resort so that the foreign investor community does not get unnecessarily perturbed. As it is, the IRA has earned the reputation of being one of the most difficult government authorities in India, arguably for cogent reasons. With the kind of wide powers granted to them under the GAAR provisions, they should be well advised to invoke these provisions sparingly so that the recent steps initiated by the Government to curtail the extent of tax litigations do not get derailed.



Competition Law and Private Equity – Changes and Implications

Introduction

The Competition Act, 2002 **(Act)** is the primary legislation in India enacted to promote and sustain competition in the markets. In order to prevent an appreciable adverse effect on competition **(AAEC)**, the Act seeks to regulate anti-competitive agreements, abuse of dominance as well as mergers/amalgamations and acquisitions in India.

From a competition law perspective, the most apparent law risk for any private equity investor is the likely value impact on a portfolio company which has contravened the provisions of the Act. Further, a private equity investor should be aware of the implications of non-compliance with the Act, particularly in the context of information exchange and cartelization, the trigger for notification, level of information to be disclosed in the merger notification as well as liability of key management personnel.

Anti-competitive Agreements and Abuse of Dominant Position: Implications for Private Equity Investors

The Act prohibits both horizontal agreements (i.e. agreements entered between competitors) and vertical agreements (i.e. agreements entered between enterprises at different stages or levels of a production chain) which cause or are likely to cause an AAEC. While horizontal agreements are presumed to cause an AAEC, in case of vertical agreements, the AAEC must be established (the rule of reason approach applies). The Act also prohibits enterprises from abusing their dominant position. A finding of abuse of dominance is premised on demonstrating the enterprise's dominance in the relevant market and abuse of such dominance by way of certain prohibited conduct, as stipulated under the Act. Market share is only one of the factors that the Competition Commission of India **(CCI)** considers to determine dominance of an enterprise.

The Act prescribes extremely high economic penalties - extending up to 10% of the average turnover for the last three financial years upon each person or enterprise which is a party to such anti-competitive agreement(s). Further, in the case of a cartel,[1] a penalty of up to 10% of the average turnover for each year of the existence of the cartel or up to three times of the profit on each of the cartel members for each year of the continuance of such cartel, whichever is higher, can be imposed. Given that

1 Under the Act, 'cartel' includes an association of producers, sellers, distributors, traders or service providers who, by agreement amongst themselves, limit, control or attempt to control the production, distribution, sale or price of, or, trade in goods or provision of services.

cartelization is an offence of a civil nature, the has adopted low evidentiary standards of "preponderance of probabilities" and not that of "beyond reasonable doubt" evidence.

The penalties for abuse of dominance under the Act are similar to those that may be imposed by the CCI for entering into anti-competitive agreements, with an additional power to direct the division of a dominant enterprise. Further, the CCI also has powers of search and seizure and has recently exercised such powers by way of a dawn raid to gather evidence in a potential abuse of dominance investigation.

It is pertinent to note that the CCI may also impose personal liability on persons in-charge of and responsible for the conduct of the business of the enterprise in case of contravention of the Act. The CCI has in certain instances, imposed a penalty on both the infringing enterprise as well as the officers in charge of such enterprise.

In view of the substantial penalties that the CCI has imposed in its past decisions and is empowered under the Act to impose, it is imperative for private equity investors to conduct competition law audit on the portfolio companies, prior to their investment in such portfolio companies. Such diligence will have to be conducted to ensure that there are no anti-competitive practices or abusive conduct by such portfolio companies in contravention of the Act to avoid liability under the Act. Imposition of any sort of penalty will not only lead to serious damage to reputation and adverse publicity but also may significantly diminish the value of the investment, given the penalty regime under the Act.

Besides undertaking appropriate due diligence, private equity investors can get protection by seeking requisite competition warranties and indemnities to ensure that they are indemnified against any competition risks for such period where the private equity investor exercises decisive influence or control in the portfolio company. As an additional safeguard, private equity investors should consider putting in place competition compliance programmes in the companies they invest in, in order to identify, assess and mitigate any existing and potential competition law infringements.

Merger Control: What Private Equity Investors should look out for

The Act provides for a mandatory and suspensory regime (i.e., the parties cannot complete the transaction before seeking approval of the CCI) which requires acquisitions, mergers and amalgamations meeting the prescribed thresholds of assets or turnover that may relate to the size of the parties or the group to which the parties to a transaction belong (**Jurisdictional Thresholds**) under the Act (**Combinations**), to be notified to the CCI for its prior approval. The CCI thereafter undertakes an analysis of whether a Combination causes or is likely to cause an AAEC within the relevant market in India. Combinations causing or likely to cause an AAEC are void. It should be noted that Combinations are construed widely to include not only private equity and M&A transactions but also exercises pertaining to corporate restructuring.

Fortunately, small Combinations are exempt from such approval requirements. The Government of India, through the Ministry of Corporate Affairs (**MCA**), issued a notification dated 4 March 2011, whereby a combination would not require prior notification to, and approval from, the CCI if the target enterprise, including its divisions, units and subsidiaries has either assets of the value not exceeding Rs. 250 crores in India or turnover not exceeding Rs. 750 crores in India (**Target Exemption**). The Target Exemption which expired on 3 March 2016 was re-issued on 4 March 2016 with enhanced thresholds, which exempts an enterprise, whose control, shares, voting rights or assets are being acquired has either assets of the value of not more than Rs. 350 crores in India or turnover of not more than Rs. 1000 crores in India. This exemption is valid for a period of 5 years i.e., until 3 March 2021. As such, it should be noted that a Combination where the target enterprise, including its divisions, units and subsidiaries has either assets of the value not exceeding Rs. 350 crores in India or turnover not exceeding Rs. 1000 crores in India would not require prior notification to, and approval from, the CCI. However, the availability of the Target Exemption has been diluted whereby if as part of a series of steps in a proposed transaction, particular assets of an enterprise (i.e. a business or a division) are moved to another enterprise (i.e. a special purpose vehicle), which is then acquired by a third party, the entire assets and turnover of the selling enterprise (from which these assets and turnover were hived off) will also be considered when determining if the Target Exemption is available to a proposed transaction. Additionally, the Target Exemption is not available to transactions structured as merger or amalgamations.

A transaction which cannot avail of the Target Exemption will require mandatory notification to and approval of the CCI if the Jurisdictional Thresholds are met. The Jurisdictional Thresholds consider both, Indian as well as global assets and turnover, to capture global transactions having an Indian nexus. The CCI requires the acquirer and target's audited financial statements to ascertain whether the Jurisdictional Thresholds have been breached, resulting in the requirement to file a merger notification with the CCI.

Such notification will have to be made within 30 days of execution of any binding definitive agreement or any 'other document' conveying a decision to acquire (which includes a public announcement made in terms of the Securities Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, in case of acquisitions or final board approval in case of mergers or amalgamations.

Exemption from Notification

Schedule 1 of the Competition Commission of India (Procedure in regard to the transaction of business relating to combinations) Regulations, 2011 (**Combination Regulations**), exempt certain transactions from the requirement of filing a merger notification with the CCI. Pertinently, the Combination Regulations exempt an acquisition of a non-controlling minority stake, i.e. acquisition of less than 25% of shares or voting rights of the target from the requirement of filing a merger notification provided that such an acquisition is made solely as an investment or in the ordinary course of business; and does not lead to the acquisition of control of the target enterprise (**Item 1 Exemption**).

2 Explanation (a) to Section 5 of the Act provides that: 'control' shall include "controlling the affairs or management by – (i) one or more enterprises, either jointly or singly, over another enterprise or group; (ii) one or more groups, either jointly or singly, over another group or enterprise."

3 Alpha TC Holdings Pte Limited/Tata Capital Growth Fund I, C-2014/07/192.

By way of recent amendments to the Combination Regulations, it has been clarified that an acquisition of less than 10% equity interest will be presumed to be made "solely as an investment" and will be able to avail of the Item 1 Exemption provided:

- No special rights are allotted to the acquirer and the acquirer can only exercise ordinary shareholder rights to the extent of its shareholding;
- No right to appoint a board member on the board of the target; and
- The acquirer does not intend to participate in the affairs or management of the target.

Although the provisions of the Act do not lay down a substantive test for 'control',[2] the CCI by way of its decisional practice, has interpreted 'control' under the Act to include both positive control as well as negative control. The CCI treats the acquisition of any of rights relating to the annual business plan, the annual budget, appointment of key managerial personnel and their remuneration, investment decisions (without any materiality thresholds), entry or exit from lines of business, or amendment to the memorandum of association and articles of association, etc. as acquisition of control. The CCI has recognized the aforesaid rights to be strategic commercial decisions and not mere investor protection rights.[3] Since there is no bright line test to determine 'control', different regulators have often adopted varying thresholds at different times in their determination of 'control'. The CCI has a lower threshold for control in comparison to SEBI. Accordingly, a Combination involving an acquisition of less than 25% of shares or voting rights of the target enterprise, where the investor acquires such rights, would constitute an acquisition of control under the Act and require mandatory notification to the CCI. Typically, private equity investments are notified as short form merger notifications (i.e. Form I). The level of information to be disclosed in filing a merger notification may raise confidentiality concerns for the investor since it entails details of investments in portfolio companies in India by such private equity investor, financials of the acquirer and target, market share of the target, details of top 5 competitors, customers and suppliers, etc.

Further, the Combination Regulations also provide for certain exemptions in relation to intra-group transaction. For instance, an exemption is available for aquisition of shares, voting rights or assets by a person or enterprise, of another person or enterprise within the same group except in cases where the acquired enterprise is jointly controlled by enterprises that are not part of the same group. As such, this exemption excludes an entity that is jointly controlled from the applicability of an intra-group exemption.

The Combination Regulations provide that the requirement of filing a merger notification with the CCI shall be determined with respect to the substance of the transaction and any innovative structuring that has the effect of avoiding notice in respect of the whole or a part of the Combination shall be disregarded. Effectively, this anti-circumvention clause gives the CCI the complete discretion to pierce the veil and look into the substance and ultimate intended effect of all transactions and structures to determine whether the same ought to have been notified for CCI's approval.

Timelines

The CCI is required to issue its prima facie order within 30 working days of receiving a merger notification. This 30 working day period excludes the time taken for clock stops when the CCI requests parties for additional information. Typically, parties can expect between 1-4 information requests from the CCI in the course of its review of a merger notification. It is important to note that the CCI has not disapproved a private equity transaction to date. In fact, the CCI typically tends to review private equity minority investments with certain veto rights fairly benignly. The CCI has reviewed over 326 merger notifications thus far, of which 41 merger notifications relate to private equity investments. The longest the CCI has taken to approve such transactions is 99 days, including clock stops.

Penalties

The CCI can impose a penalty of up to 1 % of the total global assets or turnover of the defaulting parties for the preceding financial year, whichever is higher (on the acquirer in case of acquisition and on both the parties in case of a merger or amalgamation), for failing to notify a notifiable Combination or for filing a belated merger notification. A penalty can also be imposed by the CCI if a Combination or any step leading to such Combination is consummated prior to obtaining the CCI's approval. In addition to the CCI's power to impose penalty for non-notification or for belated notification of a notifiable transaction, the CCI has the power to “look back” for a period of one year from the date on which such Combination has come into effect and unwind the Combination, if required.

Rise in Prominence of Listed Non-Convertible Debentures (NCDs)

Structuring investments, more often than not, is the interplay between the regulatory platform and commercial objectives. Added to that, limited availability of capital for certain sectors with banks and financial institutions maintaining an invisible negative list, we have a virtual Robinson Crusoe sector. Investors proposing to invest in such sectors through the equity route are either required to bite the bullet or come up with alternative investment avenues and instruments.

While various hybrid instruments such as warrants and partly-paid up shares, are playing their part in aligning the commercial reality with the regulatory crests and troughs in the equity space, investors have also been exploring opportunities for cashing in, on the debt segments. Listed non-convertible debentures (NCDs) have in the recent past been seen as instruments of change, providing an alternative to tacking issues in the equity space and at the same time, keeping commercial needs intact.

According to data sourced from SEBI,[1] the corporate bond market has raised about Rs. 414,623 Crores through private placement in 2015-16.

A little bit about the particulars of the regulatory layout which makes this route an interesting one. Under the foreign exchange regulations, foreign portfolio investors (FPIs) registered with the Securities and Exchange Board of India (SEBI) are permitted to subscribe to/ invest in, listed or to be listed NCDs (with the only exception being investment in unlisted non-convertible debentures issued by an Indian company in the infrastructure sector). This, as an investment route, is separate from the foreign direct investment (FDI) regime and consequently, sectoral caps and conditions, pricing and restrictions on assured returns as applicable to FDI are not applicable to such investments.

The NCDs are required to have a residual maturity of 3 years, which essentially means that the target cannot redeem the NCDs (even through optionality clauses) prior to the expiry of 3 years. The 3 year lock-in however, is not applicable to the sale of the NCDs to domestic investors. Having said that, albeit the law being clear on this, certain authorized dealers are taking the view that this lock-in may apply to sale of NCDs to domestic investors as well.

Issuance of listed privately-placed NCDs is governed by the Companies Act, 2013, with listing and disclosure requirements being regulated by the SEBI (Issue and Listing of Debt Securities) Regulations, 2008 and the SEBI (Listing, Obligations and Disclosure Requirements), 2015 (LODR). NCDs with less than 1 year maturity are also required to comply with the Reserve Bank of India (Issuance of Non-Convertible Debentures),

1 http://www.sebi.gov.in/cms/sebi_data/statistics/corporate_bonds/privatenew.html

2010 Directions which prescribe higher compliance requirements such as credit rating/ eligibility of the borrower and a restriction on redemption/ put option for a period of 90 days from the date of issuance.

An alternative to equity?

What makes investment through listed NCDs attractive are the simplicity of the entry route (conditions are essentially compliance driven), limited end-use restrictions as compared to other foreign currency debt such as external commercial borrowings, and saving from foreign currency exchange rate risk, since it is rupee denominated debt. For sectors which are cash strapped and alienated by other financing institutions, private placement of NCDs is more than just an alternative.

From an investor perspective, NCDs are the 'go-to' product as it offers assured returns on their investment through coupon payments or redemption premia without any cap on interest rate. Payments of interest and redemption premium being periodic, the frequency of returns is what sets this apart from the equity model where dividend payments are linked to profits, which are often not achieved. The tax regime on repatriation has also to a large extent remained favourable; for example the extension the withholding tax on interest payments (at 5%) until 2017.

On liquidation, the investors being creditors stand ahead of equity holders in the distribution chain, a legally established principle as opposed to a contractual liquidation preference in equity structures. Investments through this route also offer a mechanism for securing investments (through a mortgage, pledge, hypothecation etc.) which is not permissible for equity instruments. Restrictions on creation of interest on immoveable property in favour of non-residents have been addressed through creation of security in favour of an Indian debenture trustee. Repatriation through enforcement, however, may require the approval of the Reserve Bank of India. The challenges in enforcement are however largely untested.

For borrowers, limited end-use restrictions are a key. From a tax optimization point of view, interest payments are a deductible expense of the borrower unlike dividends paid on equity and buyback of equity which are distributed after payment of tax.

On the flip side, listed NCDs, however, come with their own compliance baggage. Unlisted Indian companies which raise listed NCDs get categorized as 'listed' companies for the purposes of the Companies Act, 2013 which require a higher compliance and become subject to additional disclosure, reporting and consent obligations under the LODR. While this may be beneficial to the investor from a corporate governance perspective, it increases compliance and administration for the borrower. The LODR, many complain have made the simplified debt listing not so simple anymore.

Deal Design

With private equity investors looking for alternatives, gone are the days of plain vanilla debt. Investors are now looking at these investments to get an upside from the business by structuring returns based on business performance/ project based conditions. Being debt, there is downside protection of the principal. Given the fundamental jurisprudence of debt being an absolute obligation to repay, absorbing downside risks remains tricky. Structures with private equity investors investing in nominal equity along with private debt are not uncommon. These structures allow investors to exercise control through affirmative voting rights, obtain a board seat as equity holders and receive assured return on their investments as creditors. This not only helps bridge the gap in a company's capital structure but is also commercially viable for investors as it occupies a place between senior debt and equity, both in terms of security, returns and influence. There are instances where investments are purely into debt but veto matters are shaped as negative consent rights which are standard across the lending arena.

NCDs usually earn mid-to-high yields through various combinations of cash coupon coupled with redemption premium, cash flow or profit linked coupons, market linked returns obtained through exposure on exchange traded derivatives and/or equity liked components such as warrants or convertibles.

While sectors such as infrastructure and manufacturing have witnessed considerable private equity debt over the last few years, the real estate sector in particular has witnessed substantial increase in debt investments by private equity players.

The slowdown in the real estate market, lack of funding for land acquisition, defaulting developers, downgrading of their ratings, has led to this sector being highly leveraged. These developers are now relying on private debt whether as fresh debt or by way of refinancing existing debt. With a high risk appetite, private equity players have shown interest and invested in NCDs of such companies. However, owing to the risks involved in such investments such as delay in completion of projects, projects under litigation and general slack in market demand for real estate, interest rates are substantially higher than other sectors. To insulate themselves from the risk associated with such investments, private debt investors typically collateralize their investment by security cover depending on the developer's credit rating, personal and corporate guarantees. The trend in securing high return and easy exit is evidenced by way of redemption premiums and default interest being charged on non-completion of pre-determined construction milestones. From regulatory stand point NCD investments in the real estate sector have come a long way from being considered speculative to now being accepted as a regular form of investment.

There's many a slip between the cup and the lip

While private equity players enjoy many advantages of investing in debt instruments in India, given that the NCDs are traded on a wholesale debt market segment, a large part of the deal specifics have to be disclosed to the stock exchanges, where information is publically available. With the LODR being effective from December, 2015, key changes to the structure of the debentures also require approval of the stock exchanges.

Amidst typical challenges of structuring, in order to create equity type returns, the debt character of the investment, should not be lost exposing the investment to risks of recharacterization.

An ever increasing requirement for capital across almost all industry/ sectors and varying risk appetites of investors, have paved for effective alternative means of attaining the illusive 'return'. Though available to a limited category of investors, investments through NCDs have certainly found their calling.

Co-Investment Structures

A co-investment structure typically contemplates investors (including pooled vehicles or their investors) making direct investments in target companies on a co-investment basis and on terms that would substantially be the same for all investors except for certain legal, tax and regulatory considerations.

A co-investment structure is beneficial to the sponsor (or the manager or general partner of a fund) (i) for making big ticket investments without breaching diversification requirements prescribed by law (for example, pooled investment vehicles established in India are not allowed to invest more than 25% (or 10% in certain cases) of their investible funds in one investee company) or provided in definitive documents; (ii) in garnering 'pledges' (usually non-binding) for co-investments during a difficult fund raising climate – even if there is no pledge, a sponsor would have visibility on potential co-investors for hiving off part of an investment opportunity; (iii) in exercising higher degree of control over the portfolio; (iv) in alignment of economic interest between the co-investing investor and the fund; and (v) as certain investors may bring strategic or reputational value to a portfolio investment.

From the investors' perspective, the main factors driving a co-investment structure would include: (i) reliance on a sponsor who would provide local expertise and on-ground supervision of the portfolio – including depending on the sponsor's due diligence and key investment team; (ii) flexibility to pick and choose investments as there is no requirement to commit capital upfront on an entire suite of deals; (iii) higher alignment of economic interest with the sponsor and can therefore rely on the sponsor as opposed to an 'unaided' or 'blind' investment; (iv) good avenue for deal sourcing (as the sponsor would have conducted due diligence for its fund investment, including as to track record and capability, which would otherwise primarily be an burden some obligation of the investor); (v) likelihood of having to pay lower or no management fee and/or carry; and (vi) assistance in establishing partnership across geographies between co-investors.

In India, key considerations to be considered prior to adopting a co-investment model are tax, legal and regulatory, on the one hand, and commercial, on the other.

Tax Considerations

In a typical co-investment structure wherein an offshore pool, established in a treaty friendly jurisdiction, co-invests alongside a domestic pool, it would need to be ensured that the offshore fund can demonstrate sufficient substance in order to avail treaty benefits. Therefore, for making direct investments in a co-investment structure, appropriate deal making and evaluation capability would need to be demonstrated. Lack of sufficient substance would jeopardize benefits available under the double taxation treaties. Generally, substance is demonstrated through a number of means depending upon the requirements of the concerned treaty jurisdiction, including on adequate fund management set up housed in a manager entity in the relevant treaty jurisdiction.

Another issue to be kept in mind is that the co-investment structure may be open to challenge under the general anti avoidance regime (when implemented). It may also be subject to effective management and permanent establishment issues in India (given that in a typical co-investment structure, the core advisory teams may be based out of India) potentially subjecting the offshore pool of capital to tax exposure in India under Indian tax laws.

Further, a typical co-investment agreement / arrangement requires the offshore pool to offer all opportunities for investment and divestment to the domestic pool to ensure that there is no 'cherry picking' of deals. The tax risk may be aggravated by such co-investment agreement / arrangement including possibility of the offshore pool and domestic pool being considered as an 'Association of Persons' under India tax laws.

Legal and Regulatory Considerations

Legal and regulatory considerations in a co-investment structure could be divided at the offshore and domestic level, viz., considerations related to setting up an offshore pool of money and the routes available for making direct investments in India. However, given that the legal and regulatory considerations at the offshore level will remain the same for any other structure (for example for a 'master-feeder' structure), considerations related to the routes available for making direct investments in India have been discussed below.

The offshore pool may co-invest along side the domestic pool under the (i) foreign venture capital investors (FVCI) route; (ii) foreign direct investment (FDI) route; and/or (iii) foreign portfolio investors (FPI) route. Currently, the Reserve Bank of India (RBI) restricts investments by FVCI in ten sectors (therefore, the target sectors should be within this ambit), FPIs can only make listed or to be listed investments (therefore, the investment strategy should be within this ambit) and the governmental approval may also need to be sought to the extent the offshore pool chooses to invest in sectors that are not within the permissible FVCI sectors, are not listed investments and are also not under the automatic route (i.e., no approval required) under the FDI policy.

Further, it should also be kept in mind that there are certain benefits of investing through the FVCI route over the FDI and FPI routes, such as no approval requirement and free entry and exit pricing.

Commercial considerations

In order to show 'skin in the game' or to meet the regulatory requirement of making a sponsor commitment, sponsors generally make sponsor commitment directly to the fund. However, for an offshore pool investing in India, due to certain commercial constraints such as non-availability of funds outside India or regulatory delays in obtaining approval for making sponsor commitment to the offshore pool, the sponsors may co-invest alongside the offshore investors. In such circumstances, carry structuring becomes important.

The carry generated at the offshore level could be paid to the offshore manager, if any, however, the characterization of the payment (whether treated as a fee or distribution) would depend on the taxation rules in the relevant jurisdiction. In certain circumstances, carry received by the offshore manager could be streamed to the team at the ground in India. However, the drawback with using this mechanism is that it substantially increases the risk of the offshore pool seen as being effectively managed in India or has a permanent establishment in India. Accordingly, a co-investment structure may be less efficient if carry is largely paid to Indian recipients.

Further, a co-investment structure may be efficient from a timing standpoint as it allows de-linking of closings and regulatory approvals for both the pools of capital. However, depending upon the jurisdiction of the offshore pool, a co-investment structure may be inefficient due to higher cost structure i.e., demonstration of higher substance requirements for the offshore pool in terms of actual fund management (as opposed in a 'master-feeder' structure) and operational in-convenience.

Where the sponsor exercises discretion over an investor's co-invest portion, typically investment and exit is tied to that of the fund (including pricing, timing and terms). A 'side-car' to the fund vehicle affords maximum control to the sponsor. However, the sponsor should be aware of potential conflict of interest situations that may arise and hence relevant provisions in the fund documents for resolution of such conflicts should be provided. The sponsor should consider the number and the pedigree of investors to which co-invest rights are proposed to be offered (including assessment of speed of execution by the co-investor and strategic or reputational value that such co-investor may add). Selection of such co-investors also plays a critical role from an investor relations perspective (in relation to other investors who do not have such rights).

Investing in Multi Layered Structures – The Right Approach

In recent times, we have witnessed a growing trend among private equity (PE) investors to acquire shares at the holding company level rather than acquiring shares in the operating company. Such investments are predominant where, in a group structure, the substantial part of the business is carried out by subsidiaries, and the holding company is only a vehicle providing managerial and policy guidance, while also holding majority shares in such subsidiaries. Such an investment enables economic participation by the investor in the group without having to hold shares in each entity of the group, and also allow parties some degree of flexibility of structuring. However, such an investment comes with its own challenges for the investor, particularly where the subsidiary is independently and professionally managed, or when there are other financial investors in the subsidiary.

To understand the practicalities of such transactions, one must recognize the importance of control in a parent-subsidiary relationship. An elementary and uncomplicated summary of the relationship between a parent company and its subsidiary was provided by the High Court of Delhi in one of the matters before it where it observed that "the ability to control the conduct of the subsidiary is a hallmark of the holding company".

With this backdrop in mind, we analyse the implications of a private equity investor exercising rights in one or more subsidiaries through its investment in the holding company. Even while the direct investment is in the parent, private equity investors would prefer to exercise a certain degree of control (to the extent possible, directly) in the investee company as well as its subsidiaries. On the flipside, control may, at times, lead to complexities and requirements, which may be a bit more than what the investor desires.

Exercising Control in a subsidiary

Direct means of exercising management rights in a subsidiary would be through exercising the right to appoint directors on the board of the subsidiary, coupled with affirmative voting rights on identified matters. This would give the investor a fair degree of visibility regarding the affairs of the subsidiary, and the ability to participate in the decision making process through its board. However, since the investor does not hold shares directly in the subsidiary, it would necessarily have to rely on the parent to ensure that rights as the controlling shareholder of the subsidiary are exercised in a manner agreeable to the investor. This may even require upstreaming the decision making process to the shareholders of the parent company, or by a separate voting arrangement between the investor and the parent, to enable the investor to exercise rights without being bound by the fiduciary obligations of nominee directors. However, for this right to be exercised effectively, the investor would be well served by having robust information rights in relation to the subsidiaries as well. Another approach would be to have certain key rights, such as the right to appoint and/or remove key managerial personnel such as the CEO, CFO in the subsidiaries, and any divestments subject to the approval of the investor.

While it is relatively straightforward to mirror rights in a parent company in a wholly owned subsidiary of the parent, discussing rights in a subsidiary which has other investors requires a slightly more nuanced approach, largely due to the asymmetrical position of the two investors. Investors in the parent company would also like to retain the ability to swap down into the subsidiary if the subsidiary is offering a viable exit, and have a say in relation to transfer and issuance of shares of the subsidiary, which could affect the indirect ownership interest of the investor in the subsidiary. Therefore negotiating rights in the subsidiary requires a balancing act since several rights in the subsidiary can only be exercised through the parent, and it is important that the investor provides for rights relating to in the subsidiary in its agreements with the parent.

In order to effectively exercise rights in a subsidiary, to the extent possible, it would be advisable for the investor to have the subsidiary made a party to the investment agreement and be bound by its terms, followed by an amendment to the articles of association of the subsidiary at thee time of the investment in the parent. In this regard, the entrenchment provisions of the Companies Act, 2013 support the ability of a company to provide for a more stringent process to amend the articles than a special resolution.

The dynamics of the game change when the subsidiary in question is a listed one. Acquisition of 'control' leads to various other compliances being triggered, primarily those relating to the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeover) Regulations, 2011 (**Takeover Code**), which prescribes an open offer requirement in specific circumstances. These circumstances arise when an acquirer has agreed to acquire or has acquired control over a target company or shares or voting rights in a target company which would be in excess of the threshold limits prescribed in this regard. Also, if the investor/ acquirer is considered a person acting in concert with the promoters, the shareholding of the investor/ acquirer (upon such acquisition) would be aggregated with that of the promoters, and in such cases, the investor/acquirer may be required to make an open offer under the Takeover Code.

In most cases, the investor would want to avoid making an open offer, while acquiring stake in a company which has a listed subsidiary in India, since this would require the investor to make an additional investment and acquire a larger stake in the investee company, than was originally envisaged.

To avoid such a collision with the Takeover Code, it is important to draft the shareholders agreement in such a manner that the rights of the investor do not constitute “control”. In a scenario where the investor intends to purchase minority stake in an unlisted Indian company which in turn has a listed Indian subsidiary, the investor should be careful in ensuring that none of the provisions contained in the shareholders agreement constitute 'control', directly or indirectly. The following elements would be relevant to be examined, from a 'control' perspective:

- Board Control: Either through a right to appoint a majority of directors on the board of the subsidiary or right to appoint a director on the board of the subsidiary with affirmative voting rights;
- Affirmative vote matters: Having affirmative vote on matters dealing with the day-to-day operations and functioning of the subsidiary, such as the subsidiary requiring the consent of the investor for sale of assets above a prescribed value, even if such sale is in the ordinary course of business, borrowing powers, approving business plans, etc.
- Deemed shareholding: Provisions granting certain securities such as preference shares rights equivalent to those of equity holders would have the effect of increasing the shareholding of the investor/ acquirer for the purposes of determining control;
- Extension of rights to subsidiaries: Provisions extending the rights of the investor/ acquirer to the subsidiaries of the parent company may also be regarded as 'control', depending on the nature of rights being so extended;
- Amending charter documents of subsidiary: The provisions for amending the charter documents of both parent and subsidiary to reflect the terms of the transaction documents may suggest certain degree of control;
- Promoters/ existing shareholders to vote to effect the transaction documents: Provisions requiring the promoters/ existing shareholders to vote in a certain manner, with the object to obtain the desired outcome (such as enforcing the terms of the transaction documents), may lead to the possibility of the investor/ acquirer being construed as a 'person acting in concert' and thus triggering the Takeover Code.

Finally, the extent of control that can be exercised by a foreign private equity investor becomes critical where the subsidiary is engaged in business within a restricted sector like multi-brand retail, B2C e-commerce, real estate, etc. The extent of control of the foreign private equity investor determines whether the parent is considered to be owned and controlled by residents as against non residents. This in turn has a bearing on whether the downstream investment is considered 'Indian' or 'foreign', and therefore whether the investment in subsidiaries would have the same restrictions as for direct foreign investment. It may be remembered that the definition of control is still attributed with some subjectivity by the regulators.

In conclusion, one can view slightly varying but identifiable standards of deemed control at the subsidiary level and PE investments at a parent level must take cognizance of the need to maintain the right and a fine balance.

New Insolvency Law – an Opportunity for PE?

The Insolvency and Bankruptcy Code, 2015 (**Bill**) was tabled by the Government of India in the lower house of the Parliament on December 21, 2015 and the Bill has been referred to a Joint Parliamentary Committee (JPC). While presenting the Union Budget 2016, the Union Finance Minister once again emphasised the need for an effective insolvency regime in India and recent news reports have indicated that the Government is keen on having the Bill passed during the Budget session of the Parliament itself.

The Bill proposes a unified framework for insolvency and bankruptcy applicable to companies, limited liability partnerships, partnership firms and individuals. If this Bill is passed, it will repeal existing insolvency laws for individuals and partnership firms and make substantial changes in the insolvency laws applicable to companies, including the Sick Industrial Companies (Special Provisions) Repeal Act, 2003 and will amend certain other related legislations. The Bill envisages expeditious and time-bound resolution of insolvency process and if adopted in its current form, is likely to facilitate ease of doing business in India, boost investor confidence and be a shot in the arm for stalled projects.

What's New in the Insolvency Process of Companies?

Under the existing insolvency regime (for instance, under the Companies Act, 1956), a petition for winding up can be filed if, inter alia, a company is unable to pay its debts and such application for winding up can be filed, inter alia, by the company, contributories and creditors of the company. Further, under the Companies Act, 2013, a petition for revival can be filed upon default to a secured creditor representing more than fifty percent of its outstanding debt and the application for winding up can be filed, inter alia, by a company or the secured creditors. Under the Sick Industrial Companies Act, 1985, in the event accumulated losses of an industrial company at the end of any financial year has resulted in the accumulated losses exceeding the company's net worth, proceedings for revival and reconstruction of the company can be commenced.

The revival oriented insolvency regime under the Bill for companies and limited liability partnerships (a **"Corporate Debtor"**) i.e. the corporate insolvency resolution process (CIRP) commences upon default by a Corporate Debtor in repayment of its debt (being a minimum of Rs. 1 Lakh (equivalent of USD 1500)). Upon such a default, the relevant creditor (financial or operational) or a corporate applicant (includes shareholders or partners of the Corporate Debtor authorized to initiate insolvency under the constitutional documents) can file an application for initiation of CIRP. No distinction has been made between Indian and foreign creditors. The National Company Law

Tribunal (the adjudicating authority for Corporate Debtors under the Bill) (NCLT) is required to admit or reject the application within 14 days. Upon admission, a moratorium is declared barring initiation of actions against the Corporate Debtor including enforcement of security and termination of contracts and an interim resolution professional (IRP) (regulated professionals who can be nominated by the applicant for the CIRP or the NCLT) is appointed by the NCLT for managing the CIRP and the affairs of the Corporate Debtor and powers of the board of directors of the Corporate Debtor stand vested in the IRP. The IRP thereafter constitutes a committee of financial creditors for taking all decisions in relation to the CIRP. The committee of creditors appoints a resolution professional for conduct of the CIRP and at the instance of the resolution professional, a resolution plan is submitted for approval by the committee of creditors and the NCLT. The resolution plan can set out the scheme for revival of the Corporate Debtor and once approved by the NCLT, the plan is binding on all stakeholders including shareholders, creditors, employees and guarantors. The Corporate Debtor has to then ensure that the resolution plan is implemented as per the scheme of the plan, failing which the Corporate Debtor will be liquidated.

Entire CIRP is required to be completed within 180 days of admission of the CIRP application extendable by 90 days for complex cases. If no resolution plan has been approved, the Corporate Debtor goes into liquidation.

How are existing investments impacted?

During CIRP, disposal of shares or change in capital structure of a Corporate Debtor will require approval of the committee of creditors and the investors may therefore, remain locked in during the CIRP. Also, the resolution plan as proposed by the creditors for revival of the business of the Corporate Debtor can provide for restructuring of the capital (including write downs and conversions) or dilution of the existing shareholders (including private equity players), which will be binding upon approval of the resolution plan. An equity investor, unlike in a traditional restructuring scheme, will have virtually no say in the approval of the resolution plan which is a creditor-driven process.

However, an investor holding debt / quasi-debt instruments, being a financial creditor, can be instrumental in formulation of the resolution plan as part of the committee of creditors by proposing a suitable resolution plan including proposing a change in the promoters of a distressed company. The Bill does not restrict any proponent for a resolution plan and therefore, may encourage “pre-arranged” or loan-to-own restructuring plans by the investors or creditors, hitherto seen in the US and the UK markets.

Under the Bill, if an investor controls more than twenty percent of voting rights of the Corporate Debtor, such an investor cannot be part of the committee of creditors. Thus, an investor who holds both debt / quasi-debt instruments and equity instruments as part of one investment can be barred from being a part of the committee of creditors and will not be able to participate in the resolution plan, if such investor holds more than twenty percent of voting rights of the Corporate Debtor. Going forward, this will be a material consideration while structuring investments in the Indian market.

New Opportunities Galore?

Short term cash improvement by cash injection and financial restructuring are usually at the heart of a corporate rescue. In the post-recession times, many developed markets (especially the US) are seeing private equity players (and not traditional financial institutions, who were already stretched) emerge as dominant players in bankruptcy exit funding. Decent returns on a priority basis and potential to convert the investment into substantial equity stake have been the drivers for such investments.

It is certainly reasonable to expect that the flexibility in formulation of the resolution plan offered by the Bill will open up a market for bankruptcy exit funding as well as distressed debt positions. The Bill provides that any interim finance raised during the CIRP will have priority over all other debts in liquidation. Perhaps peculiar to the Indian market, change in management / majority shareholders is also expected to feature regularly in turnaround of companies. It is therefore likely that commercially viable companies will be in the market for equity and debt. Having said that, for the Bill to pick up full steam, relevant banking regulations (especially in relation to asset classification for banks), foreign investment laws, tender offer regulations, anti-trust laws will all need to accommodate a rescue plan proposed pursuant to the CIRP as well as facilitate effective participation of international players in such rescue plans. With local banks reeling under the weight of non-performing assets, private equity players can play a big role in this market including through private equity sponsored resolution plans. Their international experience will come in handy. The Bill does not follow the debtor-in-possession model and control of the company shifts to the financiers during the CIRP and hence, co-operation from the existing management should also not be a hindrance (under the Bill they are required to co-operate with the committee of creditors).

Is this the answer?

The Indian Government has made a good start with the Bill. If the Parliament does approve it, the Government needs to support it with adequate institutional infrastructure, help to insolvency professional agencies to shore up and ancillary legislative changes. With assigning crown debts a lower priority than financial debt, it has also made it clear that it intends to not interfere in the corporate rescues that Indian economy urgently needs. While a constitutional challenge of the nature which stalled the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 can not be ruled out, any such challenge will be a big set back given that other existing restructuring and recovery tools have proved to be grossly ineffective. Indian market has, on a number of occasions, seen debt restructuring plans under the Reserve Bank of India guidelines going awry due to dissatisfied creditors who were not bound by the restructuring guidelines or were unwilling to provide consents for the sale of distressed assets or change in management. The Bill may just prove to be the disruption distressed asset market in India needs.

Offshoring Investments - Is it worth the trouble?

Indian companies have been expanding their business presence internationally and with the global expansion, there has been an increase in migration of holding structures from India to favourable offshore jurisdictions that suit the business ambitions of Indian groups. Offshore holding structures refers to transfer of ownership of operational Indian resident companies (**Indian OpCo**) to offshore jurisdictions such that the Indian OpCo becomes a subsidiary of an offshore holding company (**Offshore HoldCo**). The choice of jurisdictions for Offshore HoldCos has been driven by several factors such as lower tax rates, strong confidentiality norms, greater business flexibility, deeper markets and extent and nature of regulatory compliances.

Economic dynamics are also creating incentives for jurisdictions to allow for import of holding companies. Globally various jurisdictions have modified their regulatory regimes to befit the needs of companies and investors for favourable offshore destinations such as Mauritius, Singapore, Cayman Islands, Cyprus, British Virgin Islands, The Netherlands and Luxembourg.

Given exchange control restrictions applicable to transfer of shares of Indian companies from residents to non residents, restructuring to create offshore holding structures involving Indian companies (**Restructuring**) is usually complex and protracted. The threshold condition to such Restructuring is the availability of offshore funds (i.e. funds that have no recourse to an Indian resident entity or assets) for purchase of the shareholding of an Indian OpCo. While an exception to such condition is merger of the Indian holding company of the Indian OpCo into an offshore company to form the Offshore HoldCo, such merger of an Indian company into an offshore company is not permitted under the Companies Act, 1956. The provisions of the Companies Act, 2013, which bridge this gap are yet to be notified.

Objectives and Benefits

One of the primary reasons for Restructuring is availing tax benefits. For instance, per the annual report of the Reserve Bank of India for the year 2014-2015 (dated August 27, 2015), approximately 24% of the total investments in India in the relevant financial year were routed through Mauritius. One of the primary reasons for the same was to avail the tax benefits available under the Indo-Mauritian Double Taxation Avoidance Agreement, which resulted in an overseas investor paying little or zero tax on the returns for their investments in India. Other tax friendly jurisdictions also provide favourable framework for indirect investment in India, with the investors incurring much lesser tax liability in comparison to their counterparts who invest directly in India.

However, in the light of the 2012 Supreme Court's verdict in the matter of Vodafone International Holdings BV, the retrospective amendment of the Income Tax Act, 1961 by the Finance Act, 2012, and the recent notice issued by the revenue department to Vodafone seeking INR 14,200 crores in relation to its USD 11 billion acquisition of Hutchison Whampoa's India telecom business in 2007, the predictability of tax benefits through Restructuring has suffered a severe blow. Further, the implementation of General Anti Avoidance Rules (**GAAR**), which adopts a 'substance over form approach', expected to be undertaken by April 1, 2017 (per the 2016-2017 budget announcements), may possibly empower the tax authorities in India to negate the offshore structuring undertaken primarily for tax considerations. In fact, though GAAR has not yet been notified, anti-avoidance as a principle has generally been applied by the Indian courts in its rulings on tax matters.

Further, the initiatives at the global level by governments to contain tax inversion including the Base Erosions Profit Shifting Project by the Organization of Economic Co-operation and Development/G-20 have made companies and investors acutely aware of the commitment of the governments to plug the loopholes allowing companies and investors to avoid taxes by offshoring their holding structures.

While minimising tax liability appears to be the primary motivation for Restructuring, there are several other factors as well:

Access to offshore debt funds: Restructuring allows the Offshore HoldCo to raise debt from offshore lenders on terms which may not necessarily have been available to the Indian OpCo given regulatory and exchange control restrictions. For instance, under the Indian exchange control laws, an Indian company is not permitted to leverage funds from offshore entities and utilise the proceeds for equity investment domestically. Further, borrowing of funds from offshore entities is subject to several regulatory constraints (including interest rates, all in cost ceilings, term, nature of creditors, etc.). Through Restructuring, the Offshore HoldCo has the flexibility to leverage funds through multiple options and structures which can then be infused into the Indian OpCo through equity investment. It is generally observed that most preferred offshore jurisdictions provide more flexibility on issues such as use of proceeds of capital issuance, pricing, transfer restriction as compared to others.

Options to structure investor friendly equity investments: Restructuring allows the Offshore HoldCo to raise equity investments through hybrid instruments (which are not permitted to be issued by an Indian company) and on terms that provide greater flexibility to investors to exit the investment (including receipt of assured returns). Restructuring also provides the investor a better opportunity to find a suitable buyer with limited, if not nil, regulatory restrictions such as pricing restrictions with wider structuring options, at the time of exit as well as minimises enforcement and currency risk for the investor.

Listing on global platforms: Another key consideration is that the Offshore HoldCo may also be able to consider listing on global listing platforms which usually have facilitative regulations in terms of timelines and costs incurred for the listing and provide wider participation of investors. Given that the Indian securities law regulations proscribe direct listing of shares/stock on global listing platforms, this is also beneficial when there are regulatory or commercial challenges in listing of the Indian OpCo on an Indian exchange. Whilst unlisted Indian companies are now permitted to list their depository receipts on global listing platforms pursuant to notification of the Depository Scheme 2014 in December 2014, in addition to certain operational clarifications being awaited from securities law and taxation perspectives, it is believed that such part-listing of capital may not achieve optimal price discovery. Consequently, listing of Offshore HoldCo on global listing platform may also be a factor for the Restructuring.

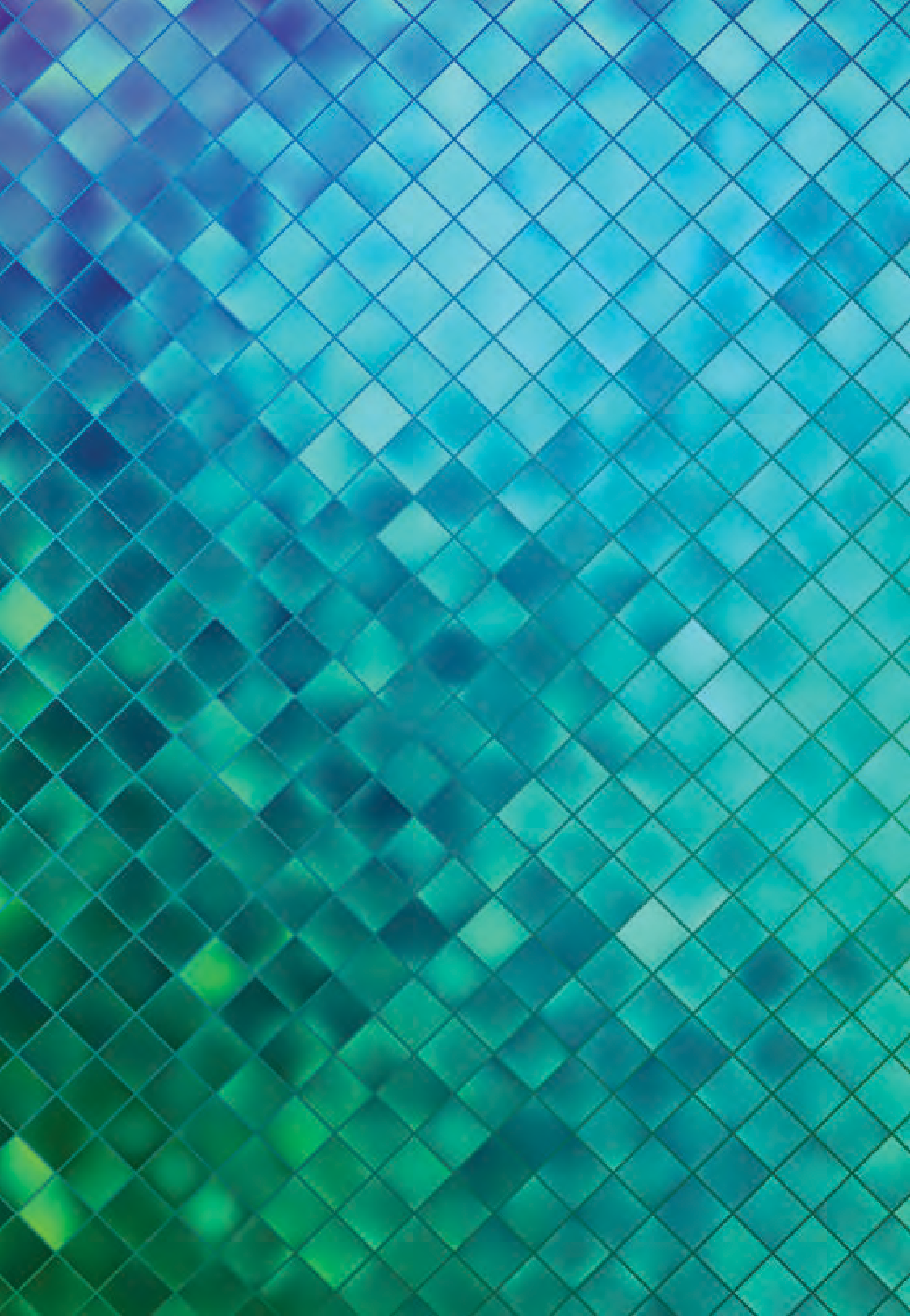
Operational flexibility: The preferred offshore jurisdictions, in order to be attractive for offshore holding companies, usually provide efficient processes to complete various corporate actions required for setting up and operating an Offshore HoldCo. For instance, the merger process in Mauritius usually can be completed within a period of one month as opposed to at least 6 months in most Indian states. In addition, Restructuring allows the shareholders to utilise flexible trust structures to manage ownership and control of the Indian OpCos. Restructuring also allows the shareholders and investors to maintain confidentiality of their holding structures to a large extent.

Emigration: Given increased mobility of Indian promoters due to globalisation and expansion of Indian businesses, Restructuring is also a result of emigration of Indian promoters and their consequential preference to have the holding companies of their Indian businesses in offshore jurisdictions.

Conclusion

While there are many benefits of Restructuring, given the complexities involved from Indian exchange control and taxation perspectives, it is imperative to undertake a 'risks versus rewards' analysis before implementing the same. In our experience, Restructuring is usually truly beneficial only if the holding of all companies of a group or a conglomerate are offshored.

One of the criticisms of Restructuring from a protectionist perspective is that it results in “externalisation of GDP” and makes Indian OpCos foreign owned. In our view this may be a myopic perspective as Restructuring is subject to compliance with all sectoral caps as well as extant foreign exchange related regulations and policies and therefore, should not be considered detrimental from an exchange control perspective. In fact, given that Restructuring results in strategic investment from Offshore HoldCo, it is a source of long term foreign capital for the country.



Regulatory Behaviour – Impact on Dealmaking

The most commonly encountered regulators for private equity investors in the Indian context are the Reserve Bank of India (**RBI**), Securities and Exchange Board of India (**SEBI**), Competition Commission of India (**CCI**), and Foreign Investment Promotion Board (**FIPB**).

One of the primary objectives of a PE investor is to obtain conservative entry valuations and high returns on exit. While non-resident (**NR**) to NR transfers are not regulated from a pricing guideline perspective, the RBI guidelines cover pricing methodologies for primary and secondary investments in both unlisted and listed companies for transactions between resident and NR investors.

Where an NR is the first subscriber to the Memorandum of Association, investments can be made at face value. The RBI requires the price of shares issued or transferred to NR to be at a price not less than the fair valuation of shares as per any internationally accepted pricing methodology on an arms length basis in the case of an unlisted company, and at a price not less than the price worked out in accordance with the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 (SEBI ICDR Regulations) for listed companies. Where a NR seeks to exit by selling its shares to a resident, it must ensure that the price at which it sells to the resident does not exceed a certain minimum price.

The RBI has moved from rigid valuation methodologies over the years starting from the Controller of Capital Issues valuation methodology which looked at historical data, and then to the Discounted Cash Flow valuation methodology which determined pricing based on future cash projections (that clearly offered flexibilities in valuation processes) to currently, any internationally accepted pricing methodology on an arms length basis. The recent liberalization is a clear indication of the Indian regulatory regime loosening its grip on valuation controls and offering increasing flexibilities in this regard.

Typically, global PE players interested in investing in India sought to incorporate put options in shareholders agreements with a view to getting a minimum assured return while exiting, and as a protection against any downturn in the value of the investment. However, the enforceability of such options was questionable given that RBI and SEBI did not historically permit such transactions. This created a lot of angst in the minds of investors. Recently both SEBI and RBI have made optionality clauses legal, which gives some relief to investors although this is subject to a 1 year lock-in from the date of allotment of the shares and the exiting investor cannot be assured any returns.

Under the existing regime, the price/conversion formula for convertible capital instruments should be determined upfront at the time of issue of the instruments. The price at the time of conversion should not be lower than the fair value determined at the time of issuance of such instruments. This helps the PE investor garner the benefit of a significant upside at the time of exercise of the option if the company has performed better than expected.

A PE investor may wish to pay a consideration at the time of purchase, or sell shares held by it at the time of exit, in a staggered manner. Creation of non-interest bearing escrow accounts on behalf of residents/NR towards payment of share purchase consideration or for keeping securities in escrow without the resident/NR seeking approval of the RBI is permitted for a period of 6 months from the opening of the escrow account. Any extension beyond such time would require RBI approval, which may be subject to delays in process, and is a matter of regulatory discretion. There has been no significant change in the RBI approval process or timelines in the last few months.

Approval from the FIPB would be required for investment in specific sectors (amongst others, telecom, insurance, and defence production) which are specified as falling under the Government route subject to applicable sectoral conditions, and also where the foreign investor intends to effect a downstream investment including through a multi-layered structure. Further, where the deal size is large and the foreign equity inflow is more than Rs. 5000 Crore, the FIPB would place the proposal for consideration by the Cabinet Committee on Economic Affairs (CCEA). Timelines can be impacted in transactions requiring approval of the FIPB/CCEA.

Another consideration is the CCI approval for investments in Indian companies whose asset or turnover value crosses the prescribed thresholds and where no statutory exemption is available. An application seeking CCI approval should be made within 30 days from a binding agreement being executed, or from the communication of the intention to acquire to a Government authority where no agreement has been executed. To cite an example, in 2014, the CCI imposed a fine of Rs. 3 Crore on Tesco (in the retail sector) since Tesco delayed filing the notice with the CCI almost 73 days after its communication to the other regulators (i.e. FIPB and DIPP).

In the cement sector, Swiss company Holcim had proposed acquiring the shares of French company Lafarge, which was approved by the CCI in 2015 subject to divestment of Lafarge's assets in India to an approved purchaser. However, given regulatory uncertainties with respect to transfer of mining leases, the CCI in February 2016 approved the revised proposal for divestment via a sale of shares. The entire approval process in this case took more than a year and a half.

Since notification to the CCI seeking approval is time bound, relevant information for the application should be garnered much ahead of the actual filing. The timeline taken to secure such approvals should also be factored in as a part of the investment process.

PE investors are typically reluctant to share information relating to their limited partners. The CCI asks for detailed information on the parties involved, the transaction structure, ownership and control of parties, and has an overreaching power to ask for information on the indirect shareholders of the investors. The FIPB will not typically ask for detailed information on the indirect shareholders of the investors as long as such investor and its shareholders are duly registered in accordance with the laws of the country in which they have been incorporated, and they have passed the KYC test of RBI and SEBI. However, there have been some instances where FIPB has also asked for detailed information on the indirect shareholders of the investors.

While eyeing an investment opportunity, the investor may want to associate with a valued and trusted promoter, but may not want to be viewed as a promoter. Indian law mandates onerous obligations on promoters including substantial disclosures and liabilities for mis-statements and contravention of applicable laws. The promoter of a listed company is also required to make a contribution of 20 % of the post-issue capital of the company in case of an initial or further public offer, which is required to be locked in for 3 years from the date of allotment in a public offer.

Under Indian law, a promoter is one who has control over the company or is named in an offer document as a promoter. Most regulators have taken similar views on what constitutes control i.e. the right to appoint majority of the directors, the right to control the management/policy decisions whether directly or indirectly by way of shareholding or management rights or through shareholding agreements, voting agreements or otherwise. SEBI has in many instances viewed veto rights as amounting to control.

In Subhkam Ventures (I) Private Limited v. SEBI, Securities Appellate Tribunal (SAT) held that control only included a positive power to control but excluded control through negative rights. It viewed affirmative voting rights as investor's investment protection rights and not as an indicator of control. The Supreme Court disposed the appeal made by SEBI against the aforementioned SAT order, and kept the question of law open on this point. This is a grey area that continues to bother investors. However, SEBI has recently issued a discussion paper on 'Brightline tests for acquisition of control under the SEBI Takeover Regulations' inviting comments from the public on this issue to arrive at a more conclusive test on what constitutes control.

Therefore, PE investors prefer specifically stipulating in investment agreements that they are financial investors and should not be construed as a promoter. However, this is not a straight forward solution. In fact the analysis can be fairly complex, especially when one investor group is a single large block if not largest shareholder block, or in other cases where the promoter shareholding is insignificant (say for instance even less than 10 %). In such cases, the onus of being named as promoter increasingly shifts to the PE block.

A last issue to be considered is the differential approach of multiple regulators to the same issue, such as the concept of "control" for instance. A case in point is that of Jet Etihad. While it was not a PE transaction, the learning from the transaction is a good takeaway for PE investors.

Etihad Airways PJSC (a foreign airline) sought to acquire a 24 % equity stake in Jet Airways (India) Limited (a domestic airline). At the time of the proposed investment, foreign airlines were permitted to invest in upto 49 % of the equity stake of Indian airlines subject to FIPB approval. Even so, Etihad opted to invest only 24 % in Jet since it did not want to trigger the open offer requirement stipulated by SEBI for acquisition of more than 25 % equity stake or resulting in control.

SEBI initially cleared the transaction stating that prima facie there appeared to be no change of control and that Etihad was not a person acting in concert (PAC) with the promoter group of Jet. However, SEBI reserved its right to reconsider its position if any other regulator decided that Etihad was acquiring control over Jet. Thereafter, FIPB and the CCEA accorded their approval to the investment. Separately, the CCI approved the transaction stating that the deal was not likely to have an appreciable adverse effect on competition in India, while noting that the transaction agreements entered into established Etihads' joint control over the assets and operations of Jet.

SEBI reconsidered the acquisition of control by Etihad over Jet, and noted that FIPB and the CCEA had approved the transaction since effective control pursuant to this acquisition remained in Indian hands. The Aircraft Rules, 1937 is the genesis of the 'substantial ownership and effective control' clause being vested in Indian hands as incorporated in the FDI policy. This clause has also been heavily debated at an international level in the airline sector.

SEBI noted that the definition of 'control' for the purposes of the FDI policy and SEBI legislation was pari materia, while the CCI's definition of 'control' was much wider than SEBI's views on what constituted 'control'. Therefore, SEBI chose not to be guided by CCI's perspective on control. SEBI approved the transaction noting that the agreements had been suitably re-examined for amendments by the parties to ensure that effective control continued to vest in Indian nationals, and that FIPB and CCI would be duly notified by the parties of the same. In the instant case, SEBI's behavior was affected by the behavior of other regulators, and this played a prime part in delaying completion of the transaction.

Indian regulators frequently review the existing policy framework in light of the economic environment, and strive to make the investment regime more investor friendly and less protectionist. The recent and ongoing regulatory mood is definitely more receptive. With the operationalisation of the CCI, there is yet another regulator overlooking the transaction, and this also contributes to extended timelines for consummation of the transaction. Regulators may make policy changes reversing previous positions, and to that extent there is some level of unpredictability. PE investors would therefore do well to navigate carefully, and build in significant contractual safeguards before diving into an investment in India.

Mechanics of Control Deals in India

Conventional wisdom suggests that India is a notoriously tricky market for control oriented deals by private equity funds. The broad narrative has largely been to the tune of financial investors acquiring minority stakes in mid-sized companies, without being involved in the management or control of the operations, barring the right to appoint a nominee director on the Board, coupled with minority investor protection in the form of affirmative rights over identified matters. Considering that most Indian companies follow the 'insider' model of shareholding wherein control is concentrated in the hands of a few promoters as opposed to the 'outsider' model with large, diffused public shareholding, it is not surprising that the traditional view has always been that promoters (who in most cases comprise management in such companies) are not comfortable divesting majority shareholding to outsiders. However, both empirical and anecdotal evidence suggests that this is changing.

The Increase in 'Control' Deals

A McKinsey report states that in 2006-2007, 13 % of Indian PE investments by value were control investments. By 2013, this had increased to 29%, with an all time high of $2.24 billion invested in acquiring control interests across 23 transactions. 2015 continued this trend with 20 PE funds concluding control deals worth $2 billion. Funds including Blackstone, KKR, Fairfax and Everstone concluded majority control transactions in 2015.

Control deals have always been more prevalent in more mature economies than in India, but all signs point to greater accommodation and acceptance by Indian promoters of PE firms acquiring higher stakes in companies as well as PE firms understanding the unique nature of Indian businesses as well as appreciating the need to cater to the interests of promoters. This perhaps stems from changing trends and growing maturity in the manner in which Indian businesses are run and the experience of the PE funds investing in them.

Traditionally, Indian companies have been a family run affair, with the promoter shareholders hesitant to lose control over the family business, and keeping things churning for the next generation to take over. But the growth of the Indian economy gave birth to a new generation of entrepreneurs; the executive turned entrepreneur as well as those joining the start up band wagon. Further adding to this pool is the second or third generation promoters running family businesses, ones who are open to the idea of selling out or those facing succession issues. The change in nature of the promoter shareholders can be characterized by the change in attitude wherein these promoter shareholders are receptive to ceding control for both growth and expansion of the business and with a view to exit. Further, this new generation of promoters is also aware of the need to bring in professional management and recognizes the inherent advantages that financial investors can bring to the table. At the same time, private equity is in its third cycle in India, where the PE funds have invested in the Indian markets for a sufficient period of time and are well aware of both the regulatory framework and the risks and gains associated with investing in India, and have the necessary wherewithal to deal with governance related risks and exposure. This has put experienced PE funds in an advantageous position wherein they can utilize their relevant expertise in running businesses globally while tailoring it to suit an Indian context. While the institutional investor community has always been aggressive in acquiring controlling stakes in companies in other markets and has developed sufficient expertise in doing so, experience in Indian markets has allowed PE firms to attempt application of similar business practices.

The net result has been that promoters are welcoming PE firms, while PE firms are utilizing their local experience and global expertise to chart a more aggressive, control based route for their investments. This, coupled with available professional management talent, the situation is being looked upon as a win-win by both promoters and investors. Another factor aiding the growing comfort between promoters, who wish to stay on in their company, and investors, who plan on acquiring majority stakes, is the fact that both parties are aware of the limited time of their relationship. The financial investor has no option but to chart an aggressive growth course and bring in the best possible management team for the investee company since it is a limited time investment. Any failure to do so would mean the failure of its investment. The stakes for a financial investor are greater than those for the promoter, allowing the promoter to take reassurance in the fact that the best possible decisions will be taken for his company.

All About Exit

It is easy to understand the comparative advantage and the reasoning behind acquiring controlling stakes, mainly the ease of exits. PE funds in India have on occasions, found it tough to exit in cases where they are the minority shareholders. PE funds with minority stakes looking to exit mostly look to exit by selling their stake to the promoters by way of a put option, creating liquidity through an IPO, or by a sale to third parties. The exercise of put option requires a promoter's willingness to abide by the promises made at time of the investment, with the only recourse in case of any default by the promoter lying in a long-drawn dispute resolution process. In case of an uncooperative promoter, the related problem as far as exit is concerned is that a secondary sale for such a minority stake would be difficult since other funds would be loathe to invest in companies where the current investor is finding it difficult to exit. Similarly, an investor would find it very difficult to cause a company to implement an IPO with an unwilling promoter.

Another potential pitfall for a minority financial investor is the limited control that such investor has in the governance and running of the company. Ordinarily, the only governance rights such a financial investor has are limited blocking rights along with the odd nominee, non-executive director on the board of the company. A financial investor has little to no say in the operations and running of the company and is mostly dependant on the promoter doing a good job. In the event that the promoter is not up to the task and the company's performance suffers as a result, the investor has limited options. The investor may exercise its limited rights, but due to the fact that the promoter is in the majority, such exercise maybe blocked, leaving no option but dispute resolution. More often than not, sub-par performance by the promoter leads to an adverse impact on the investment. In certain cases this has lead to a farcical situation wherein the financial investors have privately sought to replace the promoter with little to no success, while publicly maintaining their confidence in the promoter's abilities.

Conversely, in majority control situations, the exit lies solely in the control of the PE firms and they can exit at an opportune time, without being subject to or even requiring the promoter to act. While an IPO is usually not sought after owing to the necessary involvement of the PE investor as the promoter post listing, a controlling stake in a successful company would lead to easier exits by attracting both strategic and financial investors, with limited interference by or drawback arising out of the presence of a minority shareholder in the form of a promoter. In this regard, evidence can be drawn from the fact that 2015 had some of the largest PE exits arising out of earlier control deals. Blackstone sold its controlling stake in CMS Info Systems to Barings Private Equity Asia, while BNP Paribas SA acquired Sharekhan Ltd from certain PE funds who together controlled the company. Further, Everstone Capital, IFC and Anand Rathi Financial Advisors Pvt. Ltd also managed a successful exit by selling their stake in Global Hospitals to IHH Healthcare Bhd.

Furthermore, in case of majority control, the investor has complete say in the governance of the company it has invested in. The investor can bring in professional management, and ensure that the company is run in the best possible manner. Unlike situations where the financial investor is a minority shareholder and is solely dependent on the promoter to perform, in case of control deals the financial investor is completely in charge of the company's performance. Irrespective of whether the investor brings in new management or retains the promoter, the tenure of the management of the company shall always be subject to the performance standards laid down by the investor. In case of any shortcomings, the investor has the right to replace such management.

These inherent advantages of being a majority shareholder have led to more and more PE firms opting for control deals as opposed to minority investments. Coupled with increasing promoter acceptance, financial investors are finding it more advantageous to invest in majority stakes in Indian companies.

Challenges and risk diversification

While control deals do provide easier exits, there are certain challenges associated with them. Acquiring majority control in companies would require a greater investment in pure monetary terms, increasing the risk associated with the investment. Further, PE firms might find it difficult to individually finance such transactions.

Unlike in cases where the PE firm has a minority stake in a company, and is mostly a passive onlooker, control deals require great involvement on part of the financial investor. The greatest challenge to such control deals from a practical point of view is operational expertise and the liabilities associated with acting as a promoter of a company. The PE firm would have to be involved in management and such investments would require strong operational execution abilities. Prior to any such majority investment, it has to be determined whether the PE fund has the operational ability and market expertise to run a company where it is the majority shareholder. Traditionally, promoters have always taken on all the responsibilities, including day-to-day management, dealing with regulatory hurdles and assessing expansion. These significant tasks would fall on the PE firm investing in a company, especially if the selling promoter is exiting or does not want to be involved with the company on a whole time basis. In such cases the PE firm would have to bring in a new management team having sufficient expertise to run the business. In this regard, the acquisition of a majority stake in Paras Pharmaceuticals by Actis Capital and subsequent sale by Actis, serves as a notable success story.

Additionally, since the role of the promoter is limited, recourse to the promoter for an exit will be practically non-existent. An exit would firmly be dependent on whether a third party strategic or financial investor deems the company attractive. Any successful exit by a PE firm would certainly require the PE firm to have successfully run the operations of the company during the tenure of its investment. The onus here is solely on the PE firm, and in most cases there shall be no recourse to a promoter. In cases where the PE firm has not successfully managed the affairs of the company, an exit would be difficult.

While a high level of due diligence as well as requisite business expertise is a pre-requisite for any control deal, it may also be prudent for PE firms to diversify their risk in such transactions. One option available to PE firms maybe to co-invest with another financial investor, especially in case of large transactions. The advantage of such co-investment is that both monetary and management risk would be shared between the financial investors, while control still remains with the financial investors. Further, such co-investment would allow for much larger control deals to take place. 2015 had several such co-investments taking place, an example being Advent International Corp and Temasek International Pte Ltd.'s acquisition of majority control of Crompton Greaves Consumer Electricals Ltd. Another potential risk diversification option maybe for a financial investor to partner with a strategic investor, especially in the case of promoter buy-outs. The strategic investor would bring in sufficient business expertise to run the operations of the company. At the same time, the strategic investor may also provide the financial investor with an exit.

Conclusion

The year 2015 saw a significant chunk of the total PE investment devoted to acquiring controlling stakes in companies as well as some of the largest PE exits arising out of control deals struck earlier. Based on current evidence, the landscape for such transactions is maturing and control deals are here to stay. If the challenges posed by such investments can be tackled effectively, which it surely can be, with good governance approach to management, such control deals may provide for a better alternative than acquiring minority stakes.

Investing in and Exiting from a Listed Company – What has changed?

Over the past one year, India has made significant strides in enhancing its business environment. With the government's initiative of improving India's position in the 'ease of doing business' rankings compiled by the World Bank, a slew of changes have been introduced in the legal regime governing listed companies in India. Further, noteworthy changes have been introduced to enhance good corporate governance practices in listed companies and to protect minority investors. Some of the noteworthy changes introduced by the securities market regulator, Securities and Exchange Board of India (**SEBI**), over the past one year to improve the business environment in India are examined below.

One Step Takeover cum Delisting Process

One of the noteworthy changes that have been introduced in the past year is the one step takeover-cum-delisting process under the Securities and Exchange Board of India (Delisting of Equity Shares) Regulations, 2009 (**Delisting Regulations**) and the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (**Takeover Regulations**). Prior to the introduction of the takeover-cum-delisting process, no person, other than a 'promoter' of a company, i.e. the controlling shareholder of the company, was permitted to make an offer to the shareholders to delist the equity shares of the company. Thus, the acquisition of control of a listed company and its subsequent delisting would be a two or even a three step process, with the first step involving making an open offer under the Takeover Regulations; the potential second step being the requirement to sell down by the acquirer within a period of 1 year from the completion of the open offer if the acquirer's shareholding exceeds 75% of the equity shareholding of the target company; and the third step being to delist the company by making a second offer for delisting the company.

This cumbersome process resulted in substantial time and costs being borne by the investors, who did not wish to invest in a listed company, but who are willing to pay a significant premium to the company's existing shareholders in order to take it private. Further, given the element of uncertainty in terms of the requirement of shareholders' consent and participation of the shareholders in a delisting offer in order to make it successful, it was entirely possible that an acquirer may end up acquiring shares in an open offer (and possibly pursuant to the underlying transaction) under the Takeover Regulations only to find that the company continues to remain listed as the delisting process failed. This discouraged a host of legitimate commercial transactions, deprived public shareholders of an attractive exit opportunity, and also precluded enterprising promoters from cashing out and starting new businesses.

SEBI acknowledged the above difficulties and introduced an amendment to the Takeover Regulations pursuant to which an acquirer is permitted to declare his intention to directly delist the company upfront at the time of making the detailed public announcement for an open offer under the Takeover Regulations. In the direct delisting offer, the acquirer is required to acquire the shares as per the Delisting Regulations. If the direct delisting offer is not successful in terms of the Delisting Regulations, then the acquirer is required to proceed with the open offer under the Takeover Regulations. However, in such an event, the price payable by the acquirer in this succeeding tender offer has to be increased by 10% per annum for the period between the scheduled date of payment of consideration to the shareholders if the acquirer had made a mandatory tender offer under the Takeover Regulations instead of a direct delisting offer and the actual date of payment of consideration to the shareholders under the abovementioned mandatory tender offer.

However, the takeover-cum-delisting process is not without hurdles. The acquirer is still required to obtain prior approval of the board of directors of the company as well as the approval of the shareholders by way of a special resolution and comply with other requirements of the Delisting Regulations. This is unlike an open offer under the Takeover Regulations which does not require any shareholders approval. Whilst the Delisting Regulations were amended to streamline the process of delisting by considerably reducing the timelines for delisting, the requirement to follow the entire process of delisting under the Delisting Regulations, in a takeover-cum-delisting offer may be too elaborate and time consuming for an investor. Further, if a competitive offer is made under the Takeover Regulations after the announcement of the delisting offer, none of the parties are permitted to take the company private.

Reclassification of promoters into public shareholders

Another positive change introduced by SEBI to improve investor sentiment and encourage deal making in India is permitting re-classification of promoters of a listed company to public shareholders (**Reclassification**). Prior to the introduction of the law permitting Reclassification, there was no objective process for the same. This adversely impacted investments in companies by strategic or global investors seeking to acquire complete control over the company without promoter interference. The change now allows renunciation of control by the outgoing promoters in favour of an incoming investor. Given that the promoters are culturally relevant in the Indian context and most companies in India are still promoter-controlled, more often than not, a company's identity is associated with the identity of its promoters. The new law requires the permission of the Stock Exchanges for allowing Reclassification. Further, Reclassification is permitted only in certain circumstances i.e. firstly when there is a transmission or succession or inheritance, with the inheritor being classified as promoters, secondly, when a new promoter replaces the previous promoter subsequent to an open offer under the Takeover Regulations and thirdly, where an entity becomes professionally managed, and does not have any identifiable promoter.

While Reclassification is a welcome change, there are still certain roadblocks in achieving it, like for example, Reclassification subsequent to an open offer is not automatic, but requires shareholder approval, thereby making the process uncertain. Yet another potential roadblock is that even though the Reclassification may result in increase in the level of public shareholding, the shareholding of the reclassified promoters cannot be taken into account for counting the minimum public shareholding requirement in a public company. This restriction has been introduced to prevent companies from attempting to comply with the mandatory requirement of minimum 25% public holding in listed companies by reclassifying a part of the promoter group entities as public. While this restriction may be imposed for an initial few years, there should not be a complete prohibition. In this regard, it is to be noted that the discussion paper on 'Re-classification of Promoters as Public' released by SEBI on December 30, 2014 had a sunset period of 3 years from the date on which the Reclassification is permitted for the reclassified promoters not being considered a part of the public shareholding of the listed company.

Introduction of the stock exchange mechanism

The Delisting Regulations, the Takeover Regulations and the SEBI (Buy Back of Securities) Regulations, 1998 (**Buy Back Regulations**), were amended to allow shareholders to tender their shares while participating in open offers, buybacks and delisting offers through the stock exchange mechanism **(Stock Exchange Mechanism)** as opposed to through off-market transactions.

The facility for acquisition of shares through the Stock Exchange Mechanism pursuant to an offer under the Takeover Regulations, Delisting Regulations or the Buy Back Regulations (**Offer**) is available on the stock exchanges having nationwide trading terminals in the form of a separate acquisition window. The Stock Exchange Mechanism, which is mandatory for all offers for which public announcement has been made post July 1, 2015 makes the entire process of tendering shares easier, less cumbersome and completely paperless. The Stock Exchange Mechanism also has beneficial tax implications for foreign investors tendering their shares in the Offer and results in a lower tax deduction at source than settlement through the off-market mode. This is because while long term capital gains taxes or short-term capital gains taxes are levied on off-market transactions, only short-term capital gains taxes and a minimal Securities Transaction Tax is levied on transactions through the new Stock Exchange Mechanism. No long-term capital gains taxes are levied on shares bought or sold through the stock exchanges. Thus the Stock Exchange Mechanism is beneficial for non-resident shareholders holding shares in the Company for more than one year from the date of tendering their shares in the Offer, since such shareholders will be exempted from paying heavy long-term capital gains taxes while tendering their shares in the Offer.

Despite the above benefits, the Stock Exchange Mechanism may appear to be a complicated and a cumbersome process for tendering shares in the Offer given the requirement for shareholders holding physical shares to appoint their own brokers for tendering shares through the Stock Exchange Mechanism, opening a trading account and also to ensure that such trading accounts are classified as active trading accounts by the stock broker.

Other changes

Several other changes have been introduced over the past year to improve the ease of doing business in India. For example, significant changes have been incorporated in the Delisting Regulations including streamlining the process of delisting, reducing the time taken for completing the delisting process and allowing relaxations on a case-to-case basis. Further the SEBI (Listing obligations an Disclosure Requirements) Regulations, 2015 (Listing Regulations) have been brought into effect, which for the first time consolidates and streamlines the provisions of existing listing agreements for different segments of the capital market into one single document, thus, ensuring ease of reference and doing away with the confusion on the applicability of the regulations, as was the case earlier. Some of the noteworthy changes introduced in the Listing Regulations to improve corporate governance practices are the requirement of appointing a qualified company secretary responsible for ensuring compliance with various regulations, mandatory registration in SCORES, i.e. the SEBI Complaints Redress System and quarterly submission of investor complaint status report within 21 days of end of a quarter to the stock exchanges, which is required to be placed before the board of the listed company.

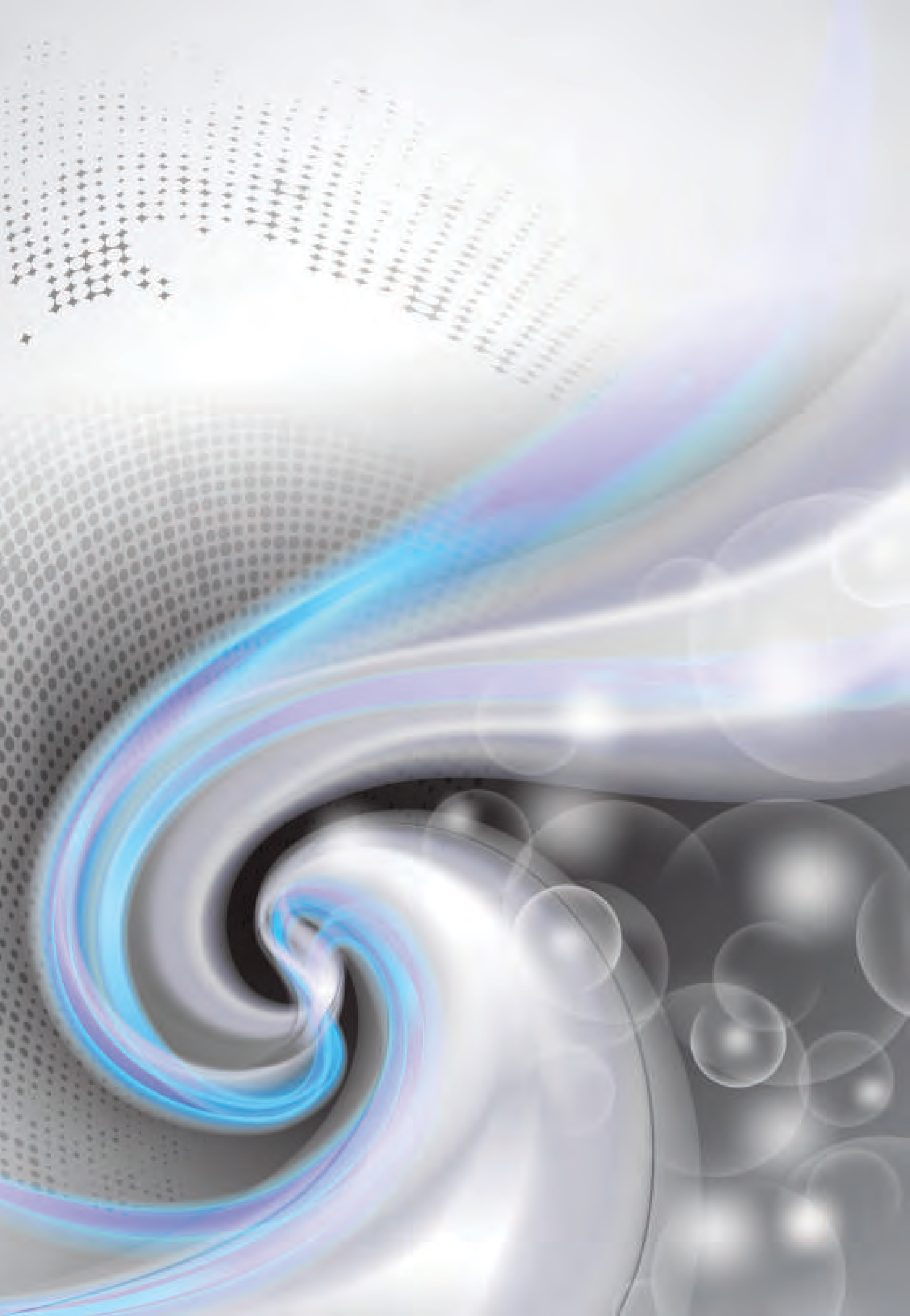
While the above changes demonstrate SEBI's efforts to improve the business environment in India and boost investor confidence, on the flip-side, stringent corporate governance norms have been introduced, which may have the unintended effect of deterring potential investors to invest in listed companies in India. One such example is the rules and regulations with respect to communication of unpublished price sensitive information (**UPSI**) under the SEBI (Prohibition of Insider Trading) Regulations, 2015 (**2015 Regulations**) which replaced the erstwhile SEBI (Prohibition of Insider Trading) Regulations, 1992. The 2015 Regulations cast an obligation on the board of directors of a listed company to form an informed opinion that a proposed transaction, irrespective of whether the transaction triggers an open offer under the Takeover Regulations or not, is in the best interest of the Company (**Upfront Board Approval**). This is of particular significance, especially in the context of a potential investor desiring to undertake comprehensive due diligence into the affairs of the listed company. This is because not only will such a transaction require approval of the board of directors of the company (which ordinarily is not required) but the board approval may also not be forthcoming unless strong commercial or strategic rationale is set out by the acquirer to convince the board of directors of the transaction being in the interests of the company even when there is no direct or obvious benefit from such a secondary transaction.

The requirement of seeking an Upfront Board Approval also significantly impacts the dynamics of deal making in India, as usually the management of companies are empowered to negotiate and take all steps necessary (including disclosure of information to counter parties as part of due diligence) to finalise the terms of the transaction, including transaction documents. The board of directors then, in a meeting held usually a day or two in advance of the execution, reviews the finalised terms and the agreed drafts of the transaction documents for a final sign off and for granting its approval for execution. Therefore, the Upfront Board Approval will modify the usual process of deal making and is not just a procedural hurdle, given that at this early stage, it is unclear how the board of directors will form an 'informed opinion' on the proposed transaction, without having had the management negotiate the terms of the transaction and finalise the transaction documents, which in turn will depend upon the management having allowed the counter party to undertake due diligence. Under the circumstances, it may be pragmatic to say that in order for the board of the target company to decide that the transaction is in the best interest of the company, the name of the acquirer need not be disclosed as any such disclosure will be extremely premature and given the risk of leakage, affect the stock price.

For transactions that do not trigger an open offer, any UPSI shared with the prospective acquirer is required to be made generally available two trading days prior to the proposed transaction being effected, in a form determined by the board of directors (**Mandated UPSI Disclosure**). In SEBI's view (a) the Mandated UPSI Disclosure will ensure ruling out of any information asymmetry before any transaction that has involved sharing of UPSI on a selective basis; and (b) non-applicability of this requirement to an open offer under the Takeover Regulations is acceptable as the open offer process itself requires disclosure of such UPSI. However, it is not clear if SEBI has considered whether the Mandated UPSI Disclosure will lead to speculative trading and if so, is this is an acceptable consequence. From a deal making perspective, such Mandated UPSI Disclosure is bound to impact the stock price, which consequently will also impact the commercials of the underlying transaction, as under Indian law, the floor price for acquisition of shares of listed companies is linked to the trading price over a specific look back period from the date of signing.

The above changes in the 2015 Regulations may be viewed as an instance where corporate governance initiatives have been too overreaching, resulting in jeopardizing investment opportunities and as well as hampering the ease of doing business in India.

On the whole, the picture that emerges is that, while minor tweaking may be required to the changes introduced in the legal regime governing listed companies in India for removing certain hurdles, the changes introduced are headed in the right direction. However, given that most changes and amendments are still in their nascent stages, it is yet to be seen how these amendments impact deal making in India and improve investor sentiment. It is expected that as new amendments and regulations are tested over the coming months, the market and the investors will have more clarity on the manner in which the changes are implemented through clarifications and directions issued by the SEBI, thereby making the legal regime governing listed companies more robust and conducive for investors.



Riding the Disruption wave

"The line it is drawn, the curse it is cast; the slow one now, will later be fast
As the present now, will later be past; the order is rapidly fadin'.
And the first one now will later be last; for the times, they are a-changin'."
-Bob Dylan, The times they are a changin'

"Disruption" is often used as a generic term to describe cases where smaller companies with fewer resources are able to successfully challenge established incumbent businesses and upset status quo. While a case has been made to define the term more precisely, being recognized as a 'disruptor' brings significant cachet and visibility to an enterprise, particularly when it comes to attracting private equity investment. In our experience however, disruption is far more nuanced, and can result from a variety of factors ranging from technological innovation to disintermediation to regulatory arbitrage.

This distinction however, is more than just academic, as knowing the nature of disruption can help in assessing its regulatory viability, sustainability and the ability of the underlying enterprise to retain value.

The story so far

The first wave of disruption in India was seen in spaces which were relatively unregulated, or sparsely regulated. This vanguard of disruptors operated in spaces like classifieds (online and telephonic directories and classified advertisements), retail (e-commerce), travel (airline reservations and hotel bookings) and information technology services (streaming services and online content stores). These entities relied on a combination of disintermediation and innovation to drive business in markets which had not seen significant disruption. While the disruptive impact of these businesses was undoubtedly significant, operating in regulatory white spaces allowed them the leeway to explore various operational and business models.

Here, the case of e-commerce merits closer examination. Early participants in the sector opted to operate business in the most commercially expedient manner, opting not to control inventory, and capturing margins by selling goods through related party entities, exercising rigid price control and relying on a system of brittle legal constructs to maintain the illusion of being a marketplace.

In due course, increasing volumes of sales through e-commerce and high profile instances of restricted goods or content being sold led to increased regulatory scrutiny. While more robust business models which were predicated on due diligence and formulated as genuine marketplaces largely avoided regulatory sanctions, several operators who acted otherwise, and who enjoyed substantial sales and revenue growth hit a regulatory speed breaker by way of show cause notices, litigation and censure. The impact of some of this regulatory intervention is not yet evident. At the very least, early or mid-stage businesses embroiled in regulatory proceedings have been required to devote management time and incur considerable costs in such proceedings.

Businesses which have strictly followed the marketplace framework have recently seen their approach vindicated by the official recognition of 100% Foreign Direct Investment into marketplace based e-commerce under the automatic route.

Another example of disruption has been in the online education and publishing space. Traditionally, the education space in India has seen substantial regulation being linked to a framework of accreditation, certification and grants. Some disruptors in the online education space have focussed on areas which are not subject to rigid regulation like skill certification, continuing education and courses amenable to certification through online examinations. Operators who have sought to unbundle core value (such as course content, software and training tools and services) from physical infrastructure and delivery channels (which are subject to regulation) have managed to operate successfully even in the context of education being perceived as a broad social need.

Investments into the first wave of disruptors in India have matured for the large part and borne fruit, both fair and foul.

Several disruptors who have followed the path of least resistance are working to realign their operations to comply with regulations either to comply with current best practices or learnings as a result of the regulatory scrutiny being faced by some operators. Such realignment brings with it a financial cost, a potential disturbance in the business operating model, and most importantly, the proverbial regulatory 'Sword of Damocles' which extends not only to the investee company and its directors, but also the private equity investors. On the other hand disruptors who have consistently focused on analysing the applicable regulatory regime, structuring, risk mitigation, documentation and future proofing may currently enjoy a significant competitive advantage over their non compliant competitors.

The Second Wave

The second wave of disruptors in India has sought to operate in spaces in which conventional entities are more regulated. These areas involve greater degrees of perceived or actual societal risk and disruptions in these spaces have been accompanied by vociferous calls for increased regulation, including from entrenched operators who are subject to stringent norms.

An example of this form of disruption is ride hailing applications. The sector historically comprised of various licensed taxi operators, who either operated conventional taxis or 'radio taxis' under state level rules and schemes prescribed by the relevant road transport authorities in each state. Disruption in this sector was driven by the emergence of smart phone based ride hailing applications. While ride hailing applications leverage disintermediation and allow licensed drivers to connect directly with potential customers while continuing to enjoy economies of scale, they also rely on a certain amount of regulatory arbitrage.

Several ride hailing applications have sought to claim that they are mere intermediaries and providers of information technology based services and not taxi operators, which may have been the case going by the letter of the law. However, a combination of scattered regulatory interventions and public perception made that stance unsustainable. Ride hailing applications were marred by multiple bans, diverse stop-gap attempts at regulation, business interruptions and general uncertainty about their sustainability.

Eventually, and pursuant to extended consultations, a new framework for these aggregators was proposed in the form of an 'Advisory for Licensing, Compliance and Liability of On-Demand Information Technology based Transportation Aggregator [Taxis (4+1)] operating within the jurisdiction of India' passed by the Ministry of Road Transport and Highways. The advisory was followed by binding regulations issued by different state governments for aggregators operating within their jurisdiction.

A different trajectory was followed by disruptors that provided access to GPS based mapping information and turn-by-turn directions. The mapping sector, specifically topographical maps of above a certain resolution, are subject to restrictions on export, processing and display, as a result of which entrenched businesses were reliant on limited data sets and subject to substantial regulation. Given the security concerns surrounding the sector, the disruptors pursued a more proactive approach and the ability to operate in the sector was finally secured following extensive consultations with the Ministry of Home Affairs, Ministry of Defense and other relevant regulators.

Providers of 'Over The Top Messaging And Calling Services' similarly disrupted established providers of calling and messaging solutions. Again, the initial stance of being pure application service providers did not hold water, particularly where encrypted conversations were sought to be accessed by security agencies. Eventually, extensive consultations and an approach more aligned with regulatory expectations became necessary. Discussions in this sector are still ongoing on permissible levels of encryption and the protection of carrier revenues.

Online pharmacies seek to disrupt the pharmaceutical retail business by offering the advantages of e-commerce to buyers of pharmaceuticals through websites or mobile applications. While the sale of pharmaceuticals is heavily regulated, India does not have a specific framework regulating online pharmacies. Adapting regulations applicable in a physical world to an electronic medium has posed challenges, particularly with reference to ensuring one-time use of prescriptions, verification, validation and delivery. Several drug control authorities have issued show-cause notices to operators for alleged violations. The Drugs Consultative Committee has set up a sub-committee to formulate regulations for online pharmacies and in the meanwhile, the Drug Controller General has directed that e-pharmacies must fully comply with the Drugs and Cosmetics Rules, 1945. Online Pharmacies will find themselves subject to increasing scrutiny in days to come and more proactive players who comply with regulations in letter and spirit may find themselves at a distinct advantage over competitors who have not invested in such compliance.

Private equity investors seeking to invest into disruptors of this nature will be well served to learn lessons from more mature investments. In addition to requiring a thorough evaluation of the operations of their investees, an in-depth analysis of the applicable legal regime and ensuring that operating procedures and documentation support legal compliance (albeit of rules and regulations that were promulgated before the advent of disruptors), investors into emerging disruptors will also be well served by being proactive in identifying emerging regulatory trends and mitigating emerging regulatory risks through a combination of insisting on compliance or by separating regulated portions of the business from unregulated parts thereof or by engaging well in advance with the regulator at a policy level.

A Third Wave

An emerging set of disruptors is seeking to operate in sectors not usually amenable to disruption by reason of their being heavily and actively regulated. Such regulation is often justifiable in light of the systemic importance of these sectors, and the risks associated with them.

Telemedicine and virtual consultation solutions is an example. While the benefits of instant and convenient consultations are undeniable, regulations surrounding the practice of medicine and medical/health advice are substantial. In addition to professional rules of conduct regulating doctors and caregivers, such operations are also subject to an extensive body of case law surrounding medical negligence and acceptable standards of care. This jurisprudence, predicated on conventional consultation and examinations, is often incompatible with the proposed mode of operation of these disruptors. Proactive operators in the sector are using a combination of back up physical consultations, international best practices and carefully calibrated exclusions of service to protect against the liability which is likely to follow any incidents of malpractice.

Virtual trading platforms, particularly those offering notional pools of assets ranging across a variety of domestic and international asset classes have the potential to disrupt conventional investment vehicles. However, in addition to the regime governing the trading of securities and derivative instruments, these trading platforms may have to address restrictions on online gambling.

Online news and current affairs aggregators and publishers are seeing substantial traction and visibility in India. While their operations did not seem to be prima facie regulated as newspapers and equivalent publications, regulators have extended limits on foreign direct investment to them, and required them to comply with detailed requirements for accreditation.

Financial technology based innovations such as Peer-to-Peer lending platforms (P2P Platforms) in particular may prove to be the most prominent disruptors of all. P2P platforms seek to facilitate direct small and medium ticket loans to individuals and SMEs through third party lenders. While they subsume the conventional role of an arranger, connecting pools of lenders and borrowers, P2P Platforms also seek to facilitate disbursements, repayments and contracting in consideration for service fees. While some of the above services may well be rendered more efficiently through technology enabled means, the key value proposition for P2P Platforms is to drive loans which are not addressed by existing means. This would require participation by non-traditional lenders, simplified enrollment and lending procedures and unconventional lending and repayment mechanisms and terms. P2P Platforms may be subject to limitations on interest rates chargeable, prudential and capital adequacy norms for participation in risk, reporting requirements, regulations governing KYC requirements and restrictions surrounding potential enforceability of electronic documentation for recovery. Again, proactive compliance and regulatory engagement will bring distinct advantages.

Conclusion

Private equity investors investing into potentially disruptive businesses need to be mindful of the nature of disruption, its long term sustainability, and how prepared their potential investee is for regulatory interventions.

An analysis of trends from legal issues affecting investments into various sorts of disruptive businesses indicate that it is in the interest of private equity investors to proactively future proof business models and operations against emerging regulatory changes and trends. One way this could be achieved is through conducting thorough due diligence (financial, legal and technical) on potential investees with special emphasis on the regulations governing their more entrenched competitors and investee compliance with such regulations. Investors must also analyze investee business operations and put in place suitable processes and documentation to comply not only with best practices but also at the very least with the spirit of applicable rules and regulations. Further, analyzing, estimating and classifying risks, and structuring businesses in such manner as to compartmentalize riskier, more regulated portions thereof from the remainder of their operations (if practically possible) will also go a long way in ensuring that the investment into a disruptive business is in the investor's best interests.

Disruptive operations in highly regulated sectors are subject to very substantial and proximate regulatory risk. The focus in this nature of investment moves from risk mitigation to risk classification, with the intent being to mitigate the most serious risks first as much as possible. Given the emerging nature of regulation which is intended to regulate disruptive behavior in these sectors, some level of regulatory crystal ball gazing is also called for by investors into these sectors. Indeed, given the increasing ability of public comments and industry bodies to influence potential legislation, disruptors in these sectors can try to make their own trails in emerging regulatory environments.

Entrenchment Provisions – Minority Protection or Further Confusion ?

According statutory protection to minority shareholders' rights has been a prime focus of company legislation across the world. The Companies Act, 2013 (**2013 Act**) has retained several minority protection provisions from the Companies Act, 1956 such as small shareholder directors and action for oppression and mismanagement, and has also introduced substantive rights, including class actions by minority shareholders (a provision that is yet to be notified). In addition, the 2013 Act also provides statutory recognition to a commonly adopted practice of protecting minority rights through the concept of entrenched provisions in articles of association of a company (**Articles**), which aims to ensure that majority shareholders cannot take away minority shareholders' rights by making unilateral amendments to the Articles.

Significance of the Articles

The Articles of a company contain regulations for its management, and other matters that are prescribed. The Articles of a company assume significance due to the statutory principle that when registered, the Articles of a company bind the company and its members. The binding nature of the Articles is further strengthened through a legal fiction in company law that the articles are binding on the members and the company to the same extent as if they had been signed by the company and each member, and contained a covenant on the part of the company and each member to comply with all the provisions of the Articles.

The Articles assume significance for a number of other reasons. Under the 2013 Act, shares of a company are transferable in accordance with the Articles. Certain actions can be undertaken by a company only if its Articles permit it, or do not prohibit it. For instance the requirement of having only two kinds of capital (equity and preference), and the restriction on preference shares having voting rights akin to equity shares, does not apply to a private company whose Articles so provide.

Entrenched Provisions – The Concept

As a legal principle, entrenched provisions of a law are those provisions which are more difficult to amend compared to other provisions. The 2013 Act has recognized the principle of entrenchment provisions in Articles. It provides that the Articles may contain provisions for entrenchment, i.e. specified provisions of the Articles may be altered only if conditions or procedures which are more restrictive than those applicable in the case of a special resolution, are met or complied with. Such provisions for entrenchment can only be made either on the formation of a company, or by an amendment to the Articles agreed to by all the members in case of a private company, and by a special resolution in case of a public company.

The 2013 Act does not provide any guidance as to what 'conditions or procedures' may be prescribed in the Articles for amending entrenched provisions, and it may be argued that the shareholders of a company would be free to impose any procedure or condition that they may deem fit. However, such conditions and procedures cannot be designed to be violative of the 2013 Act, which will prevail over the Articles, memorandum of association, agreement or any resolution of the shareholders or the board of directors of a company. This position also existed under the old regime under the Companies Act, 1956 (**1956 Act**). Decisions of courts on the subject indicate that principles of repugnancy would only be invoked when the stipulations in Articles, memorandum or resolutions are contrary to statutory provisions. Provisions found in Articles which mandate a higher threshold than what is prescribed under the 1956 Act have been upheld by courts Act as long as such requirements were not contrary to the provisions of law.[1]

Incorporating Shareholder Rights in Articles

As is the norm with most equity financing transactions, all rights relating to the management and governance of the investee company, transfer restrictions, exit rights and other rights of a private equity investor are incorporated in the Articles. Investors holding minority stakes typically have affirmative voting rights which would require investee companies to obtain the relevant shareholders' prior approval for undertaking certain actions which could have otherwise been taken by the company without such approval. An entrenched provision in the Articles is effectively a statutory recognition of the affirmative voting rights of shareholders with respect to amendment of Articles. Therefore, by implication, all protective rights accorded to shareholders would have to be necessarily incorporated in the Articles with an entrenched right of the relevant shareholder with respect to all amendments to the Articles which may impact that shareholder's rights. Due to the legal fiction regarding the binding nature of the Articles, incorporating provisions in the Articles also provides a means to bind minority shareholders (such as employee shareholders or other minority shareholders) to terms agreed to contractually by the majority of the shareholders, even where such other shareholders have not executed agreements themselves. In addition, incorporating consent provisions or other conditions in the Articles of the subsidiaries or associate companies of the investee company provides for the rights of private equity investors to flow through to these companies without the investor holding shares in these companies itself.

Further, though there were some conflicting judgments and opinions in relation to enforceability of provisions of contractual arrangements not expressly included in the Articles, as a matter of transactional practice, all shareholder rights and obligations contained in shareholders' agreements are typically incorporated in the Articles to

1 The Punjab and Haryana High Court has, in Amrit Kaur Puri v. Kapurthala Flour, Oil and General Mills Co. P. Ltd. and Ors., ([1984] 56 CompCas 194 (P&H)), ruled that a company is not prohibited from providing a higher quorum for board meetings in its articles than that prescribed under the 1956 Act.

ensure that any action taken by a company in violation of those provisions are ultra-vires the Articles and are invalid. This acts as an added protection over and above the contractual protection under a shareholders' agreement. Introduction of the principle of entrenched provisions in Articles under the 2013 Act buttresses the argument in favour of including the relevant provisions of a shareholders' agreement in the Articles.

Impact of Entrenchment on Deal Making

As mentioned above, entrenchment provisions can be included in Articles either at the time of the formation of a company or a later point in time provided the requisite shareholders' approval has been obtained. Given that investors would typically seek affirmative rights on amendment of Articles, amending and restating the Articles pursuant to transactions would mean that an entrenched provision is being added to the Articles. under the 1956 Act, amendments to the Articles could be undertaken by passing a special resolution, incorporating entrenched provisions in Articles would, under the 2013 Act necessitate agreement of all members in case the investee company is a private company. This would make it particularly onerous for private companies where the shareholding is scattered across multiple shareholders including employees who may have had exercised their stock options since the provision is unclear whether the entrenched provisions need to be passed by a unanimous resolution of members present and voting (in which case, the provision could have been worded to state that), or whether it would necessarily require obtaining the consent of all members. There is also the technical question of whether members, who do not have voting rights (such as preference shareholders, who have restricted voting rights) would be required to agree to the entrenchment. Out of caution, investors should obtain consent for amendment of the Articles at closing from all members, either by executing the shareholders' agreement or otherwise, and ensure that the resolutions passed at closing for adopting the restated articles are unanimously approved by all members present and voting.

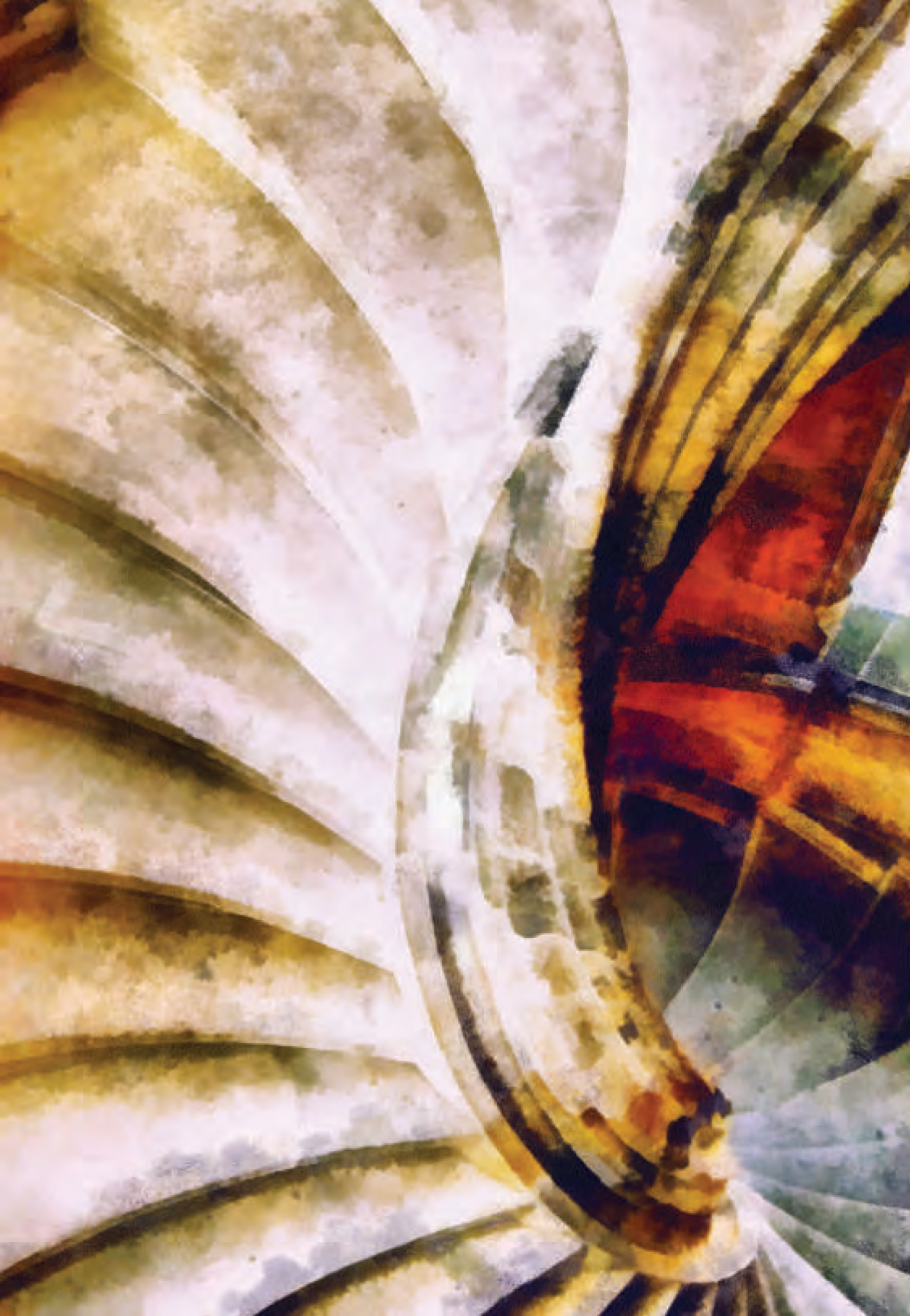
The legislative intent for insisting on the agreement of all members is unclear. There are no other matters under the 2013 Act that require unanimous approval of all members of a company, and having such a high threshold could impact the ability of a company to make decisions through majority – a principle that is reflected through various other provisions of the 2013 Act. The provision of the 2013 Act which provides for entrenchment, is almost identically worded as Section 22 of the (UK) Companies Act, 2006 (**"UK Companies Act"**) except to the extent that the UK Companies Act does not draw a distinction between public and private companies and the agreement of all members of a company are required to make provisions for entrenchment in the Articles of existing companies. It may be noted that Section 22 of the UK Companies Act is not yet in force and is being reviewed by the Department for Business, Innovation and Skills on the ground that the expression "provision for entrenchment" could apply to provisions sometimes included in Articles in connection with rights attached to classes of shares, and thereby restrict the ability of the management of the company to create a class of shares with distinct rights, since such rights, if required by the holder of shares to be entrenched in the Articles would effectively require approval of all members of the company.

The provision also raises some questions, the answers to which will depend on the interpretation adopted until these matters are decided by a court, or the ministry of corporate affairs otherwise clarifies these. For instance, if an entrenched provision for example, the provision in the Articles that requires the consent of a private equity investor to amend the provision requiring the investor's affirmative vote) can only be amended with a particular shareholder's consent, would the amendment of this provision to include the consent rights of another shareholder (where a subsequent private equity investor is investing in the company with similar rights) be considered as a new entrenchment provision requiring the agreement of all members, or would it be considered as an amendment that was carried out in accordance with the Articles since the "conditions or procedures which are more restrictive than those applicable in the case of a special resolution" have been complied with?

There is also doubt as to whether an "amendment" to an entrenched provision would necessarily mean altering the specific provision itself, or an amendment could be achieved by introducing a new provision that takes away the effect of or overrides the provision that has been identified as an entrenched provision, without making any changes to the entrenched provision itself.

Conclusion

Recognising entrenchment provisions in Articles is a step in the right direction towards protection of minority shareholders. Having said that, the provision in the 2013 Act could have been drafted more clearly recognising affirmative voting rights of shareholders not just with respect to amendment of Articles but for a wider set of rights. Further, requirement of obtaining consent of all members would be extremely onerous for private companies and could become a major impediment in deal closure.



Nominee Directors - PE Approach to Greater Responsibilities

A key pillar of corporate governance of a company, is the role that its directors discharge on the board and the parameters that they subject themselves to while performing such duties. The debate about nominee directors, their duties and responsibilities vis-à-vis the investor nominating such directors and the company and other shareholders, must be seen in this context. While on one hand, private equity investors invariably demand for representation on the boards of portfolio companies to be able to effectively participate in the company's governance and safeguard their interests (operational or otherwise); on the other hand, given the change in legal framework relating to corporate governance pursuant to the enactment of the Companies Act, 2013 (**2013 Act**), the role of such investor representatives on the board of directors has undergone a substantial change.

We deal with some changes that the law has brought in the realm of corporate governance by codifying the duties of the directors and the impact of such codification in the governance structure and the liability of the nominee directors, along with some recent trends and practices of relevance to private equity players.

2013 Act: Codification of Duties and Liabilities

The duties of directors were not codified under the Companies Act, 1956, but they had evolved through judicial pronouncements. In the context of nominee directors, the courts often held that nominee directors should look after the interests of the company as a whole and must not represent only those appointing them. The 2013 Act now seeks to bring about greater standards of corporate governance, by codifying and imposing higher duties for directors, and imposing liabilities on them –monetary and personal, depending upon the nature of breach of such duties. However, in the context of non-executive (including nominee directors) and independent directors, such liability is imposed only for acts or omissions which occurred with their knowledge (through board processes) or with their consent or connivance or where they had not acted diligently. A similar construct is used in the definition of the term "officer in default" (for the purpose of placing liability with respect to offences committed in the name of company), which includes directors who are aware of any contravention by virtue of receipt of any proceedings of board meetings (such as agenda, notices and minutes of meetings) or participation in such proceedings, without objecting to the same.

Given these changes under the 2013 Act, the perception surrounding fiduciary duties as a concept has changed and become more structured, enforceable, and tangible.

Therefore, it is crucial that these are carefully considered at the time of determining the rights of a private equity investor (in the investment documentation) and also the role of the nominee director on a day-to-day basis.

Balancing Act: Mitigating the Liabilities of Nominee Directors

With the growing emphasis on fiduciary duties of directors, it is axiomatic for good corporate governance that the board of the portfolio company exercises oversight and control over its operations. In this context, nominee directors, apart from providing strategic guidance and contributing to decision making, are also expected to act as watchdogs for good business practices. As representatives of an investor, having access to company information, nominee directors have the capacity to be independent of the influence of the promoters or controlling shareholders and keep a check on them by calling out any irregularities in the functioning of the company. While it may be easy to establish independence from the influence of the promoters, the real test for a nominee director is to avoid conflict of interest and make independent decisions beneficial to the interests of the company and the shareholders at large.

Given the primary purpose of appointment of a nominee director is to safeguard the interests of its appointer, the nominee's fiduciary duty towards the company is likely to take a backseat. Typically, the interests of the company and the investors will be aligned to a great extent; however, there may be certain instances where a nominee director following the instructions of its appointer may not be taking decisions in the interests of the company as a whole. Owing to these extensive changes brought by the 2013 Act, there has been a need to adopt a pragmatic approach to mitigate the risk of nominee directors being held liable for breach of their fiduciary duties.

In this context, as Lord Denning observed, there is nothing wrong with a director being nominated by a shareholder to represent his interests "so long as the director is left free to exercise his best judgment in the interests of the company which he serves. But if he is put upon terms that he is bound to act in the affairs of the company in accordance with the directions of his patron, it is beyond doubt unlawful." The challenge therefore becomes to strike the right equilibrium between the conflicting interests vis-a-vis the company and the investor.

Drawing from experience and recent market trends, below are some practical aspects that may be considered by nominee directors and their appointers in this balancing act:

- The nominee directors should ensure that they have access to sufficient information about the business, activities and financial position and prospects of the company to make an informed decision about what is in its best interests. In this context, it is recommended that adequate information, reporting and inspection rights are provided under the investment documentation. Further, the nominee should adopt an inquisitive approach and question the background information of any concerned matter, how it was obtained, and the decisions that are taken based on such information. Where the information is confidential, the nominee directors should refrain sharing such information with their appointers as the same could amount to a breach of the duty of confidentiality as well as fiduciary duties by such nominees. While this would not necessarily preclude proceedings against nominee directors, it could form an initial defence in such cases.

- The nominee directors should ensure that they attend the board meetings regularly, and in case they dissent to any particular matter placed before the board, such dissent should be recorded in the minutes. They should be particularly cautious about approving any course of action that seems to provide little or no benefit to the company, either directly or indirectly. In this regard, the nominee director or investor may also insist that the portfolio companies adopt an appropriate policy regarding recording of the minutes of the meetings to ensure that the minutes are detailed, comprehensive and list down the assent/dissent of the nominees, along with their reasons for such assent/dissent, that are sufficient to reflect and explain the company's transactions.
- The nominee directors should regularly highlight their concerns on balancing the competing interests between their role as a keeper of the interests of the shareholder they represent and their duty to the company on whose board they sit during annual board evaluations conducted by such company.
- It is also important that the nominee director does not get involved or take the responsibility of any kind in the functioning or affairs of the company. Since a non-executive director does not control the day-to-day affairs of the company, he should not attempt to assume authority where he does not have control.
- In conflict scenarios directly involving the nominee director's appointer, it is important that the same is disclosed to the board and such nominee recuses from voting. Further, there may be situations where the interests/opinion of the company and the investors may differ. In order to pre-empt such conflicts, it is advisable to agree to a list of reserved matter/ affirmative voting items under the investment agreement, whereby prior consent of the investor will be mandatorily required prior to or independent of a board meeting (either directly or at a shareholders' meeting).
- Given that typically, such nominees of private equity investors act as directors on boards of a number of portfolio companies, it is pertinent to ensure that adequate Chinese walls are in place (preferably documented and otherwise) so that there is no data leak across portfolio companies.
- In situations where the interests of the company do not coincide with the interests of the investor, the nominee director of such investor should not simply follow the instructions of his appointer. While this may be difficult, the director must be mindful of the fact that he is distinct from the appointer, and as such, his primary duty is towards the prospects of the company as a whole. The courts have also consistently re-iterated their position and held that "in the exercise of discretion, the directors have to act for the paramount interest of

the Company and for the general interest of the shareholders." Therefore, it is important that such nominee acts freely, without any influence from his appointer, and like any other director on the board.

- Apart from acting without any influence from the appointer in the situations of conflict, the nominee director may approach an independent counsel or expert to seek professional advice on the issue and course of actions, which he may take on board so as to avoid any liability. This would also reflect his independent exercise of due diligence as a director.

- Having a directors and officers insurance (**D&O Insurance**) from the company might be useful given risk factors associated with directors owing to the change in the regulatory environment in India. D&O Insurance has been statutorily recognised under the 2013 Act and has now become a customary demand from the investors appointing their nominees, as they would want to shield such nominees from the risk of any liability emanating from poor corporate governance. Such clauses in the investment agreements should be cautiously and thoroughly negotiated.

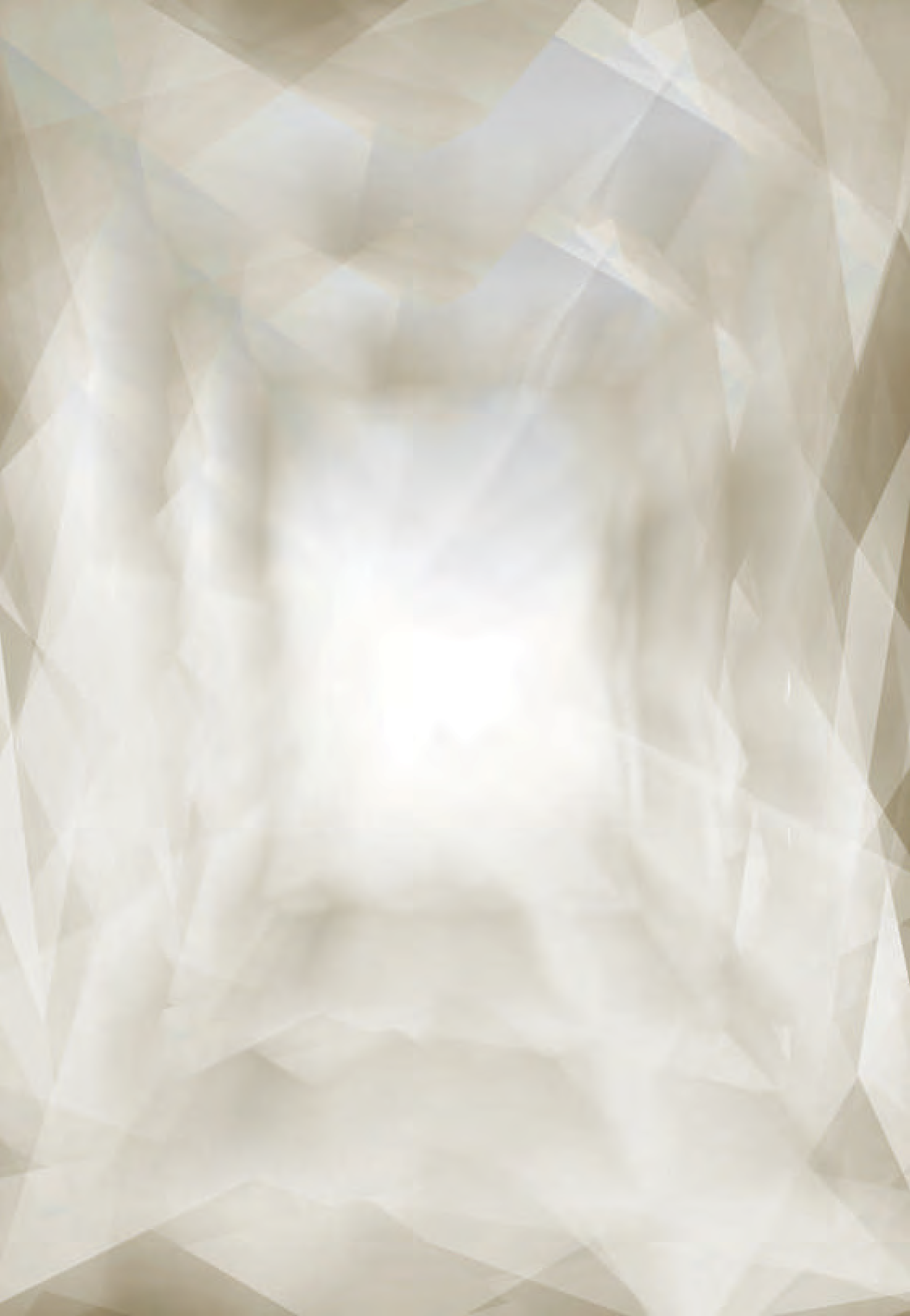
- In order to add a further level of independence to the board's decision making, the controlling shareholder (financial investor) may thus insist occasionally on appointing consultants and experts on the board to add expertise in a particular business area, and ensure that it is professionally managed without attracting any undue liability under the provisions of the 2013 Act. Another alternative which is being considered by the nominee/ private equity investor is to seek a sub-committee represented by experts and independent consultants which in turn advise the board from time-to-time in relation to the affairs of the company. However, it is to be noted that such practice is not a norm and seems to be an emerging concept.

- With the intent of maintaining oversight over the affairs of the company, without assuming authority, the nominating investor may seek representation on non-board committees/ sub-committees of the company with appropriate governance processes mandated contractually so as to be binding on the company Alternatively, private equity investors are increasingly seeking representation on the board of the parent company, rather than the portfolio company. While this may mitigate liability to an extent, investors should be advised that they may run the risk of the regulator lifting the corporate veil, in cases where it is warranted, to ascertain liability in case of any breach by the portfolio company.

Another cautious approach which some private equity players, especially those which have invested in portfolio companies in highly regulated sectors (such as education, e-commerce, financial services, etc.), have started evaluating to potentially avoid any conflicting interests and liabilities of their nominee is by having an observer rather than a director on the board of the company. In such a case, the investors are vested with the right to appoint a representative to attend all board meetings in a non-voting observer role. The investors then exercise any affirmative rights as a shareholder. In this context, it is important to set out the role that the observer will play on the board so as to avoid any liability that may get attached to the observer, if such observer gets classified as a 'person in accordance with whose directions the board is accustomed to act' and regarded as an 'officer' under the 2013 Act. The observer is typically not insured under the D&O Insurance, unless the company specifically obtains such coverage.

Conclusion

The changes to the 2013 Act have resulted in enhanced scrutiny in the role of the directors in ensuring sound corporate governance. As such, it is important that a nominee director be apprised of the requirements prescribed by the law, the liabilities arising out of breaches, and be guided on the procedures he should follow in the event of any conflict between the interests of the company and the appointing investor. In this regard, private equity players should not exercise this right in a mechanical manner, but should be cautious and responsible and should ensure that the nominee is a person who understands the implications under law and discharges his responsibility in accordance with the same.



PE Promoter Tangle – Changing Landscape of Disputes in India

'Make in India' – the mantra of India's first single-party majority government in three decades, was greeted with optimism in India and the global business community. India continues to be on the wishlist of several global investors. Relatively low inflation coupled with strong GDP growth projections has seen a consistent increase in overall private equity deal activity in India, both in terms of deal volume and deal values. Foreign investors continue to be enthused and foreign capital constitutes a substantial majority of these commitments, albeit investments are now made with more care and diligence.

However, with increased investment, there has also been a striking rise in the number of investments tangled in legal battles between the investor and the promoters of the investee company. Underlying reasons for these battles seems to be the complete difference in the interests and approach to business of promoters and investors. Promoters, who have been historically used to treating the company as their fiefdom, catch their investors by dismay when the investors find that normal rules of business and indeed corporate governance may not have been appropriately applied in the conduct of business.

A glance at the nature of the issues that are contentious bears out that these are often in the context of the differences in perception and actions taken by Indian promoters, as opposed to what private equity investors consider to be a breach of fiduciary duty, misrepresentation, deliberate fraud or sheer negligence in corporate governance. The tipping point for the investor is usually a breakdown of trust following discovery of financial inappropriateness, which can range from accounting fraud, withholding or fudging of key financial information, misrepresentation, siphoning of funds, related party transactions that are either undisclosed or not at arm's length, etc. Often the discovery could have been made sooner, or even prior to the deal, had the investor conducted a thorough due diligence rather than seeking a quick closing of the deal. In other cases, difficulties can (and often do), arise from a failure to obtain the expected returns from the business or not agreeing to proceed with an IPO, and refusal by the promoter group / company in honouring the investor's exit options in the agreed manner, such as a buy-back of shares, strategic sale with tag-along or drag-along right, and famously, not honouring the investor's put option, all with the excuse of regulatory infraction.

The recent past has seen an increase in media reportage of disputes arising from some form of financial mismanagement or active fraud of the promoters. In some cases, the fraud would not even had come to light had a whistleblower not brought the issue to the knowledge of the investor. For instance, two large PE funds who were investors collectively holding 45% shareholding in a children's clothing company, received an anonymous call just days prior to the announcement of a proposed IPO that the company's revenue figures were inflated and profits overstated. With some haste, the PE investors demanded a forensic audit of the accounts and stalled the proposed IPO. A tool that is probably most effective and well used by an investor is the insistence on an independent audit (a right which may well be incorporated into the investment documentation), and the court lost no time in appointing an auditor at the investors' request. Ultimately, and as is often the case in private equity disputes, the parties settled, and the promoter bought out the investors at an undisclosed price. There have also been instances where a PE investor has, not content with suing the promoters of the investee company, also proceeded against its financial / investment advisors in relation to disputes over financial and accounting irregularities holding it responsible for wrong investment advice. Exaggeration of a company's revenues / valuation is obviously something that a conscientious investor should look out for. Highly publicised was the fiasco where German parent sportswear company discovered through a forensic audit that its Indian subsidiary had likely fudged accounts to the extent of several hundred million rupees, to show fake transactions with unauthorized customers. The extent of the fraud was investigated by both the local police and the Serious Fraud Investigation Office (SFIO), an arm of the Ministry of Corporate Affairs, with SFIO indicting the parent company for lapses in corporate governance and internal controls at its Indian subsidiary. The German parent claimed that the fraud resulted in an "impairment of (its) goodwill", which it valued at several million Euro in its consolidated financial statements. SFIO slammed the parent company, stating that the disclosure should have also been reflected in the Indian Company's annual financial statements "to protect the interests of the Indian stakeholders".

Several similar cases of misappropriation, diversion of funds, fictitious accounting etc., have come to light over the last several years leading to a rise in disputes and in forensic audits being conducted by investors – either with or without the co-operation of the company and the promoters concerned. Public sources reveal disputes that have arisen with big name investors; for example Azim Premji-owned Zash Investments, which purchased 10% equity stake in Subhiksha Trading Services and New Silk Route, Citigroup Venture Capital and Baring Private Equity Asia, who invested in KS Oils.

Sometimes a mere forensic audit is not sufficient. The Companies Act gives wide ranging powers to the Company Law Board (CLB) (and the National Company Law Tribunal, once constituted), to safeguard minority shareholders. A minimum of 100 shareholders of a company; or shareholders holding 10% of the issued share capital or 10% of the total number of members, may file a petition seeking relief in relation to oppression by the majority shareholders and / or mismanagement by the management of the company. An investor group, holding more than 10% of the company's share capital, may put the power to good use, as did two private equity funds which had invested over USD 100 million in an infrastructure company. The investors sought the appointment of an administrator to take control of the company and undertake an investigation into its financial affairs, claiming that the promoters had siphoned off funds from the company, and that the company, its shareholders and the investors were the victims of forgery and wilful deceit. The CLB constituted a committee to look into various aspects of operation and also co-operate with the forensic audit which was to be conducted.

Related party transactions which were prior to receipt of foreign investment in a company, just ordinary business to the promoter group, and failure to give the opportunity to investor shareholders to exercise affirmative or veto rights are also a big bone of contention, leading to disputes between the investors and the managing promoter group. Remedial action is often taken by the investor by filing proceedings alleging oppression and / or mismanagement before the CLB. For example, a real estate private equity fund moved the CLB seeking cancellation of an allotment of 5 lakh equity shares made by its investee company to a related party, in contravention of the Companies Act and without their consent. The CLB granted interim relief to the investor, restraining the related party from exercising voting rights in relation to the shares allotted.

Another and extremely contentious issue between investors and promoter groups has been the failure / refusal to honour the exit options granted to the investor. Particularly in the case of foreign investors foreign exchange regulations are used (and abused), as an excuse to either not perform obligations at all, or perform them, but at a discounted rate. Most common are disputes relating to the investor's exercise of a put option requiring the promoter group to purchase the investor's shares at an agreed rate (which would give the investor the hoped-for rate of return). The Reserve Bank of India has clarified that a non-resident investor cannot exercise the option/right to exit at an 'assured' or 'fixed' return and that such shares must be sold at fair market value, resulting in a situation where owing perhaps to promoter defaults, the value of the shares is not as was expected and has been devalued. The promoter group then uses these regulations to argue that the put option itself is not valid or that the put price suggested by the investor is in contravention of such regulations and is not linked to the then fair market value. In such situations, the exercise and methodology of valuation of the company and the investor's shares assumes supreme importance. Other issues related to the difficulty in repatriation of proceeds of sale of the shares. Some investors have sought to include a provision in the investment agreement to the effect that if the agreed-upon rate of return is not achieved by the investor when exercising its option to exit its investment, the shortfall between the exit price realised and the exit rate agreed, will be compensated by the company / promoter group concerned, by way of damages. It is not certain however that an award / judgment granting damages in lieu of the agreed rate of return would be enforceable in India and could possibly be opposed as being contrary to the fundamental law of India and public policy. The solution to the agreed upon exit rate will be ever more creatively negotiated till India's foreign exchange regulations are brought on par for both foreign and Indian investors.

Few of the exit related disputes have seen final adjudication (whether through court or arbitration – which is the more preferred option). Several Indian companies / promoter groups have succeeded in creating enough difficulty and 'litigation fatigue', that rather than agitating the matter through legal proceedings, investors have opted for an out of court settlement in which they typically exit at a lower rate than initially agreed. Examples include private equity funds which acquired minority stakes in a real estate company. The investors' planned exit by virtue of an IPO was derailed owing to unfavourable market conditions, leading to the investors invoking their put options and initiating arbitration proceedings. Eventually, the parties settled by the promoter buying out the shares of the investors.

A UK-based investor's Indian fund, which invested Rs. 800 crores for a minority stake in a port company, also exercised (in 2013), a put option against its other shareholders and promoters, which put option the investor was entitled to exercise at any time during a specific time period. The promoter group, refused to honour the put option on the basis that a put option with an assured return to the investor was in breach of RBI regulations and clarifications. The dispute is still raging in arbitration, 3 years after the exercise of the put option by the investor, while the investee company is looking around for a new investor for the beleaguered asset.

In another instance, a Japanese telecom major invoked its right to sell back its shares in respect of its investment in a telecom company, to the promoter company inasmuch as the company failed to achieve certain specified performance targets. While the promoter group was willing to honour the put option, regulatory hurdles intervened. RBI was initially in favour of allowing the sale of shares by the non-resident investor at a price higher than their fair value on the rationale that contractual agreements should be honoured. In fact, RBI was also in favour of a change in policy in this respect. The Ministry of Finance however was wary of making any exceptions (perhaps validly so), and asked the RBI to evaluate the matter in line with the existing guidelines. The promoter group fairly claimed that its hands were tied due to RBI's stand and did not execute the put option. The investor finally invoked arbitration to enforce the put option, and the matter is pending before an international arbitral tribunal.

Hot on the list of issues that regularly give rise to disputes is the dreaded 'deadlock', which can fundamentally affect the management, control of the business of the company. Typically, certain fundamental decisions relating to the business or policies of a company, require either the affirmative vote or no veto vote from the investor. Many a time, it is the investor's own inaction or disinterest in exercising its rights that exacerbates the situation and gives the management room to ignore those rights or argue waiver / acquiescence on the part of the investor. However, failure to grant an affirmative vote or the exercise of a veto by the investor at consecutive meetings and failure to reach mutual agreement, can lead to a deadlock. Various mechanisms can, and are often, put in place to deal with a deadlock situation, including escalating the issue to senior representatives of the investor and management / promoters to reach amicable resolution; appointment of an agreed independent third party who would step in the event of a deadlock – this is more akin to a mediation; and of course, in case of failure to alleviate the deadlock, either of the parties may be given a put / call option or drag-along / tag-along right and a consequent exit from the company.

Deadlock situations often have the minority shareholders (usually the investors) approaching the CLB (once again on the grounds of oppression and mismanagement by the managing shareholders), for appropriate reliefs, including for holding board meetings, taking certain decisions, appointment or removal of directors, etc. While the provisions of the Companies Act in this regard are primarily for the benefit of minority shareholders, it is open also to the majority shareholders – if they are oppressed or if the minority group is in management of the company, to approach the CLB on a similar basis.

The predominant manner of dispute resolution in private equity agreements is arbitration. Foreign investors have typically railed against the thought of arbitrating in India, citing interventionist courts and delay in the arbitral and court process. Prior to October 2015 and the amendments to India's arbitration law, several investors were faced with a choice of arbitrating in India in order to have recourse to Indian courts, or avoiding Indian courts by proceeding with a foreign seat, but then risking the inability to enforce an interim order (there is no provision under Indian law to enforce the interim order of a foreign court or tribunal). With the new amendments to Indian arbitration law being brought in, parties to a foreign seated arbitration may nevertheless approach an Indian court for interim relief (unless agreed otherwise), bringing sighs of relief to foreign investors worldwide and bringing Indian law in line with what most arbitration friendly jurisdictions mandate under their arbitration laws. Investors who are investing through Indian incorporated subsidiaries should however keep in mind that although parties to an international commercial arbitration (where at least one party is a foreign entity), may chose to arbitrate in a foreign seat, there are divergent views on whether two Indian parties may also opt to do so. This issue is before the Supreme Court and should be decided imminently, bringing some clarity, but in the meantime, it may be safer to include as a party to the investment agreement, the foreign parent if possible, or otherwise providing for an Indian seat.

Either which way, resolution of a dispute through an adversarial process – whether through litigation or arbitration, is often a last recourse of the investor. Groups that have several investments certainly do not want to be spending their time (and money), in chasing an elusive decree which, at the end of the day, may not be enforceable for the sheer reason that the judgment debtor simply cannot pay the amount decreed. Moreover, from a sheer reputational standpoint, an institutional investor may not want to be involved in too many (or any), legal proceedings for fear that it may be seen as being 'difficult' or 'litigious'. By far the more preferred option for everyone seems to be an out of court settlement, perhaps started with demands, posturing and even the initiation of legal proceedings and the all important obtaining of interim relief to protect the asset, but thereafter, time off to lick their wounds and live to invest another day. Perhaps that's best for business!

The role of Private Equity in Shareholder Activism

While isolated instances of shareholder activism have occurred in India in the past, only recently have they become commonplace. In our experience, related party transactions and revisions to executive remuneration are the most controversial actions – encompassing a large majority of instances of shareholder activism till date. This trend is the outcome of a global move towards greater transparency, accountability and shareholder involvement in business decision-making; of legal changes in the form of the enactment of the Companies Act, 2013 leading to new remedies in the offing (class action suits), as well as new avenues for participative decision making (majority of minority consent for related party transactions); of an increased push from the securities market regulator, including through the amended Clause 49 of the Listing Agreement (now to be found in the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015); and the rise of proxy advisory firms.

To understand the extent and form of shareholder activism in India, one must first understand the nature of the market for corporate control. Given the presence of a controlling family shareholder, or 'promoter', in most Indian companies, and the widely dispersed shareholding of the remaining shareholders, instances of shareholder activism have differed in their form and frequency in India as compared to jurisdictions such as the United States.

The first point of difference is that shareholder activism has been seen as being limited to providing a counterbalance to promoter dominance. As a result, it has been almost entirely reactive in nature. Instances of shareholder activism have centred around objecting to actions proposed by promoter-led management. In other jurisdictions, however, there have also been instances of proactive shareholder activism, in which shareholders actively suggest actions that management can take to increase shareholder value. Given the wider (as compared to shareholder-centric) stakeholder model of corporate value creation now being accepted globally, including under the Companies Act, 2013 in India, the merits of these actions have to be analyzed on a case-by-case basis. However, in the right instances, it would help shareholders generally if private equity investors were to step in and play this role in India.

A second point of difference is the lack of a co-ordinated shareholder approach in most instances. The multitude of minority shareholders, each of whom ordinarily has a sub-5% holding, has typically failed to co-ordinate their efforts. This is not the case in jurisdictions such as the United States, where notable activist investors such as Carl

Icahn often build up substantial holdings (through shares and proxies) in companies before raising a management issue. While the dilution of efforts caused by dispersed shareholding are being mitigated by the rise of proxy advisory firms, which through their voting recommendations help to inform shareholders of issues (even as they play no role in co-ordinating activist efforts), there is still a lack of co-ordination amongst shareholders. It is unclear how effective or willing private equity investors will be at co-ordinating shareholder activism efforts. However, given their significant minority stakes in investee companies, they can go a long way towards reacting to or proposing changes in management or to the decisions made by them. Private equity investors can also liaise with institutional shareholders to set up a significant and unified minority block for the purpose of particular matters. A limiting factor that must be noted is that there are, arguably, cultural differences between India and the United States. Whereas in the United States, a private equity investor is seen as a genuine financial investor, they are viewed more as partners of promoters in the Indian context – relying heavily on a good relationship with the promoter in the absence of a robust dispute resolution mechanism as discussed later. Activist private equity investors will have to keep in mind that they are breaking away from this fold, and that there may be potential reputational risks associated with doing so – in particular, being labelled as obstructionist in the promoter community, possibly limiting further investment opportunities.

Another point of difference, which is a result of the second, is the increased level of involvement of the Indian securities market regulator – the Securities and Exchange Board of India – in governance matters. By recourse to its almost unfettered statutory responsibility to ensure the protection of investors, as well as to promote the development of the securities market, the regulator has taken an active role to both analyze individual transactions, as well as to coax market participants to play a more activist role – for example, by requiring mutual funds to mandatorily vote on resolutions of listed companies in accordance with publicly disclosed voting policies. However, the impact of the regulator's emphasis on egging on institutional shareholders to play a more active role in tempering the dominant influence of promoter shareholders is limited by its stance on other forms of involvement – in particular, the monitoring of companies through contractual protective rights. This is, however, changing.

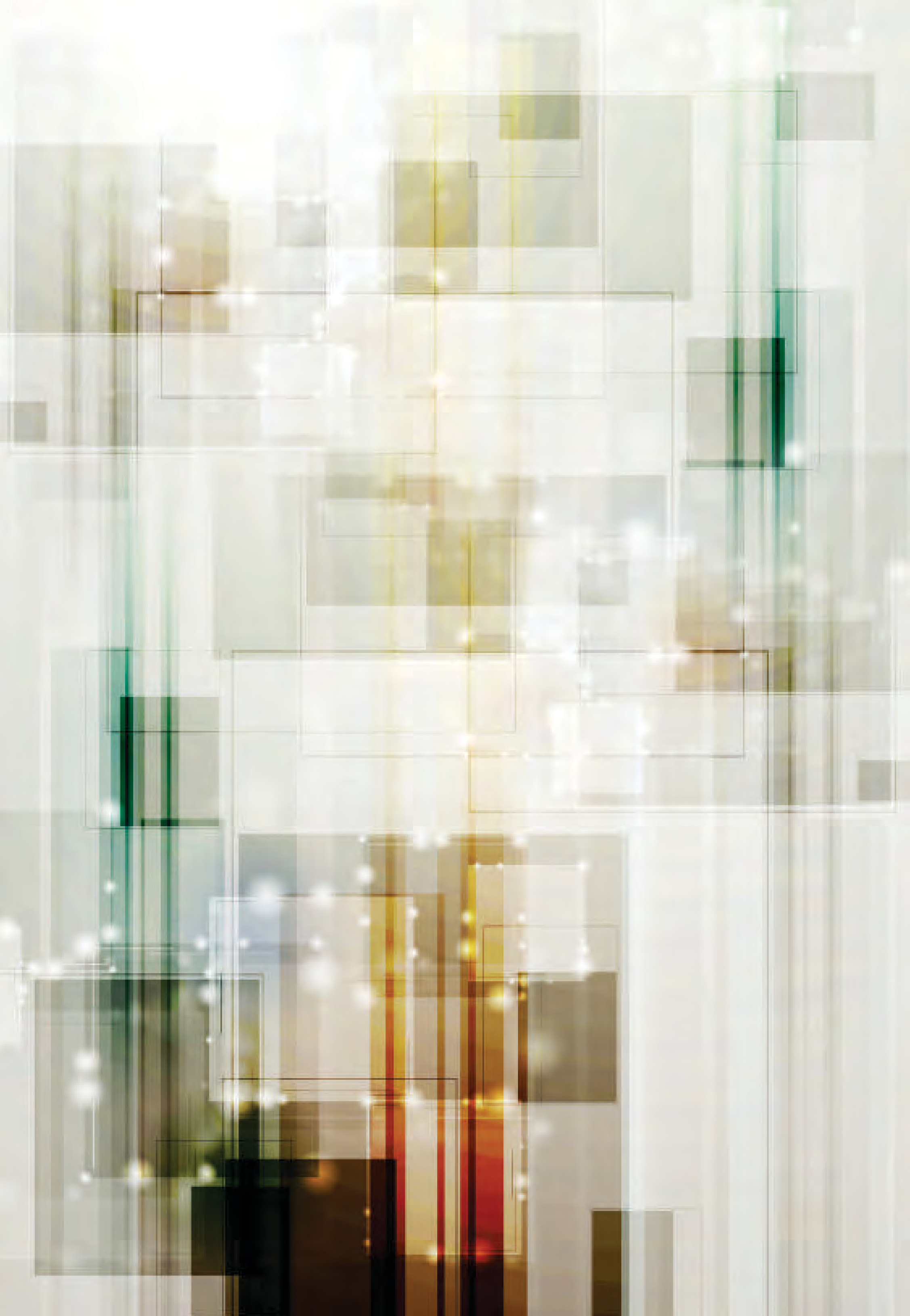
Owing to the historically poor enforcement regime under Indian law, both in terms of costs involved and time taken to obtain redress, investors have traditionally sought recourse to ex ante contractual rights in order to protect their investments. This is especially true of financial investors such as private equity investors, who prioritize financial discipline and are answerable to their investment committees.

Contractual rights can broadly be classified into two categories – participative and protective. Participative rights are those rights that allow their holder to influence the day to day management of a company. These would include rights such as say over non-material financial transactions, disproportionate (to shareholding) board and committee representation, and the power to amend the business plan. On the other hand, protective rights are those rights that do not allow their holder to influence the day-to-day management of the company in a material way, but only to act as a counterbalance to the dominant promoter with the aim of protecting their investment in the company from capricious decisions which are often aimed at leaking value out of the company in favour of third parties related to the promoters. Protective rights would include proportionate board and committee representation, veto rights over critical matters such as amendment of charter documents, restructurings and changes in the scope of business, and information rights.

The Securities and Exchange Board of India has hitherto often conflated the two categories and objected to, in many instances, any rights other than token board representation as amounting to 'control'. As being in 'control' increases compliance and disclosure obligations, and results in a one-time obligation to make a tender offer to the other shareholders of the company under the takeover rules, this is a position private equity investors are loath to place themselves in. This has left them to resort to typically unsatisfactory statutory rights made available to them under the Companies Act and in common law. In addition to the traditional common law remedy of bringing a derivative action on behalf of the company (available when the wrongdoer is in control of the company and will therefore prevent the company from bringing an action), and statutory remedies against oppression and mismanagement, the Companies Act also contemplates an investor to bring a class action suit against corporate malfeasance.

The regulator is now considering a more flexible regime that is more accommodating of commercial realities by permitting private equity investors to hold protective rights in companies will allow them to play a more activist role with respect to their investee companies.

Accordingly, the frequency and scope of activist interventions in corporate management are likely to increase manifold in India going forward. Given their relatively larger financial interests (as compared to other non-promoter shareholders) in investee companies, private equity investors are likely to lead this charge. This will likely be through recourse to statutory as well as contractual rights, and is expected to be supplemented by regulatory efforts, the co-ordinating impact of recommendations of proxy advisory firms and interventions by institutional shareholders.



Class Action Suits – Better Governance?

The Companies Act, 2013 (**CA 2013**) has laid greater focus on shareholder democracy and accountability. One of the key changes in CA 2013 is greater representation of shareholder interest and democracy. In aiming to achieve this, it has incorporated the principle of 'Class Action' in Section 245, which is yet to be notified. Although the genesis of this provision can be seen in the Companies Act, 1956 (**CA 1956**), CA 2013 clearly seeks to expand the scope of the jurisdiction and powers substantially. Additionally, to a limited extent, group action is also contemplated under Section 34 of CA 2013, albeit in a very restricted area relating to a misleading prospectus and is in force.

The concept of Class Action can be seen in effect in the United States, where such action is fairly common and governed by Federal Rules of Civil Procedure. Such action is also recognised in the Indian legal framework, both in the form of 'public interest litigations', which are in the domain of 'writ' remedies before the High Courts, as also in some of the existing statutes, viz., the Code of Civil Procedure, and the Consumer Protection Act.

The need for incorporating the Class Action principle was felt in the wake of the Satyam Scam (often referred to as the 'Indian Enron'), where the shareholders of the company were largely left remediless in respect of their grievances. The Indian shareholders took action under the Consumer Protection Act and went from the National Consumer Disputes Redressal Commission to the Supreme Court, but had their claims rejected. The US Investors, on the other hand, who owned American Depositary Receipts (ADRs), were able to claim USD 125 million from the company invoking the jurisdiction of the American courts.

Section 245 appears to be an all encompassing provision enabling members, depositors or any person or association of persons, representing the persons affected by any act or omission, which is the subject matter of the complaint. In addition to circumstances where the management or conduct of the affairs of the company are being conducted in a manner prejudicial to the interests of the company, its members or depositors, the Section spells out a wide range of aspects on which such application could be filed. These include (i) restraining the company from committing an act which is ultra vires or in breach of its memorandum or articles or any law, acting contrary to a resolution passed by its members, (ii) declaration that any amendment to the memorandum or articles is void, if such resolution was passed by suppressing material facts or by misstatement to the members or depositors or restraining the company and its directors from acting on such resolution, (iii) claim damages, compensation or other suitable action against the company and its directors for any fraudulent, unlawful, or wrongful act or omission, against the auditor and audit firm of the company for misleading statement or particulars made in the audit report, etc.

The benefit of an order passed under this provision is available to all the members and depositors of the company, regardless of whether they filed the complaint or not. Similarly, it is binding on the company, its auditor, audit firm, experts, consultants, advisors and any other persons concerned with the company. If any company fails to adhere to such orders, the Tribunal can impose a fine.

Evidently, an effort has been made in structuring the jurisdiction of the Tribunal and the reliefs that can be granted in a manner that it is not restricted to the areas of "oppression" or "mismanagement". In fact, under the provisions of the CA 2013, even a single act which is sought to be undertaken in violation of law or the articles of the company or a resolution of the members could be taken to the Tribunal for relief.

It is noteworthy that, even a claim for damages or compensation can be now be made within the fold of the 'Class Action' contemplated. Such a claim can be maintained, not just against the company but also against the directors, professional advisors/ experts engaged by the company, which earlier would have been restricted by the principles of privity.

This has the potential of having a very significant impact on the governance of the company since the professionals engaged would now come to realize that it is not just the management of the company that they are answerable to, but they are, indeed, accountable to the members and depositors of the company. The immunity that could hitherto be extended by the management to these professionals by insulating them from the members and depositors, has, by these provisions, been lifted. Devoid of such protection, the professionals engaged by the company would be faced with action by members and depositors for incorrect or misleading advice. It is expected that the fear of consequences would promote better corporate governance.

The language used for holding an auditor liable is 'improper or misleading statement' while that used for an expert / advisor / consultant is 'incorrect or misleading statement'. Clearly there has to be a difference in the standard applied for 'improper' versus the standard applied for 'incorrect', which in absence of clarity in the statute, would depend on judicial interpretation. More importantly, both of these are qualified by language which says that such improper / incorrect / misleading statement should be "for any fraudulent, unlawful or wrongful act or conduct". In other words, it is not enough that the advice itself is improper/ incorrect/ misleading, but that it would give a right to the members/ depositors to take action only when such advice is for a fraudulent, unlawful or wrongful act or conduct. The statute therefore increases the standard from a mere fact, to ascertainment of intent. This qualification therefore dilutes the principle that the professional should be answerable to the members/ depositors, by bringing in the question of 'intent'. Civil law principles of professional liability are not qualified by intent, but in this instance, an incorrect advice would not make an expert liable unless it further satisfies the intent for which such incorrect advise is rendered.

An important aspect of the class action contemplated under Section 245 is that it allows any association of persons 'representing the persons affected' to maintain an action. This therefore opens up the possibility of having Non Government Organisations, which focus on protecting interests of members and take up such actions by representing the persons affected. Such representation could go a long way in reducing the cost of litigation for the members and depositors, which is often the biggest deterrent to initiation of action in appropriate cases. A more vigilant pool of members, aided by associations could be one of the most effective tools to push companies for better corporate governance.

The class action enabled in the CA 2013, therefore, opens up a number of possibilities and, most importantly, has the potential of unlocking the potential of vigilant members and depositors in giving an impetuous to better corporate governance. The formation of associations to support such members, would come with time as the jurisprudence on these aspects grow. The beginning, of course would require that Section 245 of the CA 2013 is brought into effect.

This increased scope of grievance redressal could easily be a tool in the hands of PE and other investors, to ensure better enforceability of individual breaches of the articles of association. Under the CA 1956, an individual breach of the articles may have required invocation of the arbitration provisions since the scope of the CLB for oppression and mismanagement would require a series of such actions. The investors should however be conscious of the ability of the other shareholders to also take up such action, which, on occasions, may have the ability to hinder commercial interests. It would thus be in the interests of the entire community of shareholders, including the investors, to consciously promote a regime of better governance and compliance to prevent disruptions.

Bridging the Warranties Gap

Warranty Gaps and Indemnity

The primary protection for a buyer of any business is the scope and quality of warranties and indemnities provided by a seller. From a buyer's perspective, the sale of shares of the company in question (**Target**) by a private equity (**PE**) investor is no exception, particularly where one or more PE investors are selling a majority stake (the promoter holding only a minority shareholding in the Target). Indeed, a buyer would normally expect to receive business warranties, not only for the period that the selling PE investor held shares in the Target, but also for historical periods. However, PE investors are usually reluctant to provide business warranties, since they are generally not involved in the day-to-day operations of portfolio companies. The warranties offered by PE investors are typically limited to fundamental matters, such as those relating to ownership of their stake and the authority to sell. Hence, unless the promoter (if any) of the Target is willing to provide business warranties, the buyer is effectively exposed to post-closing value erosion, leaving such buyer with a warranty gap in the PE exit.

As regards buy-sell transactions involving Indian companies, if the seller is domiciled outside India (for instance, in Mauritius), the buyer may also be exposed to a potential 'withholding tax' liability. Under Indian tax laws, if the sale of shares results in a gain for the seller, such sale is subject to capital gains tax. Normally, the liability to pay such tax is that of the seller. However, where the sale is made by a seller resident outside India, the burden of withholding and paying such taxes is on the buyer. Any failure to deduct and pay such taxes could result in the imposition of interest and penalties, of up to three times the amount involved, in addition to the recovery of the tax payable – clearly an expensive proposition for the buyer.

In the case of Mauritius, the sale of shares of an Indian company by a seller domiciled in Mauritius is not subject to capital gains under the double taxation avoidance treaty between India and Mauritius. India has also executed similar double taxation avoidance treaties with a number of other countries. There have been instances where the availability of benefit under double taxation avoidance treaties has been sought to be denied by the Indian tax authorities on grounds, among others, that the seller lacks substance or is, in effect, being managed from outside the country of its incorporation. As the buyer is primarily responsible for withholding and depositing such tax, it is common for buyers to seek comprehensive tax related representations and withholding tax indemnities from the seller. Given that most of the PE funds have structured their investments into India through Mauritius or other tax friendly jurisdictions, withholding tax related provisions are often the most negotiated provisions in a PE exit.

To compound matters, PE funds have a limited life cycle and investments in portfolio companies are often structured through special purpose vehicles (**SPVs**) for tax and other reasons. Given the uncertainty surrounding the long term existence of PE funds and the creditworthiness of such SPVs, reliance on indemnities as the only recovery option is risky for a buyer.

Finding the Middle Ground

Compromise solutions to close the warranty gap and make provision for the withholding tax indemnity include procuring parent fund guarantees and holding a portion of the sale proceeds in escrow. Where the buyer is resident in India, holdbacks and escrow of sale proceeds owed to a non-resident seller require approval of the Reserve Bank of India under Indian exchange control regulations, which could potentially delay the transaction. Further, these solutions are not ideal for either party to the transaction. The goal for a selling PE investor is to provide maximum returns on investments made, which is primarily dependent on a successful and clean exit. Parent fund guarantees and holdbacks involve recognizing contingent liabilities and restricting distribution of the entire amount of the sale proceeds to the investors in the PE fund. For the buyer, such post-closing contingencies may increase the cost of the transaction and may become a deal breaker, especially in an auction process.

Is Insurance a Solution?

To bridge the warranty gap and provide for withholding tax indemnity, buyers and sellers often use transaction risk insurance as a deal protection tool. Broadly speaking, this works like any other insurance, where the insured party pays a premium to an insurer, who agrees to cover a defined amount of losses resulting from claims under the warranties or withholding tax indemnities.

There are two kinds of warranty and indemnity insurance (**WI Insurance**) - a buy-side policy and a sell-side policy. A buy-side policy is a policy where the insurer pays the buyer directly for losses arising out of a breach of warranty. Such policies are usually structured as 'top-up policies', which supplement the seller's indemnification by extending the time limitation and/or aggregate liability caps under the transaction documents, or 'parallel policies', where the buyer can claim against the insurer, as the sole recourse. Sell-side policies allow the seller to recover from the insurer, amounts that are paid or required to be paid to the buyer for breach of seller's warranties.

While the terms of each policy are a matter of negotiation between the insurer and the insured, usually the parties aim for policy coverage to match the scope of warranties and indemnities in the transaction documents. Insurers also insist on the retention of an amount (usually 1%-2% of the deal value) for which the insured is at risk, before the policy can be invoked. This 'skin-in-the-game' approach ensures that the seller runs a proper disclosure process and the buyer undertakes a comprehensive due diligence.

It is important to note that a standard policy customarily excludes from the insurer's liability any losses arising out of matters of which the insured has actual knowledge before the date of the policy; fraud on the part of the insured (except buy-side policies, which provide cover for fraud by the seller); environmental contamination warranties;

money laundering, bribery and corruption liabilities; criminal penalties and punitive damages; forward looking or speculative warranties; certain tax penalties; deficiencies in pension schemes and post-close consideration adjustments. Further, in a WI Insurance policy, insurance for 'known risks' or 'specific indemnities' is ordinarily not available, but can be negotiated with the insurer on a case-by-case basis.

WI Insurance can help address the warranty gap, however, it does not typically include within its cover, any taxes payable in relation to the sale transaction. As a standard practice, WI Insurance policies contain explicit exclusions for such taxes. Consequently, the buyer continues to remain exposed to withholding tax related risks. To address this, insurers offer bespoke policies which provide a cover for any withholding tax liability that the buyer may be exposed to on account of a successful claim by the tax authorities that the benefit of capital gains tax exemption under the relevant double taxation avoidance treaty is not available to the sale transaction (**Withholding Tax Insurance**). Such policies additionally cover defence costs in connection with contesting a demand for tax and any interest or penalties that may be imposed.

Insurance has now become an industry standard in markets, such as Europe, the United States and Australia, where insurance companies offer a variety of products that not only bridge the warranty gap between the seller and buyer, but also facilitate cleaner exits by PE investors by reducing the residual seller liability.

India is considered to be a high risk jurisdiction and, therefore, fewer insurers have the appetite to provide WI Insurance and more particularly Withholding Tax Insurance for transactions involving an Indian Target. Certain sectors are considered to be more 'high risk' than others, e.g. telecom, financial services and infrastructure. As a result, the premium levels are relatively high, i.e., 2% to 2.5% of the insured limit (reduced from the historical levels of 3% to 3.5%) for WI Insurance policies and about 4-5% for Withholding Tax Insurance policies. As the WI Insurance and Withholding Tax Insurance business grows, the premium levels are expected to reduce further. As a trend, the use of insurance has steadily increased in the recent past, particularly in deals involving PE exits and for covering risks related to withholding tax liability.

In conclusion, insurance does appear to be a viable solution to address the warranty gap between the buyer desiring comprehensive representations and warranties and the seller unwilling or unable to provide the same, as well as to fulfill the withholding tax indemnity obligation. The nature of such insurance is flexible enough to be tailored to the specific requirements of each transaction. Moreover, in the context of PE and M&A transactions, indemnity rights have rarely been enforced due to the reputation of the Indian judiciary of being slow in resolving disputes, with the dispute process at times spilling over several years. Insurance can be seen as a more expedient mechanism for the buyer to obtain compensation. Be that as it may, the transactional risk insurance market in India is still nascent, and largely untested. Thus, it would be prudent to examine its growth and maturity, including in respect of the claims that are actually made and honoured or dismissed, to understand the practical advantages and limitations of such insurance in providing the protections sought by the insured.

Consolidation in the E-commerce Space

India witnessed a significant increase in private equity (**PE**) investments in the year 2015-16 with a record total deal value of USD 19.5 billion. The contribution of the e-commerce segment has been a sizeable USD 5.4 billion, accounting for almost 28% of the total PE investments in 2015. A large part of this PE investment boom has been on account of the success of consumer focused online start-up companies including e-tailers, online travel companies, app-based taxi services and online food delivery applications. The entrepreneurial zeal of start-up founders, riding high on the burgeoning Indian e-commerce wave, has provided significant potential for high valuations in a short lifetime and been an important driving force in attracting volumes of PE investment.

Consolidation Phase: Factors and Trends

While a vast majority of PE investment is taking place in growth stage targets, an emerging trend in the e-commerce sector is consolidation through heightened mergers and acquisitions (**M&A**) leading to horizontal and vertical integration. Such activity is largely being driven by PE investors in both acquiring as well as target companies to ensure better capital efficiency and lucrative future exits.

As start-ups struggle to raise additional funding from non-institutional sources when capital becomes scarce PE investment provides much needed capital, apart from bringing in valuable experience and a network of relationships. From the viewpoint of a PE investor in the acquiring company, consolidation is valuable to aid future value creation at the time of exit. Similarly, from the point of view of the PE investor in the target company, consolidation is welcome since it would provide them with an option to exit the company or continue to retain stake in the acquiring entity, which in many cases could be a more viable option. Some key deals include the acquisition of Myntra by Flipkart, Ibibo group's acquisition of redbus.in, Ola Cab's acquisition of TaxiForSure, Grofer's acquisition of Mygreenbox, CarTrade's acquisition of CarWale and Oyo Rooms' acquisition of Zo Rooms.

With several "me too" competitors in the market offering similar products and high cash burn rates caused by aggressive pricing, deep discounts, cash backs, free delivery and high commissions to vendors in a race for customer acquisition, horizontal consolidation would eliminate competition thereby increasing profitability. This is particularly important since a significant number of e-commerce companies continue

1 PricewaterhouseCoopers India Private Limited, *MoneyTree™* India Report (Q4 2015), available at https://www.pwc.in/assets/pdfs/publications/2016/moneytree-india-report-q4-2015.pdf (Last accessed on March 26, 2016).

to operate in losses as the focus of the founders remains on aggressive customer acquisition. A high cash burn rate also directly affects the longetivity of start-ups, forcing these companies to sell, downsize, or shut shop, thereby making them viable targets for consolidation. With PE investors forcing the entrepreneurs to look at sustainable growth, customer retention and profitability, horizontal consolidation is being looked at as a key way to reduce competition and for more effective deployment of capital. PE investors are increasingly developing and implementing value creation plans with portfolio e-commerce companies to ensure maximum return on their future exits. PE investors also continue to increase the exit value of their portfolio with add-on acquisitions of other portfolio companies. Another common trend given the high cash burn rate, is for a group of PE investors to create strategic alliances to jointly invest in targets to combine greater financial strength and industry knowledge. Consolidation through vertical integration on the other hand is viewed as a means of achieving profitability by building capacity especially by acquiring vertical players such as e-payment service providers, m-commerce services providers and logistics service providers which would enhance customer experience and satisfaction, build economies of scale and reduce overall costs. Notable deals include Snapdeal's acquisition of mobile commerce platform Freecharge and mobility solution company LetsGoMo Labs, Zomato's acquisition of NexTable and Maple Graph and Quickr's acquisition of CommonFloor.

Another factor enabling consolidation is the entrepreneurial nature of the young founders of start-ups with a healthy risk appetite and willingness to sell their business to a bigger brand and move on to build other businesses, in contrast to traditional family-owned businesses unwilling to give up controlling interest. Interestingly, while founders may choose to continue to remain in the consolidated entity, their integration poses its own challenges including incompatible expectations or cultural differences. There have been recent examples in India of founders of high profile e-commerce companies who initially elected to remain with the combined entity, but eventually made on exit to start a new business.

Consolidation Challenges

Whilst consolidation poses fewer challenges when the PE investors in the target and acquirer are common, e.g. Flipkart acquired Letsbuy which had common PE investors i.e. Tiger Global and Accel Partners, consolidation could lead to multiple challenges when the PE investors on both sides are different. In these cases, the PE investors in the target entity have to first decide whether they should exit or continue to stay invested in the consolidated entity. The PE investors who choose to stay invested aim to ensure that their investment is not affected by the consolidation and they get the same rights as the PE investors of the acquirer. However, the PE investors of the acquirer often demand to be most favoured investors with greater rights than the existing PE investors of the target company. This divergence in the positions also makes transaction structuring extremely crucial, as it is the determining factor on whether whether integration takes place harmoniously, without conflict and deadlock between various PE investors. An equally relevant aspect that comes into play is the role of the founders of the acquired entity in the consolidated entity. While in some cases, the founders are given charge of operating the acquired business in the combined entity, in other cases the founders may negotiate a transitional role, after which they are considered as passive financial investors in the acquirer.

With the PE investors of the target remaining on board and new PE investors of the acquiring company garnering stake in the target, the inter-se rights between both sets of PE investors are affected. Negotiations on the structuring in such transactions focus on two things; firstly, the manner of investment (i.e. the type of instrument to be issued) and consideration for the consolidation and secondly, the inter-se rights between between both sets of investors including extent of controlling interest over the business and management of the consolidated entity, the ranking of the investors (i.e. whether the new PE entrant would be treated at par with the existing ones or whether the existing PE investors would continue to be the most favoured investors), nature of affirmative voting rights, transfer restrictions, exit rights and valuation, anti-dilution rights and liquidation preference. Another relevant factor is the relative valuations of the acquirer and target entities, which would impact the stake that the investors of the target would hold in the acquirer. In situations where there is a significant difference between the valuations of the two entities, the stake issued to investors of the target could be relatively small, and sometimes below the agreed thresholds for certain rights being available to investors in the acquirer.

Regulatory developments in FDI impacting consolidation

Historically, a significant portion of PE investment in Indian companies has been through foreign PE funds. Foreign direct investment (**FDI**) was permitted only in e-commerce companies engaged in business-to-business (**B2B**) activities and not in e-commerce companies engaged in business-to-consumer (**B2C**) activities. This lead to the establishment of various innovative structures to facilitate FDI in this sector, one of the most popular being the market-place model in which an e-commerce entity acts as a facilitator of trade between the consumer and the seller of the goods by providing an online platform for the sales to take place.

On account of various foreign investment related interpretation issues questioning the structuring of various e-commerce companies including recent litigations filed by retail associations that were impacted significantly by e-commerce sales and discounts, the Government recognised the need for clarity in foreign investment laws. In November 2015, single brand retail entities operating through brick and mortar stores were permitted to undertake single brand retail trading through e-commerce as well on the fulfillment of various conditions. Further, on March 29, 2016, the Government issued guidelines for FDI in the e-commerce sector and clarified that 100% FDI under the automatic route is permitted in the market place model of e-commerce (in which and e-commerce entity provides an IT platform, on a digital and electronic network, to act as a facilitator between the buyer and seller) and is prohibited in the inventory based model of e-commerce (where inventory of goods and services are owned by the e-commerce entity and are sold to the consumers directly). While these clarification come as a welcome change, the clarification on permissibility of FDI in the market sure place model of e-commerce has come with some strict conditions, including the requirement that an e-commerce entity carrying on business on the marketplace model will not be permitted to effect more than 25% of the total sales effected through its marketplace from one vendor or their group companies. Further, e-commerce entities providing market place are restricted from directly or indirectly influencing the price of sale of goods or services, to maintain a level playing field.

Another relaxation in the FDI policy that will aid consolidation is the permissibility of swaps under the automatic route. Previously, any FDI by way of swap of shares required prior approval of the Foreign Investment Promotion Board. In November 2015, the Government permitted investment by way of swap of shares without such approval, provided, inter alia, that the target companies are in the automatic sector. This relaxation opens up structuring possibilities for consolidation of companies where foreign investors have invested in the consolidating entities and wish to swap their investment in one entity for another.

However, competition law aspects continue being a key consideration while evaluating M&A transactions for consolidation. In this regard, the re-issuance of the target exemption in March 2016 with enhanced thresholds (which is valid for a period of 5 years) is likely to be supportive of consolidation transactions.

Conclusion

The environment for PE investments, in the e-commerece space despite high valuations, remains largely optimistic and consolidation of the e-commerce space is expected to continue with the shift in the focus of the PE investors (on the acquirers side) from valuations to profitability and capacity building and a wait and watch approach to exits of the PE investors (on the target side). In the consolidation phase, PE investors would need to strategise and strengthen their investments by facilitating and ensuring that the investee companies undertake acquisitions in the vertical and horizontal sphere to enhance growth and provide strategic profitable exits. While the recent amendments to the FDI Policy on e-commerce have legitimised the market place model of e-commerce, the realistic impact of the restrictions set forth in the March 29, 2016 guidelines on investment and consolidation in the e-commerce sector remains to be seen.

Go to market – the IPO Exit Scenario

"There is a tide in the affairs of men
Which, taken at the flood, leads on to fortune"
-Julius Caesar, Act 4, Scene 3, 218-219

As per the PwC MoneyTree™ India Report – Q4 '15, the calendar year 2015 was the 'best ever' for private equity (PE) investors in India, both in terms of investments as well as exits. It witnessed exits aggregating to USD 8.7 billion in 230 deals, which was twice the amount during the previous calendar year, and over 50% higher than the amount in 2010 – the best exit year for PE investors until 2015.

Whilst these figures are a good portent after the sustained lull that has impacted capital raising in India since the global economic crisis, a few scratches on the surface reveal that there is significant ground to be covered. For instance, PE investors invested over USD 103 billion into the Indian economy between 2001 and 2014 in over 3,100 companies spread across a variety of sectors. However, of the approximate USD 51 billion invested between 2000 to 2008, only about USD 16 billion has seen exits so far, at a value of USD 27 billion.[1]

Exiting investments and realizing returns has been difficult across most sectors, with real estate and telecommunications being the worst hit.[2] Therefore, while PE firms held investments in India for an average of 3.1 years between 2001 and 2007, the average holding period for exited investments increased to 5.7 years by 2013.[3] An offshoot of the unfavourable capital raising conditions during this period was also the diminished significance of IPOs as a means of exit, in spite of public offerings traditionally being a preferred exit method for PE investors. This is evidenced from the fact that of the 37 IPOs in 2008 and 17 IPOs in 2009, only two IPOs each year involved PE exits.

In sharp contrast, the last two years have witnessed a resurgence of IPOs as a preferred mode of exit. For instance, between January 2015 and March 2016, out of a total 27 completed IPOs, there have been 15 IPOs involving PE exits. And going forward, with the improving macroeconomic environment, a pro-reform government, positive market sentiment and an ever increasing number of PE-backed companies waiting in the pipelines to go public (by some estimates, the number is as high as 2000),[4] IPOs as a mode of exit are likely to regain the favor of the PE investor community.

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1 Indian Private Equity: Route to Resurgence, McKinsey & Company, June 2015
2 Indian Private Equity: Route to Resurgence, McKinsey & Company, June 2015
3 Indian Private Equity: Route to Resurgence, McKinsey & Company, June 2015
4 Anand Adhikari & Mahesh Nayak, 'Stuck in a maze', Business Today, October 25, 2015

As such, it is imperative to discuss some of the key regulatory and procedural considerations that PE investors face while making an exit through the IPO route, and some recent trends with regard to these issues.

Key considerations

Unlike other exit options such as strategic sale, secondary sale and buyback, an IPO marks a radical shift in the corporate lifecycle of the investee company, and consequently, the dynamics of the relationship between the PE investor and the investee company. While taking a decision of exiting through the IPO route, a PE investor has to take into consideration a number of factors, such as the consequences of being classified as promoter, pricing protection and achieving desired valuations, assuredness of the IPO process, and also, liability under the IPO process, including that of the PE investor's nominee directors.

Classification as 'promoters'

As holders of a substantial stake in the pre-IPO share capital of the company, and as participants in the management process of the company (albeit through a typical laundry list of affirmative matters), whether PE investors may get classified as 'promoters' of the company is one of the key issues for consideration.

Historically, there has been no bright line test to determine the nature of rights, or the shareholding which would determine whether a PE investor was in fact 'in control'. In the absence of any such objective criteria for determination, 'control' may be imputed to PE investors depending on the extent of their shareholding along with their ability to influence decision making in the company, including if the board of directors is 'accustomed to act' on the advice of the PE investor. In the mind of the regulator, there are only three kinds of shareholders in a company- promoter, promoter group (includes persons acting in concert) and public. Therefore, the extent of a PE investor's shareholding and the termination of affirmative and other rights in a typical shareholders agreement are key determining factors towards categorizing the PE investor as forming part of the public shareholding, notwithstanding any provisions of the shareholders documentation which explicitly provide that such PE investor will not be categorized as a 'promoter'.

Being designated as promoters carries with it the civil and criminal liability for misstatements in the prospectus, substantial disclosures in the IPO offer documents, compulsory lock-in of their shareholding and most importantly, the tag of being promoters for the life of the company (or until depromoterization under the provisions of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015) and consequently all liabilities associated with that fact.

Given the number of representations, informal guidance, and pre-consultations with SEBI on this issue and the issue of 'control' being ultimately undecided in the Subhkam case, SEBI has recently released a discussion paper on 'Brightline Tests for Acquisition of Control under SEBI Takeover Regulations'. It has invited comments from the public on the discussion paper, in which the need for brightlines on control has been discussed given the historical perspective of the legislation on the definition of 'control' and the international scenario. SEBI has proposed two options for the bright line test: first, a list of protective rights which would not amount to exercise of 'control' either individually or collectively; and second, a numerical threshold of 25% of voting rights of a company.

Practically, while a determination is required in each transaction, as a general rule, it would be fair to conclude that so long as a natural promoter of an investee company is identified, a termination of the investment agreement and the rights under such agreement is effected upon listing, and the post-IPO shareholding of PE investors is in the minority, they should not be categorized as promoters.

Fall away of rights and conversion of convertible securities

Commercial considerations typically dictate whether a PE investor sells its entire shareholding or a part of it in the investee company as part of an IPO. PE investors (especially those who are subject to the mandatory one year lock-in) who continue to hold a substantial holding post-IPO, would typically like to continue to enjoy certain rights enshrined in the shareholders agreement post listing. Under the current regulatory view, all rights held by PE investors are required to fall away upon listing, irrespective of their post-IPO shareholding in the investee company. The jurisprudence flows from the rationale that all public shareholders should be pari passu to each other, and hence all forms of special or minority protection rights are disallowed. A termination of rights could also impact the effectiveness of a typical upside sharing clause, potentially prejudicing Indian promoters who have created value for the company and its stakeholders. While the recent SEBI discussion paper also refers to the suspension of all rights under such agreements in case of IPOs, it does envisage these rights getting reinstated after the IPO if approval of all shareholders is obtained.

In practice, there are a few stray examples where IPOs have been completed with certain rights of the PE investors having survived listing such as nominee board seat or certain information rights or transfer restrictions, but such examples are few and far between. The preponderant view is clearly to the contrary, with SEBI having issued a number of observations as well seeking and ensuring that no shareholder has any form of preferential right. In terms of mechanics, this falling away of rights is facilitated either through termination provisions built into the investment agreement, or through a termination agreement executed prior to filing of the draft offer document with SEBI.

SEBI regulations also mandate that the company proposing an IPO should not have any outstanding convertible securities or any other right which would entitle any person with an option to receive any equity shares. Because there are certain advantages of holding convertible securities over equity shares, the mandatory conversion of convertibles prior to filing of the draft offer documents is not always in the best interests of the PE investor. Investors are likely to be concerned that the abandonment or postponing of the IPO process may result in the premature surrender of preferential rights or the conversion of convertible instruments by the PE investor. SEBI regulations, in recognition, permit such conversion as late as the filing of the red herring prospectus.

Further, the SEBI regulations prescribe that equity shares forming part of the offer for sale component of an IPO should have been held for a period of at least one year prior to the draft offer document with SEBI, (or in case of equity shares received on conversion of convertible securities the holding period of the underlying convertible securities should be greater than one year and similarly for bonus shares), and consequently, a PE investor holding preference shares will be required to convert that portion of shares that it is offering as part of the offer for sale prior to the filing of the draft red herring prospectus with SEBI. A recent view emerging, though untested as yet, is that even the shares being proposed to be offered for sale are only required to be converted along with the other convertible securities at the time of the filing of the red herring prospectus.

Pricing protection

Investment agreements often provide for a valuation benchmark for conversion of convertible securities, and an IPO, including an internal rate of return that the PE investor hopes to make at the end of the investment period. An IPO, unlike other exit options, is a regulated process, and notwithstanding the provisions relating to internal rate of return or conversion valuation or IPO valuation, the valuation of an IPO is dependant on market conditions, SEBI regulations which require the price band and issue price to be determined by the company (and selling shareholders) in consultation with the lead merchant banker. Therefore, irrespective of any contractual arrangements, the price discovery in an IPO, which is typically undertaken through the book-building process, is sacrosanct. SEBI has in the past issued observations as well specifically prohibiting investors from enforcing their pricing protection under an investment agreement on an IPO process.

Conversion of securities also occurs at an assumed valuation prior to the filing of the RHP, when neither the price band nor the issue price is known. Company and investors try and align the potential price band to the valuation benchmarks set out in the investment agreement, as a commercial solution to a legal impediment, though there is no guarantee that the final price will be at or above the preferred valuation. Practically, PE investors seek representation on the IPO committee which is constituted for determining key IPO related parameters such as timing, pricing and other procedural matters.

Offer Expenses and Taxation

In terms of the Companies Act, selling shareholders are required to 'reimburse the company all expenses incurred by it in this matter'. Legally the position is unambiguous, which is supported by the provisions of the old Companies Act, which prohibited a company from directly or indirectly financing the purchase of its own shares. The logical conclusion was that all expenses in relation to an IPO were to be shared by the company and selling shareholders in proportion to the fresh issue and the offer sale. Historically, prior to the promulgation of the new Companies Act, in all the IPOs, all expenses except listing fees have been shared between the company and its selling shareholders (in case of fresh issue plus offer for sale). The introduction of specific language in the new Companies Act, has led to a 'penny-wise--pound foolish' approach to start splitting expenses into those attributable to the company and selling shareholders, and effectively loading the costs onto the Company. A survey of 47 draft red herring prospectuses filed between April 2014 and February 2016 indicate that a significant majority of the transactions have been completed on a 'true' sharing and reimbursement basis. The errant practice has also led to SEBI issuing specific observations in recent transactions requesting merchant bankers to confirm that all expenses in relation to the IPO have been shared proportionately between the company and the selling shareholders, and in some cases has clearly specified that all expenses are not to be borne by the company. Violation of the above provisions of the Companies Act carries both civil and criminal liabilities.

As far as the tax implications of the sale of shares in an IPO are concerned, sale would enjoy the benefit of the securities transaction tax ("**STT**") regime (currently, payable at the rate of 0.2 per cent), where the payment of STT on shares held for over 36 months exempts payment of long term capital gains tax on the sale of shares. For shares which have been held for less than 36 months, short term capital gains tax at the rate of 15% shall be payable. PE investors who typically invest through a tax efficient jurisdiction, however, should review the relevant double taxation avoidance regimes to determine their tax liability for participating in an IPO.

Classification as 'group companies'

On account of a recent change in the definition of 'group company' under the SEBI regulations, PE Investors run the risk of getting classified as group companies in the offer document, as a result of 'significant influence' (as defined in Accounting Standard 18) that they exercise on portfolio companies. Further, entities related to the PE investor may have other transactions with the company (often, a corollary of the investment agreement), as a result of which such entities could be included in the list of related parties. Identification as a group company entails, inter alia, disclosures and confirmations with respect to the group company's litigation, corporate information and financial information. This classification of group companies could also lead to a single PE investor getting classified as a 'group company' for multiple portfolio companies.

Insider Trading

A PE investor's involvement in the day-to-day management of the company is largely through its nominee director appointed on the board of the company. In the absence of a nominee director, the PE investor typically ensures that arrangements are put in place for the periodic sharing of information from the company to the PE investor. This information, which comprises financial and operational data of the company, is likely to get covered within the purview of 'unpublished price sensitive information', and assumes all the more importance in the scenario of the company intending to go public. As 'insiders', therefore, PE investors should ensure that the flow of information is managed in a manner that possible insider trading related questions are avoided.

Due Diligence and Disclosures

The disclosure standards in India for offer documents are substantially at par with other securities markets in the world, with certain additional requirements. To ensure that an offer document is true, adequate and accurate in all material respects, a typical due diligence exercise could stretch from eight to twelve weeks, and the entire IPO process could take months. The extent of the due diligence exercise that is typically required of the PE investors acting as selling shareholders are limited to certifications (and limited counsel opinions) and related representations and warranties in the transaction agreements on basic matters such as their ability to sell their shares and the ownership of their shareholding in the investee company. Typically, selling shareholders' liability is restricted to statements explicitly made by them or confirmed by them in the offer document.

While the SEBI Regulations, which enable PE investors to access public markets through IPOs require only two details to be disclosed – name of PE investor, and number of shares proposed to be sold, increasingly, SEBI in some recent deals has required additional details regarding the background of PE investors. The inclusion of such information would lead to an enlargement in the scope of diligence that is required to be undertaken, which goes against established market practices. In this scenario, a legal opinion from the PE investor's counsel (both Indian counsel and foreign counsel, typically Mauritius) appointed for the IPO is a must, to ensure that the legal sanctity of the PE investor's participation in the IPO process is assured. While market practice is increasingly veering towards obtaining only robust certifications in relation to PE investors, the practice of obtaining legal opinions from each selling shareholder remains the gold standard in terms of the due diligence defense available to merchant banks in relation to PE investors.

Directors Liability

Directors are required to sign the offer documents confirming that the disclosures contained in the offer documents are in accordance with applicable law, and that all disclosures are true and correct. This declaration carries with it both civil and criminal liability under the Companies Act and is enforceable by SEBI. For PE investors who do not hold a significant stake in a portfolio company post listing or those who sell their entire stake in the IPO, the general practice is for their nominee directors to resign prior to filing of the draft red herring prospectus (retaining a position on the IPO committee as an observer in order to protect their valuation and pricing). This approach also assists in directors not having to weigh conflict of interest situations of discharging their statutory and common law fiduciary obligations to all stakeholders of a listed company, and of representing the interests of their PE fund. Nominee directors continuing on the boards and committees of portfolio companies should be well versed with the new, technical and often procedural provisions of the Companies Act, rules and secretarial standards where compliance is mandatory, obligations are strict and penalties for non compliance carry a combination of criminal and civil liabilities depending on the nature and severity of non-compliance.

Conclusion

In the Bain-IVCA Private Equity Survey 2015, over 60% of the general partners surveyed pointed to IPOs as the most common exit route in the next one to three years, up from about 40% in the previous year. While the IPO activity has picked up considerably in the last one year, the number of prospective deals in the pipeline seem to suggest that this is just the tip of the iceberg. In this scenario, a thorough understanding of the legal intricacies and nuances discussed here would make the IPO process efficient and meaningful.

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Offices of Cyril Amarchand Mangaldas

MUMBAI
Peninsula Chambers,
Peninsula Corporate Park, GK Marg,
Lower Parel, Mumbai - 400 013, India
Tel: +91 22 2496 4455
Fax: +91 22 2496 3666
Email: cam.mumbai@cyrilshroff.com

3rd Floor, Lentin Chambers,
Dalal Street, Fort, Mumbai - 400 001, India
Tel: +91 22 2265 0500
Fax: +91 22 2265 9811
Email: cam.mumbai@cyrilshroff.com

NEW DELHI
4th Floor, Religare Building,
D-3, District Centre, Saket,
New Delhi - 110 017, India
Tel: +91 11 6622 9000
Fax: +91 11 6622 9009
Email: cam.delhi@cyrilshroff.com

BENGALURU
201, Midford House,
Off. M. G. Road, Bengaluru - 560 001, India
Tel: +91 80 2558 4870
Fax: +91 80 2558 4266
Email: cam.bengaluru@cyrilshroff.com

HYDERABAD
8-2-622/5/A, 3rd Floor, Indira Chambers,
Road No. 10, Banjara Hills,
Hyderabad - 500 034, Telangana, India
Tel: +91 40 6730 6000
Fax: +91 40 6730 6002
Email: cam.hyderabad@cyrilshroff.com

CHENNAI
2nd Floor, ASV Chamiers Square,
87/48, Chamiers Road, R. A. Puram,
Chennai - 600 028, India
Tel: +91 44 6668 4455
Fax: +91 44 6608 3490
Email: cam.chennai@cyrilshroff.com

AHMEDABAD
1304/1305, Shapath-V,
Opp. Karnavati Club, S. G. Road,
Ahmedabad - 380 051, India
Email: cam.ahmedabad@cyrilshroff.com

cyril amarchand mangaldas
advocates & solicitors

Offices: Mumbai • New Delhi • Bengaluru • Hyderabad • Chennai • Ahmedabad