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The International Comparative Legal Guide to:

# Private Equity 2017

**3rd Edition**

A practical cross-border insight into private equity

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Chapter 17

# India


Vineetha M.G.

Samvād: Partners

Ashwini Vittalachar


## 1 Overview

### 1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

In 2016, private equity ("**PE**") transactions in India amounted to approximately USD 16.3 billion across 652 deals. Last year, the investment was dominated in the information technology ("**IT**") and IT-enabled services ("**ITeS**") sector, as compared to the e-commerce sector. There were also a number of investments in the banking, financial services and insurance sector. Acquisitions continued to be the popular exit route for most PE firms and 2016 saw close to 200 exits worth approximately USD 7.2 billion.

While the number of PE deals was less in 2016 as compared to 2015, the "dry powder" earmarked for India is still fairly substantial; India will continue to attract significant PE investments in the coming years.

The "Digital India" programme and the ongoing efforts on: "Smart Cities"; ITeS; FinTech companies; banking and financial services, including P2P lending platforms; retail; telecom; and logistics, may provide more opportunities to investors for investment. The liberalisation of the FDI regulations in the financial services space is a step towards that direction. Health services (including diagnostics), the renewable energy sector (which has a strong focus under the "Make in India" campaign), infrastructure services, education and certain consumer derivative sectors may also attract considerable foreign investment.

The rising volume of non-performing assets in the banking system, could result in a large number of deals in the stressed assets space as well (both strategic and financial), aided by the strategic debt restructuring and the S4A norms including the bankruptcy code.

### 1.2 What are the most significant factors or developments encouraging or inhibiting private equity transactions in your jurisdiction?

The Government of India ("**GoI**") has been taking an active role in ensuring a conducive environment for entrepreneurship and investments. On the foreign investment front, the GoI has already undertaken substantive reforms in the Foreign Direct Investment ("**FDI**") policy in the last two years. More than 90% of the total FDI inflows are now through the automatic route. The recent proposal of the Finance Minister to phase out the Foreign Investment Promotion Board ("**FIPB**") is a significant move. One will need to wait and watch on this proposal, especially whether any other mechanism would effectively replace this body. These changes, along with a strong and stable political environment and economy, has encouraged PE transactions.

Taxation has been another bottleneck. The uncertainty relating to the General Anti-Avoidance Rule ("**GAAR**") is a stumbling block for the PE/venture capital ("**VC**") community. The implications of the Place of Effective Management ("**POEM**") guidelines, issued in January 2017, are also uncertain at this stage and how it plays out will have profound implications on the PE/VC players.

## 2 Structuring Matters

### 2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction? Have new structures increasingly developed (e.g. minority investments)?

Given the size of the deals, a lot of deals have been structured as co-investments between General Partners and Limited Partners. In recent times there has been a significant growth in co-investment structures. As co-investment structures offer access to funds, better assets, increased degree of control over investment portfolios and increased returns from capital, PE houses have increasingly adopted this medium of investment.

We have also seen a significant increase in control/buyout deals. PE investors are able to bring in professional management to run the business. There is also a significant change in the mindset of promoters who are more open to divesting control. The minority deals continue to exist.

PE investments are typically infused by way of a combination of equity and convertible instruments, such as convertible preference shares or convertible debentures (compulsorily convertible in case of offshore investors). The investor also typically acquires a nominal number of equity shares to exercise voting rights. The control/buyout deals are structured more as a secondary acquisition transaction.

### 2.2 What are the main drivers for these acquisition structures?

The tax regime, the foreign exchange law, antitrust laws and the sectoral guidelines play a dominant role in determining the investment/acquisition structures. Important factors such as who can be eligible investors, where and how the investing entity would be set up, the nature of the instrument being subscribed to/acquired, investment limits based on the sectoral caps, timelines for payment of consideration, feasibility of escrow arrangements are determined on the basis of these laws.

### 2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

A PE investor will generally acquire between 10%–25% of the equity share capital of the company (assuming conversion in case of convertible instrument). The controlling equity stake is held by the promoter/promoter group. In family-owned companies, equity shareholding is generally scattered across multiple family members. In such cases, the promoter group appoints a lead member to exercise rights on their behalf. Companies also implement an Employee Stock Option Plan ("**ESOP**") where key officials and employees of the company are entitled to receive equity shares based on their performance. Where the PE investor is desirous of acquiring a controlling stake, the promoters retain anywhere between 10%–25% and are entitled to an upside based on the performance of the company. In certain cases, the existing shareholders have fully exited and the PE investors have acquired 100% pursuant to a co-investment structure.

### 2.4 What are the main drivers for these equity structures?

The primary drivers for equity structures are: (i) business carried on by the target company and the restrictions imposed by law on such business (if any); (ii) foreign exchange law restrictions including sectoral caps and conditions; (iii) the target company being a private limited company or public company; (iv) approvals that may be required; (v) the sector specific guidelines and approvals; (vi) anti-trust considerations and approvals; and (vii) tax considerations.

### 2.5 In relation to management equity, what are the typical vesting and compulsory acquisition provisions?

ESOPs are the most common form of management equity incentives in a PE transaction. In light of certain restrictions on the issuance of ESOPs to promoters, it is also typical to have equity incentives structured through warrants and ratchets including phantom options. The equity would vest over a period of four to five years, with compulsory vesting under certain circumstances. If there is termination for cause, then there are mechanisms for forfeiture of these options.

### 2.6 If a private equity investor is taking a minority position, are there different structuring considerations?

Customary protection rights such as elaborate veto rights, board nominee rights, quorum rights, information rights, exit rights, tag along rights, (as elucidated in Section 3 below), accelerated drag, to name a few, play a key role in ensuring that the PE fund's governance and management rights are protected notwithstanding the minority role. Sometimes, PEs also prefer acquiring between 10%–25% in the company to enjoy the benefit of certain statutory protections as discussed in the response to question 3.4 below.

## 3 Governance Matters

### 3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

Shareholders' agreements govern the rights and obligations of the shareholders. Among other things, the agreement sets out the rights of the shareholders and provides for the manner of conduct of the business, governance, share transfer rights and restrictions. Typical governance arrangements in such agreements include:

- <u>Appointment of the nominee director on the board</u>: PE investors typically have one or more representatives on the board depending on the stake held in the portfolio company, with his/her presence being mandatory for the purposes of quorum. Similarly, decisions as regards certain identified matters require the prior consent of the investor. Given the codification of director obligations under the Indian corporate laws, many PE investors prefer to exercise their veto rights by way of a shareholder consent/investor consent, rather than through a nominee director. PE investors also seek a board observer to be appointed to track the progress of the business, as opposed to insisting on a nominee director.
- <u>Anti-dilution protection</u>: To prevent value depletion, PE funds seek anti-dilution protection. Any dilutive round would entitle a PE fund to exercise anti-dilution rights, either on a weighted average basis or on a full ratchet basis, depending on the agreed position.
- <u>Transfer restrictions on securities and exit mechanism</u>: Since PE investors are not in charge of the company's day-to-day management, a PE fund relies substantially on the capabilities of the promoter to run the business. Therefore, lock-in obligations are imposed on the promoters. Common forms of share transfer restrictions applicable to promoters (and at times, other significant shareholders), are lock-in, right of first refusal or offer, drag-along rights and tag-along rights. Exit mechanisms are usually negotiated upfront at the time of investment, and details of the same are set forth in the transaction documents.

The company is also made a party to such agreements so as to make it binding on the company. In addition to the shareholders' agreement, the articles of association ("**AoA**") are the bye-laws of the company and sets forth the governance rights and share transfer mechanisms. Non-conformance to the AoA would render the action *ultra vires*, and will not be enforceable. Hence the provisions of the shareholders' agreement are included in the AoA for better protection of a PE investor's rights. It is a statutory mandate to file the AoA with the jurisdictional registrar of companies. To that extent, the provisions of the shareholders' agreement become publicly available.

In the case of listed entities, the acquisition of some of these rights could also trigger an open offer and these rights are required to be disclosed in the open offer documents.

### 3.2 Do private equity investors and/or their director nominees typically enjoy significant veto rights over major corporate actions (such as acquisitions and disposals, litigation, indebtedness, changing the nature of the business, business plans and strategy, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

Yes. Veto rights are extended to PE investors on matters concerning the target entity's business and operations, such as acquisitions, disposals, litigation, indebtedness, changing the nature of the business, business plans and strategy.

In case of a minority stake investment, the scope of veto rights gets broadened to include other operational aspects of the business, such as changing the name of the business, opening of branch offices, termination of key employees, grant of and amendments to any equity incentives (especially for key employees), and related party transactions. These veto rights are exercised either by the investor or its nominee director. Although, given the codification of director obligations under the Indian corporate laws, many PE investors prefer to exercise their veto rights by way of a shareholder consent/ investor consent, rather than through a nominee director.

### 3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

There are no limitations on the effectiveness of veto arrangements at shareholder level. Since a director of a company is required to discharge fiduciary obligations towards the company, which may not always be aligned with the interest of the nominating PE investor, arguably, there could be some limitation around the effectiveness of a veto arrangement at the nominee director level. This is typically addressed by ensuring that the veto rights are also available at the shareholder level. In certain cases, such veto rights are exercised by way of investor consent even prior to the matter being taken up at the board/shareholder level.

### 3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

There are no statutory duties owed by PE investors towards management shareholders. However, if a PE investor holds a majority stake in the company, it is important that the investor does not act in an unfair, fraudulent or oppressive manner against the interest of any minority shareholders (including management shareholders, if applicable). A shareholder must have at least 10% in the company so as to be considered as a minority shareholder for the purposes of enforcing such protective rights. Some of the protections granted to minority shareholders are:

- Right to file an application with the jurisdictional court, in the event the affairs of the company are being conducted in a manner prejudicial to the interest of the company or its members, especially the minority shareholder in question.
- In a listed company, minority shareholders can appoint a director for special representation.
- Consent rights with respect to merger and amalgamations.
- Right to file an application with the tribunal (class action suit) against the company, directors, auditors in the event the affairs of the company are being conducted in a manner prejudicial to the interest of the company, its members or depositors.

Since most PE transactions in India are structured as a minority stake investment, and since the control of management is seldom overtaken by the PE investor in question, typically these issues are not predominant in the normal course of business. However, it is possible for a promoter holding a minority stake, to allege oppression in the event of the exercise of control rights by a PE investor.

### 3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

There are no restrictions generally on the enforceability of shareholder agreements. Previously, there were enforceability concerns around option contracts and transfer restrictions in public companies. However, with the recent changes in Indian laws (namely, the Companies Act, 2013, the foreign exchange laws and Securities Contract Regulation Act, 1956), it is now possible to have such arrangements subject to certain conditions.

Incorporating the provisions of such shareholder agreements in the AoA of the company enables dual protection *vis-à-vis* enforcement, in case of a breach. It is advisable for shareholder agreements to be governed by Indian laws to enable better enforcement, as in any case, the operation of the company will need to comply with Indian laws.

A shareholders' agreement also contains restrictive covenants such as non-compete and non-solicitation restrictions and confidentiality obligations. Such restrictive covenants have limited enforceability under Indian laws. While it is possible to enforce non-competition restrictions under Indian law in the context of a sale of goodwill, such restrictions are usually not enforceable purely in the context of employment, especially post termination of such employment. It is to be noted that reasonability of a non-competition restriction does play a vital role in determining the scope and extent of its enforceability.

It is possible to enforce breach of a confidentiality obligation as well as a non-solicitation restriction.

### 3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies under corporate law and also more generally under other applicable laws (see section 10 below)?

PE investors appointing nominee directors are required to comply with the provision of the Companies Act, 2013. The Companies Act, 2013 provides for a list of disqualifications for the appointment of directors, which includes failure to procure a director identification number, a person being an undischarged insolvent, a person being convicted by a court for any offence involving moral turpitude or others, to name a few.

In India, the directors of the company are responsible for the day-to-day affairs and management of the company. They have a fiduciary duty towards the company to act in the interest of the company. The responsibility, risk and liability of any director, including a PE fund's nominee director, has gone up manifold. The Companies Act, 2013 specifically provides for the duties of a director and the consequences of a breach of such duty. Stringent penalties have been prescribed, such as a minimum fine of Rs. 25,000 and maximum fine of Rs. 25 crores, in the event of contravention of the provisions of the Companies Act, 2013. Apart from monetary penalties, certain offences even attract imprisonment. While a nominee director will hold a non-executive position on the board, he nonetheless must discharge and fulfil his fiduciary obligations. These fiduciary obligations are now prescribed under the statute, and are no longer common law requirements.

Consequently, if such a nominee director becomes an "officer in default", i.e., an officer of the company who contravenes any provisions of the Companies Act, 2013, he will be subject to the same penalties as an executive director of the company.

Previously, a nominee director could recuse his liability on account of a lack of knowledge of the contravention and express consent over such contravening act. However, the Companies Act, 2013 has raised the bar in terms of a nominee director's obligations and such a defence is available in a restricted manner. A nominee director is deemed to have knowledge by virtue of receipt by him of any proceedings of the board. Similarly, a nominee director who has consented or connived in the facilitation of a contravening act will be liable as an officer in default. In this regard, he is deemed to have consented if he has not objected to the contravening act during his participation in such board proceedings.

In light of the above, a nominee director can no longer escape liability purely on the basis of his appointment as a nominee/non-executive director. This regime has made PE investors cautious about the extent of the governance and oversight being exercised over the portfolio companies, and certain PE investors in fact are choosing to appoint a non-voting 'observer' on the board, instead of appointing a director (who then has various fiduciary obligations towards the company).

Since a PE fund would be a shareholder in the portfolio company, the PE investor's liability is restricted only to the extent of any unpaid capital as regards the shares held by such PE fund. Such liability would normally be enforced only in the context of a winding up.

### 3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

As discussed in question 3.6, directors have a fiduciary duty towards the company to act in its best interest. To this extent, there could be a potential conflict of interest, if the interest of the PE fund is not aligned with the interest of the company. However, the possibility of a PE investor's interest being distinct and separate from the interest of the company is fairly remote, as the value of a PE investor's investment can grow only on the basis of the company's growth and performance.

Similarly there could be a potential conflict of interest if a common nominee director is appointed by a PE fund, as regards two portfolio companies that are engaged in a business transaction, where such transaction is not being carried out on an arm's-length basis, in the ordinary course of business, and that such a transaction is motivated by self-dealing by the common nominee director in question, and not on the basis of commercial prudence. Further, there could also be conflict situations where the portfolio companies could be competing with each other. Typically, in such cases, the director recuses himself/herself from one of the boards, if any sensitive matters/bids are being discussed. Nowadays, the promoters are also insisting that the person appointed as the nominee director in the company, should not be appointed on the board of a competing entity.

## 4 Transaction Terms: General

### 4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including competition and other regulatory approval requirements, disclosure obligations and financing issues?

Timelines of a transaction would be affected in the event an approval is required, especially from the Reserve Bank of India ("**RBI**"), Securities Exchange Board of India ("**SEBI**") or FIPB. If a PE investment is envisaged by an offshore PE fund, in a company whose business falls within a regulated sector (such as defence, insurance, to name a few), or if such foreign investment is in excess of the prescribed sectoral caps, then such an investment would require approvals. Also, if the portfolio company is a listed entity, timelines for seeking necessary corporate approvals to facilitate the investment will need to be factored, and could have an impact on the overall transaction timetable.

Consent from the Indian antitrust regulator, the Competition Commission of India ("**CCI**") is also becoming very critical in PE deals, especially given the nature and size of the deals. While the competition regulations do provide for certain exemptions from notifying the CCI, the CCI's decisions in the past have tended towards narrowing down of these exemptions. Obtaining this approval is also impacting the timelines.

### 4.2 Have there been any discernible trends in transaction terms over recent years?

Typically, PE investments are structured by way of a subscription to convertible preference shares or convertible debentures, apart from equity. In case of an offshore PE investor entity, such instruments must be mandatorily convertible, in light of the foreign exchange regulations in India. In the recent past, the RBI has permitted issuance of warrants to offshore PE funds, subject to the pricing of such warrants and conversion formula being determined upfront at the time of issuance, and at least 25% of the total consideration for the issuance of such warrants being paid upfront. The balance consideration must be paid fully within a period of 18 months from the date of investment.

Tax indemnities are being negotiated in detail in the context of an exit by a PE fund, due to an increased tax burden under Indian laws (even where the buyer and seller entities are offshore companies, but dealing with Indian securities). Where the sale is being made by one offshore PE fund to another offshore entity, tax exposures and tax indemnities are being looked at more closely with a view to provide necessary comfort to the buyer entity but at the same time minimising indemnity exposures for the seller PE entity. Consequently, tax indemnity insurances are gaining popularity to help mitigate this risk.

Given the tax and foreign exchange restrictions, there have been no discernible trends affecting transaction terms, *per se*, in recent years.

## 5 Transaction Terms: Public Acquisitions

### 5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

In India, PE investors are seldom parties to public-to-private transactions. 25% of the share capital of a listed company is required to be publicly held (i.e. to be held by persons other than promoters). Depending on the rights available to the PE fund, the PE fund may be classified as a part of the public shareholding.

The SEBI (Delisting of Equity Shares) Regulations, 2009 ("**Delisting Regulations**") governs the delisting of equity shares of listed companies. Under the Delisting Regulations, no company can make an application for delisting and no recognised stock exchange shall permit delisting of shares of a company in the following circumstances:

- pursuant to a buy-back of equity shares of the company;
- pursuant to preferential allotment made by the company;
- unless a period of three years has lapsed since the listing of that class of equity shares on any recognised stock exchange; or
- if any instruments issued by the company, which are convertible into the same class of equity shares that are sought to be delisted, are outstanding.

There are several other restrictions that apply to a listed company proposing to delist, including the minimal shareholding that a promoter needs to hold pursuant to the delisting, price determination for the delisting, etc. Delisting is therefore not a preferred mode of exit for PE investors, who typically consider an IPO as a method for exit and prefer the liquidity offered by way of listed shares. Consequently, PE investors invest at a stage that is three to five years before the target company is proposing to list, and exit the target company at the time of listing or shortly thereafter. Alternatively, PE funds invest in companies post delisting.

Delisting as an exit option is only considered in listed companies where the shares are infrequently traded or where such a company is in distress.

### 5.2 Are break-up fees available in your jurisdiction in relation to public acquisitions? If not, what other arrangements are available, e.g. to cover aborted deal costs? If so, are such arrangements frequently agreed and what is the general range of such break-up fees?

Break fees are not typically seen in listed transactions, since parties do not enter into a binding contract unless all commercial terms are finalised. Upon execution of a binding contract, exiting a proposed transaction/terminating a transaction involves a fair number of regulatory challenges and is seldom seen in practice. Parties may, however, have cost apportionment arrangements for deals that do not go through.

## 6 Transaction Terms: Private Acquisitions

### 6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

In the context of an investment, PE investors adopt both single as well as tranche wise investment structures in equal measure. Although, on the sell-side, PE investors as well as promoters/management prefer investments to come through in a single tranche. This helps in implementing growth targets better, and also gives a great impression about the robustness of the business and the company's performance in the market.

In the context of an exit/acquisition, it is fairly common to have a tranche wise acquisition, with the majority stake being acquired upfront and payments for such acquisition being made simultaneously. In the case of a buyout the deal is structured as a complete acquisition with retention mechanisms, especially for the management team. This helps in ring fencing the acquirer from any potential claims in the coming years, as well as gives an incentive to the erstwhile promoters (who are typically retained in the target in a consultant/employee role), to ensure better alignment of the business and increased growth/opportunities for the target, post-acquisition.

Previously, deferred consideration structures were not permitted under the automatic route under the Indian foreign exchange laws, and were thus not preferred. However, recently, the RBI has allowed deferred consideration structures under the automatic route, so long as not more than 25% of the total consideration is being paid by the buyer on a deferred basis. The deferment has been recognised for a period up to 18 months from the date of the transfer agreement.

### 6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

A PE seller usually provides basic warranties on title and authority. The scope of warranties would also extend to enforceability and tax liabilities. A PE seller rarely provides detailed warranties or indemnities, especially on the operation of the company. It is possible to receive such warranties in case the control is being exercised entirely by the PE seller, which is typically rare in India. A buyer, however, is given ample comfort by the promoters who normally provide exhaustive warranties to the buyer both on the business and operations of the company as well as enforceability, title, etc. Typically, the liability of a promoter to indemnify is equally exhaustive, subject to certain standard limitations on such liability such as time limitation and cap on the liability.

While the indemnities of a PE seller are typically limited for breach of warranties, as discussed in the first paragraph of the response to question 6.2, tax indemnities are becoming fairly comprehensive in the context of a sale by a PE investor, and is being negotiated closely, in the recent years. In certain PE deals, PEs are seeking insurance for indemnities, especially tax indemnities.

### 6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

PE sellers do not undertake any covenants, except for completing sale of shares within the timelines envisaged. The management team is bound by confidentiality obligations, non-compete and non-solicitations restrictions.

Additionally, the management team is usually retained in the acquired company post such acquisition. This period varies from one to three years depending on the stage of the investment cycle. This is to help facilitate integration and ensure better synergy and growth post acquisitions. Accordingly, the management team usually enters into necessary contracts setting out the terms of such employment/consultation, as the case may be.

The scope of indemnities provided by a PE seller and the management team is set out in the response to question 6.2 above.

### 6.4 Is warranty and indemnity insurance used to "bridge the gap" where only limited warranties are given by the private equity seller and is it common for this to be offered by private equity sellers as part of the sales process? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such warranty and indemnity insurance policies?

As discussed in the response to question 6.2 above, the "gap" in the warranties/indemnities provided by the PE seller is usually covered by the warranties and indemnities of the promoter group. Hence from a buyer's perspective, ring fenced protection is sufficiently extended. However, in recent years, PE sellers are exploring insurance options for covering liabilities in the context of tax indemnities.

**6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?**

Since the scope of a PE seller's indemnity is limited (on account of the nature of the warranties being given), additional limitations typically are minimal. It is possible to seek limitation of liability on the basis of time and a cap on the overall liability (which can be up to 100% of the consideration received). Since the scope of warranties extended by the promoters are exhaustive, detailed limitations to a promoter's liability are negotiated. It is fairly standard to have a time limitation and a cap on the overall liability of the promoters (which again is usually up to 100% of the consideration received). Breach of fundamental warranties, specific indemnities and fraud are usually uncapped. Additionally, it is also possible to negotiate time limitations, *de minimis* and a basket, in addition to exclusions such as non-liability for indirect and consequential losses, exclusions in case of an insurance cover, etc.

**6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?**

It is not usual for PE sellers to provide security for any warranties/ liabilities. However, in the case of specific identified liabilities, the parties could agree to hold back mechanisms, which is then kept in the escrow for a certain time period and thereafter released.

Again, it is not usual to provide security in the context of an investment by a PE investor. At best, there could be hold back mechanisms or conversion adjustments provided in the documents to address any liabilities.

**6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain if commitments to, or obtained by, an SPV are not complied with (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?**

Typically, representations are obtained from the PE investor with respect to their funding ability. Sometimes escrow mechanisms are also put in place.

In the case of listed companies, where an open offer is made, the law requires that the open offer consideration be kept in escrow. In certain buyout deals we have seen comfort letters being provided.

**6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?**

A reverse break fee is provided in certain cases and is usually limited to a pre-estimate of the costs incurred up to the negotiation stage. This helps to ensure that neither party engages in unreasonable negotiation nor breaches any exclusivity without having to suffer a penalty.

## 7 Transaction Terms: IPOs

**7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?**

An IPO process in India is typically run by the company and the promoters. The SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 ("**ICDR Regulations**") impose various pre-conditions, including minimum net tangible assets, track record of distributable profits, and minimum net worth, among others. An issuer company not satisfying any of the conditions may still be able to carry out an IPO if it undertakes to allocate at least 50% of the net offer to qualified institutional buyers and to refund all subscription monies if it fails to make such allocations to qualified institutional buyers. Some of the other key challenges that an IPO exit poses for a PE investor are as follows: (a) pre-IPO shareholding is typically locked in for a period of one year (other than for foreign venture capital investors ("**FVCI**")); (b) PE investors run the risk of being characterised as promoters where they hold more than 20% shareholding, and consequently they could become subject to promoter related obligations (including disclosure obligations), under the ICDR Regulations; (c) market conditions typically require an IPO to comprise a primary as well as a secondary component and therefore a complete exit by way of an IPO is not generally possible; (d) where PEs are exiting by way of an offer for sale, certain indemnities and warranties may have to be provided by PEs in the prospectus in relation to those shares; (e) prior to the filing of the red herring prospectus, all special rights (such as veto rights/transfer rights) of the PE investor need to be dropped from the constitution of the company and, in certain cases, SEBI has required that the agreements be terminated, and hence enforceability concerns arise in cases where the IPO does not go through; and (f) post listing, all sale transactions will also need to comply with the onerous conditions of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 and the SEBI (Prohibition of Insider Trading) Regulations, 2015.

Furthermore, failed IPOs could adversely impact the valuation for the PEs. Therefore, IPO exits are only attempted where the company is confident of completing the IPO. Also, the Indian law now imposes an obligation on the company to provide an exit to dissenting shareholders in the context of an IPO, hence the additional exit burden could have an impact overall for IPO exits for a PE seller.

In light of the regulatory processes and uncertainties on the return involved, an IPO is not a preferred exit mechanism for PE funds in India.

**7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?**

ICDR Regulations mandate that the minimum promoter's contribution be locked in for a period of three years from the date of commercial production or date of allotment in the public issue, whichever is later. Promoters holding in excess of the minimum promoter's contribution, are locked in for one year. In this regard, the term 'minimum promoters' contribution' for an IPO has been defined as not less than 20% of the post-issue capital. On the other hand, the entire pre-issue capital held by persons other than promoters shall be locked in for a period of one year. FVCI registered with the SEBI are, however, exempt from such lock-in restrictions, provided they have held securities of the issuer company for at least one year.

**7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?**

A dual-track exit process is quite common, as PE investors tend to pursue several exit channels in parallel, continuing to ready an IPO even as they negotiate terms for a direct sale to a third party. The IPO process is fairly lengthy and often contingent on market conditions, and given the limited life of funds, PE funds typically explore multiple exit options simultaneously.

## 8 Financing

**8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).**

Indian laws do not permit banks to extend loans for funding an investment/acquisition of shares in India. Hence it is not possible for PE funds to raise debt finance from banks for their investments in India, although some promoters approach non-banking finance companies for acquisition financing. The RBI is currently considering relaxation of these regulations especially to enable leveraged buyouts of distressed assets.

**8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?**

As discussed in the response to question 8.1 above, banks cannot extend loans for financing acquisitions. Additionally, public companies are also prevented from providing financial assistance for the purchase of its own shares.

## 9 Tax Matters

**9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?**

Under the Income Tax Act, 1961 ("**ITA**"), income earned by a domestic fund registered with SEBI as a venture capital fund ("**VCF**") or as category I and category II alternative investment fund ("**AIF**"), are exempt from tax under section 10 (23FB) and section 10 (23FBA) of the ITA. Such VCF and AIF have been granted pass through status. The tax pass through status granted to AIF under section 115(U) is with respect to incomes other than business income. Business income of an AIF is taxable at the fund level, at applicable rates, and is exempt in the hands of the unit holder. However, no tax pass through status is applicable to category-III AIFs. Section 56(2) of the ITA, exempts a VCF receiving a share premium amount from a portfolio company from being taxed under the head 'income from other sources'.

There are no specific tax exemptions available to FVCIs. However, as per section 90(2) of the ITA, a non-resident investor investing from a country with which India has a tax treaty, would have an option to be taxed as per the provisions of the tax treaty or the ITA, whichever is more beneficial. Thus, FVCI investing through a tax treaty jurisdiction can avail benefits under the tax treaty. It is relevant to mention here that India has amended its double tax avoidance treaties with Mauritius taking away such tax benefits on and after April 1, 2017. This could have a domino effect also in terms of investments from Singapore, as the double tax avoidance treaty between India and Singapore adopts the position under the treaty with Mauritius. All investments through entities in Mauritius, made on or before April 1, 2017, are grandfathered. The GoI has also introduced the GAAR which shall come into effect from April 1, 2017. GAAR seeks to provide transparency in tax matters and helps curb tax evasion. Under this, if a transaction is structured with the principal purpose of obtaining a tax benefit, then such a transaction will be deemed impermissible for the purposes of such tax benefit. Consequently, these rules will not apply if the jurisdiction of a foreign investor (including a FVCI) is finalised based on non-tax commercial considerations and the main purpose of the arrangement is not to obtain tax benefit.

Offshore structures were quite common in the past. Previously, investments through jurisdictions like Mauritius and Singapore were very common in light of the taxation considerations. The amendments to the tax treaty coupled with the introduction of GAAR will have a significant role in fund structuring decisions, in the coming years.

Also, as discussed in the response to question 1.2 above, the implications of the POEM guidelines issued in January 2017, are also uncertain at this stage and how it plays out will have profound implications on the PE/VC players.

**9.2 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?**

Capital gains tax would be the most important consideration while exploring sale/roll over of investments into newer acquisition structures. Short-term capital gains ("**STCG**") accrues if the asset has been held for less than three years (or in the case of listed securities, less than one year) before being transferred; and gains arising from the transfer of assets having a longer holding period would be treated as long-term capital gains ("**LTCG**"). The income earned by foreign institutional investors or foreign portfolio investors are also treated as capital gains income. LTCG earned by non-residents on the sale of unlisted securities may be taxed at the rate of 10% or 20% depending on certain considerations. LTCG on the sale of listed securities on a stock exchange are exempt and subject to a securities transaction tax ("**STT**"). STCG earned by a non-resident on the sale of listed securities, subject to STT, are taxable at the rate of 15%, or at ordinary corporate tax rate with respect to other securities. This may, however, not apply in case the seller is an offshore entity that is entitled to benefits under a double taxation avoidance treaty.

**9.3 What are the key tax-efficient arrangements that are typically considered by management teams in private equity portfolio companies (such as growth shares, deferred / vesting arrangements, "entrepreneurs' relief" or "employee shareholder status" in the UK)?**

Equity incentives granted to an employee (including a promoter), has tax implications, and the vesting and exercise period of such incentives are typically structured so as to ensure minimal tax burden for such employees.

**9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?**

In February 2016, the Central Board of Direct Taxes ("**CBDT**") issued a circular clarifying that income arising from the transfer of listed shares and securities, which are held for more than 12 months would be taxed under the head 'Capital Gain' unless the tax-payer itself treats these as its stock in-trade and transfer thereof as its business income, thus reducing the incidence of tax on transfer of shares of listed companies. In May 2016, the CBDT issued a circular clarifying that income arising from the transfer of unlisted shares would be considered under the head 'Capital Gain' irrespective of the period of holding, unless: (a) the genuineness of transactions in unlisted shares itself is questionable; (b) the transfer of unlisted shares is related to an issue pertaining to lifting of corporate veil; or (c) the transfer of unlisted shares is made along with the control and management of underlying business.

Additionally, as discussed in the response to question 9.1 above, the changes to the tax treaties with Mauritius, and the implementation of GAAR and POEM are other significant developments in the taxation regime.

## 10 Legal and Regulatory Matters

**10.1 What are the key laws and regulations affecting private equity investors and transactions in your jurisdiction, including those that impact private equity transactions differently to other types of transaction?**

The key laws and regulations affecting PE transactions in India are:

- Foreign Exchange Management Act, 1999 and Regulations thereunder.
- SEBI Act, 1992 and the Regulations thereunder.
- The Companies Act, 2013.
- The Income Tax Act, 1961.

**10.2 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?**

<u>Foreign Exchange Laws</u>:

- FVCIs registered with SEBI are now permitted to invest in: (i) Indian companies engaged in any of the 10 sectors listed in Schedule 6 of Foreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations, 2000 ("**FEMA 20**"), including the newly added infrastructure sector; (ii) startups irrespective of the sector in which the startup is engaged; and (iii) units of a VCF or of a Category I Alternate Investment Fund (Cat I AIF) or units of a scheme or a fund set up by a VCF or by a Cat I AIF, without the need for prior approval of the government. Furthermore, the residency status of the sponsor of such AIFs, and downstream investments of such AIFs, may be subject to certain conditions.
- Composite sectoral cap on foreign investment now takes into account all types of foreign investment such as FDI, FPI, FII, NRI, FVCI, QFI, etc. Individual FII/FPI/QFI can invest up to 10% of the share capital of a company and the aggregate investment limit for FII/FPI/QFI investment is capped at 24% of the share capital of a company. The composite caps are, however, not applicable to the defence and banking sector.
- Foreign investments into various sectors including insurance, financial services and manufacturing, has been liberalised.
- The RBI has allowed deferred consideration structures to be adopted in cross border transactions, under the automatic route, so long as not more than 25% of the total consideration is being paid by the buyer on a deferred basis. The deferment has been recognised for a period up to 18 months from the date of the transfer agreement.

<u>SEBI</u>

- Guidance Note dated August 24, 2015 on SEBI (Prohibition of Insider Trading) Regulations, 2015 ("**PIT Regulations**") has been amended with effect from February 17, 2016 to clarify that the exit offer is also exempted from the restriction on contra trade under the PIT Regulations.

Recent changes to the taxation regime has already been discussed in response to the questions in Section 9 above.

**10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)? Do private equity investors engage outside counsel / professionals to conduct all legal / compliance due diligence or is any conducted in-house?**

Legal due diligence complexity depends on the tenure of operations of the company. The legal due diligence exercise typically covers review of statutory records, examining the licences and material contracts of the company, examining compliance *vis-à-vis* various laws affecting the business, including employment laws, intellectual property laws, real estate laws and tax laws. Legal due diligence is most often conducted by external counsels and is completed within three to five weeks.

**10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?**

Anti-corruption laws and compliances thereunder, are certainly playing an important role in PE transactions in the recent years. The existing Indian anti-corruption law, i.e., the Prevention of Corruption Act, 1988, criminalises receipt of illegal gratification by public servants. However, the legislation currently does not cover private sector bribery. An amendment to the Act criminalising private sector bribery is pending approval by the Indian Parliament. Given the gap in the scope of applicability of anti-corruption laws in India *vis-à-vis* private bribery in offshore jurisdictions, offshore PE investors specifically seek compliance with the more stringent/encompassing anti-bribery laws as applicable in their jurisdiction, by way of contractual undertakings.

PE investors typically seek warranties as well as covenants from the management team confirming compliance with anti-bribery laws including Foreign Corrupt Practices Act, 1977 and the UK Bribery Act, 2010. Breach of such warranties/covenants typically entitles the PE investor to seek an immediate exit, in addition to indemnity/damages as applicable.

**10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?**

As discussed in response to question 3.6 above, as a shareholder, a PE fund has negligible liability *vis-à-vis* a breach by a company, although a director nominated by the PE fund in the portfolio company may be subject to various liabilities, especially in case of a breach/dereliction of duties. A PE fund may, however, become liable in case of oppression or mismanagement in the event the PE fund is a majority investor exercising management control over the portfolio company. There are very limited circumstances where the corporate veil of the company is pierced by Indian courts. This has been further explained in response to question 3.4 above.

## 11 Other Useful Facts

**11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?**

Dispute resolution mechanisms in India pose certain challenges. To this extent, we strongly advice institutional dispute resolution mechanisms such as arbitrations to be incorporated in agreements proposed to be executed by PE funds with their portfolio companies. India is evolving in terms of having a robust legal framework around arbitrations and institutional arbitration centres are being established. However, as of today, overseas institutional arbitrators such as the Singapore International Arbitration Centre, or the like, are preferred for resolving disputes effectively and in a commercially savvy manner.

An area of increasing concerns for PE funds and LPs is the threat of enforcement actions under the FCPA and the UK Bribery Act, 2010. These laws essentially expose PE funds to liabilities in the event that their associates in foreign countries engage in corrupt practices. Despite a vast legislative framework, India ranks 79 out of 176 countries in Transparency International's Corruption Perception Index, reiterating that corruption compromises corporate governance, heightens reputational risks and increases costs of doing business in India. It is of pivotal importance that PE funds conduct adequate anti-corruption due diligence in connection with their investments and conform to adequate safeguards against corruption throughout. Failure to do so exposes the funds to potential successor liabilities, which can result in huge fines and penalties, often for months or years after a deal is closed.

As discussed in this chapter, tax and regulatory bottlenecks do pose a few challenges to PE investors, especially those offshore. To this extent, the government has taken note of these concerns and is implementing steps to mitigate such concerns.

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Vineetha M.G. has extensive experience in advising clients on private equity investments, cross-border and domestic M&A, and banking and financing transactions.

Vineetha is widely experienced in advising onshore and offshore funds which invest in several sectors. Vineetha represents and advises, various private equity investors including Government of Singapore Investment Corporation, New Silk Route, Morgan Stanley Infrastructure Fund, Cerestra Advisors, Sequoia Capital, and IDFC Investments in relation to investments in India, in both listed and unlisted companies, as well as on exits from such investments. Vineetha has also represented and advised Warburg Pincus, IDFC Private Equity, ICICI Ventures and SBI Macquarie in relation to their investments and exits in India. She also represents corporate houses such as the Times Group, CMS Computers, Sintex Industries, Parksons Packaging, UTICO and L&T IDPL in their M&A transactions in India.

On the investment funds side, some of the funds Vineetha has assisted in setting up include Cerestra Edu-Infra Fund, IDFC Private Equity Fund II and IDFC Private Equity Fund III, Nalanda Capital Fund I, Nalanda Capital Fund II and Kae Capital.

Vineetha has also assisted clients on a broad range of financing matters including project finance, corporate finance, microfinance, securitisation, structured products and pre-litigation strategies. Some of the clients advised by her include ICICI Bank Limited, YES Bank, IDFC, L&T Finance, Indostar, J.P. Morgan, Grameen Foundation, Swadhaar, Samunnati, Cashpor, Blue Orchard and DWM.

Vineetha regularly advises clients on issues arising out of corporate governance, domestic anti-corruption laws as well as foreign anti-corruption laws such as the US Foreign Corrupt Practices Act, 1977 and the UK Bribery Act, 2010 in connection with mergers and acquisitions, private equity and financing transactions.

Prior to the formation of the Firm, Vineetha had founded V Chambers of Law which then merged with NDR, to form the Firm. Before that Vineetha was a Partner for over a decade at AZB & Partners, where she handled their private equity, infrastructure, banking & finance and funds' practice. Vineetha began her career at ICICI Bank Limited, Mumbai, in 1998 before joining AZB & Partners in 2001.

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Ashwini Vittalachar has close to 10 years of experience, and works extensively on mergers and acquisitions, joint ventures, private equity and venture capital investments advisory matters.

Ashwini has a wide range of experience advising various stakeholders in the funding ecosystem, including early stage companies, growth stage companies, promoters, early stage investors as well as large corporate groups/PE funds, both in the context of investments as well as acquisitions. She also advises companies regularly on issues of employment and general corporate compliances. Ashwini has co-authored the Indian chapters on private equity published by the Practical Law Company (a question and answer guide to the Indian laws applicable to private equity; forms part of a multi-jurisdictional guide) as well as a chapter on 'Employment laws in India' in *Getting the Deal Through* (a publication of Law Business Research Limited, London).

Ashwini is admitted to practise law in India. Ashwini Vittalachar is a recommended practitioner for Labour & Employment. (*The Legal 500 2016*.)

Ashwini Vittalachar has played a key supporting role in many of the firm's recent M&A deals. This has included acting on cross-border M&A deals in the life sciences and automotive sectors. (*Chambers 2015*.)

Ashwini is singled out by clients for her "communication skills, quick understanding of key business issues, and negotiating ability." She has acted on several mandates for clients in the automotive and pharmaceutical sectors of late. (*Chambers 2014*.)

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