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The International Comparative Legal Guide to:

Private Equity 2016

2nd Edition

A practical cross-border insight into private equity

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General Chapters:

Country Question and Answer Chapters:

EDITORIAL

Welcome to the second edition of *The International Comparative Legal Guide to: Private Equity*.

This guide provides the international practitioner and in-house counsel with a comprehensive worldwide legal analysis of the laws and regulations of private equity.

It is divided into two main sections:

Four general chapters. These are designed to provide readers with a comprehensive overview of key private equity issues, particularly from the perspective of a multi-jurisdictional transaction.

Country question and answer chapters. These provide a broad overview of common issues in private equity laws and regulations in 25 jurisdictions.

All chapters are written by leading private equity lawyers and industry specialists and we are extremely grateful for their excellent contributions.

Special thanks are reserved for the contributing editors, Dr. Lutz Zimmer and Simon Rootsey of Skadden, Arps, Slate, Meagher & Flom LLP, for their invaluable assistance.

Global Legal Group hopes that you find this guide practical and interesting.

The *International Comparative Legal Guide* series is also available online at www.iclg.co.uk.

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Chapter 14

India


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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?

Private equity (PE) transactions in India have seen significant growth over the years, due to the steady return on investments that were made in the past. In 2015, PE investments touched a record high of US$ 17.5 billion across 685 deals making it the best year for Indian PE industry in history. Minority stake deals are more common in India, although majority stake investments as well as private investments in public companies (PIPE) are gaining popularity. 2015 was also a strong year for exits, over all the four quarters, with over 230 deals worth US$ 8.6 billion in value, marking it as the year with the highest exit record.

Sectors like pharmaceuticals, healthcare, IT&ITES, banking and financial services, biotech, and e-commerce continue to draw lot of PE investments.

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

After the general elections in 2014, the newly formed government took note of various operational difficulties faced by entrepreneurs as well as investors and introduced various measures to facilitate ease of doing business and to foster growth in India. Please see our response to question 10.2 on the nature of reforms introduced in the recent past.

In some cases, the reforms have been a double-edged sword and hence ironically continue, in some cases, to be the impetus for growth and, in other cases, to inhibit growth. Whilst the intent of the reforms is positive, the intent sometimes appears to be lost when translated into text. Therefore the implementation of the reforms has posed certain challenges. For example, the recent press note that recognises ‘marketplaces’ as a permitted FDI activity poses several structural challenges to marketplaces in the manner that they operate today.

Further, PE investors are evaluating businesses more closely to identify companies with stronger cores while considering a potential investment. To this extent, deal making in India is no doubt currently at a slower pace but at the same time it is also more steady and stable, and India will continue to attract PE investments.

Lastly, tax reforms continue to be a thorn in the side of several private equity investors. PE investors continue to find that the Indian taxation framework lacks desired clarity. Specifically, the Government of India is committed to implementing the General Anti-Avoidance Rule on April 1, 2017; however, the final form in which these rules will be applied is still unclear.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

Investors generally invest by subscribing to equity shares and/or convertible instruments (being compulsorily convertible in case of offshore investors). The majority of the investment amount is infused by way of convertible instruments. The convertible instruments are converted on the basis of a ratchet and the conversion price is linked to future performance by the Company. The conversion price is linked either to EBITDA or is IRR based. The Investor also acquires a nominal percentage of equity shares upfront to exercise their governance rights in the Company.

Investment vehicles are commonly based out of Singapore or Mauritius or other relevant jurisdictions, based on the type of securities being subscribed to.

In recent times, we have also witnessed a significant growth in co-investment structures where multiple PE houses pool their investments in an offshore vehicle, and then such offshore vehicle thereafter invests in Indian securities.

2.2 What are the main drivers for these acquisition structures?

Tax considerations play a prominent role in determining the form of entity of a PE fund. Domestic funds registered under the VCF Regulations or as category I AIF, under the AIF Regulations, have been granted certain tax exemptions (section 10(23FB), Income Tax Act 1961 (Income Tax Act)) and pass through status (section 115U, Income Tax Act) is currently available to category I and category II AIFs.

Also, the share premium amount received from a VCF by a portfolio company (not being a listed company) is exempt from being taxed as ‘income from other source’ (section 56(2)), Income Tax Act. Furthermore, PE funds are exempted from paying withholding tax on dividends distributed to their investors. Also, shareholders are exempt from paying tax on the dividends.

India

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 on an as-if converted basis. The instruments being subscribed to comprise equity shares and convertible instruments. The convertible instruments are subject to a ratchet. The controlling equity stake is held by the Promoter/ Promoter Group. In family-owned companies, equity shareholding is generally scattered across multiple persons. However, for the purposes of an investment, the promoter group appoints a lead member to exercise rights on their behalf. Companies also implement an ESOP scheme 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 controlling stake, the Promoters retain anywhere between 10%–25% and are entitled to an upside based on performance of the Company.

2.4 What are the main drivers for these equity structures?

The main drivers for equity structures are Indian tax laws and foreign exchange laws. The Indian government is focusing on establishing a stable and consistent tax and foreign exchange regime, for promoting the ease of doing business.

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

Employee stock option plans (ESOPs) are the most common form of management equity incentives in a PE transaction. In light of certain restrictions on issuance of ESOPs to promoters, it is also typical to have equity incentives structured through warrants and ratchets for promoters. The equity would vest over a period of four to five years, with compulsory acquisition on termination (whether for cause or otherwise). The price at which such equity is acquired, as well as the percentage of retention by the promoter, is negotiable.

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

With the increasing liabilities on promoters under the Companies Act, 2013 (Act), preference for a minority stake remains a preferred option. Customary protection rights such as veto rights, board representation, presence being mandatory for quorum, tag along rights, (as elucidated in Section 3 below), 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. An important distinguishing aspect in minority stake transactions would, however, be the scope/extent of veto rights. Since a minority stake does not *per se* guarantee decision-making rights on operational issues, the veto rights of PE funds holding minority stakes are typically very elaborate and exhaustive. Additionally, PEs prefer acquiring a stake in the range of 10%–25%, since certain statutory protective rights get vested with shareholders at these thresholds.

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. The company is also made a party to such agreements so as to make it binding on the company. 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, to name a few. Typical governance arrangements include:

- <u>Appointment of 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. Also, the presence of such representative director would be mandatory for the purposes of quorum. Similarly, decisions as regards veto matters are not taken at any adjourned meetings, without the consent of the investor/his nominee director. Following the introduction of the Companies Act, 2013, we have, in certain instances, noticed that private equity investors prefer to exercise their veto rights by way of a shareholder consent/investor consent and appoint a board observer as opposed to a nominee director. This development is on account of codification of director obligations under the Companies Act, 2013 and a more rigorous implementation framework for enforcement of duties of directors by Indian courts.
- <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 of 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, PE investors usually impose various restrictions on the transfer of shares by 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.

In addition to the shareholders' agreement, the Articles of Association (AoA) acts as 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 mandatory to file the AoA with the jurisdictional ROC. To that extent, the provisions of the shareholders' agreement become publicly available. In this regard, one needs to be balanced about the extent of commercial matters that they would like to include in the AoA and try and minimise inclusion of commercial terms (e.g. ratchets/conversion formulas) other than as may be absolutely required from an enforceability perspective.

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 available over major corporate action, including acquisition, litigation, indebtedness, change in nature of business, and adoption of business plans, to name a few. In the case of a minority stake investment, such veto rights would also extend to certain operational aspects of the business, such as changing the name of the business, the opening of branch offices, termination of key employees, grant of and amendments to any equity incentives (especially for key employees), and related party transactions, to ensure better contractual protection in the absence of a statutory control over such operational aspects.

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, there could be some limitation around the effectiveness of such veto arrangement at the director nominee level. However, such limitations can be easily addressed by requesting a decision on the said matter to be taken at a shareholders' meeting (so as to prevent any conflict of interest). Alternatively, it is also possible to have such veto consent be structured as a separate consent, to be taken before any shareholder/board meetings.

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, it is important that PE investors do 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 a 10% stake 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:

- The 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, small shareholders can appoint a director for special representation.
- Consent rights with respect to merger and amalgamations.
- The right to file an application with the tribunal (class action suit) against the company, directors, or 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 the control of management is seldom overtaken by the PE investor in question, 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 generally no restrictions on the enforceability of shareholder agreements. Previously, there were enforceability concerns around option contracts and transfer restrictions in public companies, which have also now been clarified under the Companies Act, 2013, the pricing guidelines by Reserve Bank of India and Securities Contract Regulation Act, 1956.

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.

It is possible to enforce breach of a confidentiality obligation as well as non-solicitation restriction. However, breach of a non-competition restriction has limited enforceability. It is to be noted that the reasonability of a non-competition restriction does play a vital role in determining the scope and extent of its enforceability. Typically, Indian courts have upheld non-compete provisions as are required to protect the interests of the business of the entity question.

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 Act. The Act provides for a list of disqualifications for 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 owe 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 Act specifically provides for the duties of a director and consequences of breach of such duty. The Act provides for stringent penal provisions, providing for a minimum fine of Rs. 25,000 and maximum fine of Rs. 25 crores, in the event of contravention of the provisions of the Act. 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 a common law requirement.

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

Previously, a nominee director could recuse his liability on account of lack of knowledge of the contravention and express consent over such contravening act. However, the Act has raised the bar in terms of a nominee director's obligations and such a defence is available in a restricted manner. The 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 governance and oversight being exercised over the portfolio companies, and certain PE investors are, in fact, choosing to appoint a non-voting 'observer' on the Board, instead of appointing a director.

Since a PE fund would be a shareholder in the portfolio company, a 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 above, directors owe a fiduciary duty towards the company to act in the best interest of the company. 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. The possibility of such conflict will only arise due to deviations in the investment horizons of a PE Investor as against the Promoters of a company.

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.

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?

The timeline of a transaction would be affected in the event an approval is required, especially from the Reserve Bank of India (RBI), SEBI or Foreign Investment Promotion Board (FIPB), or the competition commission. PE investment by an offshore PE fund, into a company whose business falls within a regulated sector (such as defence, or insurance, to name a few), or in excess of the prescribed sectoral caps 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 in, and could have an impact on the overall transaction timetable.

Since PE transactions are purely financial investments for seeking a return on investment, the likelihood of such an investment becoming subject to competition law restriction and the approvals thereto, are minimal unless the PE acquires a stake in excess of 25% or acquires controlling rights.

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

Typically PE investments are structured by way of subscription to convertible preference shares or convertible debentures, apart from equity. In the case of offshore PE investor entity, the RBI requires such instruments to be mandatorily convertible. 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 are no discernible trends affection 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. PE Investors invest at a stage where the target company is proposing to list in the immediately succeeding three to five years and exit the target company at the time of listing or shortly thereafter. Where a public company is looking to go private, the Investor generally steps into the company post delisting.

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, the PE 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 the 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 private equity investors, who typically consider IPO as a method for exit and prefer the liquidity offered by way of listed shares. 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?

PE investors typically prefer a tranche-style consideration structure for their investments. The second/third tranche investment amount is typically linked to certain performance milestones, especially in the recent transactions. On the sell-side, PE investors as well as promoters/management prefer investments to come through in 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-style acquisition, with the majority stake being acquired upfront and payments for such acquisition being made simultaneously. Alternatively, it is also common to have a complete acquisition but with retention mechanisms. This helps in ring fencing the acquirer from any potential claims in the coming years, and also gives an incentive to the erstwhile promoters (who are typically retained in the target in a consultant/employee role). Deferred consideration structures are not permitted under the automatic route, in cases where there are offshore/foreign parties involved in the transaction.

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 and indemnity. The scope of warranties would extend to enforceability, authority for execution, title over shares being sold, and tax liabilities. PE sellers rarely provide detailed warranties or indemnities, especially on the operation of the company. It is possible to receive such warranties in cases where control is being exercised entirely by the PE seller, which is typically rare in India. Consequently, while the indemnities of a PE seller are typically limited for breach of warranties, as discussed in question 4.2, tax indemnities are becoming fairly comprehensive in the context of a sale by a PE investor, and are being negotiated closely, in the recent years.

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, cap on the liability, to name a few. In certain PE deals, PEs are seeking insurance for breach of representations and warranties.

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, 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 synergies 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 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 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 management group. Hence from a buyer's perspective, ringfenced protection is extended. However, in recent years, certain PE sellers (especially those that are based offshore) 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 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 management team is 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). Additionally, it is also possible to negotiate a *de minimis* and a basket, in addition to exclusions such as non-liability for indirect losses, exclusions in case of an insurance cover, to name a few.

India

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)?

PE sellers do not provide escrow arrangements; however, a buyer may insist on security (such as escrow, bank guarantee, etc.), for protection on indemnities. Typically PE exits are done at the time of expiry of their fund life and therefore PE houses undertake minimum or no obligations at the time of exit. If required the promoters/company provide security in rare cases.

It is, however, not common to have such security arrangements in the context of an investment by a PE investor.

In the case of acquisition of shares in listed companies which trigger open offer obligations, escrow arrangements are required to be put in place in terms of Applicable Law.

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.)?

In India, the promoters or group company/parent company provide personal/corporate guarantee for any debt financing. Securities for equity financing have been discussed in questions 6.3 and 6.6. PE funds, whether as sellers or investors, do not provide guarantees or comfort, whether in the context of an equity or debt financing.

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

Reverse break fees are common in India, and are usually a negotiated right that becomes applicable only if a break fee is being sought. Break fees and reverse break fees are 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?

Some of the key challenges that an IPO exit poses for a PE investor are as follows: (i) given the broad spectrum of veto rights available with PE investors or where they hold in excess of 25% shareholding, they run the risk of being characterised as promoters and need to clarify upfront that the existing promoters ensure that PEs are not characterised as promoters and no promoter related obligations (including disclosure obligations apply to PEs); (ii) 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; (iii) 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 IPOs do not go through; (iv) pre-IPO shareholding is typically locked in for a period of one year (other than for FVCIs); (v) 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; and (vi) post listing, all sale transactions will also need to comply with the Takeover Code. Lastly, an IPO process in India is typically run by the Company and the Promoters. 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.

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. FVCIs 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?

Dual track exit processes are not uncommon. Since the IPO process is fairly lengthy, and given the limited life of funds, funds typically explore multiple exit options simultaneously. IPOs are also contingent on market conditions and hence secondary exits are more common method for exits by PEs.

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 raise debts 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. Some promoters approach NBFCs for acquisition financing. However, the central banking regulator is considering relaxing the regulations for facilitating leverage 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?

Presently banks are not permitted to undertake acquisition financing. Further there are restrictions on companies to provide assistance (by way of securities, etc.) in financing of its own shares. As a result, leverage transactions are not possible on shore in India.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction?

Under the Income Tax Act, income earned by a domestic fund registered with SEBI as VCF or as category I and category II AIFs are exempt from tax under section 10 (23FB) and section 10 (23FBA). Such VCF and AIF have been granted pass through status. The tax pass through status granted to AIF is with respect to incomes other than business income. Business income of the AIFs 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.

There are no specific tax exemptions available to foreign venture capital investors (FVCI). However, as per section 90(2) of the Income Tax Act, 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 Income Tax Act, whichever is more beneficial. Therefore, FVCI investing through a tax treaty jurisdiction can avail benefits under the tax treaty. Further, in order to be entitled to claim relief under a treaty, the government of India requires a non-resident to provide a tax residency certificate and such other documents and particulars as may be prescribed. However, this may not preclude the ability to withhold taxes, especially in the context of capital gains made on sale of shares.

Section 56(2) of the Income Tax Act, exempts a VCF receiving share premium amount from a portfolio company from being taxed under the head 'income from other sources'.

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 is 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 an ordinary corporate tax rate with respect to other securities.

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)?

In general, there are no specific tax-efficient arrangements applicable in India for a PE investment. However, the nature/structure of the investing PE fund, including whether they are set up domestically or offshore, becomes relevant for the purposes of availing tax exemptions. Apart from this, equity incentives granted to an employee (including a promoter), have 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?

There have been many developments in the recent past on the taxation regime applicable to PE transactions. A brief summary of this is as follows:

The central board of direct taxes (CBDT) has issued a few notifications paving the way for better on the PE transactions. Accordingly, the following are important developments:

- <u>Safe Harbour Rules for eligible funds having fund managers in India</u>: the Finance Act, 2015, had introduced an exemption to the concept of 'business connection', whereby, satisfying certain eligibility criteria, an offshore fund could be managed from India without attracting taxes in India. However, stringent eligibility conditions affected the implementation of these Rules. The CBDT issued Notification No. 14/2016, dated March 15, 2016, clarifying the eligibility criteria for offshore funds being managed from India through their managers. The notification provides: (i) clarity on the scope; (ii) an administrative mechanism enabling the offshore PE fund to ascertain beforehand whether it is eligible for such benefit; (iii) compliance requirements to be undertaken by the offshore PE fund; and (iv) circumstances in which flexibility shall be granted to the offshore PE fund from complying with such specified conditions. The ability of seeking prior approval of the CBDT in relation to an offshore PE funds' eligibility for seeking benefit, is a positive step as that gives more certainty and stability on the taxation regime.

  In this regard it is also important to note that the central government had already taken note of the difficulties faced by offshore PE funds, and had proposed the relaxation of two of the eligibility conditions, in the Budget 2016. Accordingly:

  - In order to be considered as an eligible fund, the PE fund should be resident of a country with which India has a double taxation avoidance agreement or a tax information exchange agreement or a treaty has been signed between specified associations of the two jurisdictions. Additionally, PE funds which are registered or incorporated in certain notified countries shall also be covered in addition to the tax treaty criteria, and the residence criteria in this regard shall not be applicable.
  - Restrictions on the PE fund from carrying out or controlling or managing, directly or indirectly, any business in India or from India, is no longer a condition. This greatly enhances the flexibility of advisors and fund managers based locally, in connection with their advisory role.
- <u>Debenture holding period to be included for shares when convertible debentures are issued</u>: there was an ambiguity on the calculation of holding period for a debenture and the consequent tax treatment. Previously, the taxation law merely specified that if a tax payer acquires capital assets (shares of a company), as a result of conversion of debenture or bond, the cost of acquisition of the share would be the cost of acquisition of the debenture or bond, and the period of holding became relevant for the purposes of calculation of capital gains tax upon sale of such capital asset.

The CBDT issued Notification No. 18/2016, dated March 17, 2016, the period of holding of the capital asset (i.e. share issued post conversion of a debenture or a bond), would include the period for which the debenture or bond was also held by such taxpayer prior to the conversion. This clarification, however, does not clarify the position for preference shares, and the treatment of the holding period for equity shares issued upon conversion of preference shares.

- Treatment of listed securities held for more than 12 months: in the recent past there has been ambiguity with regards to the classification of gains arising on the transfer of shares/ securities as capital gains or business income. Due to the low tax rate, taxpayers preferred the capital gains tax classification, whereas the tax authorities usually taxed these gains as business income. In this regard, the CBDT vide Circular No. 6/2016, dated February 29, 2016 issued a new set of instructions to be followed by the tax authorities while assessing whether the gains arising on the transfer of listed shares/securities should be treated as capital gains or business income. The circular provides that:
  - Where the taxpayer opts to treat such listed shares/ securities as 'stock-in-trade', irrespective of the period of holding, the gains would be taxed as business income.
  - In respect of listed shares/securities held for a period of 12 months immediately preceding the date of transfer, if the taxpayer desires to treat the income arising from the transfer as capital gains, the same shall not be disputed by the assessing officer.
  - In all other cases, the nature of the transaction, shall be governed by the aforesaid test laid down in the circular.

The circular clarifies that the test shall not be applicable in respect of such transactions where the genuineness of the transaction is itself questionable. The circular brings clarity and should encourage investors to invest for a period more than 12 months in the securities market.

In addition to the CBDT notifications, there have been few other announcements made in the budget for 2016–2017, affecting PE transaction. A brief summary of the same is as follows:

- Proposed implementation of rules relating to "effective management" from April, 2017.
- Proposed implementation of General Anti-Avoidance Rules from April, 2017.
- The period of holding securities of an unlisted company for qualifying as long term capital gains has been reduced from three years to two years.
- Proposed non-applicability of minimum alternate tax provisions with retrospective effect from April 1, 2001, to a foreign company.
- LTCG rates for non-residents, in the case of a sale of shares of a private company has been reduced from 20% to 10%, to align the taxation of unlisted public and private companies.

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 the Regulations thereunder.
- SEBI Act 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?

FDI Policy

- FDI policy has been liberalised on several counts including but not limited to, the following:
  - Permitting FDI in LLPs.
  - Liberalisation of FDI in defence, air transport, information & broadcasting, real estate sector, etc.
  - Issue of Press Note 3 of 2016 that clarifies that, marketplaces are permitted to raise foreign direct investment up to 100% under the automatic route subject to conditions stated therein.
  - Opening up of the insurance sector up to 49% under the automatic route.

RBI

- RBI permitting foreign investment in REITs, INVITs and Alternative Investment Funds by NRIs and Foreign Portfolio Investors subject to certain specified conditions.
- Implementation of the Strategic Debt Restructuring (SDR) Scheme by the Reserve Bank of India.

SEBI

- Notification of the New Insider Trading Regulations by SEBI in February 2015.
- Relaxation of SEBI regulations whilst applying the same to institutional investor trading platforms to ease up fund raising by start-ups.
- SEBI notified the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, thereby codifying the compliance requirements required to be complied with by listed entities, which were previously governed by way of listing agreements executed with stock exchanges.
- On February 17, 2016, SEBI issued SEBI (Issue of Capital and Disclosure Requirements) (Second Amendment) Regulations, 2016. By this amendment a new chapter was inserted in the ICDR Regulations, providing conditions and the manner for providing exit opportunities to dissenting shareholders.
- SEBI constituted a standing committee "Alternate Investment Policy Advisory Committee" to suggest reforms and changes in the existing laws, to facilitate capital raising by AIFs. The committee submitted its report, suggesting the following recommendations:
  - Creating a favourable tax environment to bring about ease of doing business, ensuring neutrality, clarity, consistency and certainty in the tax policy, and establishing parity in tax policies between alternate investments and public market investments. The report contains the following tax recommendations:
    (a) Make pass-through status work effectively by: (i) ensuring that the exempt income of AIFs is not subject to a 10% withholding tax; (ii) exempting investors from the withholding tax of 10%; and (iii) ensuring that investment gains of AIFs are treated as capital gains, to name a few.

(b) Make the provisions of safe harbour rules more effective for fund managers in India by relaxing the conditions under section 9A of the Income Tax Act.

(c) Introduction of STT for private equity and venture capital investments, including SEBI registered AIFs.

(d) To attract more foreign investment into India-centric private equity and venture capital fund vehicles, the investors should not be subject to the indirect transfer provisions.

- Unlocking domestic capital pools for investment as venture capital and private equity.
- Promoting onshore fund management in India.
- Reforming the AIR regulatory regime.

Some of the recommendations of the committee are very pertinent to address the concerns of the industry. One of the most important recommendations is to rationalise the tax and regulatory regime in India to prevent loss of business to overseas jurisdictions.

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 licenses 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 typically 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 a PE transaction in the recent years. The existing Indian anti-corruption law, i.e. the Prevention of Corruption Act, 1988, criminalises the receipt 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. Hence, 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/all-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 entitle 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 question 3.6, as a shareholder, a PE fund has negligible liability *vis-à-vis* breach by a company, although a director nominated by the PE fund on the portfolio company may be subject to various liabilities, especially in the 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. This has been further explained in question 3.4.

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?

- The dispute resolution mechanism in India poses certain challenges. To this extent, we strongly advise that institutional dispute resolution mechanisms such as arbitrations are incorporated in agreements proposed to be executed by PE funds with their portfolio companies. Having an institutional arbitrator such as the Singapore International Arbitration Centre, the London Court of International Arbitration or the like, resolve disputes, ensures a timely resolution in a commercially savvy manner.
- 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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Apurva works on mergers & acquisitions, private equity, venture capital investments, general corporate matters, banking and finance, and regulatory matters. Prior to joining Samvād: Partners, Apurva worked with some of India's top tier law firms such as AZB & Partners, Mumbai and Amarchand Mangaldas & Suresh.A.Shroff, Mumbai.

In the past, Apurva has represented several private equity and venture capital investors with their inbound investments into Indian listed as well as unlisted companies across sectors and assisted offshore as well as Indian corporates with their strategic investments and joint ventures in India. She has also assisted several leading Indian and overseas banks and financial institutions with lending in the project finance space. Apurva has advised clients on a significant number of regulatory matters before the Securities Exchange Board of India, Reserve Bank of India, Enforcement Directorate and the Insurance Regulatory and Development Authority.

Apurva is keenly interested in legal writing and research and has contributed articles on several topical legal issues, such as the extant corporate governance framework for listed companies, liabilities of Directors' under Indian law, the takeover regulations in India and various aspects of the Indian foreign exchange laws in various publications.

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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* and *2015*.)

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