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The International Comparative Legal Guide to:

Private Equity 2018

4th Edition

A practical cross-border insight into private equity

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EDITORIAL

Welcome to the fourth 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 chapters are designed to provide readers with an 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 34 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 Richard Youle and Lorenzo Corte 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.com.

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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?

In 2017, Private Equity ("**PE**") transactions in India amounted to approximately USD 26.4 billion across 682 deals. Consumer-tech and banking, financial services (especially FinTech space) and insurance segments attracted the largest PE investments in India. While deals in the consumer technology sector re-emerged with an average deal size of USD 47.1 million, the manufacturing sector witnessed a decline of approximately 67% in the volume of investment. Further, deals in the information technology and IT-enabled services segment also saw a decline of approximately 29%, with the number of deals falling from 130 in 2016 to 92 in 2017.

Exit momentum continued to be robust, indicating healthy and strong public markets in India. The exit values for 2017 grew by approximately 60% over 2016 to almost USD 16 billion.

The push towards digital platforms by the government of India ("**GoI**") translated into investments into Flipkart, Ola and Paytm. Further, demonetisation resulted in more people opting for digital payment which facilitated the growth of digital payment platforms such as e-wallets, as well as driving the growth of the FinTech industry in India.

2017 witnessed an increase in the volume of non-performing assets in the banking system. This could result in a large number of deals in the stressed assets segment with the aid of insolvency and bankruptcy code.

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

The GoI has undertaken various initiatives to reform, rationalise and simplify laws to encourage and attract further foreign investments in India. In particular, special attention has been given to foreign exchange laws, employment laws and tax laws to foster an environment conducive for business.

The Foreign Investment Promotion Board, the government body approving foreign investment in India, was abolished to make foreign direct investment ("**FDI**") into India easier and less time-consuming. While approvals in relation to FDI are now granted by the concerned administrative ministries or departments, the filing of necessary applications has been streamlined with the Foreign Investment Facilitation Portal ("**FIFP**") being set up as the single window agency to clear applications in one week's time. With only 11 notified sectors/activities requiring government approval for receiving foreign investment, FDI inflows have enhanced.

The implementation of the Goods and Services Tax ("**GST**") has ushered in a uniform tax regime in India with centralised registration. While it does not have a direct impact on PE funds or their investments, the general improvement in business and clarity in taxation regime has had a positive impact on the ecosystem, encouraging greater PE investments.

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.

In recent years we have seen an increase in control/buyout deals as PE investors have become successful in bringing professional management to run the company. With the Indian promoters being more open to divesting their shareholding in the company, control/buyout deals have seen a steady increase and are typically structured as secondary acquisition. Minority deals still continue to lead, with significant PE investments of 2017 being in minority deals.

PE investors typically invest in a combination of equity shares and convertible instruments such as convertible preferences shares or convertible debentures. Such convertible instruments are compulsorily convertible in case of offshore PE investors. Investors also typically acquire a nominal number of equity shares to exercise voting rights.

2.2 What are the main drivers for these acquisition structures?

Regulatory considerations such as the tax regime, foreign exchange laws and anti-trust laws act as a catalyst in structuring acquisition

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transactions. Several restrictions are imposed on Indian companies for investments/acquisitions especially in case of share acquisitions/ investments by a foreign investor. Restrictions such as who can be an eligible investor, the nature of instruments that can be issued, limits on investment and sectoral caps, government approval for investments, timelines for payment of consideration and issuance of securities and feasibility of escrow arrangements are some of the restrictions imposed by the foreign exchange laws.

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

PE investors generally hold between 10%–25% of the share capital of a company and the controlling stake is typically held by the promoters/promoter group. 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 the company 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 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) 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?

Employee stock options are the most common type of management equity incentives. As per the Companies Act, 2013 ("**Act**") promoters and directors (directly or indirectly) holding more than 10% of the equity share capital of a private company are not entitled to receive stock options. Options are vested over a period of three to five years, with compulsory vesting under certain circumstances. The stock option schemes formulated by companies provide for mechanism for vesting/forfeiture of options in the event of death of an employee/termination of employment.

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

Generally, PE investors hold a minority stake in Indian companies and the same is a preferred option because of the increasing liability on promoters under the Act. In transactions where PE investors are in the minority, customary protections such as board seat, veto rights, quorum rights, information/inspection rights, tag along rights and exit rights play a key role in ensuring that an investor's rights are protected. The scope and extent of veto rights granted to minority investors are generally limited, especially to matters affecting the rights attached to such investors' shares and no veto rights are granted for operational matters.

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?

The shareholders' agreement sets out the rights of shareholders and provides for the manner of conduct of business, governance, share transfers and other restrictions. The typical governance arrangement includes:

- <u>Appointment of representative on the board</u>: PE investors seek for director representatives on the board depending on the percentage of shareholding in the company. The presence of such director is made mandatory for quorum, and meetings are adjourned in the absence of such quorum. Investors also seek to appoint observers to the board to attend meetings. Such observers are appointed in the capacity of non-voting and speaking observer. Similarly, investors negotiate and identify a list of matters on which decisions cannot be taken without the prior written consent of the investors. Typically, PE investors prefer to exercise their rights by way of shareholder consent rather than through appointment of nominee directors due to the extent of director obligations under the Act.
- <u>Anti-dilution</u>: Investors seek anti-dilution protection in order to prevent dilution in the shareholding percentage in a down-round. Anti-dilution rights entitle an investor to subscribe/ acquire additional shares in the company, either on a full ratchet basis or weighted average basis, as may be agreed.
- <u>Transfer restrictions</u>: Investors are not in charge of the management of the company and depend on the promoter's expertise to run the business. Therefore, share transfer restrictions are imposed on promoters in order to retain them in the company. Common restrictions include lock-in restrictions, right of first offer or refusal, drag along rights, tag along rights and escrow arrangements.
- <u>Exit mechanism</u>: Exit mechanisms are usually negotiated upfront between the parties and captured in the transaction documents. Common exit mechanisms include initial public offer, strategic sale, third-party sale, buy-back and drag along rights.

The articles of association ("**AoA**") of the company are the bye-laws of the company and set forth the governance rights and share transfer restrictions. Every company is bound to act in accordance with the provisions of its AoA, and non-conformance with the AoA would render any action as *ultra vires* and such act would not be enforceable. Therefore, provisions of the shareholders' agreement are incorporated in the AoA for better protection to PE investors and also to make such provisions binding on the company.

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?

PE investors are given veto rights on matters such as corporate restructuring, indebtedness, litigation, change in business plan, change in the nature of business, to name a few. Where a PE investor holds a minority stake, veto rights extend to matters such as

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change in name of the business, opening branch offices, execution, variation or termination of any material agreement outside the course of ordinary business, appointment or termination of key employees, approval or modification of the terms of the stock option plan for employees and change in the composition of the board. As explained in question 3.1 above, investors choose to exercise such veto rights by way of shareholder consent rather than through nominee directors, in light of the fiduciary obligations imposed on directors under the Act.

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 the shareholder level. Every director has a fiduciary duty towards the company which may or may not always be aligned with the interest of the investor, resulting in limitation on the effectiveness of veto matters at the nominee director level. This can be addressed by ensuring that 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?

PE investors holding a majority stake in a company should ensure that they do not act in an unfair, fraudulent or oppressive manner against the interest of minority shareholders. A shareholder is considered as a minority shareholder if he/she holds at least 10% shares in the company. The Act provides the following protections to minority shareholders:

- Right to file an application before the tribunal in the event affairs of the company are being conducted in a manner that is prejudicial to public interest or prejudicial or oppressive to the shareholder(s) or prejudicial to the interest of the company.
- Right to file an application with the tribunal (class action suit) against the company, directors, and/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.
- Consent rights with respect to merger and acquisitions.
- Minority shareholders of listed companies have the right to appoint a director to represent the interest of such small shareholders in the company.

Since most PE transactions in India are structured as minority stake investments, 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 on the contents and enforceability of shareholders' agreements. As explained in question 3.1, provisions of the shareholders' agreements are incorporated in the AoA to ensure dual protection *vis-à-vis* enforcement, in case of breach. It is advisable for shareholder agreements to be governed by Indian laws so as to enable better enforcement, as operations of the company will need to comply with Indian laws.

It is common to incorporate restrictive covenants such as non-compete, non-solicitation and confidentiality obligations in shareholders' agreements. While it is possible to enforce breach of confidentiality and non-solicitation restrictions, enforceability of breach of non-competition restrictions is limited to sale of goodwill only under the Indian laws. Also, enforceability of non-compete restrictions is not possible in the context of post-termination of employment. Indian courts take into consideration reasonability of non-compete restrictions while determining the scope and extent of enforceability of such restrictions.

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 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, directors of a 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, have gone up manifold. The Act 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. 250 million 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 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 Act, 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 Act 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-

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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 mentioned in question 3.6, directors have a fiduciary duty towards the company and are required to act in the best interest of the company. In the event interest of the PE investor is not aligned with the interest of the company, there could be a potential conflict of interest. Since a PE investor's investment is dependent on the company's growth and performance, the possibility of the investor's interest being separate from that of the company is fairly remote.

There could also be a conflict of interest if a PE investor nominates a common nominee director on the board of two of its portfolio companies that are competing with each other or engaged in business transactions that are not on arm's length basis and in the ordinary course of business and is motivated by self-dealing by such nominee director. In such cases, the nominee director steps down from the board of one of the companies to avoid conflict of interest.

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**") and Securities and Exchange Board of India ("**SEBI**"). PE investment by an offshore PE fund in a company whose business falls within a regulated sector (such as defence, insurance, to name a few), or investments in excess of the prescribed sectoral caps, require approvals from the concerned ministry or department through the FIFP.

Also, where 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 anti-trust 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 the narrowing down of these exemptions. Obtaining this approval is also impacting the timelines for PE deals in India.

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

PE investments are structured by way of a subscription to equity, convertible preference shares or convertible debentures. In case of an offshore PE investor, such instruments must be mandatorily convertible, as per the extant foreign exchange laws in India. In 2014, RBI permitted issuance of warrants to offshore PE funds, subject to pricing and conversion formula for warrants being determined upfront at the time of issuance, and at least 25% of the total consideration for such issuance being paid upfront and balance being paid within a period of 18 months from the date of investment. Tax indemnities are being negotiated in detail in the context of 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). In case of sale 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. At the same time, such comfort is not drawn at the cost of an increased indemnity exposure for the selling 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. A minimum of 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/promoter group). 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.

Several other restrictions apply to a listed company proposing to delist, including minimal shareholding that a promoter needs to hold pursuant to the delisting and price determination for the delisting. Delisting is therefore not a preferred mode of exit for PE investors, who typically consider an initial public offer as a mode of exit from the portfolio companies and prefer the liquidity by way of listed shares. Consequently, PE investors invest at a time when the portfolio companies still have three to five years before listing and exit the company at the time of listing or shortly thereafter. Alternatively, PE investors invest in companies after listing.

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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?

The concept of a breakup fee is at a nascent stage in India and is making its way through transactions as well. Although it is much more common to private deals (especially where financial institutions are involved or in case of termination due to non-satisfaction of certain conditions), deal protection mechanisms such as break fees and reverse break fees are extremely rare in public deals in India.

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?

On the buy-side, PE investors adopt both single and tranche-based investment structures. Although, on the sell-side the promoters prefer the investment to be completed in a single tranche. This helps the company better implement its targets and leaves a strong impact on the market about the robustness of the business and company's performance.

It is common to structure acquisition transactions on a tranche basis, with majority stake being acquired in the first tranche and payments for such tranches being made simultaneously. Buyout deals are structured as complete acquisition upfront along with a mechanism for retaining the management team. The acquirer ensures that the management team is retained either as employees or consultants post acquisition to ensure better alignment of the business and growth opportunities for the target company. Management team is also retained as this helps in protecting the acquirer from any potential claims in the coming years.

RBI has permitted deferred consideration structures under which 25% of the total consideration can be paid by the buyer on a deferred basis within 18 months from the date of the transfer agreement. Also, the buyer is permitted to settle 25% of the total consideration through escrow arrangement for a period not exceeding 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 have been negotiated closely in recent years. In certain 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 seldom provide any covenants/undertakings, except for completing the sale of shares in accordance with law and within the prescribed timelines.

The management team is bound by confidentiality, non-compete and non-solicitation restrictions. Also, the management team is usually retained in the company for a period of at least three years post acquisition. This is to ensure integration of business and better growth of the company post acquisition. Buyers usually insist on the management team entering into necessary agreements setting out the terms of their engagement with the company. The scope and extent of indemnities provided by the PE seller are explained in question 6.2.

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?

Warranties and indemnities provided by the promoters are usually used to cover the gap in the warranties and indemnities provided by the PE sellers. Therefore, from a buyer's perspective, sufficient protection is extended to it by the promoters.

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 are typically 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 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). 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)?

PE sellers seldom provide any security for warranties/liabilities. However, for specific indemnity matters, the parties usually agree to an escrow mechanism under which a certain percentage of the total consideration is held in an escrow account for a certain time period and thereafter released, subject to absence of any indemnity claims.

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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?

The procedure involved in an IPO is governed by the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 ("**ICDR Regulations**") and is typically run by the company and its promoters. The 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 the issue is made through a book building process and the issuer undertakes to allocate at least 75% of the net offer to qualified institutional buyers and to refund all subscription monies if it fails to make such allotment to qualified institutional buyers. Some of the other key challenges that an IPO exit poses for a PE investor are: (a) pre-IPO shareholding is typically locked in for a period of one year (other than for foreign venture capital investors ("**FVCI**"), alternative investment funds under category I and II ("**AIF**") and employee stock options); (b) PE investors run the risk of being characterised as promoters where they hold more than 20% shareholding, in which case 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 may require that the agreements be terminated, giving rise to enforceability concerns in cases where the IPO does not go through; and (f) post listing, all sale transactions must comply with the conditions of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 and the SEBI (Prohibition of Insider Trading) Regulations, 2015.

A failed IPO can have an adverse impact on the valuation of the PEs. Therefore, IPO exits are only attempted where the company is confident of completing it successfully. Furthermore, the ICDR Regulations impose an obligation on the company to provide an exit to dissenting shareholders in the context of an IPO. This additional exit burden could have an impact overall for IPO exits for a PE seller.

Even though an IPO is strictly regulated, 2017 has witnessed multiple exits by way of an IPO. The upgrade in India's rating by Moody may have encouraged this trend. The popularity of IPO as a mode of exit is dependent upon market confidence. Therefore, it may not be preferred by some investors in light of the regulatory processes and uncertainties on the return involved.

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

Under the ICDR Regulations, the minimum promoter's contribution is required to 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, AIF, and employees holding shares under an employee stock option scheme are, however, exempt from such lock-in restrictions, provided that such FVCI and AIF 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?

Since PE investors tend to pursue several exit channels, a dual-track exit process is quite common. This allows PE investors to prepare themselves for an IPO even as they negotiate terms for a third-party sale. Additionally, the procedure for an IPO is highly regulated and contingent on market conditions. 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).

Banks are not permitted to extend loans for funding an investment/acquisition of shares in India. Therefore, PE funds cannot raise debt finance from banks for their investments in India. However, some

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promoters do approach non-banking finance companies for financing acquisitions. RBI has been considering relaxing 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 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 their 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 ("**IT Act**"), income earned by a domestic fund registered with SEBI as a venture capital fund ("**VCF**") or as an AIF, is not eligible to tax as per Section 10 (23FB) and Section 10 (23FBA). Such VCFs and AIFs have been granted pass through status under Section 115U of the IT Act with respect to income 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. Further, Section 56(2) of the IT Act, exempts a VCF receiving a share premium amount from a portfolio company from being taxed under the head 'income from other sources'.

While there are no specific tax exemptions available to FVCIs, as per section 90(2) of the IT Act, the provisions of the IT Act apply to a non-resident investor investing from a country with which India has a tax treaty, only to the extent the provisions of the IT Act are more beneficial. Thus, a FVCI investing through a tax treaty jurisdiction can avail benefits under the relevant tax treaty. It is pertinent to note that India has amended its double tax avoidance treaties with Mauritius and Singapore taking away such tax benefits on and after April 1, 2017. However, investments through entities in Mauritius or Singapore, made before April 1, 2017, have been grandfathered. The GoI also introduced the Generally Anti-Avoidance Rule ("**GAAR**") with effect from April 1, 2017 with the aim of providing transparency in tax matters and curb tax evasion. Where a transaction is structured, devoid of any business reason with the principal aim of obtaining a tax benefit, such a transaction is deemed impermissible for the purposes of such tax benefit. Consequently, GAAR does not apply if the jurisdiction of a foreign investor (including a FVCI) is finalised based on commercial considerations and the sole purpose of the arrangement is not to obtain tax benefit.

In the past, offshore structures were quite common, with investment flowing from Mauritius and Singapore in light of various tax considerations. Amendments to the tax treaties in these jurisdictions along with the introduction of GAAR will have a significant role in fund structuring decisions in the coming years.

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 is one of the most significant considerations while exploring sale/roll over of investments into newer acquisition structures. Where an asset is held for less than 36 months (12 months in case of listed securities) before transfer, such transfer is eligible to short-term capital gains ("**STCG**") tax whereas, gains arising from the transfer of assets after 36 months are treated as long-term capital gains ("**LTCG**") and taxed accordingly. LTCG on sale of debt instruments will be taxed at the rate of 20% (both listed and unlisted instruments). Further, LTCG on the sale of equity instruments will be taxed at the rate of 10% (both listed and unlisted instruments). STCG on the sale of equity linked mutual fund and securities is taxed at the rate of 15% (both listed and unlisted instruments).

However, the aforesaid may not apply in case the seller is an offshore entity in a jurisdiction having a double taxation avoidance treaty with India and entitled to benefits thereunder.

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 which are granted to an employee (including a promoter), have tax implications. Therefore, the vesting and exercise periods of such incentives are structured so as to ensure minimal tax burden for the 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?

GoI enforced the GST regime in 2017, unifying all indirect taxes under a single tax regime. The new regime provides for a single registration and will facilitate the setting up of new businesses and the growth and expansion of existing businesses.

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 legislations that affect PE transactions in India are:

- Foreign Exchange Management Act, 1999 and the regulations made thereunder.
- The SEBI Act, 1992 and the regulations made thereunder.
- The Companies Act, 2013.
- The Income Tax Act, 1962.

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?

Foreign Exchange Laws:

RBI issued the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2017 ("**FEMA 20**") in November 2017 which replaced the Foreign

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Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000. The key changes and amendments are:

- FDI and Foreign Portfolio Investment ("**FPI**") in listed companies: A person resident outside India can invest in a listed company either under the FDI route or the FPI route. Investment below 10% of the post paid-up share capital on a fully diluted basis will be considered as FPI and investment above 10% will be considered as FDI. If any existing FDI investment falls below 10% it will continue to be treated as investment under the FDI route and not under the FPI route.
- Issue of capital instruments: To align with the provisions of the Act, timelines for issuance of capital instruments have been revised from 180 days to 60 days from the date of receipt of share application money.
- Refund of share application money: In the event a company fails to issue capital instruments, it is required to refund the share application money to the non-resident. Timelines for refund have been revised from 180 days to 75 days, i.e., within 15 days from the expiry of the 60 days' time period.
- Other clarifications:
  - If beneficial interest in capital instruments of an Indian company is held by a person resident outside India, then even though the investment may be made by an Indian citizen, the same would be considered as FDI.
  - Exercise of options by an individual resident outside India, to whom options were granted when he/she was a person resident in India, shall be treated as investment on a non-repatriation basis.
  - Downstream investment into Indian companies shall require approval of the board of directors and approvals under the shareholders' agreement, if any. An Indian company receiving downstream investment is required to intimate the Secretarial of Industrial Assistance, Department of Industrial Policy and Promotion. Additionally, the FDI policy requires intimation of downstream investment to RBI on the FIFP. RBI will need to accordingly align the provisions of FEMA 20 with the FDI policy.
  - Earlier non-resident Indians ("**NRI**") and overseas citizen of India ("**OCI**") were permitted to transfer capital instruments held by them only to another NRI, OCI and Indian resident. Now, NRIs and OCIs are also permitted to transfer capital instruments by way of sale or gift to any person resident outside India.
  - Provision for delayed payment has been incorporated for delays in reporting. This may obviate the need to undergo the time-consuming process to compound such contraventions.

SEBI:

- FPIs are now permitted to invest in: (a) unlisted corporate debt securities in the form of non-convertible debentures/bonds issued by public or private companies, subject to minimum residual maturity of three years and end use restrictions on investment in real estate business, capital market and purchase of land; and (b) securitised debt instruments.

Recent changes to the tax regime have already been discussed in our response to Section 9.

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?

The scope and extent of legal due diligence depends on the term of the operations of the company. Legal due diligence exercises cover review of the corporate records, approvals and licences, examining contracts of the company and examining compliance under various laws applicable to the business of the company. Legal due diligence is most often conducted by external counsels and is completed within three to five weeks, depending on the scope of the diligence.

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 play an important role in PE transactions. The Prevention of Corruption Act, 1988, criminalises the receipt of illegal gratification by public servants in India. However, the legislation currently does not cover private sector bribery in India. 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/encompassing anti-bribery laws as applicable in their jurisdiction, by way of contractual undertakings.

PE investors seek warranties and covenants from the management team confirming compliance with anti-bribery laws including the Foreign Corrupt Practices Act, 1977 ("**FCPA**") and the UK Bribery Act, 2010 ("**UKBA**"). Breach of such warranties/covenants 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 investor has negligible liability for any breach by a company. However, the nominee director may be subject to liabilities, especially in case of breach of his duties. 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.

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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?

Adversarial dispute resolution through the courts in India pose challenges in terms of the time and costs involved. Therefore, we recommend incorporation of institutional dispute resolution mechanisms such as arbitration in agreements which are proposed to be executed by PE funds with portfolio companies. While a robust legal framework for conduct of arbitrations is evolving, at present, overseas institutional arbitrations such as the Singapore International Arbitration Centre, is preferred for resolving disputes effectively and in a commercially savvy manner.

The threat of initiation of actions under the FCPA and the UKBA are an area of increasing concern for PE funds. The aforesaid laws expose PE funds to liabilities in the event their associates or employees in foreign countries engage in corrupt practices. India has been ranked 81st out of 180 countries in the Corruption Perceptions Index 2017 prepared by Transparency International. Corruption leads to compromises in corporate governance which heightens reputational risks and increases the costs of doing business. Such laws make it critical for PE funds to conduct adequate anti-corruption due diligence in connection with their investments and to 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.

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 has extensive experience in advising clients on private equity investments and venture capital. 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*, *ICICI Ventures* and *IDFC Investments* in relation to their 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* and *SBI Macquarie* in relation to their investments and exits in India.

Vineetha regularly advises clients on issues arising out of corporate governance domestic anti-corruption laws and 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.

She has been ranked as one of the "*leading individuals*" in India by *Chambers & Partners 2018* and *2017* and sources consider her as "*one of the most active private equity professionals in the market*" and also added that "*she is a very knowledgeable and constructive presence at the table*".

She won the *AI Global* "*Most Influential Women in Private Equity Investment 2018 – India*". Vineetha is recommended and ranked in *Chambers & Partners Asia Pacific 2018*, *The Legal 500 2018* and *Global Law Experts*.

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Based in the firm's New Delhi office, Ashwini has more than a decade's experience in advising on private equity and venture capital transactions. She has acted for a broad spectrum of clients that include private equity investors, mid-to-late stage companies receiving private equity investments, existing venture capital investors, as well as promoters and start-ups. She has represented different stakeholders across the entire lifecycle of a transaction – right from an early stage investment, to co-investment, mid-to-late stage investments, negotiation of non-participating investor rights, as well as investor exits, giving her a holistic and practical approach at the negotiation table.

Ashwini also works extensively on cross-border M&A and joint ventures, as well as acqui-hires, business restructures and other acquisitions. Her expertise extends to strategic investments/acquisitions as well as those involving financial investor exits and promoter buyouts. She has advised a broad spectrum of clients including financial investors, global and Indian corporates, individual sellers and promoters, giving her a nuanced understanding of different stakeholder perspectives. She is also an established practitioner in employment law, and draws on this expertise in structuring acquisition transactions.

Ashwini has co-authored many articles on a wide range of private equity and employment law issues. Ashwini is admitted to practice law in India, and 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*). Ashwini Vittalachar is also a recommended practitioner for Labour & Employment (*The Legal 500* 2018, 2017 and 2016) and has been recommended by All China Lawyers Association as one of the leading lawyers in the Belt and Road region.

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