Private equity in India: market and regulatory overview

Practical Law Country Q&A 8-504-2425

Search Details

Jurisdiction:	India

Delivery Details

Date:	15 July 2020 at 6:31 am
Delivered By:	Anonymous User
Client ID:	NOCLIENTID

© 2020 Thomson Reuters. All rights reserved.

Private equity in India: market and regulatory overview

by *Pratish Kumar*, *Sumitava Basu* and *Divya Dhage*, *Juris Corp*

Country Q&A | Law stated as at 01-Jul-2020 | India

A Q&A guide to private equity law in India.

The Q&A gives a high level overview of the key practical issues including the level of activity and recent trends in the market; investment incentives for institutional and private investors; the mechanics involved in establishing a private equity fund; equity and debt finance issues in a private equity transaction; issues surrounding buyouts and the relationship between the portfolio company's managers and the private equity funds; management incentives; and exit routes from investments. Details on national private equity and venture capital associations are also included.

To compare answers across multiple jurisdictions visit the *Private Equity Country Q&A Tool*.

This Q&A is part of the Practical Law global guide to private equity. For a full list of jurisdictional Q&As visit *global.practicallaw.com/privateequity-guide*.

Market overview

Funding sources

Tax incentive schemes

Fund structuring

Fund duration and investment objectives

Fund regulation and licensing

Interests in portfolio companies

Buyouts

- Principal documentation
- Buyer protection

Debt financing

- Lender protection
- Financial assistance
- Insolvent liquidation
- Equity appreciation

Portfolio company management

Exit strategies

Reform

© 2020 Thomson Reuters. All rights reserved.

Contributor profiles

Pratish Kumar, Partner

Sumitava Basu, Principal Associate

Divya Dhage, Associate

Market overview

1. What are the current major trends in the private equity market?

2020 has seen a significant decline in private equity investments due to the outbreak of the 2019 novel coronavirus disease (COVID-19) pandemic. There is currently a likelihood of generating investment opportunities in certain sectors, such as e-commerce, enterprise technology, healthcare and on-demand services (*source: Business Today, "Coronavirus: E-commerce, SaaS and healthcare to attract more PE funding, says report"*).

More interest has been shown in the setting up of funds for the turnaround of distressed companies under the Insolvency and Bankruptcy Code, 2016.

2. What has been the level of private equity activity in recent years?

Fundraising

Private equity investments witnessed a slight surge in 2019, touching USD37 billion spread across 861 deals as compared to USD36.16 billion spread across 937 deals in 2018 (*source: Business Standard, "Private equity investments surge to all-time high of USD37 billion in 2019"*).

Investment

The infrastructure sector saw the highest private equity infusion of USD14.7 billion spread across 74 deals as against USD7.8 billion in 2018 (*source: Business Standard, "Private equity investments surge to all-time high of USD37 billion in 2019"*).

Private equity funding has increased in the following sectors:

- Energy.
- Telecoms.
- IT and IT-enabled services (ITES).
- Financial services.

© 2020 Thomson Reuters. All rights reserved.

- Airports.
- Payments.

The total private equity investment in the energy sector was USD4.9 billion spread across 26 deals, led by Brookfield Infrastructure Fund's USD1.8 billion investment in Reliance Pipeline Infrastructure (*source: Business Standard, "Private equity investments hit ten-year high in 2019, shows Refinitiv data"*).

In the telecoms sector, Brookfield's USD3.7 billion buyout of Reliance Jio's tower assets accounted for one of the largest deals of 2019.

In the ITES sector, Alibaba Group and Softbank invested USD1 billion in Paytm.

Transactions

See below for a snapshot of the recent trends in the private equity space in India:

- **Buyouts.** Leveraged buyouts (LBOs) are not permitted under Indian law, except in limited circumstances. While the majority of private equity investments are for a minority stake, majority control/buyouts have increased. Some buyout deals have been driven by the recent focus on the stressed assets space and a drive to clean up the non-performing assets of the banks. In December 2019, ArcelorMittal acquired debt-ridden Essar Steel and formed a joint venture with Nippon Steel Corporation.
- **Regulation-driven deals.** Due to regulatory conditions, companies are being forced to divest their assets and that has attracted considerable private equity interest.
- **Private investment in public enterprises.** Private equity investments in public enterprises are currently rare due to regulatory issues and restrictions.
- **Start-up and tech sectors.** Start-up funding deals amounted to USD7.9 billion (*source: Business Insider India, "These are the top start-up investment deals that got VCs interested in 2019"*).

Exits

2019 saw a 70% slowdown in the number of exits. Open market sales and strategic sales were the preferred form of exits, and the number of exits via initial public offerings (IPOs) were low (*source: Mint, "Private equity exits slow down in 2019"*).

Funding sources

3. How do private equity funds typically obtain their funding?

Private equity funds typically obtain their funding from:

- High net-worth individuals.
- Banks.

© 2020 Thomson Reuters. All rights reserved.

- Insurance companies.
- Pension funds.
- Sovereign wealth funds.
- Funds of funds.
- Offshore investors.

Tax incentive schemes

4. What tax incentive or other schemes exist to encourage investment in unlisted companies? At whom are the incentives or schemes directed? What conditions must be met?

Incentive schemes

The following are some of the tax incentives for encouraging investment in unlisted companies:

- Domestic funds registered as Category I and Category II alternative investment funds (AIFs) have been provided a tax pass-through status (tax is not charged at the level at the fund itself but on distributions to investors). Further, tax withholding at 10% by AIFs will now only apply to Indian residents. AIFs are permitted to obtain nil/reduced rate tax withholding certificates. For non-residents, the tax withholding will be at the applicable domestic law or double tax treaty rates.
- Tax on share premiums received from venture capital funds (VCFs) (a type of Category I AIF) is exempt in the hands of unlisted companies.
- Capital gains arising from the sale of unlisted shares held for a period of 24 months can qualify for long-term capital gains tax and are therefore taxed at a lower rate (*see Question 14, Taxes*).

At whom directed

The tax pass-through applies only to investments made by private equity funds registered as a Category I AIFs (which include VCFs and angel investors) and Category II AIFs (which are typically private equity funds), or Securities and Exchange Board of India (SEBI) registered Foreign Venture Capital Investors (FVCIs).

Conditions

The treatment of unlisted share transfer income as a capital gain as mentioned will not be applied if the:

- Genuineness of transactions in unlisted shares itself is questionable.
- Transfer is related to an issue relating to lifting of the corporate veil.
- Transfer is made along with the control and management of underlying business.

© 2020 Thomson Reuters. All rights reserved.

The tax exemption for share premiums received from VCFs applies automatically.

The tax treatment of income from the sale of unlisted shares as qualifying for long term capital gains tax applies if the holding period is met (*see above, Incentive schemes*).

Fund structuring

5. What legal structure(s) are most commonly used as a vehicle for private equity funds in your jurisdiction?

Typically, funds are set up as trusts, registered as an AIF with the SEBI (*see below, Trusts*). AIFs can only be set up as a trust, company or limited liability partnership (LLP).

Trusts

This is the most common structure for setting up a fund in India.

Companies

Private equity funds can be set up as companies under the Companies Act 2013. However, this structure is rarely used, as there are not clear precedents for raising funds in a company structure, and because there are stricter compliance requirements than those relating to a trust structure.

LLPs

AIF funds can be set up as LLPs under the Limited Liability Partnership Act 2008. However, the Registrar of Companies does not permit LLPs to be set up merely as investment vehicles, and therefore their use for private equity funds is rare.

6. Are these structures subject to entity level taxation, tax exempt or tax transparent (flow through structures) for domestic and foreign investors?

The income earned by Category I and II AIFs (except from a business or profession) is not taxed at the level of the fund. Withholding tax is charged on the distribution of income to the unitholders who are Indian residents; the taxation of other unitholders will depend on their jurisdiction and whether a double taxation treaty applies (*see Question 4*).

7. What (if any) structures commonly used for private equity funds in other jurisdictions are regarded in your jurisdiction as being tax inefficient (whether by not being recognised as tax

© 2020 Thomson Reuters. All rights reserved.

transparent or otherwise)? What alternative structures are typically used in these circumstances?

In Mauritius, Singapore and The Netherlands, funds are typically set up as companies or LLPs. While a trust, company or LLP set up as a Category I or Category II AIF now all receive positive tax benefits, a trust remains the most preferred mode of structure (*see Question 5 and Question 6*).

Fund duration and investment objectives

8. What is the average duration of a private equity fund? What are the most common investment objectives of private equity funds?

Duration

The average duration of a fund is between five to seven years, but the period differs from fund to fund depending on factors such as the:

- Sectors in which the private equity fund is targeting its investment.
- Purpose for which the fund is set up.

Investment objectives

Under the SEBI AIF Regulations 2012 (AIF Regulations), the private equity fund must clearly describe certain matters at the time it makes an application for registration to the SEBI (*see Question 10*), including, but not limited to, the investment objective and targeted investors.

The following are some of the key investment objectives of a fund.

Returns on investment. To obtain optimum/higher returns on investment. The rate of return that a fund seeks to make depends on the sector in which it invests:

- Typically, the expectation is to make an average internal rate of return (IRR) of 18% to 24%.
- Funds that invest in the infrastructure sector expect a higher rate of 25% to 28%.
- Social sector focus funds expect to make a lower IRR of 10% to 14%.

Investment strategy. Private equity funds make investments based on factors such as sector, size of the company, and potential for growth. Certain funds are “special situation” funds and their strategy depends on their mandate. There are other private equity funds that target investment only in start-ups and medium size companies.

© 2020 Thomson Reuters. All rights reserved.

Social purpose. Private equity funds set up as social sector focused funds differ in nature from other private equity funds, as they provide grants and capital support for socially relevant sectors.

Fund regulation and licensing

9. Do a private equity fund's promoter, principals and manager require authorisation or other licences?

Promoter

Promoters of a private equity fund do not require any authorisation or licence but must meet the relevant eligibility criteria under the AIF Regulations, including being a fit and proper person under the SEBI (Intermediaries) Regulations 2008 (Intermediaries Regulations) to be granted the certificate of registration to the AIF.

Investment manager

The fund manager must be registered with the SEBI under the SEBI (Investment Advisers) Regulations 2013, which set out the eligibility criteria for investment managers, including:

- Net worth.
- Adequate experience in the financial sector.
- Being a fit and proper person under the Intermediaries Regulations.

10. Are private equity funds regulated as investment companies or otherwise and, if so, what are the consequences? Are there any exemptions?

Regulation

Domestic private equity funds must be set up as AIFs and registered with the SEBI under the AIF Regulations. Private equity funds that were set up before the AIF Regulations must be registered under the SEBI (Venture Capital Funds) Regulations 1996 (VCF Regulations). Existing funds registered under the VCF Regulations may continue to act as such without obtaining registration under the AIF Regulations until the end of the fund term or scheme.

The AIF Regulations set out three categories of funds to be registered:

- **Category I AIFs.** These funds invest in:
    - venture capital sectors; or

© 2020 Thomson Reuters. All rights reserved.

- early stage sectors; or
- social ventures sectors; or
- infrastructure sectors.

- **Category II AIFs.** Most private equity funds will fall in this category.
- **Category III AIFs.** These funds employ diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives (for example, hedge funds).

Some of the key features of an AIF are:

- They must have a minimum corpus of INR200 million per scheme.
- They are permitted to solicit or collect funds except by way of private placement.
- The minimum investment to be made by an investor is INR10 million.
- The manager's or sponsor's continuing interest in the AIF must be at least 2.5% of the fund or INR50 million, whichever is less, and this must not be through waiver of management fees.
- Sponsors/investment managers must disclose their investment in the AIF to the investors.
- The minimum tenure of a Category I and Category II AIF is three years. Category III AIFs can be open ended or closed ended.
- No scheme of the AIF can have more than 1,000 investors.
- A lock-in period/minimum investment of one year for certain types of investment is required (for example, for private equity funds registered as Category II AIFs investing in listed companies pursuant to due diligence).

Private equity funds registered under the VCF Regulations must comply with the requirements under those regulations.

If a private equity fund carries on activities without being registered (except where it is exempt), the SEBI can levy penalties and bar it from undertaking any further activities.

Exemptions

The following are exempt from obtaining registration under the AIF Regulations:

- Private equity funds in existence before the AIF regulations were in force.
- Existing funds which are not able to comply with the requirements under the AIF Regulations may apply to the SEBI for an exemption from strict compliance.
- Existing private equity funds not seeking any fresh commitments, subject to submitting information on their activities to the SEBI.
- Funds managed by securitisation companies/asset reconstruction companies registered with the Reserve Bank of India (RBI).

© 2020 Thomson Reuters. All rights reserved.

11. Are there any restrictions on investors in private equity funds?

There are no specific restrictions on investors in private equity funds. There are, however, restrictions on fund raising from investors, mainly under the following regulations:

- **AIF Regulations.** An AIF cannot have more than 1,000 investors if the AIF is formed through an investment vehicle other than a company.
- **Companies Act.** If an AIF is set up as a private limited company, the company cannot issue shares to more than 200 shareholders.
- **Foreign investment regulations.** Foreign investment in units of AIFs is permitted to residents outside India (other than citizens of or any other entity which is registered or incorporated in Pakistan or Bangladesh) without RBI approval, subject to certain conditions. A Category III AIF which has received any foreign investment can make a portfolio investment in only those securities or instruments in which a foreign portfolio investor is allowed to invest under the Foreign Exchange Management Act 1999 and the applicable rules/regulations made under that Act. Government approval is required in the case of foreign investment in Indian companies by investors from China, Pakistan, Bhutan, Bangladesh, Myanmar, Afghanistan and Nepal, or if the beneficial owner of an investment into India is situated in, or is a citizen of, any such country.

12. Are there any statutory or other maximum or minimum investment periods, amounts or transfers of investments in private equity funds?

The AIF Regulations set out conditions with respect to maximum and minimum investment periods and amounts (*see Question 10*).

13. How is the relationship between the investor and the fund governed? What protections do investors in the fund typically seek?

The relationship between investors and the fund is governed by the:

- Statute applicable to the type of fund set up (that is, trusts, companies or LLPs (*see Question 5*).
- Fund’s constitutional documents.

© 2020 Thomson Reuters. All rights reserved.

- Binding agreement entered into between the fund and the investor.

Trusts

Trusts are set up under the Indian Trust Act 1882 and registered as an AIF under the AIF Regulations. The relationship is governed by the provisions of the trust deed, the contribution agreement and the private placement memorandum.

The contribution agreement between the fund and the investor will cover such matters as minimum contributions by the investor, period of contribution, object of the fund, returns on investment and distribution mechanism.

Types of protection that investors seek in the contribution agreement include:

- Adequate representations and warranties from the promoters/sponsor of the fund.
- Corporate governance requirements, such as conduct of investors' meetings.
- Covenants about critical decisions such as:
  - removal or replacement of the trustee or the investment manager;
  - winding-up of the fund;
  - investments in excess of the threshold limits permitted.
- Non-compete obligation on the managers/sponsors of the fund during the commitment period.
- Indemnity.

Companies

Companies are set up under the Companies Act 2013. A company will be governed by the articles of association of the company, the shareholders' agreement and the private placement memorandum. The protections sought by an investor under a shareholders' agreement vary from those sought under a contribution agreement as above.

Interests in portfolio companies

14. What forms of equity and debt interest are commonly taken by a private equity fund in a portfolio company? Are there any restrictions on the issue or transfer of shares by law? Do any withholding taxes or capital gains taxes apply?

The foreign exchange regulations permit foreign direct investments only in equity shares, compulsorily convertible preference shares (CCPs), compulsorily convertible debentures (CCDs), and warrants. The issue of any other instrument, such as optionally convertible debentures (OCDs) and optionally convertible preference shares (OCPs), is treated as debt and is governed by the external commercial borrowing (ECB) norms. These debt instruments are subject to certain restrictions in relation to their end-use and minimum average maturity.

Most common form

© 2020 Thomson Reuters. All rights reserved.

The following are the most common forms:

- **Equity shares.** Equity shares provide voting rights and the right to dividends in the target company. The receipt of dividends on equity shares is subject to the company making profits and is usually at the discretion of the company. In a liquidation/winding up scenario, an equity holder is subordinated to holders of CCDs and CCPs.
- **CCPs.** CCP holders do not enjoy voting rights except where dividends have not been paid to them for a continuous period of two years or on votes concerning matters affecting their interest. They have a preferential dividend rate and preference in liquidation over equity shares. This allows a private equity investor to structure its ratchet provision.
- **CCDs.** CCD holders enjoy neither voting rights nor dividends. However, they are entitled to interest. CCD holders get a preference over CCP holders and equity shareholders in a liquidation scenario.
- **Convertible notes.** Convertible notes are an instrument issued by a start-up company acknowledging receipt of money initially as debt, repayable at the option of the holder, or which is convertible into equity shares within a period of five years from the date of issue.

Other forms

The following other forms are also used:

- **Share warrants.** Share warrants are instruments in the nature of options which give rights to the holder to subscribe to the equity shares of the company at a pre-determined price, and at an agreed time. The issue of warrants to offshore private equity funds is permitted, subject to certain conditions.
- **OCDs.** OCDs are debentures which may either be redeemed on maturity or converted into equity shares of the company at the option of the private equity fund, and at a pre-agreed price at the time of issuance. The RBI treats OCDs as debt (*see above*).
- **OCPs.** OCPs are preference shares which may be converted into equity shares at the option of the private equity fund. Similar to OCDs, they are construed as debt under the foreign exchange laws (*see above*).

Restrictions

Pricing restrictions under the Indian foreign exchange laws apply to the issue or transfer of equity shares, CCDs, CCPs and convertible notes by residents to non-residents.

Issue of CCDs, CCPs, convertible notes or equity shares. Issue of any kind of securities is subject to the provisions of the Companies Act, for example:

- Equity shares of a private company cannot be issued to more than 200 shareholders at any time. For private placement/preferential allotment of shares, CCDs and CCPs, no issue or offer can be made to more than 200 shareholders in a financial year.
- No issue can be made unless allotments under an earlier issue have been completed or withdrawn.
- Preference shares must be issued for a period less than 20 years.
- Pricing guidelines apply in relation to the issue of shares, CCDs, CCPs and convertible notes to a non-resident.

Transfer of CCDs, CCPs, convertible notes or equity shares. The following applies:

- Contractually, under a shareholders' agreement, clauses restricting transfer of shares such as lock-in periods, rights of

© 2020 Thomson Reuters. All rights reserved.

first offer, rights of first refusal, and tag-along rights (that is, where a shareholder sells their stake, the rights of other shareholders to join that deal at the same conditions) and drag-along rights (compelling other shareholders to join the deal) are usually provided. Private companies have to provide for restrictions on transferability.

- The RBI has prescribed certain restrictions with respect to transfer where an offshore investor is involved, including:
  - pricing guidelines apply in relation to transfer of shares, CCPs, CCDs and convertible notes;
  - a transfer of shares in an unlisted company is valued according to any internationally accepted pricing methodology on an arm's length basis;
  - a transfer of shares in a listed company is valued at a price in accordance with the applicable SEBI guidelines.

Taxes

The following apply to the sale or transfer of shares:

- Where shares are sold or transferred by a non-resident to a resident, the resident must withhold tax (*see Question 4*). However, such a transfer is subject to any relevant double taxation treaty with the other country.
- Capital gains are subject to taxation. For unlisted companies, long-term capital gains are taxable at a rate of 10% and short-term capital gains are taxable at a rate of 30% or 40%. In the case of listed companies, long-term capital gains are exempt if sold on the stock exchange, if securities transaction tax is paid. However, long-term capital gains exceeding INR1 million are taxed at a rate of 10%. In the case of short-term capital gains, the tax rate is 15%. Capital gains are subject to any applicable double taxation treaty.

Buyouts

15. Is it common for buyouts of private companies to take place by auction? If so, which legislation and rules apply?

Buyouts by auction of a private company are not common but can be used where there is a perceived high interest in the target company. Such auctions are usually governed by the rules drafted by the auctioneer.

16. Are buyouts of listed companies (public-to-private transactions) common? If so, which legislation and rules apply?

Buyouts of listed companies are not very common because:

- Any such news can have a potential impact on the prices of the company.

© 2020 Thomson Reuters. All rights reserved.

- All listed companies are required, under SEBI regulations, to maintain a minimum public holding of 25%.
- Under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 2011 (Takeover Code), shares must be offered to the public where the acquisition of a controlling share (either direct or indirect) or acquisition above specified thresholds is proposed.
- Under the SEBI (Prohibition of Insider Trading) Regulations 2015 (Insider Trading Regulations), investors are prohibited from acquiring trading in securities of the listed company on the basis of unpublished price-sensitive information.
- The process laid down under the SEBI (Delisting of Equity Shares) Regulations 2009 must be compiled with, including obtaining the approval of the board, shareholders and stock exchanges.

Principal documentation

17. What are the principal documents produced in a buyout?

The principal documents in a buyout transaction are:

- Share purchase agreement/buyout agreement.
- Shareholders' agreement.
- Bid document (if the buyout takes place through a bidding process).
- Offer letter and the public announcement of an open offer (in the case of a buyout of a listed company under the Takeover Code).

Buyer protection

18. What forms of contractual buyer protection do private equity funds commonly request from sellers and/or management? Are these contractual protections different for buyouts of listed companies (public-to-private transactions)?

Some key contractual protections commonly requested by buyers are:

- Adequate representations and warranties relating to, for example, the business and operations of the company, title to the shareholding, litigation, and defaults prior to the date of the buyout.
- Covenants requiring promoters to undertake certain activities, including relating to running businesses as per the agreed

© 2020 Thomson Reuters. All rights reserved.

business plan. Certain private equity funds require covenants in relation to anti-corruption and anti-bribery provisions.

- Indemnities from the seller/promoter of the company, typically for three years after the buyout (seven years for tax indemnities).
- Restrictions on transfer of shares by the promoters.
- Board seat and veto rights: private equity funds generally retain the right to appoint nominees onto the board of directors of the target company.
- Exit right (*see Question 31 and Question 32*).

The contractual protections for investments in a public listed company are limited compared to those available to an unlisted company. Representations, warranties and indemnities can be negotiated with the seller. Governance-related rights are difficult to obtain, and no exit rights will be agreed as the company is listed. In addition, private equity investors usually want a veto on matters on which no action may be taken without consent of investors (for a list of veto matters, see *Question 21*).

19. What non-contractual duties do the portfolio company managers owe and to whom?

Directors on the board of a company must comply with statutory duties prescribed under the Companies Act, including:

- Acting in good faith to promote the objects of the company and acting in its best interests.
- Acting for the benefit of the members, shareholders and employees as a whole.
- Acting for the benefit of the community for the protection of the environment.

These duties are usually owed to the company, its members and other stakeholders, such as depositors and creditors. In the case of management buyouts (MBOs) by a director, it will be important for a director to ensure balancing of the obligations.

For a listed company, the Takeover Code imposes other obligations, including setting up a committee of independent directors to provide reasoned recommendations on the open offer and to facilitate verification of shares tendered in the acceptance offer.

In an MBO of a listed company, an insider (as defined under the Insider Trading Regulations, which includes a director, officer or employee that is allowed or would reasonably be expected to be allowed access to unpublished price-sensitive information) cannot trade in securities on the basis of that information.

20. What terms of employment are typically imposed on management by the private equity investor in an MBO?

MBOs are not common in India. MBOs can be advantageous in the case of distressed companies and the management of the

© 2020 Thomson Reuters. All rights reserved.

company can take over the business in order to revive the distressed company. Standard terms of employment imposed on key managerial personnel include:

- The obligation to devote substantial time to the business.
- A restriction on taking up any other full-time employment/directorship.
- Non-compete and non-solicitation clauses.
- Confidentiality.
- Provisions related to usage and ownership of intellectual property.

21. What measures are commonly used to give a private equity fund a level of management control over the activities of the portfolio company? Are such protections more likely to be given in the shareholders' agreement or company governance documents?

The most common measure is a right to appoint a nominee on the board of the company. In addition, private equity investors typically require veto powers for decisions by the board or by shareholders, including approval rights over:

- A business plan.
- The appointment and removal of directors.
- Entering into any joint venture, collaboration or any similar arrangement.
- Entering into related party transactions.
- Entering into an important contract.
- Provisions relating to transfer of shares such as put option, tag-along and drag-along rights, right of first refusal and right of first offer.

These provisions are usually included in the shareholders' agreement as well as the constitutional documents of the company.

Debt financing

22. What percentage of finance is typically provided by debt and what form does that debt financing usually take?

The percentage of debt finance varies from transaction to transaction and on the debt requirements of the company or promoter. Typically, the debt to equity ratio is 70:30.

© 2020 Thomson Reuters. All rights reserved.

Debt financing is usually taken either in the form of:

- A term loan.
- Working capital.
- An issue of non-convertible debentures.

Under the Indian foreign exchange laws, if the private equity investor is a non-resident, the issue of partially, optionally or non-convertible debentures is treated as ECB and subject to the relevant restrictions (*see Question 14*).

Companies raising ECBs have more stringent restrictions as regards end-use and may require approval from the RBI in specific circumstances. Accordingly, this is not the preferred route for foreign direct investment.

Lender protection

23. What forms of protection do debt providers typically use to protect their investments?

Security

The typical forms of security taken by a debt provider are:

- Mortgage over immovable property.
- Hypothecation of movable property.
- Pledge of shareholding of the borrower by the promoters.
- Personal guarantee by the individual promoters or corporate guarantee by the holding company.

Contractual and structural mechanisms

Some of the key protections that debt providers obtain to protect their facility are:

- Prior consent of the debt provider (and/or the trustee appointed on its behalf) in matters such as:
  - incurring additional financial indebtedness or security creation;
  - changes in the majority shareholding or promoter of the borrower;
  - related party transactions above a specified threshold;
  - declaration of dividends to the shareholders of the borrower;
  - amendment to the constitutional documents of the borrower.
- Events of default whereby the debt provider will be entitled to accelerate the facility and/or enforce the security is also

© 2020 Thomson Reuters. All rights reserved.

provided for under the documentation.

- A covenant with respect to subordination of all other facilities obtained by the company from its group companies/holding company or promoter to the facility provided by the debt provider.

Financial assistance

24.Are there rules preventing a company from giving financial assistance for the purpose of assisting a purchase of shares in the company? If so, how does this affect the ability of a target company in a buyout to give security to lenders? Are there exemptions and, if so, which are most commonly used in the context of private equity transactions?

Rules

A public company, or a private company which is a subsidiary of a public company, is prohibited from providing financial assistance for the purchase of its shares. The scope of financial assistance extends to the provision of a loan, guarantee or security.

Exemptions

The following are the exceptions to the rules on financial assistance:

- Private companies and one-person companies.
- The provision of monies accepted by a company in accordance with any scheme approved by the company for the subscription of fully paid up shares in the company or its holding company. This is as long as the subscription or purchase of the shares is either held by a company employee or held by trustees for the benefit of the employees.
- The giving of loans by a company to employees of the company, other than its directors or key managerial personnel, for an amount exceeding their salary or wages for a period of six months, with a view to enabling them to purchase or subscribe for fully paid-up shares.

Insolvent liquidation

25. What is the order of priority on insolvent liquidation?

The order of priority on liquidation of a company under the IBC will be:

© 2020 Thomson Reuters. All rights reserved.

- Costs of the insolvency resolution process and liquidation costs.
- Debts to secured creditors (who have relinquished their security interest).
- Workmen's dues (for 24 months before commencement).
- Wages and unpaid dues to employees (other than those falling within the definition of workmen, for 12 months before commencement).
- Financial debts to unsecured creditors.
- Government dues.
- Debts owed to secured creditors remaining after enforcement of their security interests.
- Remaining debts.
- Preference shareholders.
- Equity shareholders or partners.

Equity appreciation

26. Can a debt holder achieve equity appreciation through conversion features such as rights, warrants or options?

Certain types of debt holders are permitted to achieve equity appreciation through conversion:

- A domestic debt holder can convert its debt into equity in the manner set out in the facility agreement.
- An offshore debt holder is permitted to convert the external commercial borrowing into equity, subject to the conditions specified by the RBI.
- A foreign investor can subscribe to CCPs and CCDs and convert them in accordance with the terms of such instruments (*see Question 14*). However, the conversion price of such instruments will be in accordance with the relevant foreign exchange regulations.

Portfolio company management

27. What management incentives are most commonly used to encourage portfolio company management to produce healthy income returns and facilitate a successful exit from a private equity transaction?

© 2020 Thomson Reuters. All rights reserved.

Companies typically offer as incentives:

- Employee stock options (including phantom stock options).
- Incentive-linked payments and bonuses.
- Stock appreciation.

28. Are any tax reliefs or incentives available to portfolio company managers investing in their company?

There are no tax reliefs or incentives available to portfolio company managers investing in their company.

29. Are there any restrictions on dividends, interest payments and other payments by a portfolio company to its investors?

Under the Companies Act 2013, the company can declare a dividend out of its profits after deducting amounts for depreciation and transferring such percentage of profits decided by the board into its free reserves.

The company cannot declare a dividend from its reserves other than from its free reserves. A company cannot declare a dividend, unless it has carried over previous losses and depreciation not provided in the previous year or years, which must be set off against profit of the company for the current year.

30. What anti-corruption/anti-bribery protections are typically included in investment documents? What local law penalties apply to fund executives who are directors if the portfolio company or its agents are found guilty under applicable anti-corruption or anti-bribery laws?

The Prevention of Corruption Act 1988 (PCA) does not apply to the private sector. However, the relevant provisions of the Indian Penal Code 1860, such as criminal breach of trust, cheating and ancillary sections, do apply in cases of corruption or bribery.

Given that most private equity funds are linked to entities or individuals based in the US or in the UK, private equity funds typically seek to implement relevant procedural safeguards in accordance with the US Foreign Corrupt Practices Act 1977 and the UK Bribery Act 2010. Relevant contractual provisions may be added in the private equity documentation to reflect

© 2020 Thomson Reuters. All rights reserved.

these safeguards.

If a fund's executive or a director is held to be offering bribes to a public official, he is liable for criminal prosecution under the PCA and imprisonment for a period ranging from six months to five years.

Exit strategies

31. What forms of exit are typically used to realise a private equity fund's investment in a successful company? What are the relative advantages and disadvantages of each?

Forms of exit

The most common form of exit preferred by a private equity fund in a successful portfolio company is listing of the company on the public market, or the sale of the stake to another financial or strategic investor.

Other forms of exit include strategic sale, financial sale and exercise of a put option (that is, an option to sell assets at an agreed price on or before a particular date).

Advantages and disadvantages

The advantages of listing of a company are that it can provide:

- Good liquidity even if an investor cannot exit immediately at the time of listing.
- Tax advantages in the case of sale of floor exchange companies compared to off-market transactions.
- Good valuation, subject to market conditions.

The disadvantages of IPOs are that the shares of a private equity fund are locked in for a period of one year if a complete exit is not provided. This does not apply to VCFs and FVCIs holding shares for a period of at least one year, prior to the date of filing the draft prospectus with the SEBI.

In a strategic sale or a financial sale, the advantage for a private equity fund is the ability to negotiate desired return on investment.

The disadvantages of this method are that:

- It requires involvement and support of promoter.
- It is a longer process.
- The process usually involves diligence and negotiations.

© 2020 Thomson Reuters. All rights reserved.

32. What forms of exit are typically used to end the private equity fund's investment in an unsuccessful/distressed company? What are the relative advantages and disadvantages of each?

Forms of exit

The following are typically used to end the private equity fund's investment in an unsuccessful/distressed company:

- Buybacks.
- Put options.
- Tag-along rights.
- Drag-along rights.

Advantages and disadvantages

Buyback. A buyback can be a useful exit option if the company has cash reserves. Under the Companies Act, a company can make buybacks only up to 25% of the companies' paid up capital and free reserves.

The ratio of the aggregate of secured and unsecured debts owed by the company after the buyback cannot exceed more than twice the paid-up capital and free reserves. In addition, buybacks are not tax efficient. These conditions may not make the buyback commercially viable for a company.

Put options. Put options are the preferred exit method. However, the disadvantage is that a sale of shares from a non-resident to a resident investor is subject to fair market value, which may not always give the investor the desired return. It is also dependent on the liquidity position of the person on whom the put option is exercised.

Tag-along rights. Tag-along rights are useful if a promoter is looking at an exit. The disadvantage is that they are dependent on promoters and are subject to pricing norms.

Drag-along rights. Drag-along rights are rarely used and are heavily negotiated. They are also subject to pricing guidelines and the ability to find a strategic investor for a 100% is challenging.

Reform

33. What recent reforms or proposals for reform affect private equity in your jurisdiction?

Foreign exchange laws in India

The Foreign Exchange Management (Non-debt Instruments) Rules, 2019 have been notified superseding the Foreign

© 2020 Thomson Reuters. All rights reserved.

Exchange Management (Transfer and Issue of Security by a Person Resident Outside India) Regulations, 2017 and the Foreign Exchange Management (Acquisition and Transfer of Immovable Property in India) Regulations, 2018. The RBI also notified the Foreign Exchange Management (Debt Instruments) Regulations, 2019, which deal with the provisions pertaining to debt instruments.

FDI relaxations in various sectors

Foreign direct investment (FDI) by non-residents into India is regulated through two routes:

- The automatic route (no approval is required).
- The approval route (approval of the respective ministry is required).

Relaxations in terms of threshold limits and approvals required have been introduced to the FDI Policy, 2017 whereby 100% FDI is now allowed under the automatic route in sectors such as:

- Insurance intermediaries.
- Coal and lignite mining activities.
- Contract manufacturing.
- Single brand retail trade.

Restrictions on foreign investment on account of COVID-19

As a result of the COVID-19 outbreak, Indian companies are witnessing a decline in valuations. With a view to curbing opportunistic takeovers/acquisitions of Indian companies, the Indian Government has imposed a condition that such actions will require government approval by investors belonging to countries sharing a land border with India, or from China, Pakistan, Bhutan, Bangladesh, Myanmar, Afghanistan and Nepal, or where the beneficial owner of an investment into India is situated in, or is a citizen of, any such country.

ECB framework

Restrictions on eligible lenders and borrowers have been removed and end-use restrictions been relaxed. The resolution applicants using the corporate insolvency resolution process under the IBC are now permitted to raise ECBs from recognised lenders for the repayment of rupee term loans of the target company under the approval route.

Tax-related reforms

The Finance Act, 2020 abolished dividend distribution tax and, as a result, dividends will now be taxed only in the hands of the recipients at the applicable tax rates.

Contributor profiles

Pratish Kumar, Partner

Juris Corp
T +91 22 4920 5582

© 2020 Thomson Reuters. All rights reserved.

E *pratish.kumar@jclex.com*
W *www.jclex.com/*

Professional qualifications. Member of Bar Council of Maharashtra and Goa; BBA LLB (Honours), National Law University, Bhopal

Areas of practice. Banking & finance; project finance; regulatory and policy; trade finance and securitisation; restructuring and distressed assets.

Sumitava Basu, Principal Associate

Juris Corp
T +91 22 6720 5513
E *sumitava.basu@jclex.com*
W *www.jclex.com/*

Professional qualifications. Member of Bar Council of Maharashtra and Goa; BBA LLB (Honours), West Bengal National University of Juridical Sciences, Kolkata

Areas of practice. Private equity; structured finance; corporate laws; insolvency and bankruptcy laws; securities law.

Divya Dhage, Associate

Juris Corp
T +91 22 6720 5512
E *divya.dhage@jclex.com*
W *www.jclex.com/*

Professional qualifications. Member of Bar Council of Maharashtra and Goa; BLS LLB, Government Law College, Mumbai

Areas of practice. Structured finance; banking; corporate laws.

END OF DOCUMENT

Related Content

Topics

Private Equity and Venture Capital

Articles

What tax incentive schemes exist to encourage PE/VC investment? • Published on 01-Jan-2019

Country Q&A

Retail investment funds in India: regulatory overview • Law stated as at 01-Dec-2019

© 2020 Thomson Reuters. All rights reserved.

© 2020 Thomson Reuters. All rights reserved.