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TATVALEGAL

Vineet Aneja
India

vineet.aneja@clasislaw.com
+91 98104 05782
www.clasislaw.com

Cross border mergers and acquisitions in India – Key legal issues / challenges

By Vineet Aneja

2018 has been a stellar year for merger and acquisition deals in India, and has recorded deals worth over USD 71 billion.[1] The rise in activity can be credited to a number of factors, such as regulatory changes,[2] consolidation across sectors (such as energy, power and telecommunication sectors) and stressed asset acquisitions.

While cross border mergers and acquisitions aid companies in entering new markets and in their growth, there are various issues/challenges (such as integration, cultural and political issues, compliance issues, issues related to change in management and regulatory changes) which need to be addressed, during and post the acquisition. In this article we focus on the key issues/ challenges (excluding taxation and competition aspects) under Indian law.

Key issues/ challenges faced in cross border mergers and acquisitions under Indian laws

While each transaction poses its own set of challenges, certain key challenges (which apply across the board) are as follows:

I. **Deferred consideration, escrow and indemnities**

Historically, the payment of warranty and indemnity claims required prior approval of the Reserve Bank of India ("RBI"). There were also restrictions on the payment of deferred consideration without RBI approval. These constraints affected retention mechanisms. While the regulations have been revised to address these concerns to a certain extent, the following issues still persist:

(i) not more than 25% of the total consideration can be paid by the buyer on a deferred basis, and the balance amount has to be paid within a period not exceeding 18 months from the date of the transfer agreement; and

(ii) while the regulations provide that part of the consideration can be kept in an escrow to address indemnity claims, the amount cannot exceed more than 25% of the total consideration. Further, the escrow arrangement cannot exceed 18 months from the date of the transfer agreement. Lastly, the total consideration which is retained in India (after the indemnity payout within the 18 months period) has to be more than the fair market value at the time of investment.

II. **Compliance with foreign direct investment (FDI) policy**

While most sectors are open to 100% FDI through the automatic route there are certain sector specific conditions (such as minimum capitalisation norms, minimum sourcing requirement (in the single brand retail sector)) which need to be fulfilled. Some of these sector specific conditions are onerous and impede deal structuring. Further, for certain sectors, prior approval from the sectoral regulator/licensing authority(ies) is required thereby adding to the timelines for deal closing.

III. **Working capital adjustments**

The requirement of ensuring compliance with pricing guidelines (which in essence prescribes a minimum floor price in case of sale by a person resident in India to a person resident outside India and an upper cap on the payment to be made to a person resident outside India by a person resident in India) impairs post-closing working capital adjustments, as the working capital adjustments cannot result in the fair market value price being breached.

IV. **Guarantees or borrowings by offshore merging company also treated as guarantees or ECBs, as the case may be, for the resultant Indian company**

In case of a cross border merger where the resultant company is an Indian company, if the offshore merging company has taken any borrowings or issued guarantees, which post the merger will become liabilities of the resultant Indian entity, then:

(i) all such borrowings / liabilities would constitute external commercial borrowings ("ECBs") of the Indian company, and would need to conform to the relevant regulations concerning ECBs. While a period of two years has been provided under the relevant cross border regulations, this issue presents its own challenges as the ECB regulations provide for various conditions (such as all-in-cost ceiling limits and average maturity period) which may not have been taken into account when the borrowing / liability was initially availed / assumed, and

(ii) in case of guarantees, they would need to comply with the relevant guarantee regulations which restrict the situations in which an Indian company may issue a guarantee in favour of a person resident outside India.

V. **Lack of clarity on cross border demergers**

While it was possible for a foreign company to transfer its undertaking/ business to an Indian company under the Companies Act, 1956, as Section 394 applied to demergers as well as mergers, Section 234 of the Companies Act, 2013 ("Act") only refers to "mergers and amalgamations" without any express mention of demergers. While a literal interpretation of Section 234 will lead to such demergers being disallowed, the objective behind the new provisions is to lay down a forward looking law to facilitate cross border mergers. As a result, there is lack of clarity over the question of permissibility of a foreign company demerging its business undertaking to an Indian company or vice versa under the Act.

Conclusion

While significant steps have been taken to accelerate the merger and acquisition market, there are still some areas of concern that need to be addressed in order to facilitate cross border mergers.

Vineet is the managing partner as well as a founding partner of Clasis Law. He also heads the firm's corporate practice and is widely recognised for his expertise and capabilities in acquisitions and joint ventures (domestic as well as cross borders) across sectors.

Vineet's recognitions include:

- Named as one of the top 100 lawyers for the year 2018 by the India Business Law Journal for the year 2018 (Vantage Asia) A-List.
- Awarded for outstanding performance in Commercial Law by Advisory Excellence in the year 2018.
- Recognised as one of India's Most Trusted Corporate Lawyers by the Indian Corporate Counsel Association in 2017.
- Recommended for Corporate/M & A expertise by Legal 500 in the years 2010, 2011 & 2012.
- Awarded the ILO International Client Choice Award for India in 2010 & 2011.

Disclaimer: *This article should neither be construed as an advice or recommendation to invest in India nor as an opinion or advice on aspects of law referred to.*

This article is intended to be informative rather than exhaustive and is not intended to be a comprehensive review of all developments in the law and practice, or to cover all aspects of those referred to. Readers should take legal advice before applying the information contained in this article to specific issues or transactions.

The law summarised in this article is as of 6 March 2019.

1. As per the PWC report on "Deals in India: Annual review and outlook for 2019" dated December, 2018, available at - https://www.pwc.in/assets/pdfs/publications/2018/deals-in-india.pdf

2 .Recently, the Ministry of Corporate Affairs notified Section 234 of the Act thereby enabling cross border mergers. Subsequently, the Reserve Bank of India notified the Foreign Exchange Management (Cross Border Merger) Regulations, 2018 under the Foreign Exchange Management Act, 1999 thereby, amongst other things, permitting foreign companies to merge with Indian companies. Additionally, the foreign direct investment (FDI) policy has been liberalized to permit hundred (100) per cent FDI, under the automatic route, in various sectors, such as single brand retail trade, real estate broking, cash and carry/ wholesale trading, e-commerce activities.