



ASPECTS OF DEAL STRUCTURING AND DUE DILIGENCE IN RELATION TO INVESTMENTS IN INDIA

PRESENTATION BY:



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— ADVOCATES, SOLICITORS & NOTARY —

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Legal Overview

➤ **Legislations et al**

- Foreign Exchange Management Act, 2000 and Notifications issued thereunder.
- Securities Contract Regulation Act, 1956.
- Securities Exchange Board of India Act, 1992 and Regulations issued thereunder.
- RBI Master Circular on Foreign Investment dated July 1, 2013 and the circulars issued by the RBI from time to time.
- Companies Act, 1956, the Companies Act, 2013 and Rules and Regulations issued thereunder.
- Scheme for Issuance of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Mechanism) Scheme, 1993 (**ADR/GDR/FCCB Scheme**) and the notifications thereunder.
- Other Central and State Legislations depending upon the nature of business of the company.

➤ **Government Authorities**

- Foreign Investment Promotion Board (**FIPB**).
- Reserve Bank of India (**RBI**).
- Securities Exchange Board of India (**SEBI**).



Types of Instruments

➤ **Eligible Equity Instruments under the Foreign Direct Investment Route:**

- Equity Shares (Normal or DVR)
- Fully and mandatorily convertible preference shares
- Fully and mandatorily convertible debentures
- ADRs/ GDRs : Issued in accordance with ADR/GDR Scheme

➤ **Issuance of Debt Instruments**

- Bonds: Convertible and Non- Convertible
 - Foreign Currency Convertible Bonds (FCCBs): FCCBs can be issued by an Indian Company in accordance with FEMA (Transfer or Issue of any Foreign Security) Regulations, 2004, the External Commercial Borrowing (ECB) Guidelines and FCCB Scheme of 1993.
- Non-convertible , optionally convertible or partially convertible preference shares or debentures can be issued in accordance with the ECB Guidelines.
- Warrants: Listed companies, with prior approval of FIPB, can issue warrants under the SEBI (ICDR) Regulations 2009 to investors.
 - Upfront Consideration
 - Period of Warrant



Entry Routes and Pricing -I

➤ Foreign Direct Investment (FDI):

- **Automatic Route:** Sectors, which are not prohibited sectors, and subject to the sectoral caps, investments can be made under the Automatic Route.
- **Approval Route:** Investments beyond the prescribed sectoral caps and issuance of certain type of instruments like warrants, require prior approval of the FIPB.
- **Pricing:** Investments under the Automatic Route are required to be made; (i) in accordance with SEBI Guidelines for listed companies; and (ii) above Fair Market Value calculated based on Discounted Cash Flow Method for unlisted Companies. Investments which are not in accordance with the pricing norms require prior permission of the RBI. The price of convertible capital instruments can be determined based on a formula determined upfront at the time of issuance.

➤ Portfolio Investment Scheme (PIS):

- Foreign Institutional Investors (FIIs) and Non-resident Indians (NRIs) can invest in Indian Companies through PIS.



Entry Routes and Pricing - II

- **Foreign Venture Capital Investor (FVCI):**
 - Formation and Registration
 - Pricing

- **Qualified Foreign Investor (QFI):**
 - Definition of QFI
 - Pricing
 - Transferability

- **ADRs/ GDRs/ FCCBs:**
 - Listing of ADRs/GDRs/FCCBs on Foreign Stock Exchange
 - Two way fungibility of ADR / GDRs
 - External Commercial Borrowing (ECB) norms applicable to FCCBs.



Rights available to Investor

- Rights as available to a Shareholder under the Companies Act, 1956.
- Affirmative Vote Items/ Reserved Matters.
- Board Seats.
- Right to inspect Books of Accounts of the Company.
- Information Rights.
- Commercial Rights: Use of Proceeds, Business Plan, Non- compete*, Rights relating to vote on Subsidiary's business (if applicable), Indemnity, Liquidation Preference.
*Note: Agreements which are 'in restraint of trade' are void under Indian law with certain exceptions regarding sale of business with goodwill, restraints during the term of employment etc.
- Transfer Restrictions: ROFO, ROFR, Tag Along, Drag Along, Anti- dilution Rights, Promoter Lock-in, Put Options and Call Options.**
**Note: Restrictions on sale of shares of public companies (listed or unlisted) namely put options, ROFO, ROFR etc. are unenforceable.
- Others.



Investment in Indian Companies

➤ **Private Limited Companies**

- Wider flexibility of rights

➤ **Public Unlisted Companies**

- Restrictions on rights.

➤ **Public Listed Companies.**

- Restrictions on rights that may be taken plus further application of takeover code and insider trading regulations and in case of preferential allotments, applicability of SEBI (ICDR) Regulations



Documentation

- **Term Sheet**
- **Subscription to Equity or Preference Shares: Share Subscription Agreement and Shareholder's Agreement**
- **Purchase of Equity Shares: Shareholders Agreement and Share Purchase Agreement**
- **Ancillary Agreements** depending upon the nature of the Transaction and findings based upon Due Diligence: **Escrow Agreements, Employment Agreements, Conditions Precedent and Conditions Precedent Documents, et al.**



Process of Investment

- Business Due Diligence
- Ascertaining Valuation of the Target Company
- Legal + Financial Due Diligence*
*Note: In case of listed companies, when price sensitive information is shared, the recipient of the is restricted from dealing in the Target Company.
- Termsheet with exclusivity
- Negotiation of Transaction Documents
- Application for requisite approvals, if any (FIPB, RBI or SEBI)
- Closure of the Transaction
- Allotment / transfer of the securities (as the case may be)
- RBI Filings (if under the automatic route)
- SEBI Filings (if target company is listed)



What is a Due Diligence?

- An investigation or audit of a potential investment.
- Due diligence serves to confirm all material facts in regards to a transaction.
- Generally, refers to the care a reasonable person should take before entering into an agreement or a transaction with another party.
- Blacks Law Dictionary defines ‘due diligence’ as:

Such a measure of prudence, activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent man under the particular circumstances; not measured by any absolute standard, but depending on the relative facts of the special case.



Kinds of Due Diligences

Every transaction at the minimum requires-

- Financial Due Diligence
- Legal Due Diligence
- Tax Due Diligence

Transactions in certain specialized sectors may also involve-

- Environmental Due Diligence
- Production / Engineering Due Diligence



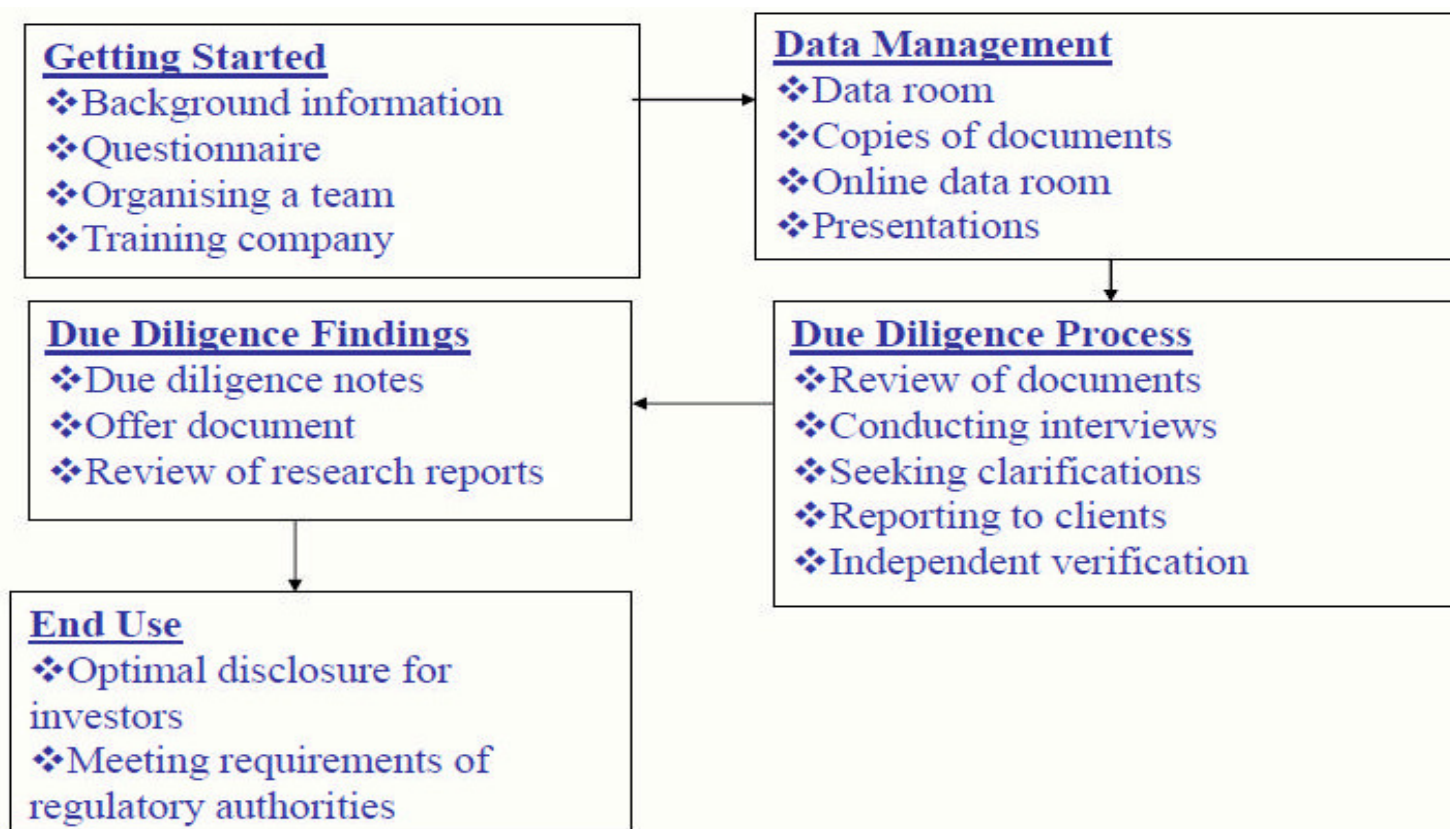
Legal Due Diligences

A Legal Due Diligence will generally cover the legal aspects of the following –

- Corporate Organization and Structure
- Secretarial and Regulatory Compliance
- Banking and Finance
- Material Contracts
- Labour
- Real Estate
- Insurance
- Litigations
- Permits and Licenses
- Intellectual Property
- Technology



Due Diligence Process



Management Discussion and Analysis

- The Due Diligence Report will identify the legal issues and the findings are set out in the Executive Summary.

- Management Discussion and Analysis of the Due Diligence Findings in relation to-
 - Identification and mitigation of risks in light of market practice and legal requirements.
 - Changes in structure of the transaction.
 - Price adjustment.
 - Conditions precedent.
 - Representations and warranties.
 - Verification of disclosures.
 - Retention of purchase price.
 - Indemnity.
 - Conditions subsequent to closing the transaction.

- Identification of Conditions Precedent and Conditions Subsequent in a Transaction Document :
 - Commercial Agreement.
 - Practice in India.
 - Due Diligence Findings.



Exit Routes

- Sale of Shares.
- IPO.
- Put Options and Call Options.
- Offer for Sale by Investors.
- Buyback of Shares by the Company.
- Tag Along and Drag Along Rights.
- Sale of Undertaking of the Company / Trade Sale.



Issues Relating to Exit Rights

- Enforceability of Exit Rights of Investor.
- Notification under, and provisions of the Securities Contract Regulation Act, 1956.
- Notification issued by SEBI
- **Spot Delivery Basis:** transfer of securities and payment of consideration for securities should take place on the same or the next day.
- Contingent Contract.
- Transferability of Shares.



Disputes between Target Companies and Investors

➤ Deadlock Items:

- Deadlock item referred to Chairman/ MD of the Investor and Promoter.
- Russian Roulette.
- Texas Shoot- out.
- Dutch Auction.
- Multi-choice Procedure.
- Cooling- off/ Mediation.
- Deterrence Approach.



Disputes between Target Companies and Investors (contd.)

- **Deadlock item referred to Chairman/ MD of the Investor and Promoter.**
- **Russian roulette:** A Russian roulette provision requires one of the two deadlocked parties to serve a notice on the other party, and the serving party will name an all-cash price at which it values a half interest in the business. The party receiving the notice then has the option to either buy the other party out, or sell out to the other party, at that price.
- **Texas shoot-out:** A Texan shoot-out involves each party sending a sealed all-cash bid to an umpire stating the price at which they are willing to buy out the other party. The sealed bids are opened together, and the highest sealed bid "wins", and that bidder must then buy (and the "loser" must sell) the other half share in the business.
- **Dutch auction.** A variation on the Texan shoot-out (and slightly different from the traditional Dutch auction), the parties send in sealed bids indicating the minimum price that they would be prepared to sell their half share for. Whichever sealed bid is the higher "wins" and that bidder then buys the "loser's" share at the price indicated in the loser's sealed bid.
- **Multi-choice procedure.** When the parties do not wish to commit themselves to a more dramatic termination procedure, the deadlock can often provide for a series of options, one of which the parties must agree on, if the deadlock cannot be resolved. The benefit of an open textured clause like this is that, when faced with the draconian consequences of the next step, the parties are thought to be better able to compromise. The downside is that if the parties are truly at loggerheads, it usually requires a third party adjudicator (often an arbitrator) to impose one of the options upon them.
- **Cooling-off/Mediation.** Not strictly a termination provision at all, many deadlock provisions 'end' by providing that the parties shall mediate until a solution is found (sometimes providing that if they cannot mediate out, the mediator will make a determination of reasonableness, which can then have knock-on effects under the contract). Whilst sounding like a 'soft' option, such clauses often represent the judgment of Solomon, as if the parties are unable to mediate the dispute out, then usually the enterprise will be dissolved.
- **Deterrence approach.** Often the termination clause in deadlock provisions provides a punitive element for the party initiating the deadlock procedure. In those clauses, a deadlock is only said to arise when one party serves a notice on the other indicating that a deadlock has arisen (instead of a failure to resolve on a key matter at a certain number of meetings). The provisions will then provide for the determination of the "fair market value" of a half share in the business, usually by having it valued by an expert or auditor (or sometimes both in consultation). Once the valuation is made, the party who served the notice must either (a) buy all the other party's share in the business at 125% of the fair price, or (b) sell its share to the other party at 75% of the fair price. The downside to such clauses is that deadlocks rarely get resolved, and can lead to the business being paralysed by indecision.



Disclaimer

- This presentation has been prepared with the intent to give a general overview of the laws applicable to foreign investments in India. This presentation is not the opinion of the Firm and shall not be construed to be legal advice in any form or manner. You are directed to take specific legal advice for each transaction.





Thank you!

