Mergers and acquisitions in India: a guide for Chinese investors - China Working Group

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Introduction

In recent years there have been legislative reforms in India aimed at further simplifying inbound and outbound mergers and acquisitions (M&As). This article aims to summarise key aspects of M&As, including an overview of the main laws governing M&As, pricing guidelines, sectoral restrictions on investments, reporting requirements, and the key hurdles that potential Chinese investors should be aware of if they plan M&As in India.

Overview of laws governing M&As

M&A transactions in India are principally governed by the 2013 Indian Companies Act (Companies Act). For M&As, preferred entities in India are private limited companies. Unlike public companies (including the unlisted ones) where shares are freely transferable, private companies offer several benefits to investors. First and foremost being restrictions on the transferability of shares. The Companies Act recognises that the shares held in private limited companies are not freely transferable and charter documents of private limited companies (ie, articles of association) can prescribe share transfer restrictions such as lock-in periods, board of directors' consent as pre-requisite to transfer of shares.

It is worth noting that the Companies Act now recognises inter-se agreements or arrangements between two or more persons as legally enforceable in the case of public limited companies. Private companies however are still a 'preferred mode' due to the conflicting positions taken by various courts regarding transferability of shares in public limited companies. This is very important to investors/acquirers wishing to invest financially in a company or who would like the promoters to continue with the company with some shareholding for 'continued interest in the company'. Private companies are also preferred due to, among other reasons, their lower compliance burdens, flexibility in operations, smaller minimum board size and number of shareholders.

The 1999 Indian Foreign Exchange Management Act (FEMA) applies in cases of M&A transactions involving foreign investors. Sectors in which foreign investment is barred include atomic energy, railway operations, lottery businesses, gambling and betting including casinos, the manufacturing of cigars and cigarettes, real estate businesses (excluding development of integrated townships), and construction of farmhouses. Foreign investment is permitted all other sectors, albeit, in certain sectors it is capped to a prescribed threshold or has sectoral conditions. The FEMA also permits commonly used structures such as earn-outs/deferred payments subject to certain conditions. For example, Under the FEMA, consideration of up to 25 per cent of the total sale consideration can be deferred for up to 18 months without any regulatory approval requirement. Put and call options are also permitted subject to certain conditions, provided such options do not confer any right to exit at an assured price.

Special rules for Chinese investors

Here is a summary of key rules and aspects which potential Chinese investors should bear in mind:

• Pricing guidelines

Investment (including secondary acquisition of shares) in companies can be made at a price no lower than the fair market value of the shares of such a company as calculated by an independent valuer.

• Sector-related restrictions

Foreign investment falls under the 'automatic route' in certain sectors but the 'approval route' in others. Under the automatic route, investments of up to a certain limit do not require prior government approval, whereas under the 'approval route', investment is allowed only after the prior approval has been given. It is important to note however that the majority of sectors including technology, manufacturing, consulting, and services have been made easily accessible, and 100 per cent foreign investment is permitted without approval.

• Reporting

If a foreign investor invests in or acquires securities of an Indian company, such an investment/acquisition is required to be reported in the prescribed form to the Reserve Bank of India (RBI).

• Restrictions on foreign loans

Under FEMA, foreign loans to Indian companies are subject to eligibility criteria prescribed for lenders and borrowers, ceilings on interest and other costs, limits on end uses etc.

• Resident directors and no requirement of supervisory board

The Companies Act requires every company to have at least one resident director who has stayed in India for a total period of no less than 182 days in the previous calendar year. The board of directors are at the helm of affairs of the company and each director owes a fiduciary duty towards the company. While the board of directors are empowered under the Companies Act to decide matters concerning the company's affairs, decisions on certain matters mandatorily have to be approved at shareholder-level. Unlike China, India's company laws do not envisage a supervisory board to oversee the functions of the board of directors.

• Special approval requirements

In case of any investor planning to open a liaison office, branch office or project office in India, such applicants registered or incorporated in Afghanistan, Bangladesh, China, Hong Kong, Iran, Macau, Pakistan and Sri Lanka would have to obtain prior consent from the RBI.

The realm of M&As in India is interspersed with a rigmarole of legislative requirements which includes approvals from regulators, corporate approvals, consent of lenders and third parties, procedural bottlenecks and seemingly never-ending compliances. In the case of a merger, the plan is required to be approved by a special majority of each class of shareholders and creditors. Furthermore, approval of the National Company Law Tribunal (NCLT) is also a prerequisite. The NCLTs are usually burdened with several pending matters and final orders approving mergers are issued only after all objections in relation to the scheme have been resolved.

Transactions involving a foreign party, administered by the RBI and exchange control laws, are prone to frequent amendments.

Although, due diligence is a key tool for any M&A transaction to identify or rather unearth the deal affecting issues, the exact liability and risk element cannot be evaluated due to non-availability of centralised information in India. For instance, there is no single platform/repository where the details of litigation proceedings can be accessed.

Conclusion

The number of M&As are gradually increasing in India helped by the relative easing of regulatory ecosystem and consolidation of regulatory filings. The country's M&As are however subject to a myriad of legal requirements. Due to the conditions prescribed under FEMA including pricing, sectoral caps, permitted investment instruments etc, M&As require well thought-through structuring bearing in mind the larger commercial objectives.