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Private Equity and Venture Capital Investments in India

Certain Legal Aspects

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Background

India has a vibrant private equity and venture capital market, with foreign direct investment (FDI) of up to 100% permitted in most sectors under the automatic route of investment and without any approval. However, to qualify for the automatic route, a few conditions must be met, for example, the price at which the shares are bought or sold must be in compliance with the valuation norms prescribed by the Reserve Bank of India.

Special Investment Route for Venture Capital and Private Equity Funds

To encourage venture capital and private equity investment in India, the Securities and Exchange Board of India (SEBI) introduced the *(Foreign Venture Capital Investors) Regulations, 2000*. These regulations enable foreign funds and other eligible investors to register with SEBI and avail of certain benefits which are otherwise not available under the FDI route.

Some of the benefits of registering with SEBI are:

- (i) no lock-up of shares held by registered investors, subject to certain conditions, which would otherwise be subject to a lock-up period if the portfolio company was going for an initial public offering, and
- (ii) exemption from applicability of the valuation norms referred to above, thereby enabling investors to buy and sell shares in Indian unlisted companies at prices they deem appropriate, upon agreement with the buyers/sellers.

However, the downside of such registration is being subject to the prescribed investment conditions and restrictions under the said regulations, such as:

- (i) not being able to invest more than 33.33% of investible funds in shares of listed companies or in debt or debt instruments, and
- (ii) being subjected to inspection and investigation by SEBI.

The time taken for registration is anywhere between one and three months depending on, for example, the background of the promoter of the fund and the track record of the investor. However, if the fund is a real estate focused fund then it may not be granted approval unless if it proposes to invest in eligible projects prescribed under foreign exchange laws.

Structuring India-focused funds

Mauritius Route

Most funds that invest in India on a regular basis are structured as special purpose vehicles in Mauritius. The chief reason is that India and Mauritius are signatories to a double-taxation avoidance agreement. Under certain conditions, the agreement exempts a Mauritius resident from being subject to capital gains tax in India (which could otherwise be as high as 40%) on the sale of shares. Also, since the local taxes in Mauritius are nominal and there are provisions for deemed foreign tax credit, Mauritius has become one of the favorite jurisdictions for structuring investments into India.

However, certain caveats with regard to the use of the Mauritius route for investing in India are (i) that the treaty may be renegotiated to limit the availability of such benefits, (ii) circulars have been issued by the Mauritius authorities making stricter the eligibility criteria to be considered a Mauritius resident (iii) the recent Hutch-Vodafone stake sale by offshore entities involving an Indian subsidiary have attracted tax litigation in the Indian courts, and (iv) recent press reports suggest that the Government of India may put on hold all applications from Mauritius funds/investors. All the aforesaid make it uncertain as to whether this route will work in all cases going forward.

Singapore Route

A new alternative that is now available is the use of Singapore as a jurisdiction to incorporate the fund vehicle. This is due to the signing of the Comprehensive Economic Cooperation Agreement between India and Singapore, which provides capital gains tax benefits akin to the India-Mauritius treaty.

However, since certain conditions, such as the need to have real and continuous business activity in Singapore and to incur certain minimum expenses in Singapore need to be complied with to be eligible for the benefits, this route is not yet as popular as the Mauritius route.

Cyprus Route

For funds which invest in debt instruments, a subsidiary in Cyprus is one option that may be considered. The India-Cyprus double taxation avoidance agreement provides significant benefits in terms of the withholding taxes applicable on interest payments made by an Indian company to a Cypriot company. However, like in the case of Mauritius, the recent press reports suggest that the Government of India may put on hold all applications from Cyprus funds/investors as well

Investment Instruments

Funds investing in Indian companies have the option of investing in equity shares, preference shares, debentures and other instruments, depending on the status of the portfolio company in India, i.e., whether it is a private limited, public unlisted or public listed company.

While private limited companies may issue innovative instruments to suit the requirements of investors, this may raise certain regulatory issues such as the need to seek the prior approval of the government of India. Thus, most investors, even if investing in private limited companies, prefer to subscribe to traditional instruments such as equity shares, preference shares, convertible debentures and warrants.

While investing in equity shares is the simplest and most straightforward option, there are issues attached to investing in preference shares and other instruments such as debentures. For example, proceeds raised by the issuance of non-convertible and/ or optionally-convertible debentures and/or preference shares cannot be used for general corporate purposes. Also, such instruments would need to have a minimum maturity period and a cap on the coupon payable if they are to be issued without approval.

While investing in preference shares would entitle investors to a preference upon a possible liquidation and on dividends, it would not allow investors to vote on all matters relating to the company unless there are certain prescribed defaults. There is also a cap on the dividend payable on preference shares.

Shareholders Agreements

As is common in other parts of the world, investors enter into a shareholders' agreement with the founders and other key investors of the portfolio company in order to safeguard their financial and other interests. Some of the key Indian law issues with regard to such agreements are as follows.

(i) Importance of articles of association: One of the key things to remember when investing in Indian companies is that the terms and conditions of a Shareholders Agreement do not bind the portfolio company unless these are incorporated into the articles of

association of the portfolio company. There are also other issues relating to enforceability of veto rights and liquidation preference etc.

(ii) **Public company:** With regard to investing in a public company the following key issues must be borne in mind.

a. **Restrictions on Transfers of Shares:** Under the *Companies Act, 1956* shares of an Indian public company are freely transferable and thus restrictions imposed on the transfer of shares held by founders or promoters of the portfolio company and/or other investors may not be enforceable. However, a remedy may be available for breach of contract.

b. **Leveraged Buyouts:** Leveraged buyouts of public companies are not possible since such companies are restricted by the said Act from directly or indirectly providing any financial assistance whether by means of guarantee, provision of security or otherwise for the purpose of or in connection with the purchase of their shares or the shares of their holding company.

(iii) **Non-compete clauses:** While most funds insist that the founders of the portfolio company they plan to invest in sign a non-compete agreement as part of the investment transaction, it must be borne in mind that non-compete clauses beyond the term of a contract are void and unenforceable. The available exception to this non-compete rule is usually not relevant in the venture capital and private equity scenario and thus usually cannot be relied upon.

About the author

Vishal Gandhi is the founder of Gandhi & Associates a leading Indian law firm which focuses on venture capital, private equity, joint-ventures, mergers and acquisitions and technology transactions. Most of the work that he is involved in is cross-border in nature. He is recognized as a leading expert in the Asia-Pacific region.

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