Indirect Acquisition of Indian Targets

Key Issues for a Foreign Acquirer from an Indian Regulatory, Law and Tax Perspective

A recent report published by Bain & Co indicates that the global M&A deal value in 2022 stood at USD 3.8 trillion, witnessing a 36% decline from USD 5.9 trillion in 2021, with the strategic M&A deal market contributing to 68% of the total deal value (USD 2.6 trillion). While the global M&A market has been undergoing a correction to pre-pandemic levels since the second half of 2022 (owing to factors such as macroeconomic uncertainty, geopolitical tensions, volatile capital markets and rapidly rising interest rates), according to a report published by Morgan Stanley, global deal-making in the second half of 2023 is expected to accelerate with financial sponsors deploying more capital, and the well-capitalised companies undertaking core-business acquisitions.

Interestingly, with the post-pandemic global trend leaning towards expansion into new markets, tapping into established back-end support infrastructure and supply chain diversification, several of such global deals (particularly across sectors that run heavily on the captive model such as IT/ITes, services, pharmaceutical and specialty chemicals) were structured as, or naturally resulted in, an India entry for the foreign acquirer through the 'indirect acquisition' of the India target/business/assets.

In case of an 'indirect acquisition', while the shares or voting rights of an Indian subsidiary are not directly transferred, its effective ownership (and control) changes hands ("Indirect Acquisition"). Such 'indirect change in control' is pursuant to a global deal that is structured as a direct stock acquisition of the overseas parent entity (or the ultimate holding entity) of the Indian subsidiary.

While the global deal involves acquisition of majority of the equity stock/securities of a foreign target (which has a direct or indirect subsidiary in India) and is structured between persons who are not Indian residents (i.e., a foreign buyer and a seller), such overseas transactions can still trigger certain implications from an Indian regulatory and/or tax perspective. Accordingly, irrespective of the value that the India business contributes to the global business of the target or how insignificant the India operations are perceived to be by a foreign acquirer in the overall scheme of things, it is important for a foreign acquirer/global deal counsel to assess and rule out any gating issues that can have the potential of delaying the closing timeline.

To illustrate some of these gating issues – in a recent global deal, the global target had an indirect step-down Indian subsidiary that was operating an R&D support center in India and was also engaged in conducting clinical trials from time to time (which is a regulated/licensed activity under the Indian legal regime). The global transaction was structured as a 100% acquisition of the equity stock of the global target and consequently, entailed an indirect change in control of the Indian subsidiary.

Since the Indian subsidiary was operating in a regulated sector, prior approval of the Indian government was required for a change in the ownership and control (whether direct or indirect) of the Indian subsidiary. However, the foreign parties had gone ahead and signed (and announced) the definitive documents without assessing the need for obtaining the necessary regulatory approvals in India. This misstep resulted in not only pushing the closing timeline for the Indian subsidiary by an additional 6 months (ie the time it took to obtain the regulatory approval in India) but also exposed the parties to increased costs and certain operational/integration challenges in other jurisdictions.

Summarised below is an overview of the key India level issues which a foreign buyer should take into account in case of an Indirect Acquisition.

Regulatory implications

Foreign exchange approval

India does not allow free convertibility of capital and any foreign investment into India (direct or indirect) is regulated by exchange control regulations. Under the foreign exchange control law, a foreign investment is permitted under the following routes: (a) automatic route, wherein foreign investment is allowed up to 100% in permitted sectors (for instance, manufacturing, construction, wholesale trading, and IT and ITes) without any government approval; and (b) approval/government route, wherein foreign investment in certain specified/sensitive sectors (for instance, print media, retail trading, brownfield pharmaceutical, insurance and defence) ("Restricted Sector") requires government approval and the investment is subject to either sectoral caps or other prescribed entry conditions.

A global deal which entails an Indirect Acquisition of an Indian company which is operating in a Restricted

Sector will require prior approval of the Indian government, irrespective of whether any sale consideration is flowing into India or not. Based on our experience, depending on how sensitive the Restricted Sector in question is, the government approval can take up to 3 to 6 months (or even longer if there are recurring information or document requests by the government).

Therefore, depending on the structure of the global acquisition and the sector in which the India target operates, it is important for a foreign buyer to undertake a regulatory diligence early in the deal cycle to assess/rule out the applicability of any approvals under the Indian exchange control law, and if applicable, to factor in the ensuing lead time for the approval in the closing timeline.

CFIUS-like restrictions

In 2020, the Indian government had introduced a CFIUS-like law restricting Indian companies from accepting foreign investments (direct or indirect) from countries that share a land border with India (including Pakistan, Nepal, Bangladesh, Myanmar and People's Republic of China, which for abundant caution, includes Hong Kong) ("Restricted Territory"). Under these provisions: (a) an entity which is based out of a Restricted Territory, or (b) where the beneficial owner of an investment into India is situated in, or is a citizen of, any Restricted Territory, can invest (directly or indirectly) in India only with approval of the Indian Government ("PN3 Approval").

While no specific guidelines or thresholds (for beneficial ownership) have been prescribed by the Indian Government for assessing the applicability of PN3 Approval, we have seen that the market practice for determining beneficial ownership from a Restricted Territory has evolved to a 10% shareholding in the acquirer (either directly or through any other holding structures). However, the regulator's view remains that any direct or indirect shareholding from a Restricted Territory would require prior PN3 Approval and therefore this determination requires a deeper fact specific discussion with all the stakeholders.

From a process and timing perspective, the PN3 Approval can take a minimum of 6 to 8 months and will require a detailed plain paper application to the Indian Government – which, amongst other things, will require detailed ownership disclosures going up to the ultimate beneficial owner of purchaser entity, along with the details of the directors and key managerial personnel of the investing entity and its shareholders/holding entities.

Anti-trust approval

Under Indian competition law, global deals require an approval from the Competition Commission of India ('CCI") if such deals have a '*local Indian nexus*'. Typically, a global transaction is seen to have a '*local Indian nexus*' if the parties meet certain prescribed monetary thresholds (based on value of assets and turnover) in India. For instance, a global deal will have sufficient local Indian nexus and therefore require an approval from the CCI if either the combined worldwide assets of the acquiring entity and the target entity exceed USD 1 billion with combined assets of at least INR 10 billion (USD 125 million) in India, or if the combined worldwide turnover of the acquiring entity and the target entity exceeds USD 3 billion with combined turnover of at least INR 30 billion (USD 375 million) in India. There are six other additional monetary thresholds which can lead to a CCI approval requirement.

However, a global deal (which breaches the monetary thresholds) may avoid approval requirements in India if the Indian subsidiary does not have significant assets or turnover in India ("Small Target Exemption"). The Small Target Exemption is available until March 28, 2027, and is applicable where either the total book value of asset (directly and indirectly) of the target(s)/amalgamating entity/merging entity in India does not exceed INR 3.5 billion (USD 44 million) or the total turnover of the aforesaid entities does not exceed INR 10 billion (USD 125 million) in India in the immediately preceding financial year.

Separately, the legislature has recently amended the Indian competition law to introduce a new notification threshold ("Deal Value Threshold") where global M&A deals will require a notification to the CCI if: (a) the target has '*substantial business operations in India*'; and (b) the value of the transaction exceeds INR 20 billion (USD 250 million). If a transaction breaches the Deal Value Threshold, then it will not be able to take benefit of the Small Target Exemption. However, the Deal Value Threshold is yet to be notified.

Company law implications

Under Indian company law, a global deal resulting in an Indirect Acquisition does not require any approval from the board or shareholders of the Indian subsidiary. However, based on our experience, it may still be relevant for a foreign buyer to diligence and assess if any change in the voting rights/control of an Indian company (particularly a subsidiary which is structured as a joint venture) is regulated under the charter documents of the Indian subsidiary, and consequently, requires any consent or triggers a call/put option in favour of the other joint venture partner.

Separately, from a compliance perspective, some of the key obligations that a foreign buyer should consider from an Indian company law perspective are discussed below.

Minimum shareholding requirements

Based on our experience, we have seen that a private limited company is the most preferred/common entity structure for setting up a subsidiary/presence in India. Under Indian law, every private limited company is required to have a minimum of 2 shareholders. The requirement of a second shareholder also becomes significant from an on-going compliance perspective, since a minimum of 2 shareholders are required to constitute quorum for shareholder meetings of an Indian company (where matters requiring shareholder approval are required to be discussed and approved) – an Indian company is statutorily required to conduct at least 1 shareholder meeting in a year.

To ensure compliance with this minimum shareholding requirement, foreign investors typically structure the cap table of the Indian subsidiary in a manner that all shares except 1 share (or a minority block of shares) is owned by the designated holding company as a legal and beneficial owner and remaining 1 share is held by another group entity as a legal and beneficial owner. Subject to certain practical challenges from an Indian exchange control law perspective, it is also common for a foreign investor to acquire beneficial interest in the 100% share capital of the Indian subsidiary and designate a nominee to hold 1 share as a legal owner. The second/nominee shareholder can also be an individual (who could be an employee, director or officer of the investing entity/group including the Indian subsidiary), but we typically do not recommend this from a continuity and influence perspective – in our experience, we have seen that having an individual as the second or nominee shareholder can become a pain point for the majority foreign investor if such individual refuses to cooperate in participating and constituting quorum for shareholder meetings or (in the future) transferring the nominee share at the direction of the majority shareholder.

In any case, while both these structures have their own inherent nuances and concerns from a transferability perspective, the practical recommendation remains unchanged that in the context of an Indirect Acquisition, it is important for a foreign buyer to replace the second/nominee shareholder (which/who is usually a related party of the seller group) with its nominee/group entity.

Separately, as far as the transfer of the minority share(s) by the second shareholder is concerned, such transfer triggers certain mandatory compliance requirements under the Indian law. For instance, the transfer is required to be taken on record and approved by the board of directors of the Indian subsidiary. Additionally, depending on the residency of the parties concerned and whether the share(s) is held by the second shareholder in a legal and/or beneficial capacity, the share transfer may also need to (a) comply with certain pricing guidelines prescribed; and (b) be reported to the Reserve Bank of India (i.e., India central bank) in a prescribed format, under the Indian exchange control law.

Disclosure of significant beneficial ownership interest

Indian company law requires every significant beneficial owner ("SBO") of an Indian company to disclose the fact (and any change thereof) of their significant beneficial ownership (in respect of an Indian company) to such company. An SBO is an individual who directly or indirectly holds: (a) not less than 10% of the shares of the Indian company; (b) not less than 10% of the voting rights in the Indian company; or (c) the right to receive or participate in the dividend or any other distribution, payable in a financial year by an Indian company.

Where the parent (or the ultimate holding entity) of an Indian company is a body corporate, then the applicable rules under Indian law prescribe that the SBO (in respect of the Indian company) shall be the individual who holds more than 50% of the share capital of the parent (or the ultimate holding entity). On the other hand, where an Indian company is ultimately owned and controlled by a pooled investment vehicle, the applicable rules prescribe that any of the following (if an individual) in relation to such pooled investment vehicle shall be deemed to the SBO of the Indian company: (a) general partner of the pooled investment vehicle; or (b) the investment manager of the pooled investment vehicle; or (c) the chief executive officer of the pooled investment vehicle, where the investment manager of such pooled vehicle is a body corporate or a partnership entity.

A foreign buyer should identify an individual in its organisation setup (if applicable) who would qualify as an SBO of the Indian target and disclose the details of such SBO in the prescribed form to the Indian company within 30 days from the effective date of the change in control. Where no such disclosure has been made to an Indian company, the Indian law obligates the Indian company to take the necessary steps (in a prescribed manner) to identify if there is any individual who is an SBO of the company.

Reconstitution of the board

In our experience, an Indirect Acquisition almost always entails a change in the management and the board of directors of the Indian target – primarily, because the erstwhile directors or key managerial personnel (at the India level) are appointees/nominees of the seller(s). Under Indian company law, every private limited company is required to have a minimum of 2 directors (the minimum number is 3 in case of public companies), out of which 1 director is required to be an Indian resident (i.e., an individual who stays in India for a total period of not less than 182 days during the financial year (ie April to March)).

Before an individual can be appointed as a director on the board of the Indian target, such individual is required to obtain certain mandatory registrations (ie a director identification number and a digital signature) from the relevant authorities, unless such registrations are already in place. From a timing perspective, it can take around 2 to 3 weeks for a foreign national to obtain such registrations (in some cases even longer owing to notary/apostille requirements) and 1 to 2 weeks for an Indian national. Given the lead time in obtaining these registrations, it becomes important for a foreign buyer to identify the replacement directors (including an Indian resident) sooner rather than later and factor the registration process in the closing timeline, especially where the commercial or operational need is to replace the India management at global closing.

Separately, where the buyer director nominee is a national of any Restricted Territory, a prior written approval/security clearance will also be required from the Ministry of Home Affairs, Government of India. Based on our experience, this approval requirement can add another 3 to 4 months to the registration process.

Public M&A Implications

In the context of an Indian target which is a public company listed on an Indian stock exchange ("ListCo"), an ixndirect acquisition is triggered when a foreign acquirer, directly or indirectly acquires control over a holding company of ListCo (whether by way of acquisition of shares or otherwise), which in turn, directly or indirectly, exercises voting rights in excess of 25% of ListCo and/or exercises control over ListCo.

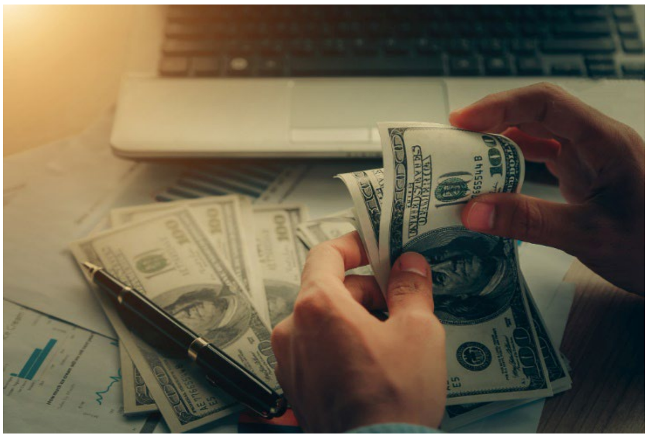
Once triggered, the foreign acquirer may be required to make an open offer to acquire at least 26% of the ListCo's shares from its public shareholders at a minimum offer price (which is determined in compliance with a formula prescribed under the applicable law).

Additionally, as part of the open offer process, 100% of the consideration payable to the public shareholders under the open offer is required to be escrowed by the foreign acquirer with a scheduled commercial bank in India. The escrow can be in the form of cash and/or bank guarantee. However, in case of a bank guarantee, the acquirer is required to ensure that at least 1% of the consideration is deposited in cash.

From a timing perspective, an open offer process can take around 3 to 4 months to complete. Given the potential impact on the closing timeline, a foreign acquirer can (in its discretion) choose to proceed with the open offer even after the completion of the global transaction. However, in this case, the foreign acquirer needs to make a mandatory public announcement (for such open offer) on the signing of the definitive agreement for the global deal (step 1) and follow that up with a detailed public statement post the completion of the global deal (step 2). There is no cap on time period between step 1 and step 2.

This is a common construct and provides the buyer with the flexibility to walk away from the obligation to complete the open offer process where the global transaction does not consummate for any reason and allows for time to arrange for deployment of funds for the tender offer. Nonetheless, this flexibility comes at a cost of payment of an additional interest @ 10% per annum (payable for the actual time elapsed between step 1 and step 2) to the shareholders of the ListCo who tender their shares in the open offer if the gap between step 1 and step 2 is more than 5 working days.

Interestingly, if the ListCo constitutes 80% or more of the proportionate net asset value, sales turnover or market capitalisation of the overseas holding entity/business that is being acquired (as per the latest audited balance sheet), then such "indirect" acquisition is deemed to be a "direct" acquisition which is subject to stricter obligations, particularly from the perspective of timing, pricing and other compliances relating to the open offer.



Purchase Price Adjustments and Risk Allocation

The significance of a due diligence (even in case of an Indirect Acquisition) cannot be underestimated. We have seen that in some cases a buyer may not want to do a deep dive into the affairs of the Indian subsidiary and the scope of the India diligence is often limited to ruling out any regulatory consents or red flags. Typically, this is either on account of aggressive deal timelines or the disparity in the value allocation between the global and the India business which often results in a buyer discounting the legal and financial risks attached to the India business.

However, post-closing, the buyer does end up inheriting all legal and financial obligations pursuant to such Indirect Acquisition, and therefore, in our experience, a robust legal, finance and tax diligence is a must for Indirect Acquisitions as well.

The scope of the legal due diligence at the India level should be broad enough to not just flag any third-party consents or any regulatory or compliance concerns but should also focus on identifying the accrued and unpaid liabilities of the Indian subsidiary which should be adjusted from the purchase price under the global document.

For instance, where the Indian subsidiary operates as a back-end support/captive unit for the global target and has 10 or more employees on its payroll, then the diligence scope should (in addition to flagging the standard HR compliance issues) focus on quantifying the historical tenure-based employment dues of the employees in India (such as the accrued and unpaid gratuity and leave encashment liabilities for the period up to the closing date). Gratuity is a terminal benefit earned by an eligible employee for services rendered as a lump sum payment on retirement or termination of employment. Leave encashment, on the other hand, is a compensation payable by the employer to an employee in lieu of unutilized leaves. While both these benefits are paid at the time of cessation of employment of an eligible employee, they continue to accrue during the term of employment and are computed in accordance with a prescribed formula which is based on the salary and years of service.

From a deal perspective, while the cost allocation of this liability is subject to a commercial agreement between the parties; in our experience, it is the seller who typically bears all employee related liabilities until the closing date, and accordingly, the accrued and unpaid gratuity and leave encashment liability amount for the period up to the closing date should be quantified and adjusted by the buyer from the purchase price under the transaction documents.

Tax Implications

An Indirect Acquisition may also attract applicability of Indian tax law. Under Indian tax law, where shares or interest of the foreign target are transferred by a foreign seller, Indian tax will be levied in the hands of the foreign seller if the foreign target derives '*substantial value*' from assets situated in India. A share or interest in a foreign target is deemed to derive '*substantial value*' from assets in India, if the fair market value of such assets (without reducing any liabilities in respect of the asset): (a) exceeds INR 100 million (USD 1.25 million); and (b) represents at least 50% of all the assets owned by the foreign target. Detailed rules have been prescribed under the tax law for determination of fair market value.

If the substantial value test is met, part of the capital gains attributable to the value derived from the Indian assets would be subject to tax in India. Capital gains will be taxed in the hands of the seller at the rate of 10.92% (where the unlisted shares are held for more than 2 years) or 43.68% (where the unlisted shares are held for less than 2 years) and the foreign buyer will be required to withhold and deposit the applicable taxes with the Indian income tax authorities before the 7th day of the month following the closing. To comply with the withholding obligation, the acquiring entity is first required to obtain certain Indian income tax registrations (i.e., a Permanent Account Number and a Tax Deduction Account Number), unless such registrations are already in place. From a timing perspective, these registrations can take up to 3 to 4 weeks, and (depending on when the closing is scheduled to take place in the relevant month) ideally should be obtained by the buyer prior to closing.

Further, there are certain additional India tax considerations (such as minimum pricing, remittance related filings and reporting requirements) which may also get triggered if withholding is applicable. However, capital gains tax on an Indirect Acquisition is exempt where the foreign seller owns less than 5% shares/voting power/interest in the foreign target or does not participate in the control or management of the foreign target. Moreover, Category I FPIs are also exempted from the application of indirect transfer provisions. Additionally, certain exemptions may also be available to the foreign seller under the applicable tax treaty but the eligibility for such exemptions would be determined on a case-to-case basis.

Separately, if capital gains tax is not applicable to the transaction, to conclusively rule out any indirect transfer tax implications under Indian law, it is recommended that the buyer should require the seller to obtain a tax valuation report (and deliver it to the buyer on a reliance basis) certifying that the foreign target does not derive 'substantial value' from assets in India in accordance with the applicable Indian tax rules.

Conclusion

To sum up, in a global deal involving an indirect acquisition of an Indian entity, it is important for a foreign acquirer to focus on some of the key issues discussed in this note and address any Indian regulatory and tax issues early in the deal cycle to avoid any last-minute hiccups in the closing of the global deal. Further, depending on the sector one is investing in, parties may also need to navigate through additional sector specific issues.

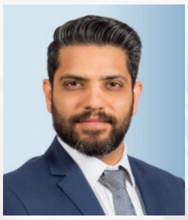
Ignoring some of these issues may increase the complexity and the risks that can arise for an acquirer and may also have an impact on the overall deal timelines.

AUTHORS

RAJAT MUKHERJEE
Partner
Corporate and M&A
E:rajat.mukherjee@khaitanco.com

SARTHAK SARIN
Partner
Corporate and M&A
E: sarthak.sarin@khaitanco.com

ABHISHEK DADOO
Partner
Public M&A
E:abhishek.dadoo@khaitanco.com



INDRUJ RAI
Partner
Direct Tax
E: indruj.rai@khaitanco.com

PRANJAL PRATEEK
Partner
Competition / Antitrust
E: pranjal.prateek@khaitanco.com

KHAITAN & CO ADVOCATES SINCE 1911

BENGALURU ▪ CHENNAI ▪ KOLKATA ▪ MUMBAI ▪ Delhi-NCR ▪ SINGAPORE

www.khaitanco.com