# Sharing the spoils or spoiling the shares?

**Heightened risk aversion and financial prudence on the part of investors may drive a revival of joint ventures. Vandana Chatlani investigates the risks and rewards of joint venturing**

To many foreign investors, India's proverbial legal labyrinth is worth navigating to launch or expand their businesses in the country. With billions of dollars of investment pouring into the country each year, multinationals and their legal counsel have become India-savvy and unafraid to employ complex strategies when picking their pawns from India Inc's chessboard.

For example, France's Sanofi Pasteur, the vaccines division of the Sanofi-Aventis pharmaceutical group, seized its position in the Indian market last July after taking control of Shantha Biotechnics for US$783 million; Norwegian telecoms giant Telenor acquired a majority stake in Indian mobile services company Unitech Wireless for US$1.2 billion; while United Arab Emirates telecom major Etisalat purchased a 45% stake in India's Swan Telecom for US$900 million.

Indian corporates are becoming equally bullish with players like Bharti Airtel pioneering the way towards global expansion. The company completed India's second largest cross-border acquisition, clinching the African assets of Kuwait-based Zain for US$9 billion earlier this year.

According to statistics from financial research house VCEdge, mergers and acquisition (M&A) activity in India increased phenomenally in the first month of 2010, as deals worth almost US$3 billion were announced. "The total foreign investment in India has grown from a minuscule US$132 million in 1991-92 to US$120.3 billion in 2009," says Ashish Ahuja, a partner at Wadia Ghandy & Co.

The M&A boom came largely at the expense of joint ventures. "Joint ventures as a form of entry strategy for investments into India are losing visibility," says Dorothy Thomas, a partner at Kochhar & Co in Atlanta. "Foreign investors are more comfortable setting up a wholly owned subsidiary and ensuring they have complete management control."

Although overseas investors are often reluctant to relinquish management control, the regulatory shackles governing certain industries forces them to do so. Other sectors remain completely closed to non-domestic investors. "There are certain sectors in which foreign investment is totally prohibited, such as gambling, agriculture and multi-brand retail," notes Raja Sujith, a partner at Majmudar & Co. This month, the government also imposed a blanket ban on foreign investment in tobacco.

While a large number of sectors no longer impose investment caps, they do exist in many key areas, such as insurance, defence and print media (all at 26%), civil aviation (49%), and banking and telecom services (both 74%). Such tight regulation has resulted in "joint venture relationships out of sheer necessity, rather than choice," says Himanshu Chahar, an associate at LexCounsel.

## Back in fashion?

The number of new joint ventures in India has fallen in recent years, but some analysts believe they are coming back into fashion. Tighter corporate budgets are certainly one of the driving forces, as is a greater sense of caution and risk tolerance among investors. As a result, the joint venture route may once again be perceived as an attractive investment strategy where funds can be pooled by both parties, risks shared, complementary resources leveraged and synergies achieved. Foreign parties may also be attracted by the local expertise of their Indian partners, while Indian partners may feel the allure of superior technology, world-class management systems and access to international markets.

Notable joint venture agreements inked last year include a deal between NTPC, India's largest power company, and Coal India for the development of two coal blocks in Jharkhand and Orissa; a defence joint venture between Mahindra & Mahindra and BAE Systems; and a deal between Europe's Airbus, India's Airspace Infrastructure and Turkey's Airlogic to provide spare parts for Indian aircraft operators.

Joining hands with an Indian partner typically offers first-time investors greater comfort, providing access to local industry expertise and better market penetration through the established Indian entity's business channels. Some investors opt for this approach in order to "explore the Indian market and understand the regulatory and licensing regime before making substantial investments into India," says Munish Sharma, a partner at Dua Associates.

Foreign companies in search of cheaper production costs and a foothold in the Indian market may also pursue this avenue, especially in manufacturing sectors where low-cost operation, production and distribution (handled by the Indian partner) is exchanged for access to foreign technology, new overseas markets and innovative managerial practices.

Joint venture relationships [have been forged] out of sheer necessity, rather than choice

Himanshu Chahar
Associate
LexCounsel

"In our experience, joint ventures have been a very popular model for India investments for many years," says Benjamin Parameswaran, partner and co-head of the India practice for continental Europe at DLA Piper. Joint ventures are structured in India typically as equity investments, technology collaborations or as franchise and distribution models.

Joint ventures are equally appealing to Indian companies since they present a platform to attain business goals which would be difficult or uneconomical to reach independently. "Many [small and mid-sized] companies which have significant growth potential and are led by an able and visionary management lack the capital and sometimes the technology to make it to the finish line," explains Attreyi Mukherjee, a senior associate at Paras Kuhad & Associates. "This is when the option of forging a joint venture with a foreign player becomes attractive."

Mukherjee adds that the popularity of the joint venture model extends beyond small enterprises and is by no means confined to inbound deals. A joint venture agreement for a US$20 billion oil project in Venezuela was signed last month by a consortium of Indian-government-owned oil companies – ONGC, Indian Oil and Oil India – and Venezuela's state oil company, PDVSA, together with partners from Spain and Malaysia. PDVSA holds a 60% stake in the joint venture, the Indian consortium has 18%, and Spain's Repsol and Malaysia's Petronas have 11% each.

Joint ventures also offer many flexible business diversification opportunities. "A joint venture may be set up as a prelude to a full merger, or only for part of the business, notes Shafaq Uraizee-Sapre, head of the joint ventures practice at Nishith Desai Associates. "It offers a creative way for companies to enter into non-core businesses while maintaining an easy exit option. Companies can also resort to joint ventures as a method to gradually separate a business from the rest of the organization and eventually sell it off."

Alternatively, they may decide to acquire complete control of the joint venture. "In this situation," says Uraizee-Sapre, "the foreign participant may choose to acquire the local participant's interest once the venture is up and running. This can be highly beneficial to both parties as the foreign party is able to establish itself in the local market while the local party gets a liquid exit."

## Legal and regulatory procedures

Foreign investment in Indian companies is regulated primarily by the consolidated foreign direct investment (FDI) policy issued by the Department of Industrial Policy and Promotion, which is part of the Ministry of Commerce and Industry. In addition, the Reserve Bank of India (RBI) regulates foreign investment under the provisions of the Foreign Exchange Management Act, 1999 (FEMA) and its associated regulations.

FDI is possible through either the automatic route or the government route. Under the automatic route, foreign investors do not require any approval from the RBI or the government for the investment. However, there is a requirement to make post investment filings with the RBI. In addition, shares issued to an investor under the automatic route must be priced in accordance with fair valuation guidelines issued by the RBI. Up to 100% FDI is permitted under this route in most sectors, subject to the applicable sectoral rules and regulations.

Under the government route, investors must obtain approval from the Foreign Investment Promotion Board (FIPB) and adhere to sectoral limits. "For instance, investments in the telecom or satellite sector beyond 49% require prior approval from the FIPB and thereafter approvals from the Department of Telecommunications, Ministry of Communications [for telecom] and Indian Space Research Organization [for satellite]," says Chahar. Similarly, investments in print media require FIPB approval and thereafter approval from the Ministry of Information & Broadcasting.

FIPB approval is also required in a number of other cases. For example, foreign investors with an existing Indian joint venture in the year 2005 must obtain FIPB approval prior to establishing another joint venture in the same field. "In the case of joint ventures formed after 2005, the concerned joint venture agreement is required to include a 'conflict of interest' clause to safeguard the Indian partner's interests," says Sujith.

Strict controls on Indian companies' ability to borrow from foreign lenders means debt from a foreign partner into a joint venture would generally be subject to RBI approval. "Foreign debt is highly regulated in India with end use restrictions, ceilings on borrowing and eligibility of resident borrowers and foreign lenders," says Surbhi Kejriwal, an associate at Khaitan & Co. "In such a scenario, financial investors prefer investing through the equity route, sometimes with a preferred dividend."

## Ownership and control

If a joint venture is incorporated as a private company, it requires a minimum capitalization of Rs100,000 (US$2,000) and a minimum of two directors and shareholders. "In the majority of the cases, joint venture partners prefer a private company, as it is less regulated under the Companies Act," says Ahuja. Where a joint venture intends to generate funding from the public, however, incorporating a public company is necessary.

Several degrees of control can be attained by shareholders of a joint venture company. As Ashwath Rau, a partner at Amarchand Mangaldas, explains, shareholders may benefit from statutory protection at four key thresholds:

- shareholders with 10% of voting rights are entitled to relief against oppression and mismanagement;
- those with 25% plus one share can veto special resolution items, such as altering the provisions of the memorandum and articles of association of the company, changing the name, objects or place of the registered office of the company or starting a new line of business;
- shareholders with 50% voting rights plus one share have effective management and board control and control over ordinary resolution subjects; and
- those with 75% are entitled to control over special resolution items.

The shareholding held by a foreign party in the joint venture will also determine the classification of the entity (whether it is foreign- or Indian-owned and controlled) and

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consequently, any downstream investments by the joint venture company will be regulated on that basis.

"Recent press reports indicate that the government is in the process of reviewing the foreign direct investment policy in relation to a 50:50 joint venture between a Indian and foreign entity, and is proposing to categorize such companies as foreign-owned companies unless the foreign partner divests 0.5% stake in favour of the Indian partner," Rau says. Such a change, if implemented, would mean that any downstream investment would be viewed as foreign investment.

The pricing of shares for the purposes of the exit from the joint venture, whether by the Indian partner or the foreign partner, through a sale of shares to the other is another regulatory issue. In May, the RBI amended the pricing guidelines for share transfers through a sale by an Indian resident (such as an Indian partner of a joint venture company) to a non-resident (such as the foreign partner of an Indian joint venture company), and vice versa.

Joint venture partners of an unlisted joint venture can now transfer their shares to the other partner at a fair value price determined by the Securities and Exchange Board of India (SEBI), registered category-I merchant bankers or a chartered accountant in line with the discounted free cash flow method. "The amended pricing guidelines thus set a minimum floor price for transfer of shares of an unlisted company by the Indian partner to the foreign partner and vice versa," says Sita Khosla, a partner at Dua Associates.

The drafting of a joint venture agreement is crucial to protect the interest of its partners. Even before an agreement is signed, parties should execute confidentiality and mutual non-disclosure agreements to keep the information exchange during the negotiation stage strictly confidential. "Both partners must be very cautious about protecting their respective intellectual property, and any IP licensed to the joint venture must be worded very carefully so as to not allow the unauthorized use of the IP by the other partner in the event of a joint venture collapse," warns Mukherjee.

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Nishith Desai Associates

## Fractured collaborations

Many joint ventures have been tremendous success stories, but others have disintegrated as a result of cultural clashes, poor due diligence, diverging business plans and differences in management control. "We have seen serious disputes and court battles between joint venture partners which have ultimately led to the break-up of the joint venture," says Parameswaran at DLA Piper.

Daniel Sharma, the other co-head of DLA Piper's India practice in Europe, observes that one of the major reasons for such disputes is that "in the past five to 10 years, many joint ventures have been concluded without a preparatory in-depth discussion of the business model and, most importantly, without ensuring that the joint venture partners really share the same business philosophy in relation to their joint venture."

Several lawyers emphasize the importance of partners fully understanding one another's business endeavours to avoid conflicts and break-ups at a later stage. "Different cultures, management styles and company policies, poor integration of resources, a lack of cooperation and leadership support in the early stages or later stages of a joint venture due to the selfish attitude of one of the partners have been some of the reasons for the failure of some joint ventures," says Manishi Pathak, a senior partner at Kochhar & Co.

The infringement of intellectual property rights by one of the partners is another issue that frequently sours relationships. Non-adherence to the terms of a joint venture, non-payment of royalty by a joint venture company to the party licensing the technology and non-compliance with local income tax, foreign exchange, labour and contract laws can create further misunderstandings, says Pathak.

Neeraj Kumar, a partner at Dua Associates, highlights other problems that can lead to the undoing of joint ventures. They include "restriction on expansion, where one of the partners does not want to contribute capital; a lack of clarity on the perceived roles of each joint venture partner; exercise of indirect control by one partner; lack of management vision or sharing of common business philosophy after the establishment of joint venture; interference by the partners in the management; a lack of transparency; and staffing issues in relation to critical functions."

While thorough due diligence may decrease the likelihood of running into any of these problems, preparatory measures are not always sufficient to guarantee a smooth ride for either partner. "Legal due diligence carried out to evaluate the scope of reputation risk of Indian counterparties can be difficult, generally due to a lack of public information available, especially in private, family-held businesses," warns Paul de Bernier, a partner and co-head of the India practice at Mayer Brown.

## New directions: Exit options

If things do go wrong, a well structured joint venture agreement can make the process of separation considerably less painful. However, several lawyers point out that practically enforcing what has been drawn up on paper is not always easy. "Non-compatibility between the two joint venture partners is an inherent pitfall," says Khosla. "While joint venture agreements provide for dispute resolutions and deadlock solutions, in practical terms, when the relationship between the two partners becomes unworkable the very enforceability of these clauses can become a dispute."

Any talk of separation proceedings through India's courts is likely to be unsettling to foreign investors, especially since winding up a company in the country is not as simple as in other jurisdictions. "In India, winding up of a company is a lengthy court-approved process and may not be the best exit mechanism," says Uraizee-Sapre.

For this reason, lawyers urge their clients to seriously consider arbitration as an exit route. "Once a joint venture dispute has been escalated to arbitration it is critical for the parties to take into account the particular features of India-linked arbitration, which may even come into play if the seat of arbitration is outside India," notes Sharma.

Most lawyers agree that successful collaborations are possible if a deep sense of cohesion can be established early on. "A joint venture is like a marriage," says KV Singh, a partner at Kochhar & Co. "Marriages of convenience will only last till it suits the interest of the parties, and if they are forced to continue in the marriage thereafter, there is likely to be hurt and pain." ■

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