Private Equity

Fund formation and transactions in 42 jurisdictions worldwide

2009

Contributing editor: Casey Cogut

Published by
GETTING THE DEAL THROUGH
in association with:

Advokatfirman Delphi
Appleby
Batalla Abogados
Blake, Cassels & Graydon LLP
Bowman Gilfillan
Carey Olsen
CHSH Cerha Hempel Spiegelfeld Hlawati
Dillon Eustace
Esinlsmen
G Breuer
Gide Loyrette Nouel
Hamelink & Van den Tooren NV
Hernández & Cía Abogados
HJM Asia Law & Co LLC
Homburger
Jones Day
Kennedy Van der Laan NV
Kromann Reumert
Latournerie Wolfrom & Associés
Lee & Ko
Lepik & Luhaäär LAWIN
Loyens & Loeff, Luxembourg
Lydian
Moussas & Tsibris
Mundie e Advogados
Navarro Abogados
Nishith Desai Associates
P+P Pöllath + Partners
Proskauer Rose LLP
Rodés & Sala
SAI Consultores, SC
Salomon Partners
Simpson Thacher & Bartlett LLP
Slaughter and May
Smaliukas, Juodka, Beniusis & Partners
Stoica & Asociatii – Attorneys at Law
Wiesner & Asociados Ltda, Abogados
WongPartnership LLP
Yangming Partners

GETTING THE DEAL THROUGH®

Private Equity 2009

Contributing editor
Casey Cogut
Simpson Thacher & Barlett LLP

Business development manager
Joseph Samuel

Marketing managers
Alan Lee
Dan Brennan
George Ingledew
Edward Perugia
Robyn Hetherington
Dan White
Tamzin Mahmoud
Elle Miller

Marketing assistant
Ellie Notley

Subscriptions manager
Nadine Radcliffe
Subscriptions@GettingTheDealThrough.com

Assistant editor
Adam Myers

Editorial assistants
Nick Drummond-Roe
Charlotte North

Senior production editor
Jonathan Cowie

Subeditors
Jonathan Allen
Laura Zúñiga
Kathryn Smuland
Sara Davies
Ariana Frampton
Sarah Dookhun

Editor-in-chief
Callum Campbell

Publisher
Richard Davey

Private Equity 2009
Published by
Law Business Research Ltd
87 Lancaster Road
London, W11 1QQ, UK
Tel: +44 20 7908 1188
Fax: +44 20 7229 6910
© Law Business Research Ltd 2009

No photocopying: copyright licences do not apply.
ISSN 1746-5524

The information provided in this publication is general and may not apply in a specific situation. Legal advice should always be sought before taking any legal action based on the information provided. This information is not intended to create, nor does receipt of it constitute, a lawyer–client relationship. The publishers and authors accept no responsibility for any acts or omissions contained herein. Although the information provided is accurate as of February 2009, be advised that this is a developing area.

Printed and distributed by
Encompass Print Solutions.
Tel: 0870 897 3239

Law
Business
Research

CONTENTS

Global Overview Casey Cogut, William Curbow and Kathryn King Sudol *Simpson Thacher & Bartlett LLP* 3

FUND FORMATION

Bermuda Sarah Moule *Appleby* 6
British Virgin Islands Valerie Georges-Thomas *Appleby* 13
Canada J Rob Collins and Frank P Arnone *Blake, Cassels & Graydon LLP* 19
Cayman Islands Bryan Hunter and André Ebanks *Appleby* 23
China Caroline Berube, Linford Liu, Patrick Pu, Ivy Yang and James Yule *HJM Asia Law & Co LLC* 29
Denmark Vagn Thorup and Lisa Bo Larsen *Kromann Reumert* 35
England & Wales Timothy Drake *Proskauer Rose LLP* 40
Germany Amos Veith *P+P Pöllath + Partners* 48
Guernsey Ben Morgan, Geoff Ward-Marshall and Emma Penney *Carey Olsen* 54
India Vikram Shroff and Richie Sancheti *Nishith Desai Associates* 60
Ireland Andrew Lawless and Sean Murray *Dillon Eustace* 66
Italy Bruno Castellini, Stefano Crosio and Velislava Popova *Jones Day* 73
Jersey Andrew Weaver and Mark Lewis *Appleby* 80
Luxembourg Gilles Dusemon and Marc Meyers *Loyens & Loeff, Luxembourg* 85
Mauritius Malcolm Moller *Appleby* 92
Netherlands Louis Bouchez, Floor Veltman and Maurits Bos *Kennedy Van der Laan NV* Jan van den Tooren and Reinier Noort *Hamelink & Van den Tooren NV* 99
Singapore Low Kah Keong *WongPartnership LLP* 106
Spain Carlos de Cardenas, Víctor Domenech, Alejandra Font, Javier Morera and Julio Veloso *Rodés & Sala* 111
Sweden Anders Lindström, Anders Björk and Peter Utterström *Advokatfirman Delphi* 118
United States Thomas H Bell, Barrie B Covit, Jason A Herman, Glenn R Sarno and Michael W Wolitzer *Simpson Thacher & Bartlett LLP* 124

TRANSACTIONS

Argentina Diego Fissore *G Breuer* 131
Austria Albert Birkner and Hasan Inetas *CHSH Cerha Hempel Spiegelfeld Hlawati* 137
Belgium Peter De Ryck *Lydian* 143
Brazil Arthur R Viñau and Ricardo P C Villela *Mundie e Advogados* 149
Canada J Rob Collins and Frank P Arnone *Blake, Cassels & Graydon LLP* 155
Cayman Islands Stephen James and Simon Raftopoulos *Appleby* 160
China James Yule, Ivy Yang, Patrick Pu and Caroline Berube *HJM Asia Law & Co LLC* 164
Colombia Mauricio Rodríguez A and Eduardo A Wiesner *Wiesner & Asociados Ltda, Abogados* 171
Costa Rica Rodrigo Zelaya *Batalla Abogados* 176
Denmark Vagn Thorup and Bent Kemplar *Kromann Reumert* 180
England & Wales Timothy Drake *Proskauer Rose LLP* 185
Estonia Gerli Kilusk *Lepik & Luhaäär LAWIN* 191
France Pierre Lafarge, Claire Langelier and Nicolas Duboille *Latournerie Wolfrom & Associés* 196
Germany Andres Schollmeier *P+P Pöllath + Partners* 202
Greece Michael Tsibris *Moussas & Tsibris* 207
Hong Kong Benita Yu and Risen Tan *Slaughter and May* 211
India Archana Rajaram and Amrita Singh Nishith Desai Associates 217
Ireland Andrew Lawless and Sean Murray Dillon Eustace 223
Italy Bruno Castellini, Stefano Crosio and Velislava Popova *Jones Day* 227
Korea Wonkyu Han and Je Won Lee *Lee & Ko* 232
Lithuania Robert Juodka, Inga Martinkute, Tomas Venckus, Vaida Pacenkaite, Arunas Kasparas, Ramunas Svencionis and Mindaugas Rimkus *Smaliukas, Juodka, Beniusis & Partners* 238
Mexico Juan Pablo Martínez Velasco and Luis Alberto Aziz Checa *SAI Consultores, SC* 244
Netherlands Louis Bouchez, Floor Veltman and Maurits Bos *Kennedy Van der Laan NV* Jan van den Tooren and Reinier Noort *Hamelink & Van den Tooren NV* 248
Peru Juan Luis Hernández, Alfredo Filomeno and Alvaro del Valle *Hernández & Cía Abogados* 255
Romania Cristiana I Stoica *Stoica & Asociatii – Attorneys at Law* 260
Russia Anton Klyachin and Igor Kuznets *Salomon Partners* 264
Singapore Ng Wai King and Dawn Law *WongPartnership LLP* 269
South Africa David Anderson and Shahid Sulaiman *Bowman Gilfillan* 275
Spain Julio Veloso, Javier Morera and Víctor Domenech *Rodés & Sala* 283
Sweden David Aversten, Clas Romander, Peter Sjögren and Michael Juhlin *Advokatfirman Delphi* 289
Switzerland Dieter Gericke, Reto Heuberger and Jürg Frick *Homburger* 295
Taiwan Robert C Lee and Claire Wang *Yangming Partners* 301
Turkey Ismail Esin and Arzum Gunalcin *EsinIsmen* 306
Ukraine Karl Hepp de Sevelinges and Illya Tkachuk *Gide Loyrette Nouel* 310
United States William Curbow and Kathryn King Sudol *Simpson Thacher & Bartlett LLP* 315
Uruguay Alfredo Navarro Castex and Alfredo H Navarro *Navarro Abogados* 322

India

Archana Rajaram and Amrita Singh
Nishith Desai Associates

1 Types of private equity transactions

What different types of private equity transactions occur in your jurisdiction?

The transactions that primarily dominate the private equity space in India are private equity and venture capital funding, private investments in public enterprises (PIPEs), mergers and acquisitions and debt and equity financing.

Leveraged and management buyouts have not matured to the extent found in other jurisdictions. Other transactions such as 'going-private' transactions for the most part occur in contexts very unlike those of other jurisdictions, such as the US and the UK.

The rarity of certain private equity transactions or the varying contexts in which they occur in India is largely attributable to the regulatory framework, which restricts the ease with which such transactions may normally occur (as elaborated in answers below).

Even so, several measures have been and are continuing to be taken by the Reserve Bank of India (RBI), India's highest monetary authority, and the capital markets regulator, namely the Securities Exchange Board of India (SEBI) to encourage more sophisticated instruments in the realm of private equity transactions.

2 Corporate governance rules

What are the implications of corporate governance rules for private equity transactions? Are there any advantages to going private in leveraged buyout or similar transactions? What are the effects of corporate governance rules on companies that, following a private equity transaction, remain or become public companies?

First, a general idea of the different kinds of companies that operate in India may be relevant as the stringency and implications of corporate governance norms vary depending on the type of the company.

Companies in India primarily operate as private or public companies. Public companies may in turn be listed or unlisted companies. The difference between a private and a public company is laid out in the Companies Act, 1956 (Companies Act), the principal legislation regulating all companies in India. In essence, private companies possess certain characteristics (such as having fewer than 50 members, right to restrict share transfers, prohibiting acceptance of deposits from the public and so on) and a public company is defined to mean any company that is not a private company.

Private companies and unlisted public companies are regulated primarily by the Companies Act, falling under the radar of the Registrar of Companies and the Ministry of Company Affairs. The Companies Act requires shareholder approval (75 per cent majority) and disclosures to be made to shareholders for certain transactions; however, these requirements apply more to unlisted public companies rather than private companies. The implications of such corporate governance norms include greater accountability to shareholders, reliability of financial statements, dissemination of information to shareholders, etc.

Listed companies, on the other hand, are required to follow elaborate corporate governance norms that are largely similar to those found worldwide. These norms are provided under the listing agreement entered into between listed companies and stock exchanges in India. The listing agreement stringently regulates the constitution of the board of directors, audit committees, disclosure standards, etc. Listed companies are also required to comply with a host of other regulations and guidelines issued by SEBI, such as the Disclosure and Investor Protection Guidelines, 2000 (which inter alia governs rights issues and private placements by listed companies) and the Substantial Acquisition and Takeover Regulations, 1997 (Takeover Code), which provides for disclosures and mandates making an 'open offer' to acquire at least 20 per cent of the target's shareholding when acquisitions trigger certain thresholds), to name a few.

Going private may thus reap benefits, as private companies are minimally regulated when compared to listed and unlisted public companies. However, for reasons and factors discussed in question 17, going-private transactions do not occur routinely in India. Thus, taking the delisting route would depend on the majority shareholders of the target and the extent to which corporate governance norms and other regulations impede the target's ability to carry out its business.

Further, a private company in India may have to comply with certain public company requirements as a consequence of being acquired by a public company outside India (except in cases where 100 per cent of its share capital is thus acquired).

3 Issues facing public company boards

What are the issues facing boards of directors of public companies considering entering into a going-private or private equity transaction? What is the role of a special committee in such a transaction where management members of the board are participating in the transaction?

Shareholder consent (ie, 75 per cent majority) is required for almost all material transactions proposed to be undertaken by a public company. The board of directors may thus be restricted from carrying out certain activities that they believe to be in the best interest of the company, but that the shareholders may feel could impact their return or exit rights.

As regards a director's participation in any proposed transaction, the Companies Act not only requires a director to disclose his or herinterest in connection with a transaction, but also bars such director from participating in any meeting convened to approve such transaction.

Statutorily, only the findings of the audit committee are binding on the board of directors in the case of public companies. However, in meeting higher corporate governance standards, the charter documents of a company may provide that where board members

are participating in a transaction, the matter may be referred to a committee of the board comprised solely of disinterested or independent directors whose findings shall be final and conclusive on the company.

4 Disclosure issues

Are there heightened disclosure issues in connection with going-private transactions or other private equity transactions?

The disclosures for a going-private transaction include disclosure of the floor price and manner in which such price was determined, a full and complete disclosure of all 'material facts', present capital structure and likely post-delisting capital structure.

As regards other private equity transactions, acquisitions beyond prescribed thresholds under the Takeover Code require disclosures to be filed by the acquirer with the stock exchanges and the target company. These disclosures are fairly standard and mostly relate to the name of the acquirer, percentage of shares purchased, etc.

Insider trading regulations also prescribe disclosures to be made by the acquirer or shareholder and the target company in connection with any change in shareholding beyond certain thresholds. Importantly, these regulations prohibit dealing in securities while in possession of unpublished price-sensitive information. As investments are seldom made without completing legal, business and financial due diligence on the target, it is likely that a potential investor would discover material non-public information. Unlike certain jurisdictions that exempt diligence findings from the ambit of insider trading norms, no such exemption has been carved out under Indian law. Consequently, any such information discovered in the diligence would need to be made public so as to avoid being penalised under insider trading regulations.

5 Timing considerations

What are the timing considerations for a going-private or other private equity transaction?

The timing consideration for a going-private transaction would be considerable as the delisting process in itself takes eight to 12 months. Time frames for other private equity transactions would vary depending on various factors (such as obtaining regulatory approvals, if any, complexity in the negotiations and so on) and the type of transaction that is being carried out. For example, private placements or secondary market purchases may take anywhere between a few weeks to a few months depending on such factors.

Obtaining approval from the Foreign Investment Promotion Board (FIPB) if required (for example for investments in sectors set out in question 18), takes about two to three months.

6 Purchase agreements

What purchase agreement issues are specific to private equity transactions?

Purchase agreements typically contain representations and warranties that are fairly exhaustive relating to almost all aspects of the target, with corresponding indemnification obligations on the target company and its promoters. However, the right to indemnification against such representations and warranties are typically tagged with a sunset date, which is usually determined based on the relevant limitations provided under the statute for limitations.

Break-up fees and reverse break-up fees are not provided for statutorily, nor are they commonplace. However, parties are free to contractually agree to such terms.

As discussed in question 10, in light of the regulatory bridges to cross while structuring a leveraged buyout (LBO), financing conditions do not assume significant importance in such agreements. However, purchase agreements typically confer veto rights on the investor for any financing to be raised by the company.

7 Participation of target company's management

How can management of the target company participate in a going-private transaction? What are the principal executive compensation issues?

Typically, the management and key employees sign detailed employment agreements with the target company (employer) as a condition to closing. While these agreements would contain provisions regarding confidentiality, IP assignment, non-solicit, non-compete, etc, to retain the services and further incentivise the key employees, such agreements also contain provisions on compensation, bonuses, share of profits, stock options or RSUs, etc. Some of these provisions are linked to the overall performance and profitability of the company. Having said that, it is also common to see forfeiture provisions in such contracts to the extent the targets are not achieved within the stipulated time frame. In order to retain flexibility, certain companies also set up employee welfare trusts to administer some of the incentives for employees and such trusts may launch specific plans or schemes for administering bonuses, stock options, RSUs, etc.

Per SEBI's ESOP Guidelines, companies are required to reflect the discounted share valuations for such ESOPs in their profit and loss account. To avoid suffering this hit to their profit and loss account, the management is thus encouraged to take a company private so as to avoid being regulated by the SEBI ESOP Guidelines.

8 Tax issues

What are the basic tax issues involved in private equity transactions? Can share acquisitions be classified as asset acquisitions for tax purposes?

The basic corporate tax rate in India for domestic companies is 34 per cent and in the case of dividends that are declared and distributed by a company, there is an additional tax of 17 per cent on such dividends in the hands of the company. Interest paid on debt instruments (such as debentures, FCCBs etc) are taxed at 20 per cent to 40 per cent depending on the currency denomination of the instrument. The rates applicable to a sale of shares (excluding surcharge and cess) of an Indian company are tabulated below.

Nature of transaction	Long-term capital gains*	Short-term capital gains**
Listed securities traded on the stock exchange	0% + Securities Transaction Tax (STT)***	15% + STT***
Listed securities traded off the stock exchange	10%	Resident – 30% Non-resident – 40%
Unlisted securities	20%	Resident – 30% Non-resident – 40%

* Securities held for 12 months or more.
** Securities held for less than 12 months.
*** STT will be levied at the rate of 0.125 per cent on both the buyer and seller of the equity share. For sale of shares settled otherwise than by way actual delivery or transfer of the equity share, STT will be levied at the rate of 0.025 per cent on the seller.

From the above, it is evident that India is a high-tax jurisdiction. It is therefore important to structure transactions from tax-friendly jurisdictions to minimise the tax effect, specifically with respect to capital gains tax. The most commonly used jurisdiction for

investment into India is Mauritius. This is because the India–Mauritius tax treaty provides that the capital gains income realised by a Mauritius resident from the sale of shares in an Indian company is not taxable in India, provided that the Mauritius company does not have a permanent establishment in India. Furthermore, Mauritius does not impose tax on capital gains. Therefore, the gains arising on the sale of Indian company shares are taxable neither in Mauritius nor in India. Dividends received from an Indian company are subject to a 15 per cent tax in Mauritius. However, against this tax, a credit is available for taxes paid in India (including the underlying taxes) or a deemed foreign tax credit of 80 per cent of the Mauritius tax liability, whichever is higher. Hence, at worst, the net tax liability in Mauritius could be 3 per cent of the dividends received from India and at best it could be nil. Mauritius also does not levy a withholding tax on dividends declared by a Mauritius company. Consequently, having a Mauritius entity between the investor jurisdiction and the Indian target company has become a rule of thumb for most foreign investments into India.

The taxability of executive compensations is wholly dependent on the way they are structured (as employee compensations may either be regarded as 'salary', where the executive suffers the tax incidence or be regarded as 'fringe benefits', in which case the company may be liable to pay fringe benefit tax (FBT) on such benefits given to the executive). In the case of ESOPs, no tax is payable by the employee at the time of allotment of ESOPs. However, it is the company that is required to pay FBT at the rate of 30 per cent whenever there is a direct or indirect allotment or transfer, of any specified security, including ESOPs, shares, etc, from the company to the employee.

Any income of a previous year received by a resident includes income that accrues or arises, or is deemed to accrue or arise, to him or her in India during such year. Accordingly, the taxability of any deferred compensation would depend on when such income accrues or arises, or is deemed to accrue or arise, to the executive.

The taxation of earn-outs remains ambiguous, as Indian tax laws do not contain specific provisions for treatment of taxation of contingent payments by way of earn-out. In the case of capital gains arising from the transfer of a capital asset, it is taxable in the year in which the transfer takes place. Consequently, there may be issues relating to the timing of taxation of the earn out payment. Additionally, in the case of earn-out payments to a promoter of the transferee company, the Authority for Advance Rulings (a quasi-judicial authority where a determination of a non-resident's tax liability may be sought) has recently classified upfront payments (ie, the initial portion of the sale consideration) as 'capital gains' and earn-out payments as 'salary'. This ruling may result in further confusion, as many private equity transactions entail earn-out payments, which in most cases is clearly a mechanism for discharging consideration for the acquisition and not as salary.

Share acquisitions cannot be treated as asset acquisitions under Indian tax laws and thus shareholders cannot pass their tax liability arising from the sale of their shares to the company.

Unlike certain jurisdictions where some forms of corporations can be treated as 'pass through' entities, in India corporations are not entitled to 'pass through' earnings to their shareholders and are required to pay tax on their income.

9 Existing indebtedness

What issues are raised by existing indebtedness at a potential target of a private equity transaction? How are these issues resolved?

A review of the target's loan documents helps to identify the issues that arise under its indebtedness. Such review would typically be done while conducting a due diligence on the target. In most cases, lender consent would be required prior to the target undertaking certain activities (for example, any transaction that changes the capital structure). It is thus important to provide that lender consent be obtained as one of the conditions to closing. In practice, obtaining such consent is a fairly straightforward process.

The assets provided as collateral may also pose a significant issue. In cases where the target's ability to repay its debt is compromised, the transaction documents should provide for the automatic trigger of the private equity sponsor's exit rights. However, this may not be practically effective in all cases, as the company may not have sufficient liquidity to implement such exit rights.

Further, any liquidation preference may also be affected as the creditors' rights to repayment would rank higher.

10 Debt financing structures

What types of debt are used to finance going-private or private equity transactions? Do margin loan restrictions affect the debt financing structure of these transactions?

LBOs entail complex structuring for two main reasons. Firstly, the RBI prohibits domestic banks from providing loans for the purchase of securities in any Indian company. Secondly, under exchange control norms, foreign-owned and controlled holding companies cannot leverage funds from the domestic market for making investments into India. This restriction imposes a significant hurdle while attempting an LBO of an Indian company.

However, domestic banks are permitted to finance Indian companies to purchase foreign securities. Lending norms are also relaxed to meet the promoter's contribution under certain conditions. Thus while an LBO of an Indian target requires structuring around regulatory hurdles, an LBO by an Indian corporate of an overseas company is permissible.

An Indian company may also borrow from foreign sources (which include banks, export credit agencies and foreign equity holders who own at least 25 per cent in the target) under the External Commercial Borrowing (ECB) guidelines. While these guidelines facilitate the ability to raise loans in foreign currency up to certain limits, they also impose several restrictions, such as end-use restrictions (ECBs are not permitted for domestic acquisitions, real estate, working capital needs etc) minimum average maturity, cap on interest and so on.

Importantly, hybrid instruments such as optionally convertible or partially convertible preference shares or debentures have been classified as debt-like instruments and brought within the ambit of the ECB Guidelines. Only instruments that are fully and mandatorily convertible into equity within a specified time would be reckoned as part of equity under the foreign direct investment (FDI) policy.

As a result, private equity sponsors (whether domestic or foreign) have limited options to raise debt from domestic banks to finance such transactions.

In light of the above, as the lending source is typically offshore, any margin restrictions on domestic banks under Indian law would not affect debt financing structures.

11 Debt and equity financing provisions

What provisions relating to debt and equity financing are typically found in a going-private transaction? What other documents set out the expected financing?

As discussed in question 17, in light of the context in which going-private transactions occur in India, financing considerations are not significant.

In the context of a voluntary delisting, a 'buyback' of the public shareholders' stake is one of the steps being used to reduce the public float, followed by a complete delisting process. However, a company may fund a buyback only through internal accruals such

as its free reserves, out of proceeds raised from a fresh issue of shares (of a class different from the class of shares being bought back) or out of the securities premium account. Thus while companies are prohibited from obtaining loans from banks to fund the buyback, where a company has poor cash flow, it may borrow from banks against its securities premium account and subsequently undertake the buyback.

12 Fraudulent conveyance issues

Do private equity transactions involving leverage raise 'fraudulent conveyance' issues? How are these issues typically handled in a going-private transaction?

As highly leveraged transactions are not commonplace in the context of acquiring an Indian target company, 'fraudulent conveyance' issues do not typically arise.

However, the RBI has issued notifications from to time as a check against any fraudulent conveyance of collateral. For instance, shares pledged with certain banks were being offered as collateral to other banks, and consequently the RBI has issued notifications tightening the norms pertaining to registration of liens and transfer procedures.

13 Shareholders' agreements

What are the key provisions in shareholders' agreements covering minority investments or investments made by two or more private equity firms?

In general, shareholders' agreements typically confer minority shareholders of Indian companies with rights largely similar to those executed worldwide, such as:

- board seat and veto rights over certain transactions;
- pre-emptive rights to participate in future financing rounds by the company;
- restriction on sales (either through a 'right of first offer' or a 'right of first refusal') and 'co-sale rights';
- anti-dilution price protections;
- exit rights – while an IPO is the most preferred form of exit, as a company's listing on a stock exchange cannot be guaranteed with absolute certainty, alternative exit mechanisms such as a buyback by the company of the minority shareholder's stake or a put option against the management may also be considered; and
- drag rights – a forced sale is usually vehemently opposed by the majority and consequently such rights though contractually agreed to, ultimately may not be effectuated or enforced.

Other protections, such as an effective dispute resolution mechanism, such as arbitration, may be adopted due to litigation being a relatively weak enforcement mechanism in India. Minority shareholders may also be provided with information rights, inspection and visitation rights to inspect financials, material contracts, etc.

Of most importance is that all the protections conferred on a minority shareholder under an agreement should be incorporated in the charter documents of the company to ensure the enforceability of such mechanisms against the company (to the extent such provisions do not violate applicable law).

14 Limitations on transaction size

Do private equity firms have limitations on the size of transactions they may engage in?

SEBI-registered venture capital funds (VCFs) cannot invest more than 25 per cent of their aggregate capital commitments in any one venture capital undertaking (VCU). A VCU means a domestic company whose shares are not listed in a recognised stock exchange in India and which is not engaged in activities that have been classified under the negative list.

It is not mandatory for an offshore fund to register with SEBI as a foreign venture capital investor (FVCI). However, it is advantageous to register with SEBI as an FVCI for certain benefits (for example, inapplicability of pricing guidelines to FVCI investments).

The 25 per cent ceiling as discussed above applies only with respect to SEBI registered VCFs. However, even in the case of unregistered VCFs and FVCIs, the internal policies of such funds typically limit the percentage of capital commitments in any one undertaking to 15 per cent of its capital.

15 Exit strategies and investment horizons

How do the exit strategies and investment horizons of private equity firms affect the structuring and negotiation of leveraged buyout transactions?

In such transactions, the bank or any other lender would typically insist that all cash flows from the target be utilised for repaying the loans granted for the acquisition. In several situations this would prolong the private equity firm's ability to exit, as the sponsor's right to exit may be possible only after the lender has been repaid.

16 Principal accounting considerations

What are some of the principal accounting considerations for private equity transactions?

India's accounting standards (AS) are broadly in line with International Accounting Standards and International Financial Reporting Standards (IFRS), except for certain exceptions and deviations to suit the laws and economy of India. For accounting purposes, a business combination may either be classified as a 'merger' (if it satisfies certain conditions prescribed under the AS) or as a 'purchase'. In a merger, the assets, liabilities as well as the reserves of the target are recorded by the acquirer at their existing carrying amount after making certain adjustments (which is referred to as the 'pooling method). In a purchase, only the assets and liabilities of the target are accounted, either at their existing carrying amount or by assigning values to individual assets and liabilities of the target on the basis of their fair values at the date of the acquisition, but not the reserves (ie, capital and general reserves). Consequently, in cases where the target has significant reserves, from an accounting perspective, it may thus be more beneficial to structure the transaction as a merger as opposed to a purchase to utilise such reserves.

In essence, the reserves of the target underlie the principal accounting considerations so as to determine whether the acquired business is to be held as a separate subsidiary or merged with the acquirer.

Unlike the IFRS, where only the purchase method remains applicable, in India, the pooling method still holds good, but would apply only in the case of mergers that meet the criteria set out under the AS.

17 Target companies and industries

What types of companies or industries have typically been the targets of going-private transactions? Has there been any change in focus in recent years?

As has been highlighted, the trend of going private in India is unlike that of other jurisdictions. In previous years (mid-2002), several multinational corporations listed in India were delisted as a consequence of being acquired by their parent companies and affiliated entities.

Certain companies (such as those in the information technology sector) that listed prematurely or that do not derive any benefits from being listed opt for the voluntary delisting route. Moreover, mandatory delisting is usually triggered because of non compliance with the listing agreement executed by the company with the stock exchanges.

Even where a transaction reduces the public free float below the minimum threshold, the target company and its promoter may be found to take steps to meet the public shareholding requirements. This is largely attributable to the difficulty in implementing 'squeeze-out' provisions. Though statutorily provided for under the Companies Act, they are difficult to implement and are often challenged in court. Consequently, in the absence of effective squeeze-out provisions, companies have been hesitant to delist for fear of being held to ransom by a handful of shareholders who may insist on exorbitant premiums.

In comparatively fewer situations, going-private transactions occur in line with the international context. Thus, it may not be possible to conclude that any particular industry has been the target of going-private transactions.

As regards other private equity transactions (such as PIPEs, mergers and acquisitions, etc) the industries that have typically been targeted are information technology and information technology enabled services, fuel, power, industrial machinery etc. However, private equity sponsors have started to diversify their interests in other high-potential sectors such as telecom, pharmaceuticals (especially biotech), manufacturing, infrastructure, banking, media and entertainment and retail.

18 Industry-specific regulatory schemes

Do industry-specific regulatory schemes limit the potential targets of private equity firms?

Potential targets may be limited due to exchange control norms. Currently, FDI is permitted in most sectors under the automatic route (ie, where no prior approval of the FIPB is required). However, certain sectors that are restricted or have sectoral caps are summarised thus.

FDI in the following sectors beyond the percentages specified below require FIPB approval:

- banking (74 per cent);
- telecom services (49 per cent – 74 per cent) (see below);
- civil aviation (49 per cent);
- insurance (26 per cent), etc; and
- investment in excess of 24 per cent in small scale industrial units.

Foreign investment up to 49 per cent in telecom services is permitted under the automatic route. However, any investment between 49 per cent and 74 per cent requires prior FIPB approval.

Certain sectors where FDI is prohibited:

- atomic energy;
- lottery business;
- gambling and betting;
- retail trading (except single brand retailing); and
- agriculture.

19 Cross-border transactions

What are the issues unique to structuring and financing a cross-border going-private or private equity transaction?

Any foreign investment into India should be carefully structured from a tax, legal and regulatory perspective.

Tax

As discussed in question 8, since India is a high tax jurisdiction, it is important to structure foreign investments into India through a tax favourable jurisdiction depending on the income stream sought from the investment.

Exchange controls

As any security issued to a non-resident that is not compulsorily convertible into equity would be treated as an ECB (which entails compliance with numerous conditions and may thus not be a preferred form of investment), structuring the instrument of investment to confer the upside and downside protections that are sought from the investment becomes critical.

Non-resident investors are required to comply with entry and exit pricing restrictions as prescribed by the RBI. Consequently, anti-dilution protections and mechanisms that contemplate securities being issued free of cost to a non-resident would need to be negotiated keeping such pricing restrictions in mind.

Further certain payments such as indemnities, break-up fees, etc, would require prior regulatory approval.

Financing restrictions

LBOs would require notable structuring in light of the issues discussed in question 10.

20 Club and group deals

What are the special considerations when more than one private equity firm (or one or more private equity firms and a strategic partner) is participating in a club or group deal?

The special considerations in group deals are largely similar to those in other jurisdictions. For instance, ensuring no conflict of interest and that the rights and protections of investors are aligned etc. In particular, veto rights should be exercised by the majority or super-majority of the investor group. For efficiency in the transaction, one lead investor is typically identified.

The sectoral caps under the FDI policy should be given special consideration bearing in mind the combined shareholding percentage of the non-resident investor group. Further, the provisions of the Takeover Code dealing with 'persons acting in concert' and threshold shareholding percentages that would trigger the open offer requirements also need to be borne in mind.

21 Recent credit market disruptions

How have disruptions in the credit markets affected dealmaking? What specific changes to transaction terms have you seen and do you expect in the future?

The global 'credit crunch' triggered by low rated securities being provided as collateral, has not arisen in India in light of the lending restrictions on domestic banks. Consequently, there exists comparatively higher liquidity in the Indian banking system. However, deal sizes and also the frequency at which they occur have undoubtedly reduced.

Some of the specific changes to the transaction terms that we expect are with respect to the exit rights. As IPOs are no longer attractive, fallback exit rights (through a buyback right, put option etc) may instead be brought to the forefront with additional obligations on the target to ensure the agreed return on investment (such as escrowing certain amounts or shares as security etc).

Earn out models may become increasingly popular as opposed to a one time payment of the consideration price to be assured of the profitability and growth of the target – an assurance that was once more liberally assumed during the bull run. Further, weighted average price protections are now sought to be substituted by full ratchet protections which may create a conflict of interest as target companies are almost never agreeable to full ratchets.

Update and trends

A shift in the trend of going-private transactions in India is now being seen. Promoter groups and private equity investors of cash-rich listed companies are increasingly opting to voluntarily take companies private. However, the price discovery mechanism to fix the exit price (reverse book building), minimum public participation, time frames, etc, continue to hamper the success of such transactions.

The recent scandal surrounding the Indian software giant Satyam Computers Services (being dubbed 'India's Enron'), where its CEO admitted to falsifying and overstating cash reserves by nearly US$1 billion has laid greater emphasis on compliance with corporate governance norms. The reforms and amendments being passed by the regulators in the aftermath of this debacle (such as requirement of disclosures on shares pledged, etc) could have a telling impact on private equity transactions.

Cross-border tax planning is being doubly considered after the Indian tax authorities pulled up Vodafone for not withholding tax on the consideration paid for the acquisition of a Cayman Islands company through its Netherlands entity, a seemingly tax-free transaction so far as India's fiscal shores are concerned. As a background, one of the Cayman Islands entities held a number of Mauritian and Indian subsidiaries, which cumulatively owned a 67 per cent stake in Vodafone Essar Limited, a company based in India. Thus the tax authorities believe that Vodafone indirectly acquired a controlling interest in an Indian company, which entitles them to bring the transaction and the gigantic US$11.1 billion sale consideration within the Indian tax net. The Vodafone controversy thus put the fear of Indian tax authorities in the heart of multinational corporations who operate in India. But to what extent it should raise concerns can be appreciated only after the tax authorities have made a determination on this issue.

Several positive developments have also taken place or are expected to take place in pursuance of certain regulatory initiatives. As a few examples:

Until recently, the manner of computing indirect foreign investment in Indian companies has been restrictive. This has been relaxed with the regulators providing that an operating company will not be treated as having any indirect foreign investment as long as its parent holding company, in which there are foreign investments, is ultimately 'owned and controlled' by Indian resident citizens. The meaning of control is restricted to the ability to appoint a majority of directors, though the regulators have retained the discretion to examine extent of control given to foreign investors under shareholder agreements through disproportionate voting rights, etc. Operating companies funded by foreign firms have been hesitant to make downstream investments and acquisitions, particularly in more restricted sectors such as retail, telecom, etc, for fear of being stalled by the FIPB. These guidelines are thus expected to boost investments and acquisitions to a large extent.

The RBI has relaxed some of the end-use restrictions under the ECB Guidelines, opening up greater avenues for foreign funding. The RBI has also permitted the pre-payment of foreign currency convertible bonds by way of a buyback prior to the expiry of the minimum average maturity subject to certain conditions for a limited period.

The pricing of listed securities has not been conducive to private equity sponsors ,due to the disconnect between the prevailing market price of a share and the minimum price at which they are to be offered under law. To bridge this disconnect, SEBI had passed amendments to bring the issue price under certain private placements of listed companies closer to the market price (reduced from a six-month to a two-week average). However, soaring interest rates and volatile market conditions coupled with SEBI's steps to boost debt investments are starting to make debt an attractive investment alternative.

Nishith Desai Associates

Legal & Tax Counseling Worldwide

Mumbai • Silicon Valley • Bangalore • Singapore

Siddharth Shah **siddharth@nishithdesai.com**

93-B Mittal Court
Nariman Point
Mumbai 400021
India

Tel: +91 22 66695000
Fax: +91 22 66695001
www.nishithdesai.com

GETTING THE DEAL THROUGH

Annual volumes published on:

- Air Transport
- Anti-Corruption Regulation
- Arbitration
- Banking Regulation
- Cartel Regulation
- Construction
- Copyright
- Corporate Governance
- Dispute Resolution
- Dominance
- e-Commerce
- Electricity Regulation
- Environment
- Franchise
- Gas Regulation
- Insurance & Reinsurance
- Intellectual Property & Antitrust
- Labour & Employment
- Licensing
- Merger Control
- Mergers & Acquisitions
- Mining
- Oil Regulation
- Patents
- Pharmaceutical Antitrust
- Private Antitrust Litigation
- Private Equity
- Product Liability
- Project Finance
- Public Procurement
- Real Estate
- Restructuring & Insolvency
- Securities Finance
- Shipping
- Tax on Inbound Investment
- Telecoms and Media
- Trademarks
- Vertical Agreements

For more information or to purchase books, please visit:
www.GettingTheDealThrough.com

Strategic research partners of the ABA International section

THE QUEEN'S AWARDS FOR ENTERPRISE 2006

The Official Research Partner of the International Bar Association

ISSN 1746-5524