

## M&A Hotline

May 04, 2011

### NO RBI APPROVAL FOR CASH AND SHARE ESCROW

The Reserve Bank of India ("RBI") vide a circular dated May 2, 2011 ("Circular 58")<sup>1</sup> has made it permissible for non-residents to open cash and / or share escrow accounts either independently or together with residents and *vice versa*, without the requirement of a prior approval of the RBI. This is a welcome change for foreign investors looking at investing into India as it provides greater flexibility in structuring foreign private equity investments and M&A's in India and exit strategies in connection therewith.

#### BACKGROUND

Prior to Circular 58, although RBI specifically permitted opening and maintaining of escrow accounts for acquisition, transfer of shares, convertible debentures through open offers, delisting, and exit offers in accordance with the regulations and guidelines issued by the Securities Exchange Board of India ("SEBI")<sup>2</sup>, the circulars issued by RBI from time to time made no mention of escrow arrangements for FDI related transactions, other than the aforementioned. The uncertainty as to whether an RBI approval was required for such escrow accounts was seen as an impediment in the structuring of transactions involving staggered execution / closing of transactions contingent on the fulfillment of certain crucial conditions by the issuer company or the transferor, as the case may be. Therefore, escrows to facilitate such transactions were often maintained outside India to facilitate the commercials of the transaction. Circular 58 has now made it possible to set up and maintain such escrow accounts for FDI related transactions in India without any delay.

#### CIRCULAR 58

Circular 58 permits AD Category-I banks to open and maintain escrow accounts on behalf of residents and / or non-residents for the purpose of keeping shares or purchase or subscription money / consideration in an escrow for a maximum period of 6 months; an escrow for a period more than 6 months shall require RBI approval. The cash accounts are required to be maintained in Indian rupees. Therefore, in case of non-residents, the cash escrow accounts may be in the form of non-resident ordinary accounts.

In case of share escrow accounts, in the event the shares are in physical form such accounts can be opened with a AD Category-I banks and in the event the shares are in dematerialised form, such accounts can be opened with a SEBI authorised depository participant. It is important to note that while Circular 58 refers to securities and shares interchangeably, equity shares, compulsorily and mandatorily convertible preference shares and debentures should fall within the purview of securities dealt with by the said circular.

Circular 58 requires that the cash escrow account maintained with the AD Category-I bank shall be non-interest bearing and fund and non-fund based facilities shall not be permitted against the balances in such cash escrow accounts. To elaborate, the balances in the cash account can neither be used by the AD Category-I bank to provide any form of financing to a third party nor for providing any non-fund based facilities such as letter of credit or guarantees against the balances in the account. The obligation to ensure compliance with the KYC requirements shall be that of the relevant AD Category-I bank. Further, it has been clarified that for the purposes of reporting of the investment such as filing of the FC-TRS in case of a secondary investment, or for calculation of 180 days for the purpose of issuance of shares, in case of primary investment, the date of transfer of consideration into the bank account of the issuer company or the transferor, as the case may be, shall be considered.

The permitted credits / debits to the cash escrow account are:

- (a) amounts remitted by non-resident investor towards the issue of shares / securities or purchase of shares / securities from Indian company or resident transferor, as the case may be; and
- (b) amounts deposited by a resident towards the purchase of shares / securities from a non-resident transferor.

There is a clear authorisation to repatriate the funds in the escrow account in the event of failure of the transaction for which the escrow arrangement was maintained. The repatriation of funds shall be at the then prevailing exchange rate with the non-resident required to bear any forex risk. Circular 58 further requires that the terms and conditions of the escrow are to be clearly laid down in the escrow agreements, share purchase agreement, conditions of issue, etc. presumably to ensure that the discretion to repatriate the funds does not lie with the escrow agent.

#### ANALYSIS AND IMPLICATIONS

Despite the short duration permitted for maintaining an escrow account opened in accordance with the requirements set out above, Circular 58 is a positive step towards attracting foreign investment into India and for structuring exit strategies. The said circular facilitates the structuring of private equity and M&A transactions involving staggered payouts dependent on the fulfillment of certain crucial conditions by the issuer company or the transferor. The circular

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also permits the repatriation of any balance funds in the escrow account upon the completion of the transaction for which the escrow account had been put in place; thereby, providing for the flexibility to adjust the valuation of the transaction in the event of non-fulfillment of any of the conditions of the transaction. Consequently, an investment where the price per share is dependent on the outcome of a target company's EBITDA over a stipulated period may be now structured in a manner where part of the consideration is paid upfront to the promoter by the acquirer / investor and the balance consideration structured as variable component is deposited in an escrow account in India which can be released to the promoters by the escrow agent upon achievement of target EBITDA. From an acquirer / investor's perspective, such type of escrow arrangements incentivize the promoters to perform better even after they have sold the target company to the acquirer / investor and from a promoter's perspective, he gets the security for the balance consideration since the same is in an escrow account. Accordingly, such escrow arrangement results in a win-win situation for both the acquirer / investor and the promoters.

The application of the circular in case of the primary issuance may be limited, given the requirement of issuance of shares / securities by companies only upon receipt of the subscription money, as also the constraints posed by the inability of the company to cancel its shares after issuance (other than by way of buy back or a reduction of capital, both having various requirements to be fulfilled prior to the same being undertaken under the provisions of the Companies Act, 1956). In case of secondary purchase, however, the said circular has opened up many structuring opportunities for investors.

Circular 58 has, however, not provided any clarity on the opening of escrow accounts for facilitating post-transaction escrow structures for the purposes of specific indemnification (typical in case of tax-related indemnities) or for setting aside some portion of the consideration for certain contingent third party claims, etc. and a clarification in this regard would be helpful.

- Priyadarshani Sherchan & Simone Reis

1 <http://rbidocs.rbi.org.in/rbiadmin/scripts/NotificationUser.aspx?Id=6369&Mode=0>

2 [http://www.rbi.org.in/scripts/BS\\_CircularIndexDisplay.aspx?Id=3549](http://www.rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?Id=3549)

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