

# Investment Funds: Monthly Digest

April 16, 2019

## TRUSTS AS AIFS IN INDIA : LEGAL CONSIDERATIONS

### INTRODUCTION

The Securities and Exchange Board of India (“SEBI”) permits an Alternative Investment Fund (“AIF”) under the SEBI (Alternative Investment Funds) Regulations, 2012 (the “AIF Regulations”) to be established as a trust, a company, a limited liability partnership (“LLP”) or a body corporate.<sup>1</sup>

Prior to the introduction of Finance Act, 2015, all categories of AIFs were not accorded a tax pass through status<sup>2</sup> solely basis their identity as SEBI registered AIFs. For these reasons among others, AIFs were set up as ‘determinate, private trusts’ to avail of tax pass through status (which is the global standard for taxation of investment funds) under the laws of trust taxation.

A distinct tax pass through was incorporated in the Indian Income Tax Act, 1961 by the Finance Act, 2015 for Category I and Category II AIFs, irrespective of the legal form in which such AIFs are set up. However, this did not take away the preferential value of a trust structure for AIFs in India, because while companies and LLPs are subject to numerous governance and compliance requirements under the Companies Act, 2013 and LLP Act, 2008, the Trusts Act offers the manager (or ‘GP’) team the ability to incorporate bespoke terms of governance for an AIF which is set up as a trust, as may be agreed between the GP and the investors (or ‘LPs’) of the AIF.

In this issue of the digest, we discuss how trusts provide the legal comfort required to operate AIFs in India and the current Indian legal considerations which are commonly discussed between LP and GP counsels with respect to Indian trusts.

### TRUSTS AS AIFS: KEY FEATURES

Private trusts in India, being trusts whose beneficiaries are ascertained and are not general public or a class of general public at large,<sup>3</sup> are formed and governed under the Indian Trusts Act, 1882 (the “Trusts Act”).<sup>4</sup> However, the Trusts Act is not an exhaustive code governing the operations of a private Indian trust, and Indian courts may apply and have been applying the common law rules of law of trusts, insofar as they are not inconsistent with the provisions of the Trusts Act.<sup>5</sup>

The peculiar legal nature of a ‘trust’ which gives rise to many legal considerations while using it for an AIF, is that it does not have a separate legal personality, like a company or an LLP – i.e. the trust, in itself, does not have the ability to sue or be sued.<sup>6</sup> It is represented by its trustee, which is primarily entitled to sue or be sued for and on behalf of the trust, as the legal owner of the trust property.<sup>7</sup>

For an AIF, an ‘irrevocably settled, determinate trust’ has been considered most appropriate.<sup>8</sup> This is stemming from traditional principles of trust taxation, because ‘determinacy’ of the trust is one of the conditions for applicability of tax pass through under trust taxation principles (in the unlikely event that the special tax pass through granted to Category I and Category II AIFs is revoked) and ‘irrevocability of settlement’ ensures that the settlor of the AIF does not have powers to revoke the trust and the trust shall continue until its purpose is served or stipulated tenure is complete.

To achieve ‘determinacy’, the AIF needs to ensure that its investors and their respective beneficial interests are ascertainable as per the terms of the ‘indenture of trust’ or the ‘trust deed’ setting up the AIF as a trust, at all times during its existence.<sup>9</sup> A discretionary trust, on the contrary, provides the trustee with the discretion to determine the beneficial interest and distribution schedule for the beneficiaries.<sup>10</sup>

Below are the key events in an AIF’s life as an investment fund, which is set up as a trust:

- 1. Formation and Registration:** Unlike a company or an LLP (both under the purview of the Ministry of Corporate Affairs), there is no separate supervisory authority who is responsible for approval and / or regulation of trusts. The creation of a trust is governed solely by the indenture of trust or trust deed, which is executed between the settlor and the trustee. The settlor (being the ‘author’ of the trust) is required to settle the trust with an initial settlement amount, which has to be transferred to the proposed trustee. The initial settlement amount creates the ‘consideration amount’ for the trust to be set up. While a trust may have its own board of trustees, in the context of an AIF the trustee is often an independent institutional trustee, who agrees to provide trusteeship services to the AIF for a fee.
- 2.** While it is not compulsory to register private trusts generally, the AIF Regulations require that the trust deed of the AIF must be registered under the Indian Registration Act, 1908. A prior appointment is to be taken with the sub-registrar of the relevant jurisdiction, for execution of the trust deed to take place in presence of the sub-registrar, along with two witnesses and a stamp paper of appropriate stamp duty (depending on the jurisdiction). The

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- procedure is simple, and less time consuming than filing and obtaining approval on the charter documents of the company or LLP with the registrar of companies or LLP, as applicable.
- Appointment of the Manager:** The trustee of the AIF enters into a counterparty agreement with the proposed manager of the AIF, in the form of an 'investment management agreement'. A trust structure permits ring fencing of the manager's liability (including from a fiduciary, breach of fund documents perspective) from that of the AIF's, because the manager is only a counterparty service provider to the AIF, unlike also being on the board of directors of an AIF which could be a company, or being a designated partner of an LLP. Separately, from a tax perspective, the income of the manager as a service provider is unambiguously delineated from its sponsor commitment, and profit sharing in the AIF as a carry recipient, allowing better alternatives for carry structuring.
  - Contributions:** The Trusts Act permits trusts to receive contributions from time to time, from persons other than the original settlor. AIFs work on this contributory model of trusts, where the investors of the AIF enter into a binding agreement with the trustee of the AIF (acting on the AIF's behalf) and the manager, to contribute a certain amount to the AIF as per the terms and conditions mentioned in the governing documents of the AIF. In the next section, we will discuss the contractual considerations and interplay between the different agreements signed by the investor, trustee and manager of an AIF. In case of a company, share allotment / application money, etc. are regulated concepts, which require compliance with the Companies Act, 2013.
  - Issuance of Units:** A 'unit certificate' for the units of an AIF is not statutorily required to be created or filed with any authority. Trustee, through Investment Manager, can provide a statement of account to any desiring LP.
  - Investments:** The trustee of a trust is permitted under the Trusts Act to invest the trust's assets as per the terms of the trust deed. For an AIF, the trustee may delegate considerable areas of its scope / powers (except those not permitted under applicable law) to the manager under the investment management agreement. Accordingly, the manager is entitled to make all investment decisions for and on behalf of the AIF. The execution of the documents with investee companies of the AIF is determined by the indenture read with the investment management agreement. It is imperative that the manager has the requisite authority from the trustee to sign investment documents on behalf of the AIF, because statutorily, the trustee is the legal owner of the AIF's assets (including any investments).
  - Compliance / Monitoring:** With respect to the AIF Regulations, the Trustee itself is required to ensure certain compliance, for which it imposes relevant restrictions under the Fund Documents (for example, compliance with providing exit mechanism to investors upon a material change in the PPM)<sup>11</sup>. However, with respect to commercial operations of the Fund (such as drawdowns, distributions, notices, voting matters) are responsibilities of the Investment Manager.
  - Liquidation:** The liquidation procedure for a trust is also permitted to be governed by its trust deed with minimal statutory intervention. For an AIF set up as a trust, the AIF Regulations also need to be complied with, for winding up of the AIF. Unless the investors of the AIF consent (the threshold for such consent is not specified under the AIF Regulations), the AIF is required to be fully liquidated within 1 year of the expiry of its tenure. From a good governance and certainty perspective, the liquidation procedure should be drafted and agreed upon with all investors in the fund documentation itself.

## CURRENT LEGAL CONSIDERATIONS

### *Enforceability and Interplay of Fund Documents*

Globally, funds are set up in a legal form which permits the key fund terms to be included in the charter documents of the fund, and only certain specific terms for some investors (which are not prejudicial to other investors) are agreed in side letters. Such charter documents are executed by all investors to the fund, along with the fund and the manager. A typical example of this structure is the limited partnership structure in Delaware, where the limited partnership agreement contains all key fund terms.

The above practice is globally followed for funds because all investors are expected to be entitled an equal access to contractual remedy with respect to actions against the fund, arising from the fund terms. Only those terms which would only require a personal claim against the fund or the manager, and not impact the operations of the fund vis-a-vis other investors, are agreed in the side letter.

The indenture of trust, being the charter document of the trust, is only executed between the settlor and the trustee. Contributors to the fund are not 'signatories' to the trust deed. The indenture of trust is shared with all investors of the AIF alike, being the charter document, and also shared with SEBI. The Contribution Agreement for each Contributor is generally not shared with other Contributors, as it contains representations and warranties which may be specific to each Contributor. The Investment Management Agreement, as discussed earlier, is a counterparty arrangement.

To achieve global standards on fund documentation as explained above, the indenture of trust is often considered as an equivalent of a limited partnership agreement for an AIF, where all terms of the fund which are intended to be binding may be incorporated in the indenture of trust itself. However, the drafting of an 'all inclusive' indenture of trust requires certain considerations from a contract law perspective, which should be discussed and disclosed to all relevant parties before commencement of fund documentation.

Given that Contributors are not parties to the indenture of trust, questions often arise as to the ability of the Contributors to enforce the indenture of trust. The law of privity of contracts (as generally applied in common law jurisdictions) requires that a person who is not a party to the contract, is not entitled to maintain an action for breach of that contract.<sup>12</sup> However, beneficiaries to a trust, as an exemption to the law of privity of contracts, are permitted to maintain an action for breach of trust. This principle has been upheld in Indian courts multiple times. Accordingly, the Contributors (even though not signatories to the indenture of trust) are all equally entitled to raise a claim under the trust deed.

The contractual interplay between the indenture of trust, investment management agreement, contribution agreement and PPM needs to be clearly stated in each of the documents, in order to ensure ease of enforcement. For example, the investment manager is not a party to the indenture of trust, and most investors would want all commercials to be incorporated in a document which is signed by the investment manager (as most claims are likely to be raised against the investment manager) – to ensure this, the Contribution Agreement is required to contain necessary provisions for all documents to co-exist in harmony.

Unlike several other jurisdictions, the PPM of an AIF in India has legal relevance. Under the AIF Regulations, (i) SEBI scrutinizes the PPM to consider the application for registration of a proposed AIF; (ii) all investors are expected to have read, understood and agreed to the terms of the PPM before making an investment in the AIF; and (iii) any changes to the PPM are matters of investor vote.

Often, it is proposed that the PPM should not be included in the definition of 'Fund Documents' as being the governing documents of the AIF because it is an 'unsigned marketing document'. However, for an AIF, even if the PPM is not included in the definition of Fund Documents, it is imperative (by virtue of the AIF Regulations) that each investor of the AIF has agreed that it has read, understood and invested upon the terms and conditions mentioned in the PPM.

Accordingly, the drafting and designing of the PPM in for AIFs has stronger legal relevance than most other jurisdictions (i.e. not just from a raising perspective, but also from the perspective of ongoing fund operations), and the risk of 'misselling' can be mitigated by a properly drafted PPM.

### **Arbitrability of trust disputes**

The Supreme Court of India ("SC"), in *Vimal Shah & Ors. vs Jayesh Shah & Ors.*<sup>1</sup>, has held that disputes arising between beneficiaries or trustees of a trust cannot be referred to arbitration as an arbitration clause contained in a Trust Deed is not an "arbitration agreement" between the trustees inter se, between the beneficiaries inter se or between the trustees and the beneficiaries for the purposes of the Arbitration & Conciliation Act, 1996 ("Arbitration Act") unless the respective parties specifically agree to the same.

The AIF Regulations state that the procedure for dispute resolution for an AIF whether by arbitration or any other mechanism should be mutually decided and agreed between the investors and the AIF.

The dispute resolution provisions in the indenture of trust and Contribution Agreement are both designed to ensure that the fund documentation for an AIF (set up as trust) is meeting its commercial needs while catering to the above legal fact.

### **REMARKS**

It is important to understand that each fund requires bespoke fund documentation depending on *inter alia* its intended asset class, type of investors, jurisdiction of incorporation and jurisdiction of investments. The market practice in this regard is also dynamic.

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You can direct your queries or comments to the authors

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<sup>1</sup> Regulation 2(1)(b), AIF Regulations

<sup>2</sup> Prior to the Finance Act, 2015, pass-through status was only available to Category I AIFs (which included companies and LLPs) under the venture capital fund sub-category and venture capital funds that were registered under the erstwhile SEBI (Venture Capital Funds) Regulations, 1996 (VCF Regulations).

<sup>3</sup> *Deoki Nandan v. Murlidhar*, AIR 1957 SC 133

<sup>4</sup> *Preamble, and Section 1 of the Indian Trusts Act, 1882, Sheik Abdul Kayum v. Mulla Alibhai* AIR 1963 SC 309

<sup>5</sup> *Collector of Gorakhpur v. Palakdhari* (1990) 12 All 1, *H.V. Law and Co. Ltd. v. Beharilal Sinha* (1933) 59 Cal 1372.

<sup>6</sup> *H.N. Bhwandiwala v. Loroastnan Corp. Bank Ltd.* AIR 2001 Bom 267

<sup>7</sup> *W.O. Holdsworth v. State of Uttar Pradesh*, AIR 1957 SC 887

<sup>8</sup> Trusts Act allows trusts in India to take different forms – it could be a determinate trust, discretionary trust, revocable trust, irrevocable trust, express trust, implied trust, etc.

<sup>9</sup> "Discretionary Power" as referred to under section 17 of the Trusts Act, if given with respect to determining distributions to beneficiaries, could lead to creation of a discretionary trust; AIG Ruling, 1997 224 ITR 473 AAR.

<sup>10</sup> From an asset-protection perspective for events such as divorce, bankruptcy or for tax efficiency, in each case, for beneficiaries, discretionary trust structures are often considered.

<sup>11</sup> SEBI Circular – June 19, 2014 (CIR/IMD/DF/14/2014)

<sup>12</sup> *M.C. Chacko v. State of Travancore* 1970 AIR 500, *Scruttons Ltd. v. Midland Silicones Ltd.* (1962) AC 446: (1962) 1 All ER 1; *Tweddle v. Atkinson* (1861) 1 B & S 395.

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