M&A UPDATE

The latest legal developments in India

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Quick Snapshot

INDIRECT TRANSFERS AND TAX IMPLICATIONS

On November 7, 2017, the Central Board of Direct Taxes ("**CBDT**") issued a circular clarifying indirect transfer provisions under the Income-tax Act, 1961 ("**IT Act**") in case of redemption of shares or interest outside India and providing certain exemptions to investment funds, venture capital companies and venture capital funds.

BLOCK DEAL MECHANISM REVISED

The Securities and Exchange Board of India ("**SEBI**") has revised the block deal mechanism which will come into force from January 1, 2018. The minimum order size for execution of trades in a block deal has been revised to Rs. 100,000,000 and 2 block deal windows have been introduced.

INDIRECT ACQUISITIONS AND EXEMPTIONS UNDER THE TAKEOVER REGULATIONS

Recently on October 30, 2017, SEBI published an informal guidance in the matter of Linde India Limited on an issue relating to an indirect acquisition of a listed company as a result of a merger carried out in foreign jurisdictions.

SHAREHOLDERS' APPROVAL FOR RESOLUTION PLANS UNDER IBC

On October 25, 2017, the Ministry of Corporate Affairs ("**MCA**") issued a circular clarifying that there is no requirement of obtaining shareholders' approval of the corporate debtor during a resolution process under the Insolvency and Bankruptcy Code, 2016 ("**IBC**").

SCREENING BIDDERS IN A CORPORATE INSOLVENCY RESOLUTION PROCESS

The Insolvency and Bankruptcy Board of India ("**IBBI**") has notified certain amendments on November 7, 2017 to ensure that a resolution plan under the IBC comes from a person who can rescue the insolvent business and the resolution process ends up with a credible resolution plan.

DETERMINATION OF PLACE OF EFFECTIVE MANAGEMENT

On October 23, 2017, CBDT issued a clarification on the guidelines for establishing place of effective management in India in case of a multi-national company with a regional headquarter structure.

PAYMENTS TO DIRECTORS, KEY MANAGERIAL PERSONNEL AND EMPLOYEES

On October 23, 2017, SEBI published an informal guidance on the issue of whether the provision of regulation 26(6) of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("**LODR Regulations**") would apply to employees of an unlisted subsidiary. The said regulation requires prior approval of the public shareholders for any employee of a listed entity to enter into any agreement with any shareholder with regard to compensation/ profit sharing in connection with dealings in the securities of such listed entity.

SEBI ORDER ON ACQUISITION OF CONTROL 'PASSIVELY'

In a recent order passed by SEBI, the issue that arose was whether an open offer was required to be made where at the time of acquisition of shares, the noticees did not have majority representation on the Board of the listed company, but subsequently had gained majority representation 'passively'.

Indirect transfers and tax implications

On November 7, 2017, CBDT issued a circular clarifying indirect transfer provisions under the IT Act in case of redemption of shares or interest outside India.

Under section 9(1)(i) of the IT Act, all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India is deemed to accrue or arise in India.

Explanation 5 of section 9(1)(i) of the IT Act provides that if any share or interest in a foreign company or entity ("**Foreign Entity**") derives, directly or indirectly, its value substantially from assets located in India, then such share or interest is deemed to be situated in India. *Thereby, any income arising from transfer of such share or interest is deemed to accrue or arise in India*. However, *vide* Finance Act, 2017, a proviso was added to explanation 5 of section 9(1)(i) of the IT Act, which exempted Category I and Category II foreign portfolio investors under the SEBI (Foreign Portfolio Investors) Regulations, 2014 from the purview of the said explanation.

As a result of the aforesaid provisions, non-resident investment funds set up with a multi-tier investment structures, investing in India, is potentially faced with multiple taxation for the same income. Such multiple taxation could occur because taxability arises firstly at the level of the fund in India on its capital gain/ business income and thereafter tax incidence arises at every upper level of investment in the fund chain on subsequent redemption or buyback.

The recent circular dated November 7, 2017 attempts to address the aforesaid issue by providing an exemption wherein the provisions of section 9(1)(i) of the IT Act read with explanation 5 shall not apply to income accruing or arising to a non-resident if the following conditions are satisfied:

- income accruing or arising to a non-resident is on account of a redemption or a buy-back of its interest or share held indirectly i.e. through upstream entities registered or incorporated outside India;
- such interest or share is held indirectly in a Category I or Category II Alternative Investment Funds regulated under the SEBI (Alternative Investment Fund) Regulations, 2012, venture capital company or a venture capital fund[1] ("**Specified Funds**");
- such income accrues or arises from or in consequence of transfer of shares or securities held in India by the Specified Funds; and
- such income is chargeable to tax in India.

However, the benefit of the aforesaid exemption will be available only in cases where the proceeds of redemption or buy-back arising to the non-resident do not exceed the pro-rata share of the non-resident in the total consideration realised by the Specified Funds from the transfer of shares or securities in India. Further, a non-resident investing directly in the Specified Funds shall continue to be taxed as per the provisions of the IT Act.

Block deal mechanism revised

SEBI had, pursuant to a circular dated September 2, 2005, permitted stock exchanges to provide a separate trading window for facilitating execution of large trades. A trade with a minimum quantity of 500,000 shares or minimum value of Rs. 50,000,000 executed through a single transaction on the separate window of the stock exchange was defined as a '*block deal*' in the said circular. Such deals are normally negotiated before execution.

On October 26, 2017, SEBI issued a circular making the following revisions to the block deal mechanism which will come into force from January 1, 2018:

[1] 'Venture capital company' and 'venture capital fund' have been defined in the Explanation to section 10(23FB) of the IT Act.

- ***Minimum order size***

  The minimum order size for execution of trades in a block deal has been revised to Rs. 100,000,000.

- ***2 block deal windows***

  There will be 2 block deal windows. The morning block deal window will be operational between 8:45 am and 9:00 am and the reference price for execution of block deals in this window will be the closing price of the stock in the previous day.

  The afternoon block deal window will be operational between between 2:05 pm and 2:20 pm and the volume weighted average market price of the trades executed in the stock in the cash segment between 1:45 pm to 2:00 pm will be the reference price for block deals in this window.

- ***Pricing***

  Orders placed should be within +1% of the reference price in the abovementioned windows.

Indirect acquisitions and exemptions under the Takeover Regulations

Regulations 3 and 4 of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 ("**Takeover Regulations**") requires an acquirer of shares or voting rights (exceeding a specified threshold) or control of a listed company to make a public announcement of an open offer for acquiring shares of at least 26% of the total shares of the target company. Under regulation 5, indirect acquisition of shares or voting rights or control of a listed company also attract the obligation of making a public announcement of an open offer for acquiring shares.

Regulation 10 of the Takeover Regulations provides certain exemptions from the requirement of making an open offer under regulations 3 and 4. One of the exemptions, provided in regulation 10(1)(d)(iii), exempts *an acquisition pursuant to a scheme of arrangement not directly involving the target company as a transferor company or as a transferee company, or reconstruction not involving the target company's undertaking, including amalgamation, merger or demerger, pursuant to an order of a court or a tribunal or a competent authority under any law or regulation, Indian or foreign, subject to certain conditions.*

Recently on October 30, 2017, SEBI published an informal guidance letter dated July 3, 2017, in the matter of Linde India Limited where informal guidance of SEBI was sought on an issue relating to the above mentioned exemption.

In the said matter, Linde AG ("**Linde Germany**"), a German company, directly or indirectly held 100% of Linde UK Holding Limited, which in turn held together with other Linde group entities, 100% of BOC Group Limited, which directly held 75% of the shares in Linde India Limited, a company listed on BSE, National Stock Exchange and the Calcutta Stock Exchange. Linde Germany and Praxair Inc. proposed to enter into a merger effected by way of business combination through an all stock transaction. As a result, a new company ("**New HoldCo**") would become the parent company and would hold shares of Linde Germany by means of a voluntary exchange offer to the shareholders of Linde Germany under the German Securities Acquisition and Takeover Act.

It was submitted that unlike in India, under the laws of Delaware and Germany, mergers would not be required to be approved by any court or competent authority. In Germany, the Federal Financial Supervisory Authority ("**BaFin**") would undertake an extensive review of the exchange offer documents. In US, the US Securities and Exchange Commission ("**SEC**") reviews the disclosures made. Further, under Delaware law, the parties would have to file a certificate of merger with the Secretary of State of the State of Delaware and the merger will become effective by operation of law.

In light of the aforesaid facts, Linde Germany sought an informal guidance from SEBI on the issue of whether the exemption under regulation 10(1)(d)(iii) of the Takeover Regulations would be applicable for the proposed transaction.

As per SEBI's informal guidance, the exemption under regulation 10(1)(d)(iii) of the Takeover Regulations would not be available as the transaction will not be approved by a *court or a competent authority*. Thus, the BaFin and SEC review process for the merger would not satisfy the said requirement even though under the laws of Delaware and Germany, there is no other approval required for the merger.

It is interesting to note that under the erstwhile regulations governing takeovers i.e. SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 ("**Erstwhile Regulations**"), while there was a similar exemption provided under regulation 3(1)(j), which exempted acquisitions *pursuant to a scheme of arrangement or reconstruction including amalgamation or merger or demerger under any law or regulation, Indian or foreign*, the requirement of the scheme being approved by a court or a competent authority was absent. In the case of *Eaton Corporation* v. *SEBI*[2], decided by the Securities Appellate Tribunal ("**SAT**") under the Erstwhile Regulations, it was held that the merger of Eaton Industries Inc into Aeroquip Vickers Inc. pursuant to an agreement and plan of merger under the laws of Ohio and where an 'Appeal Certificate' was issued by the Secretary of State, Ohio, would be exempt under regulation 3(1)(j) of the Erstwhile Regulations. The issue of whether it was specifically approved by a competent authority was not delved into by SAT in the said case.

Shareholders' approval for resolution plans under IBC

The Insolvency and Bankruptcy Code, 2016 (IBC) which came into force on December 1, 2016 has caused a paradigm shift in the insolvency and bankruptcy regime in India with regard to corporates.

Under the IBC, once a corporate insolvency resolution process is initiated, a resolution professional ("**RP**") is appointed who is, *inter alia*, required to prepare an information memorandum and provide all relevant information about the corporate debtor to a 'resolution applicant' i.e. any person who proposes a resolution plan for the insolvency resolution of the corporate debtor as a going concern. *Under section 30(2)(e) of the IBC, the RP has to confirm that a resolution plan submitted does not contravene any of the provisions of law for the time being in force*. Further, under section 31(1) of the IBC, a resolution plan approved by the National Company Law Tribunal ("**NCLT**"), is binding on the corporate debtor and its employees, members, creditors, guarantors and other stakeholders involved in the resolution plan.

One of the issues which arises in connection with section 30(2)(e) of the IBC is whether approval of the shareholders of the corporate debtor is required if the resolution plan contains a matter which ordinarily would require shareholders' approval under the Companies Act, 2013 or any other law such as the LODR Regulations. For example, under the Companies Act, 2013, issuance of shares by a company on a preferential basis or the sale of an undertaking, requires approval of the shareholders. In the event a resolution plan for the insolvency resolution of the corporate debtor contains any such matter, the issue that arises is whether approval of the shareholders of the corporate debtor would be required. The requirement of such an approval could potentially derail a resolution plan in the event such an approval is not forthcoming and such a requirement would also give a leverage to the shareholders of the corporate debtor which may include the promoters of the company.

On October 25, 2017, MCA issued a circular ("**October 25 Circular**") clarifying that there is no requirement of obtaining shareholders' approval of the corporate debtor during the resolution process. The circular states that approval of the shareholders of the corporate debtor is deemed to have been given on the approval of the resolution plan by NCLT.

The October 25 Circular would be welcome by various stakeholders eager to ensure a swift resolution of companies in respect of which a corporate insolvency resolution process has been initiated as the circular removes a potential bottle-neck of some shareholders of the corporate debtor (which may include the promoters) refusing to give the requisite approvals. On the other hand, equity investors in the corporate debtors may not be very enthusiastic about the October 25 Circular as they may potentially be

[2] Appeal No. 22/2001 dated July 18, 2001.

significantly squeezed out and several decisions, which would otherwise require their consent under the Companies Act, 2013, can now be taken as part of an approved resolution plan without their consent. One of the fundamental questions that arises is whether the October 25 Circular, being an executive action, can effectively take away the rights conferred to shareholders under the Companies Act, 2013.

Screening bidders in a corporate insolvency resolution process

As mentioned in the preceding section, when a corporate insolvency resolution process is initiated under the IBC, a resolution applicant can propose a resolution plan for the insolvency resolution of the corporate debtor as a going concern. There is no restriction as to who can submit a resolution plan.

On November 7, 2017, IBBI notified amendments to the IBBI (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 ("**IRP Regulations**") and the IBBI (Fast Track Insolvency Resolution Process for Corporate Persons) Regulations, 2017 ("**Fast Track IRP Regulations**").

IBBI also issued a press release on November 7, 2017 stating that while there is no restriction as to who can submit a resolution plan, it should come from any person who can really rescue the insolvent business. With this objective, the IBBI (Insolvency Resolution Process for Corporate Persons) (Third Amendment) Regulations, 2017 amends regulation 38 of the IRP Regulations by inserting sub-regulation (3) which provides that a resolution plan should contain details of the *resolution applicant and other connected persons* to enable the committee of creditors to assess the credibility of such applicant and other connected persons to take a prudent decision while considering the resolution plan for its approval. 'Connected persons' of the resolution applicant would include persons who are promoters or in the management or control of the resolution applicant, persons who will be promoters or in management or control of the business of the corporate debtor during the implementation of the resolution plan, and their holding companies, subsidiary companies, associate companies and related parties. Similar amendments have been carried out in the Fast Track IRP Regulations.

Further, the committee of creditors is expected to carry out a due diligence of every resolution plan to satisfy itself that (a) the plan is viable, and (b) the persons who have submitted the plan and who would implement the plan are credible, to avoid the plans which may lead to liquidation, post resolution, and to select the most suitable plan under the circumstances.

Determination of Place of Effective Management

The IT Act was amended by the Finance Act, 2015 to provide that a company will be a resident in India in any previous year, if[3]:

- it is an Indian company; or
- its place of effective management ("**POEM**") in that year is in India.

The provision was made effective from April 1, 2017 *vide* Finance Act, 2016. CBDT had issued a circular dated January 24, 2017 ("**Circular**"), providing the guiding principles for determination of POEM of a company, for the purpose of determining the residency of a company under section 6(3) of the IT Act.

On October 23, 2017, CBDT issued a clarification ("**Clarification**") on the guidelines for establishing POEM in India.

As per paragraph 7 of the Circular, the POEM in case of a company engaged in active business outside India ("**ABOI**") shall be presumed to be outside India if the majority meetings of the board of directors of the company ("**BoD**") are held outside India. However, if on the basis of facts and circumstances it is established that the BoD is standing aside and not exercising its powers of management and such powers are being exercised by either the holding company or any other person(s) resident in India, then the POEM shall be considered to be in India. It was clarified

[3] Section 6(3) of the IT Act.

that merely because the BOD follows general and objective principles of global policy of the group laid down by the parent entity which may be in the field of pay roll functions, accounting, human resource functions, IT infrastructure and network platforms, supply chain functions, routine banking operational procedures, and not being specific to any entity or group of entities *per se*; would not constitute a case of BoD of companies standing aside.

In the Clarification, CBDT has provided that where a multi-national company has a regional headquarter structure, so long as the regional headquarter operates for subsidiaries/ group companies in a region within the general and objective principles of the global policy of the group laid down by the parent entity in the field of pay roll, accounting, human resource, IT infrastructure and network platforms, supply chain functions, routine banking operational procedure (not specific to any entity of the conglomerate per se), it will in itself not constitute a case of BoD standing aside and such activities of the regional headquarter in India alone will not be a basis for establishment of POEM for such subsidiaries/ group companies.

The Clarification therefore provides clarity to multinationals/conglomerates who have established regional headquarters in India and have employees in India with multi-country responsibility or oversight over the operations in other countries. Merely having such a regional headquarter structure would not establish POEM for such subsidiaries/ group companies entailing their income from operations outside India being taxed in India.

The Clarification also provides that the provisions of the general anti-avoidance rule as set out under chapter X-A of the IT Act shall be applicable in cases where the Clarification is found to be used for abusive/aggressive tax planning.

Payments to directors, key managerial personnel and employees

On October 23, 2017, SEBI published an informal guidance dated July 19, 2017 in the matter of MAPE Advisory Group Private Limited on regulation 26(6) of the LODR Regulations ("**MAPE Informal Guidance**").

Regulation 26(6) of the LODR Regulations was introduced *vide* notification dated January 4, 2017. The said regulation requires prior approval of the Board of Directors and public shareholders of a listed company for any employee of the listed entity including key managerial personnel or director or promoter of the listed entity to enter into any agreement for himself or on behalf of any other person, with any shareholder or any other third party with regard to compensation or profit sharing in connection with dealings in the securities of such listed entity. Further, all interested persons involved in the transaction covered under such agreements are required to abstain from voting in the general meeting of the shareholders.

The introduction of regulation 26(6) had significant ramifications. For instance, in case of an acquisition, the acquirer may offer an incentive to the management in the form of an upside sharing contract or a profit sharing contract. With the introduction of regulation 26(6), such arrangements would require the prior approval of the shareholders.

In the MAPE Informal Guidance, SEBI considerably widened the scope of regulation 26(6) to include all employees of not only a listed company, but also its subsidiaries.

In the MAPE Informal Guidance, the erstwhile promoters of Mphasis Limited had entered into an agreement with Marble II Pte Limited whereby the erstwhile promoters agreed to exit by selling their entire stake to Marble II Pte Limited. Prior to the exit by the erstwhile promoters, Hewlett Packard Enterprise Company, the ultimate parent company of Mphasis Limited issued incentive letters to certain employees of Mphasis Limited as well as its unlisted subsidiaries. The employees were eligible to certain payments upon occurrence of specific events which were linked to the exit.

In its guidance, SEBI has stated that even employees of a subsidiary of an unlisted company would fall with the scope of regulation 26(6) of LODR Regulations. Accordingly, even for payment of incentives to the employees of an unlisted company, in connection with the sale of shares of its listed parent company, the approvals mentioned in the said regulation 26(6) would be required.

SEBI order on acquisition of control *'passively'*

On October 3, 2017, SEBI passed an order in the matter of Arun Varun Trade and Investment Limited ("**AVTIL**"). A summary of the facts giving rise to the said case is set out below.

An offer document was filed by Mr. Gautam Bhandari and Mr. Jayanti Lal Bhandari to acquire up to 26% of the voting equity share capital of AVTIL. While examining the offer document, SEBI observed that certain persons ("**Noticees**") in the past had violated the provisions of regulation 12 of the Erstwhile Regulations i.e. the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997.

Regulation 12 of the Erstwhile Regulations stated that irrespective of whether or not there has been any acquisition of shares or voting rights in a company, an acquirer cannot acquire control over the target company, unless such person makes a public announcement to acquire shares. 'Control' was defined in regulation 2(1)(c) of the Erstwhile Regulations as including *the right to appoint majority of the directors or to control the management or policy decisions* exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner.

Further, regulation 10 of the Erstwhile Regulations stipulated that an acquirer cannot acquire shares or voting rights entitling the acquirer to exercise 15% or more of the voting rights in the company unless the acquirer makes a public announcement to acquire shares of such company.

The Noticees had acquired 14.5% of the share capital of AVTIL on September 16, 2009. Subsequently, the Noticees were being shown as promoters or persons having control of AVTIL in the disclosures made by the Target Company to BSE. As the Noticees were shown to be in control of the Target Company, it was contended that the Noticees were required to make a public announcement for an open offer under regulation 12 of the Erstwhile Regulations.

It was contended on behalf of the Noticees that as they acquired less than 15% of the voting rights of AVTIL, an open offer for acquiring shares of AVTIL was not required to be made. It was also argued that the Noticees did not have any intention to acquire control over AVTIL at the time of acquisition of 14.5% of the share capital of the company and that they were not in majority when they were appointed on the Board of AVTIL. They *de facto* came into majority of the Board of AVTIL when the sellers were not co-operating. Thus, the Noticees *de facto* without exercising any kind of control passively turned into a higher number of directorship representation on the Board of AVTIL. It was further argued that despite having 2 representatives on the Board, there was no effective control that the Noticees could exercise on account of their shareholding being less than 15% of the total equity share capital of AVTIL. The Noticees also claimed that they were shown as promoters in the filings inadvertently as they were advised that a company should mandatorily have a promoter. Accordingly, the compliance team erroneously showed them as promoters.

SEBI rejected the contention of the Noticees that they came into majority on the Board of AVTIL passively and hence no open offer was required to be made. SEBI held that as the Noticees were in majority on the Board of AVTIL and they have been shown as promoters or persons having control of the company in exchange filings, hence they should have made a public announcement to acquire shares at the time of acquisition of the aforesaid 14.5% of the shares of AVTIL.

Therefore, the argument that at the time of acquisition of 14.5% of the share capital of AVTIL (which was below the threshold requirement for

making an open offer under regulation 10 of the Erstwhile Regulations), the Noticees did not acquire control by having majority representation on the Board, but *subsequently* had gained majority representation on the Board *only passively* did not find favour with SEBI, and SEBI held that an open offer should have been made initially when the shares were acquired.

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