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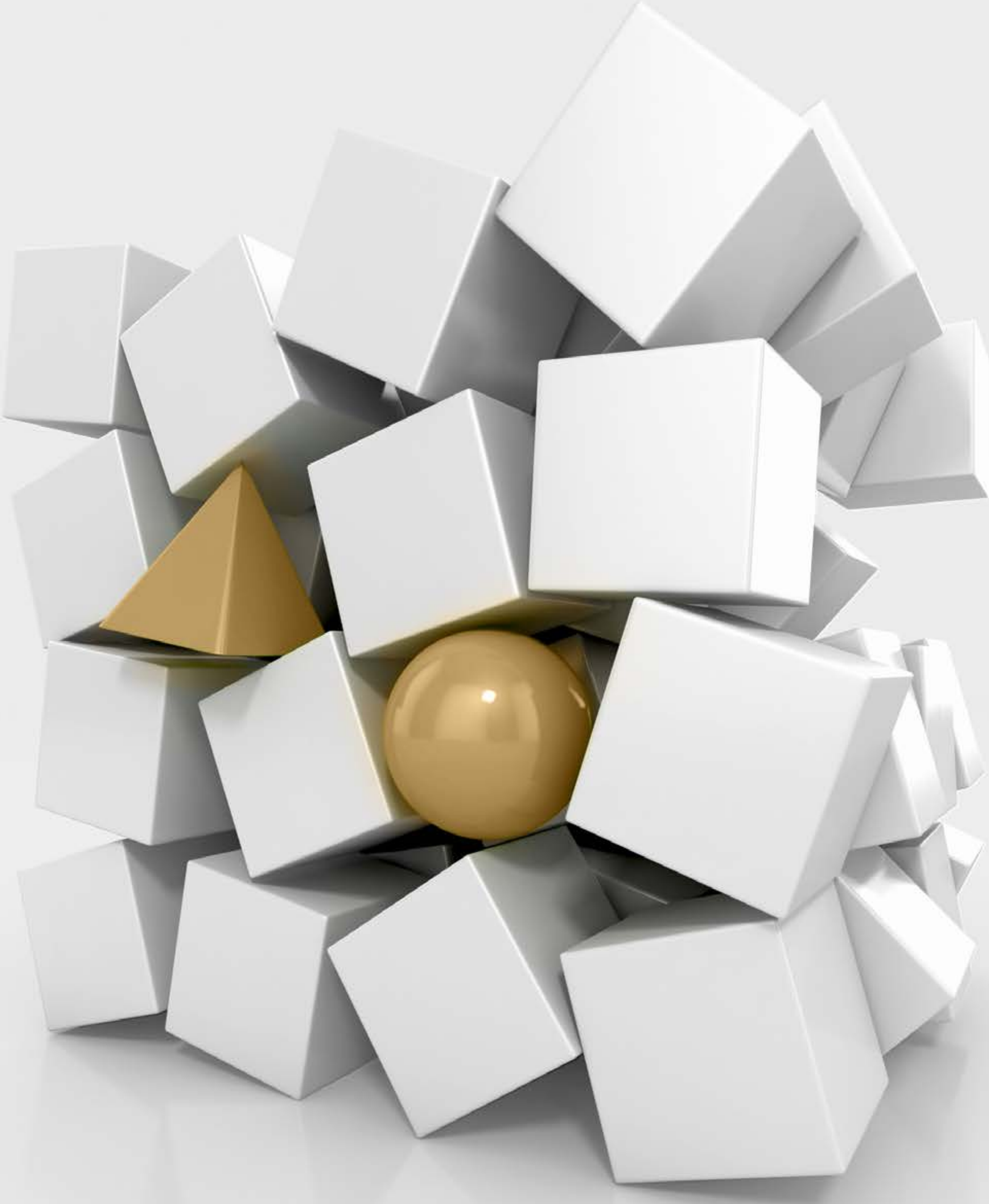

Foreign Investment in Distressed Assets in India

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Shardul Amarchand Mangaldas & Co, founded on a century of legal achievement, is one of India's leading full service law firms. Our mission is to enable business by providing solutions as trusted advisors through excellence, responsiveness, innovation, and collaboration.

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We are at the forefront of global and Indian M&A and private equity transactions, cutting edge high risk litigation and advice on strategically important matters across a spectrum of practices and industries for our multi-jurisdictional clients.

We have a pan India presence, with offices in seven cities across India - New Delhi, Mumbai, Gurugram, Bengaluru, Chennai, Ahmedabad and Kolkata.

About FICCI

Established 90 years ago, FICCI is the largest and oldest apex business organization in India. Its history is closely interwoven with India's struggle for independence, its industrialization, and its emergence as one of the most rapidly growing global economies.

A non-government, not-for-profit organization, FICCI is the voice of India's business and industry. From influencing policy to encouraging debate, engaging with policy makers and civil society, FICCI articulates the views and concerns of industry, reaching out to over 2,50,000 companies. FICCI serves its members from large (domestic and global companies) and MSME sectors as well as the public sector, drawing its strength from diverse regional chambers of commerce and industry.

The Chamber with its presence in 14 states and 10 countries provides a platform for networking and consensus-building within and across sectors and is the first port of call for Indian industry, policy makers and the international business community.

The content below is for general information purposes of any foreign investor envisaging an investment in distressed companies in India under the aegis of the Insolvency and Bankruptcy Code, 2016.

Background

Foreign investment in India is regulated by the Foreign Exchange Management Act, 1999 ("**FEMA**") and the regulations issued thereunder, specifically the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017 ("**FEMA 20**").

FEMA 20, together with the consolidated foreign direct investment policy ("**FDI Policy**") and the press notes issued, from time to time, by the Department of Industrial Policy and Promotion ("**DIPP**") in the Ministry of Commerce and Industry, Government of India, regulates foreign direct investments ("**FDI**") in India. FDI is generally monitored and regulated by the Reserve Bank of India ("**RBI**"), India's central bank and primary financial regulator.

Insolvency and bankruptcy in India is now regulated by the Insolvency and Bankruptcy Code, 2016 ("**Code**"). Enacted in May 2016, the Code overhauled and consolidated the law in India in relation to insolvency of companies, limited liability partnerships (collectively, "**Corporate Debtors**"), and bankruptcy of unlimited liability partnerships and individuals. Since its inception the Code has been amended thrice.

The Insolvency and Bankruptcy Board of India ("**IBBI**") has been set up under the Code, to perform the role of a regulator for insolvency and bankruptcy matters and has issued several regulations detailing the procedures under the Code. Clarifications and circulars have also been frequently issued by the IBBI and the Ministry of Corporate Affairs to clarify the procedures under the Code. The Code provides for a time bound corporate insolvency resolution process ("**CIR Process**") of 180 days from the date of admission of an application before the NCLT ("**Insolvency Commencement Date**"). This time period is extendable, once, by a maximum of 90 days. During this period, creditors consider measures to resolve the financial distress of the Corporate Debtor and maintain and preserve its business operations by framing a plan, referred to as a "**Resolution Plan**". Only upon the failure of the CIR Process can the Corporate Debtor be liquidated under the Code.

The adjudicating authority for CIR Process and liquidation under the Code is the National Companies Law Tribunal ("**NCLT**") and the appellate authority is the National Companies Law Appellate Tribunal.

In order to be eligible to submit a Resolution Plan in relation to the CIR process of a Corporate Debtor, the relevant resolution applicant and any person connected with the resolution applicant should not be disqualified as per the criteria prescribed under Section 29A of the Code. The Code has prescribed a very wide definition of "connected persons" which includes persons in control or management of the resolution applicant, promoters of the resolution applicant, persons who will be promoters of or in control or management of the Corporate Debtor during the implementation of the Resolution Plan and holding companies/subsidiaries/associates/related parties of the persons mentioned above. However, several exemptions have been granted from such disqualifications for persons who are 'financial entities' (as defined in the Code) and not a related party of the Corporate Debtor.

The CIR Process and the subsequent liquidation process presents a unique opportunity for foreign investors to acquire a distressed Indian company or its assets. FEMA, FEMA 20 and the FDI Policy (collectively, "**FDI Laws**") do not prescribe a special or a separate regime for making investments in distressed companies undergoing the CIR Process, therefore a foreign investor seeking to acquire or make investment in a distressed company undergoing the CIR Process or in liquidation is required to comply with various procedural and other requirements under the FDI Laws, in addition to complying with the requirements under the Code.

Two Routes for FDI

FDI may be either under the "automatic route" or under the "approval route", depending upon the business sector in which the investee company is engaged in and in certain cases the shareholding percentage being obtained by the foreign investor in the investee company.

Automatic route does not require prior approvals from the Government of India for FDI but certain specified post-investment filings are required to be made.

Approval route requires prior approval from the Government of India (through the concerned administrative ministry/department) and/or RBI, for FDI.

Further, there are certain cases where irrespective of the business sector of the investee company, prior approval of the

RBI is required, such as:

- gift from a person resident in India to a person resident outside India; and
- sale from a person resident in India to a person resident outside India, without compliance with the pricing guidelines laid down by the RBI or the Securities and Exchange Board of India ("**SEBI**").

Permissible Instruments under FDI Laws

Under FEMA regulations, non-convertible / partly convertible / optionally convertible preference shares / debentures are considered as debt instruments and are regulated by the regulations on External Commercial Borrowings ("**ECBs**") and not the FDI Laws. The eligible FDI instruments ("**Capital Instruments**") for FDI are the following:-

- Equity Shares – fully or partly paid up (subject to upfront payment of 25% of the total consideration (including share premium) and the balance payment within 12 months).
- Fully and compulsorily convertible preference shares.
- Fully and compulsorily convertible debentures.
- Share warrants (subject to upfront payment of at least 25% of the total consideration and the balance within payment within 18 months).

The choice of Capital Instruments is largely driven by considerations such as the rate of return expected by the foreign investor, voting rights, liquidation preference and tax considerations, each of which differs for the different kinds of Capital Instruments.

Pursuant to a Resolution Plan under the Code, a foreign investor can not only acquire Capital Instruments of a Corporate Debtor directly but is also permitted to acquire such Capital Instruments by way of a scheme of merger. Such a scheme of merger may be tax neutral for the parties involved, provided certain conditions are satisfied.

Under the FDI laws, where a scheme of merger or amalgamation of two or more Indian companies has been approved by the NCLT, the merged company has general permission to issue Capital Instruments to the existing foreign shareholders of the transferor company, subject to (i) compliance with the entry routes, sectoral caps or investment limits by the foreign investors; and (ii) the merged company not engaging in any sector prohibited for foreign investment. Subject to certain conditions, the merged company is also permitted to issue non-convertible redeemable preference shares or debentures out of its general reserves as bonus to its foreign shareholders.

Prohibited Sectors for Foreign Investment

Foreign investment is prohibited in the following sectors:

- Lottery business including Government or private lottery, online lotteries;
- Gambling and betting including casinos;
- Chit funds;
- Nidhi companies;
- Trading in transferable development rights;
- Real estate business or construction of farm houses;
- Manufacturing of cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes;
- Activities or sectors not open to private sector investment for example atomic energy and railway operations (that is, other than the permitted railway infrastructure); and

Additionally, foreign investment is not permitted in the agriculture sector or activities except as specifically permitted (such as in cultivation of vegetables and mushrooms, development and production of seed and planting material etc.).

Sectoral caps and conditions for FDI

<u>FDI in investment companies and core investment companies</u>. Any FDI into a core investment company ("**CIC**") or an Indian company engaged only in the activity of investing in the capital of other Indian companies or LLPs, requires prior approval of the Government. Upto 100% foreign investment is permitted under the automatic route in investing companies registered as non-banking financial companies ("**NBFC**") with the RBI, since they are being regulated, overall, by the RBI.

Except for the prohibited sectors, FDI under automatic route is generally permitted in all business/industrial sectors, such as manufacturing sector or power/electricity sector. However, FDI in certain specified sectors is permitted under the automatic route only up to a certain level and/or subject to certain conditions. Any FDI beyond such level or in the absence of compliance with the specified conditions, requires prior approval of the Government.

The sectoral caps and conditions also apply to cases of 'indirect FDI' i.e. downstream investment in an Indian company by another Indian company, which is owned or controlled by non-residents. The sectoral caps and conditions, however, do not apply in case of downstream investment by an Indian company, which is owned and controlled by residents, into another Indian company, even if the Indian company making downstream investments has non-resident shareholders.

The currently applicable sectoral caps and conditions for some of the business sectors are set out in the table below as an indicative list:

S. No.	Sector	Sectoral Cap and Entry route	Key indicative additional conditions
(a)	Mining and exploration, setting up of coal processing plants like washeries, etc.	100%, under the automatic route.	• Certain additional conditions are applicable to titanium bearing minerals and its ores.
(b)	Construction Development projects (which would include development of townships, construction of residential/ commercial premises, roads or bridges, hotels, resorts, hospitals, educational institutions, recreational facilities, city and regional level infrastructure, townships).	100%, under the automatic route.	• The investor is permitted to exit on completion of the project or after development of trunk infrastructure i.e. roads, water supply, street lighting, drainage and sewerage, or after a lock-in-period of three years, whichever is earlier; • The Indian company is permitted sell only developed plots, i.e. plots where trunk infrastructure has been made available; • Condition of lock-in period does not apply to certain prescribed projects.
(c)	Single brand product retail trading (SBRT).	100%, under the automatic route.	• Products being sold should be of a 'single brand' and the products should be sold under the same brand internationally; • If the FDI is proposed to be beyond 51%, then sourcing of 30% of the value of the goods purchased should be done from India, preferably from Indian micro, small and medium enterprises, subject to certain prescribed exceptions.
(d)	Multi-brand retail trading.	51%, under the government approval route.	• Minimum amount required to be brought in as foreign investment is USD 100 million; • 50% of the total FDI in the first tranche of USD 100 million is required to be invested in the backend infrastructure within 3 years; • retail sales outlets may be set up in those States which have agreed to allow FDI in multi brand retail trade; • 30% mandatory local sourcing requirement from Indian micro, small, medium industries which have a total investment in plant and machinery not exceeding USD 2 million.
(e)	Asset Reconstruction Companies.	100%, under the automatic route.	• All investments would be subject to provisions of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

S. No.	Sector	Sectoral Cap and Entry route	Key indicative additional conditions
(f)	Banking – Private Sector.	74%, including investment by Foreign Portfolio Investors in which up to 49% is under the automatic route and foreign investment beyond 49% and up to 74% requires Government approval.	• At least 26% of the paid up capital is required to be held by residents, except in regard to a wholly-owned subsidiary of a foreign bank; • Transfer of shares from residents to non-residents requires approval of the RBI and/ or the Government, wherever applicable; • RBI guidelines relating to acquisition by purchase or otherwise of capital instruments of a private bank apply, if an acquisition results in any person owning or controlling 5% or more of the paid up capital of a private bank.
(g)	Insurance sector (insurance companies, insurance brokers, etc.).	49%, under the automatic route.	• Investment is subject to approval/verification by Insurance Regulatory and Development Authority ("**IRDA**"); • Foreign investment is subject to compliance with the provisions of the Insurance Act, 1938; • Ownership and control of the Indian insurance company is required to remain with resident Indian entities.

Reporting Requirements

Issue of capital Instruments. An Indian company, having received FDI for issue of Capital Instruments either under the automatic route or the approval route, is required to report, in the prescribed Form ARF, the details of the receipt of the amount of consideration through an authorised dealer bank, within 30 (thirty) days from the date of receipt of the inward remittance. Further, the Indian company is also required to report the issuance of Capital Instruments against receipt of FDI, in Form FC-GPR, on the e-Biz platform within 30 (thirty) days of issue of such Capital Instruments.

Transfer of capital Instruments. The Indian transferor/transferor is responsible for reporting the transfer of Capital Instrument to/from a non-resident in Form FCTRS, on the e-Biz platform within 60 (sixty) days of the transfer of Capital Instruments or receipt or remittance of funds whichever is earlier.

Other key considerations for FDI

Pricing guidelines

The price at which Capital Instruments are issued to foreign investors under the FDI regime (other than in case of rights issues) is not permitted to be less than the Fair Market Value (FMV) which:

- in case of companies listed on Indian stock exchanges, is the price worked out in accordance with the SEBI guidelines, and
- in case of unlisted companies, is the fair valuation arrived at using any internationally accepted pricing methodology for valuation of shares on arm's length basis, duly certified by a chartered accountant or a SEBI registered merchant banker.

Further, transfer of Capital Instruments from a resident to a non-resident is not permitted at a price below the FMV, whereas a transfer from a non-resident to a resident is not permitted at a price which is above the FMV.

In case of convertible Capital Instruments, the price or conversion formula of the instrument is required to be determined upfront at the time of issue of the instrument. The price at the time of conversion is not permitted to be lower than the FMV worked out, at the time of issuance of such instruments. However, where non-residents (including NRIs) are making investments in an Indian company by way of subscription to its memorandum of association (subject to such non-resident's eligibility to invest under the FDI Policy), such investments may be made at face value.

Where the issue of Capital Instruments is pursuant to a rights issue (i) of a listed company, subject to the applicable SEBI Regulations, the issue price is permitted to be a price determined by the Indian company; and (ii) where the issuing company is an unlisted company, the issue price to non-residents is not permitted to be less than the price offered to the resident shareholders.

Swap of shares and Issue of shares for consideration other than cash

FDI through swap of shares is permitted under the automatic route for sectors which are under the automatic route, subject to compliance with the applicable pricing guidelines and certain other conditions. While issuance of Capital Instruments for consideration other than cash is not generally permitted, however, an Indian company engaged in a business sector under the automatic route is allowed to issue equity shares to a foreign investor for consideration other than cash against certain identified expenses like pre-incorporation expenses, import of machinery etc. under the automatic route.

Deferred consideration and indemnity

Transfer of Capital Instruments from residents to non-residents by way of sale (or vice versa) is permitted on a deferred consideration basis subject to compliance with the following conditions:

- the amount of consideration being deferred does not exceed 25% of the total consideration, subject to the total consideration finally paid being compliant with the applicable pricing guidelines; and
- the consideration being deferred should be paid no later than 18 months from the date of the share transfer agreement.

The consideration being deferred may be deposited in an escrow account pursuant to an escrow arrangement, provided that the term of the escrow agreement should not exceed 18 months from the date of the share transfer agreement.

Further, in an FDI transaction involving transfer of Capital Instruments from residents to non-residents by way of sale (or vice versa), the seller can provide indemnity to the purchaser, provided that (i) the seller has paid the total consideration to the buyer; (ii) the indemnity is valid for not more than 18 months from the date of payment of the full consideration; and (iii) the total consideration finally paid is compliant with the applicable pricing guidelines.

Exit rights of foreign investors

FDI laws permit exercise of options granted in favour of a foreign investor subject to a minimum lock in period of 1 (one) year or higher if prescribed by the relevant regulations, and on the condition that no fixed return is assured to the foreign investor. This, upon exercising the option**,** a non-resident investor would be permitted to exit (i) in case of a listed company, at the market price prevailing at the recognised stock exchanges, and (ii) in case of an unlisted company, at a price not exceeding that arrived at as per any internationally accepted pricing methodology for valuation of shares on arm's length basis, duly certified by a Chartered Accountant or a SEBI registered Merchant Banker. In case of any other form of exit, the pricing guidelines applicable on transfer apply.

External Commercial Borrowings

Persons not resident in India are also permitted to grant loans to an Indian company, subject to compliance with the prescribed regulatory requirements. Borrowing by an Indian entity from a person resident outside India ("**ECB**") is regulated under the Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000, as amended, read with, the notifications issued from time to time (collectively, the "**ECB Regulations**").

Pursuant to the ECB Regulations, ECB is only permitted to be raised by certain eligible resident entities from certain recognized non-resident entities. ECBs are also required to conform to parameters such as minimum average maturity period, maximum all-in cost ceiling and end-use restrictions. Authorised dealer banks are permitted to allow creation of charge on immovable assets, movable assets, financial securities and issuance of corporate and/ or personal guarantees in favour of overseas lender/ security trustee, to secure the ECB to be raised / raised by the borrower, subject to satisfying themselves with certain prescribed conditions.

Certain tax considerations for foreign investment in distressed assets

In recent past, the Indian Government has introduced certain changes in Indian tax laws to facilitate the rehabilitation of and incentivise investment in, distressed companies. We have summarised below the key tax considerations and issues, which impact foreign investment in distressed companies in India:

Special tax regime for asset reconstruction companies ("ARC") and securitization trusts.

Indian income tax laws provide tax pass through treatment to securitisation trusts. This means that the income arising from a securitisation trust is taxed in the hands of an investor in the same and like manner as it would have been taxed had the investor invested directly in the underlying assets and not through the trust. The pass through tax treatment removes the inefficiency of having another layer of taxable entities between the foreign investor and the ultimate investee company. It also allows the foreign investor to claim domestic law and tax treaty benefits applicable to them on the returns received from underlying investment in distressed companies as would be in the case of a direct investment in distressed companies.

Concessional tax rates for foreign debt.

Foreign investors are taxed on interest income arising on loans extended under the ECB regime to Indian companies at a concessional withholding tax rate of 5% (plus applicable surcharge and cess), subject to certain conditions.

Relief from minimum alternate tax (“MAT”)

MAT is payable by Indian companies if the income tax payable by them under regular tax provisions falls below 18.5% of their book profits (i.e. profits as per accounts prepared under Indian companies law subject to certain adjustments). The determination of book profits has been liberalised for companies undergoing insolvency under the Code. Such companies have been permitted to reduce their previous years’ carried forward losses and unabsorbed deprecation while determining book profits, in turn reducing the tax base for payment of MAT. At present, no similar relief has been extended to companies that have stressed loans but are not undergoing insolvency.

Valuation norms

Under Indian tax laws, if any person acquires shares or securities in a company below their fair market value which is determined as per tax rules, the difference between the consideration paid and such fair market value can be taxed in the hands of the acquirer as ordinary income.

Transfer pricing and thin capitalization rules

Any interest payment made by an Indian company to a foreign investor, which qualifies as its associated enterprise under tax laws, is subject to the arm’s length principle under Indian transfer pricing regulations. In case the interest paid exceeds the arm’s length price, the excess interest is disallowed as a tax expense in the hands of the Indian company. Moreover, secondary adjustments may be also be made if the excess interest paid to the foreign investor is not physically remitted back to India within prescribed timelines.

Additionally, under Indian thin capitalization rules, any interest payments made by an Indian company to a foreign investor (being an associated enterprise) is disallowed as a tax expense if such interest expense exceeds 30% of the Indian company’s earnings before interest, tax, depreciation and amortisation (EBITDA). However, the interest expense disallowed may be carried forward for 8 years and can be claimed as a deduction in subsequent years subject to such thin capitalization rules.

Lapse of tax losses in case of change in control

Under Indian tax laws, a company (not being a company in which the public are substantially interested) is not permitted to carry forward its previous years’ tax losses if there a change in its shareholding in excess of 50%. Distressed companies often seek new investment or convert their debt into equity for financial recovery. Lapse of tax losses on change in control of distressed companies adds to their tax burden.

To facilitate insolvency resolution, the Indian Government has recently amended Indian tax laws to provide that the previous years’ losses of a company will not lapse if the change in control is occasioned by a resolution plan approved under the Code. However, no similar relief has been extended to distressed companies that are not undergoing insolvency proceedings.

Waiver of loans

In case a company writes back a loan pursuant to a waiver by the lender, such amount may be treated as its taxable income depending on the end use of the loan. This impacts distressed companies, who after receiving a loan waiver continue to have tax exposure on such amount. At present, there is no tax exemption provided to distressed companies in respect of income arising to them from waiver of loans. On the other hand, waiver of any interest may not be treated as the taxable income of the borrower company unless it has claimed such amount as a tax deductible expense in prior tax years.

Outstanding tax dues of companies undergoing insolvency

Under the Code, all crystallised and outstanding tax claims against a company undergoing insolvency stand extinguished once an order is passed by the NCLT approving the resolution plan. This is because the Code treats income tax claims as an operational debt, which is due by the company to the Central Government. However, no such relief is available for distressed companies that are not undergoing insolvency under the Code.

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